Clause 80

Matchable Expenditures

ITA
18.1

Proposed section 18.1 of the Act restricts the deductibility of an otherwise deductible matchable expenditure incurred in respect of a right to receive production by prorating the deductibility of the amount of the expenditure over the economic life of the right. This section does not create an entitlement to deduct an amount in respect of an expenditure, unless the expenditure is otherwise deductible under existing jurisprudence. The "Backgrounder" accompanying Department of Finance News Release 96-082 dated November 18, 1996 provides general details about the tax policy concerns that lead to section 18.1 being proposed by the government. Generally, these policy objectives concern the use of royalty-type arrangements to effect tax-assisted financing by structuring the arrangements as tax shelters or as debt substitutes. The detailed rules in section 18.1 are discussed below. Generally, section 18.1 applies after November 17, 1996.

Subclause 80(1)

ITA
18.1(1)

Subsection 18.1(1) of the Act provides the definitions of the expressions "matchable expenditure", "right to receive production", "tax benefit", "tax shelter" and "taxpayer" for the purposes of section 18.1 of the Act.

ITA
18.1(2) to (4)

Subsection 18.1(2) of the Act provides that matchable expenditures are deductible only to the extent provided by subsection 18.1(3) of the Act.

Subsection 18.1(3) provides that a matchable expenditure is deductible in computing a taxpayer’s income for a taxation year to

the extent of the amount that is determined under subsection 18.1(4) of the Act. However, subsection 18.1(4) does not apply to provide a deduction in computing income for a taxation year unless the taxpayer's matchable expenditure would otherwise have been deductible in that or another taxation year.

Subsection 18.1(4) provides rules for determining the amount of a taxpayer's matchable expenditure that may be deducted under subsection 18.1(3) if that provision applies. That amount is determined as the least of three amounts.

Generally, the first of those amounts is the expenditure pro-rated over the term of the right to receive production to which the expenditure relates, except that in no event is the term used to be less than 5 years. Added to this amount, however, are amounts that would have been deductible in preceding years under this computation but for the second constraint. The second constraint is the amount of income included in computing the taxpayer's income in respect of the right for the year. Added to this amount, however, is income for previous years against which amounts could not be deducted because of the first constraint. The third constraint is the amount that would otherwise have been deductible in computing the taxpayer's income up to and including the current taxation year in respect of the taxpayer's right to receive production minus the amounts deductible under subsection 18.1(3) in computing the taxpayer's income for preceding taxation years. Two examples illustrating the application of these constraints follow the explanatory notes to proposed subsections 18.1(8) to (12) of the Act.

Special Rules

ITA
18.1(5)

Subsection 18.1(5) of the Act provides four special rules that apply for the purposes of section 18.1 of the Act. First, if a taxpayer's matchable expenditure is actually made before the related right to receive production is acquired, the expenditure will be considered to have been made on the day that the right is acquired. Second, if a taxpayer has one or more rights to renew a right to receive production for one or more additional terms, the term of the right is to be treated as terminating at the latest possible time that such an

additional term could terminate if all rights to renew the right were exercised. Third, where a taxpayer has two or more rights to receive production that can reasonably be considered to be related to each other, the rights are treated as one right. Fourth, if the term of a taxpayer's right to receive production is for an indeterminate period, the right is considered to terminate 20 years after it is acquired.

ITA
18.1(6) to (7)

Subsection 18.1(6) of the Act provides that a taxpayer's proceeds of disposition of a right to receive production are to be included in computing the taxpayer's income.

Subsection 18.1(7) of the Act provides that, upon disposition or expiry, a taxpayer may claim a terminal deduction in respect of a right to receive production to which a matchable expenditure relates. However, this terminal deduction is not available where subsection 18.1(8) or (9) of the Act applies.

ITA
18.1(8) to (12)

Subsection 18.1(8) of the Act defers a taxpayer's terminal deduction from the expiry or disposition of a right to receive production in certain cases involving non-arm's length parties. In such cases, a taxpayer's terminal deduction is governed by subsection 18.1(10) of the Act.

Subsection 18.1(9) of the Act describes a special arm's length case in which a taxpayer's terminal deduction otherwise available under subsection 18.1(7) of the Act in respect of a disposed or expired right to receive production is deferred. If applicable, an affected taxpayer's deductions are to be computed under subsection 18.1(10). In particular, subsection 18.1(9) applies where, during the 30-day period that begins at the time of disposition or expiry, a taxpayer that had a direct or indirect interest in the right has a direct or indirect interest in any other right to receive production, which other interest is a tax shelter or a tax shelter investment (as defined by section 143.2 of the Act). For example, this condition precludes Partnership 1 from claiming a terminal deduction in respect of its right to receive production if another partnership (i.e., Partnership 2) that has (or had)

an interest in Partnership 1 has an interest, directly or indirectly, in any other right to receive production and the other interest is a tax shelter or a tax shelter investment (e.g., Partnership 3 holds a right and Partnership 2 has (or had) an interest in Partnership 1 and has a partnership interest in Partnership 3 that is a "tax shelter investment").

Paragraph 18.1(10)(*a*) of the Act provides the rule for deducting matchable expenditures during the period to which subsection 18.1(8) or (9) applies. During that period, paragraph 18.1(10)(*a*) limits a taxpayer's deduction in respect of a matchable expenditure to an amount that cannot exceed the least of the three amounts described in subsection 18.1(4) of the Act.

Paragraph 18.1(10)(*b*) of the Act provides for a terminal deduction for a matchable expenditure in respect of a disposed or expired right to receive production at the earliest of certain subsequent times. These times are

- the time at which the right would, if owned by the taxpayer, be deemed by section 128.1 (change of residence) or subsection 149(10) (change of taxable status) of the Act to have been disposed of by the taxpayer;

- the time that is immediately before control of the taxpayer is acquired by a person or group of persons, if the taxpayer is a corporation;

- the time at which winding-up of the taxpayer begins (other than a winding-up to which subsection 88(1) of the Act applies), if the taxpayer is a corporation;

- where subsection 18.1(8) applies, the time at which a 30-day period begins throughout which neither the taxpayer nor an affiliated or non-arm's length person owns

    - the substituted property (referred to in subsection 18.1(8)), or

    - a property that is identical to the substituted property and that was acquired no earlier than 30 days before the period begins; or

- where subsection 18.1(9) applies, the time at which a 30-day period begins throughout which no taxpayer who had a direct or indirect interest in the right has a direct or indirect interest in another right to receive production, which other interest is a tax shelter or a tax shelter investment (as defined by section 143.2 of the Act).

Subsection 18.1(11) of the Act clarifies the result that obtains if a right to receive production expires or is disposed of by a partnership that subsequently ceases to exists. Where a partnership would otherwise cease to exist after a disposition or expiry of a right to which subsection 18.1(10) applies, the partnership is treated as not having ceased to exist, and each taxpayer who was a member of the partnership at the time of the disposition or expiry is treated as having remained a member of the partnership. This deemed continuation of the partnership (and of the membership of each partner) continues until the time that is immediately after the first of the events that trigger the partnership's terminal deduction in respect of the matchable expenditure.

Subsection 18.1(12) of the Act provides that, for the purpose of the substituted property rule in subsection 18.1(8) and (10), a "right" to acquire a right to receive production is identical to the right to receive production. This rule does not apply to a "right", as security only, derived from a mortgage, agreement of sale or similar obligation.

EXAMPLE 1: TAXPAYER HOLDS RIGHT UNTIL EXPIRY

- *Taxpayer A incurs $1,000 of matchable expenditures that relate to a right to receive production from Taxpayer B's business over a 6-year period (i.e., 25 per cent of the annual gross sales from the sale of a particular product).*

- *The $1,000 was expended for the purpose of earning income. Taxpayer A has a reasonable expectation of profit from the right to receive production, and the amount is otherwise deductible. The deductibility of the matchable expenditure is, therefore, provided for by subsection 18.1(3) of the Act (as determined under subsection 18.1(4)).*

- *Taxpayer A receives the following gross revenue payments from Taxpayer B:*

  Year 1: $100
  Year 2: $200
  Year 3: $300
  Year 4: $200
  Year 5: $100
  Year 6: $500

- *Taxpayer A's right to receive production expires in year 6 (i.e., subsection 18.1(7) applies in that year).*

Calculation of Taxpayer A's Subsection 18.1(3) Deduction:

Year 1: Taxpayer A may deduct $100 pursuant to subsections 18.1(3) and (4), being the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- $100 (receipts included in income)

- Nil
  $100

(c): $200 ($200 - Nil)[1]

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[1] Assuming a 5-year matching period under general principles.

Year 2: Taxpayer A may deduct $200 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- $ 67 (year 1: $167(a) - $100(b))
  $234

(b): the total of

- $200 (receipts included in income)

- Nil
  $200

(c): $300 ($400 - $100)

Year 3: Taxpayer A may deduct $201 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- $ 34 (year 2: $234(a) - $200(b))
  $201

(b): the total of

- $300 (receipts included in income)

- Nil
  $300

(c): $300 ($600 - $300)

Year 4: Taxpayer A may deduct $167 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- $200 (receipts included in income)
- $ 99 (year 3: $300(b) - $201(a))
  $299

(c): $299 ($800 - $501)

Year 5: Taxpayer A may deduct $167 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- $100 (receipts included in income)

- $132 (year 4: $299(b) - $167(a))
  $232

(c): $332 ($1,000 - $668)

Year 6: Taxpayer A may deduct $165 because subsection 18.1(7) applies. The amount otherwise determined under subsection 18.1(4) would have been the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- $500 (receipts included in income)

- $ 65 (year 5: $232(b) - $167(a))
  $565

(c): $165 ($1,000 - $835)

SUMMARY

Year	Income	Deductible Portion of Matchable Expenditure	Net Income (loss)
1	$100	$100	Nil
2	$200	$200	Nil
3	$300	$201	$99
4	$200	$167	$33
5	$100	$167	($67)
6	$500	$165	$335
Total		$1,000	

EXAMPLE 2: TAXPAYER DISPOSES OF RIGHT TO AFFILIATED PERSON

- *Taxpayer A incurs $1,000 of matchable expenditures that relate to a right to receive production from Taxpayer B's business*

over a 6-year period (i.e., 25 per cent of the annual gross sales from the sale of a particular product).

- *The $1,000 amount was expended for the purpose of earning income, Taxpayer A has a reasonable expectation of profit from the right to receive production and the amount is otherwise deductible (subject to matching) under previously existing jurisprudence. The deductibility of the matchable expenditure is, therefore, provided for by subsection 18.1(3) (as determined under subsection 18.1(4)).*

- *For years 1 to 4, Taxpayer A receives the following gross revenue payments from Taxpayer B:*

  Year 1: $100
  Year 2: $200
  Year 3: $300
  Year 4: $200

- *In year 4, and after receiving the $200 from Taxpayer B, Taxpayer A disposes of the right to receive production for nil proceeds to affiliated person C (assume that the transfer of the right occurred at fair market value and that the attribution rules do not apply to any potential receipts that affiliated person C may receive from the right).*

- *Affiliated person C's acquired right to receive production expires at the end of year 6.*

Calculation of Taxpayer A's Subsection 18.1(3) Deduction:

Years 1 to 3: See Example 1 above (i.e., Year 1 = $100; Year 2 = $200; and Year 3 = $201).

Year 4: Taxpayer A may deduct $167 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- $200 (receipts included in income)

- $ 99 (year 3: $300(b) - $201(a))
  $299

(c): $499 ($1,000 - $501)

Year 5: Taxpayer A may deduct $132 which is the least of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- Nil
  $167

(b): the total of

- Nil (receipts included in income)

- $132 (year 4: $299(b) - $167(a))
  $132

(c): $332 ($1,000 - $668)

Year 6: Taxpayer A may deduct $200 because paragraph 18.1(10)(*b*) applies to deem the amount determined under subsection 18.1(4)(*c*) to be the relevant amount for the year notwithstanding that the amount otherwise determined under proposed paragraph 18.1(4)(*b*) would have been the least amount of:

(a): the total of

- the lesser of
  $200 (1/5 x $1,000)
  $167 ($1,000/6)

- $ 45 (Year 5: $167(a) - $132(b))
  $212

(b): the total of

- Nil

- Nil
  Nil

(c): $200 ($1,000 - $800)

SUMMARY

Year	Income	Deductible Portion of Matchable Expenditure	Net Income (loss)
1	$100	$100	Nil
2	$200	$200	Nil
3	$300	$201	$99
4	$200	$167	$33
5	Nil	$132	($132)
6	Nil	$200	($200)
Total		$1,000	

Application of section 143.2

ITA
18.1(13)

Subsection 18.1(13) of the Act provides that a matchable expenditure is considered to be a tax shelter investment for the purpose of applying the limited-recourse debt rules in proposed section 143.2 of the Act. For this purpose, however, the limited-recourse debt rules are to be read without reference to the "at-risk adjustment" reductions.

Debt Obligations

ITA
18.1(14)

Subsection 18.1(14) of the Act provides that a right to receive production is considered to be a debt obligation to which the accrual rules in Part LXX of the *Income Tax Regulations* apply if the rate of return on the right is reasonably certain. In such cases, no amount may be deducted under subsection 18.1(3) of the Act in respect of any matchable expenditure that relates to the right.

Non-applicability of section 18.1

ITA
18.1(15)

Subsection 18.1(15) of the Act describes those matchable expenditures in respect of a right to receive production that are not subject to the new matchable expenditure rules in section 18.1. This rule applies only if no portion of a taxpayer's expenditure can reasonably be considered to have been paid to another taxpayer to acquire the right from the other taxpayer. In addition, the taxpayer's expenditure must be such that either

- the expenditure does not relate to a tax shelter and none of the main purposes for making the expenditure is that the taxpayer obtain a tax benefit, or

- before the end of the taxation year in which the expenditure is made, the total income inclusions of the taxpayer from the right to receive production to which the expenditure relates exceed 80 per cent of the expenditure.

For example, a taxpayer that manages another person's property in return for a fee that is computed in whole or in part with reference to the value of the property being managed (i.e., the right to receive the fee is a right to receive production) may incur matchable expenditures in respect of the right. Nevertheless, the matchable expenditure rules will not apply to the taxpayer's expenditures in respect of the right where the conditions in subsection 18.1(15) apply. This would be the case, for example, where

- no portion of the expenditure in respect of the right can reasonably be considered to have been paid by the taxpayer/manager to acquire the right from the other person, and

- the taxpayer/manager's expenditure in respect of the right does not relate to a tax shelter or a tax shelter investment (as defined by section 143.2 of the Act) and none of the main purposes for making the expenditure is that the taxpayer, or a person with whom the taxpayer does not deal at arm's length, obtain a tax benefit.

Clause 81

Income from Business or Property – Deductions

ITA
20

Section 20 of the Act provides rules relating to the deductibility of certain outlays, expenses and other amounts in computing a taxpayer's income for a taxation year from business or property.

Subclause 81(1)

Expenses Re: Financing

ITA
20(1)(*e*)

Paragraph 20(1)(*e*) of the Act provides for the deduction over a five-year period of expenses incurred in issuing securities, borrowing money and rescheduling or restructuring debt obligations. These expenses include commissions, fees and other amounts payable to agents and salespersons, but do not include amounts described in paragraph 18(9.1)(*c*) or (*d*) of the Act which are deductible under paragraph 20(1)(*c*) of the Act.

Paragraph 20(1)(*e*) is amended, applicable to expenses incurred after 1987, to remove the reference to amounts described in paragraph 18(9.1)(*c*) or (*d*). This reference is not necessary because paragraph 20(1)(*e*) provides a deduction only for amounts not otherwise deductible in computing income from a business or property under the Act.

Subclauses 81(2) to (4)

Reserve for Doubtful Debts

ITA
20(1)(*l*)

Paragraph 20(1)(*l*) of the Act permits any taxpayer to claim a reserve in respect of doubtful debts and a taxpayer who is an insurer or whose ordinary business includes the lending of money to claim a reserve in respect of doubtful loans and lending assets. A taxpayer whose ordinary business does not include the lending of money but does include the purchasing of debt obligations issued by arm's length persons is unable to claim a doubtful debt reserve. Instead such a taxpayer can use the inventory accounting rules to obtain a current deduction in respect of a debt obligation that has become doubtful and fallen in value.

The maximum reserve a taxpayer can claim under existing paragraph 20(1)(*l*) in respect of a loan or lending asset is equal to the

sum of two amounts. The first amount is a prescribed reserve amount under clause 20(1)(*l*)(ii)(A) of the Act in respect of certain loans and lending assets and the second amount is the amount determined under clause 20(1)(*l*)(ii)(B) of the Act in respect of other doubtful loans and lending assets. The amount under 20(1)(*l*)(ii)(B) is the lesser of two amounts one of which is the reserve reported in the taxpayer's financial statements. For this purpose, the financial statement reserve is increased by the amount of interest included under subsection 12(3) of the Act in the taxpayer's income for tax purposes to the extent that the interest has reduced the financial statement reserve.

In June 1996, two amendments to paragraph 20(1)(*l*) were proposed. They were included in former Bill C-69. The first amendment extends the application of the paragraph to taxpayers whose ordinary business is the purchasing of debt. Under the new mark-to-market rules, a taxpayer is a financial institution if the taxpayer's ordinary business is the purchasing of debt obligations. As a financial institution, the taxpayer is deemed not to hold as a property in inventory any debt obligation that is a specified debt obligation. To replace an affected taxpayer's lost inventory accounting deduction the amendment to paragraph 20(1)(*l*) broadens the paragraph's application to provide such taxpayer's with a current deduction in respect of specified debt obligations that have become doubtful and fallen in value. This amendment applies to taxation years that end after February 22, 1994.

The second amendment is to sub-subclause 20(1)(*l*)(ii)(B)(II)2 of the Act. This provision specifies the amount to be added to the financial statement reserve and is amended so that it also applies with respect to amounts included in a taxpayer's income under paragraph 142.3(1)(*a*) of the Act. This amendment is consequential on the introduction of the new rules for debt obligations held by financial institutions. It applies to taxation years that end after February 22, 1994.

The following proposed amendments to paragraph 20(1)(*l*) reflect the 1995 accounting changes announced by the Canadian Institute of Chartered Accountants, and adopted by the Superintendent of Financial Institutions, in dealing with the recognition and measurement of impaired loans. These changes are effective for taxation years that end after September 1997, and also to taxation

years that end after 1995 and before October 1997 where the taxpayer elects to have proposed new paragraph 20(1)(*l*) apply to those years. If the taxpayer so elects, the election must be filed with Revenue Canada by the end of the third month after the month in which these amendments to paragraph 20(1)(*l*) become law.

Subparagraph 20(1)(*l*)(i) of the Act provides that a taxpayer may deduct a reasonable amount as a reserve in respect of doubtful debts that have been included in income for the year or a previous taxation year. This subparagraph is amended to exclude from doubtful debts those debts to which subparagraph 20(1)(l)(ii) applies.

New subparagraph 20(1)(*l*)(ii) of the Act provides that the maximum reserve a financial institution or a taxpayer whose ordinary business includes the lending of money may claim in a year is the total of the amounts in clauses (C) and (D) of that paragraph.

The amount determined under new clause 20(1)(*l*)(ii)(C) is the percentage (not exceeding 100 per cent) that the taxpayer may claim of the prescribed reserve amount set out in section 8000 of the *Income Tax Regulations*. The reserve described in paragraph 8000(*a*) of the Regulations applies in respect of a loan to a designated country. A designated country is determined by the Superintendent of Financial Institutions and is set out in the Guidelines issued by the Office of the Superintendent. After October 1995, the Superintendent ceased to designate any new countries. Consequently, paragraph 8000(*a*) will now be relevant only in respect of loans made before November 1995 to countries designated before that time. The reserve described in paragraph 8000(*b*) of the Regulations applies in respect of loans that can be grouped according to type, such as, credit card debt and consumer mortgages, and in respect of which a reserve reduction factor can be applied. The amortized cost of the loans is multiplied by the reserve reduction factor which is referred to as the "historical loss experience". Section 8004 of the Regulations defines "historical loss experience". Paragraph 8000(*b*) and section 8004 of the Regulations are proposed to be repealed effective for taxation years that end after September 1997, and also for taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(*l*) apply to those years. The impaired loans previously subject to the "historical loss experience" calculation will now be included with all other loans in the reserve amount determined under clause 20(1)(*l*)(ii)(D) of the Act.

The amount determined under new clause 20(1)(*l*)(ii)(D) is the reserve determined for impaired loans, lending assets or specified debt obligations (the "loans") of the taxpayer for a taxation year. Loans exclude direct financing leases as set out in new subparagraph 6209(*b*)(iii) and new section 9004 of the Regulations. Loans also exclude securities prescribed by new subparagraphs 6209(*b*)(i) and (ii) of the Regulations released in June 1995. The amount determined under new clause (D) is the specified percentage of the lesser of the amount determined under new subclause (I) and (II). Specified percentage is a new term which is defined in new subsection 20(2.4) of the Act. The specified percentage for a taxation year for the purposes of clause (D) is the lesser of 100 per cent and the percentage of the prescribed reserve amount of the taxpayer for the year claimed by the taxpayer under clause (C) for the year. In other words, the taxpayer will be required to claim the same percentage under clause (C) and (D) for a particular taxation year except in the case in which the taxpayer does not have a prescribed reserve amount for that year.

New subclause 20(1)(*l*)(ii)(D)(I) of the Act provides that the reserve amount must be a reasonable amount based on the amortized cost of the loans to the taxpayer at the end of a taxation year. This provision is amended to clarify that the reserve so determined cannot include a sectoral reserve. "Sectoral reserve" is a new term which is defined in new subsection 20(2.3) of the Act.

New subclause 20(1)(*l*)(D(II) of the Act provides that the amount determined thereunder is to be determined by the formula 0.9M-N. M is the reserve for the loans for the year determined in accordance with generally accepted accounting principles. N is the total of the specified reserve adjustment for the loans for the year and all previous taxation years which is defined in new subsection 20(30) of the Act . This amendment also clarifies that for tax purposes the reserve cannot include any portion of a sectoral reserve as is defined in new subsection 20(2.3).

Subclause 81(5)

ITA
20(1)(*l*.1)(ii)

Paragraph 20(1)(*l*.1) of the Act provides a deduction for a reserve in respect of credit risk losses under guarantees of a taxpayer that are expected to arise after the end of a year. The deduction is the amount of the reserve reported in the taxpayer's financial statement multiplied by one minus the "prescribed recovery rate". The prescribed recovery rate is set out in section 8001 of the *Income Tax Regulations*. Section 8001 is repealed and paragraph 20(1)(*l*.1) is amended to refer to this percentage rather than the prescribed recovery rate. New paragraph 20(1)(*l*.1) applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(*l*) of the Act apply to those years.

Subclause 81(6)

Reserve for Bad Debts

ITA
20(1)(*p*)

Paragraph 20(1)(*p*) of the Act permits a taxpayer that is an insurer or whose ordinary business includes the lending of money to deduct an amount in respect of loans or lending assets established by the taxpayer to have become uncollectible in the year.

A taxpayer whose ordinary business is not the lending of money but the purchasing of debt obligations issued by arm's length persons cannot claim a bad debt reserve. Instead, such a taxpayer can use the inventory accounting rules to obtain a current deduction in respect of a debt obligation that has become uncollectible.

Under the new mark-to-market rules, a taxpayer is a financial institution if the taxpayer's ordinary business is the purchasing of debt obligations. As a financial institution, the taxpayer is deemed not to hold as a property in inventory any debt obligation that is a specified debt obligation. To replace an affected taxpayer's lost

inventory accounting deduction, the amendment to paragraph 20(1)(*p*) broadens the paragraph's application to provide such taxpayers with a current deduction in respect of uncollectible specified debt obligations. The amendment applies to taxation years that end after February 22, 1994.

Subclause 81(7)

ITA
20(2.3) and (2.4)

New subsection 20(2.3) of the Act sets out the meaning of the term "sectoral reserve" for the purpose of new clause 20(1)(*l*)(ii)(D) of the Act. A sectoral reserve is a reserve in respect of properties that are impaired loans, lending assets or specified debt obligations that is determined on an identifiable sector basis, such as, a geographic or industrial sector basis rather than on a property-by-property basis. This is relevant for the purposes of determining the amount of the reserve deduction under new paragraph 20(1)(*l*) of the Act. This new definition applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(*l*) of the Act apply to those years.

New subsection 20(2.4) of the Act sets out the meaning of the term "specified percentage" for the purpose of new clause 20(1)(*l*)(ii)(D). The specified percentage for a taxation year is the lesser of 100 per cent and the percentage of the prescribed reserve amount of the taxpayer for the year claimed by the taxpayer under new clause 20(1)(*l*)(ii)(C) of the Act for the year. In other words, the taxpayer will be required to claim the same percentage under clause (C) and (D) for a particular taxation year except in the case where the taxpayer does not have a prescribed reserve amount for that year. This new definition applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(*l*) apply to those years.

Subclause 81(8)

Specified Reserve Adjustment

ITA
20(30)

New subsection 20(30) of the Act provides for the calculation of a taxpayer's "specified reserve adjustment" in respect of a loan for the purposes of the description of N in subclause 20(1)(*l*)(ii)(D)(II) of the Act. This adjustment is made on a loan-by-loan basis and is 10 per cent of the interest income reported on the impaired loan for the year or reflected in the charge or credit for loan impairment. The specified reserve adjustment in respect of a loan for a year is the amount determined by the formula 0.1(AxBxC/365). A is the carrying amount of the loan for the year determined in accordance with generally accepted accounting principles. B is the effective rate of interest on the loan for that year determined in accordance with generally accepted accounting principles. C is the number of days in the year on which the loan was impaired. New subsection 20(30) applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(*l*) apply to those years.

Clause 82

Crown Corporations

ITA
27(1)

Section 27 of the Act provides special rules for the application of Part I of the Act to federal Crown corporations.

Section 27 allows the Governor in Council to impose income tax on a federal Crown corporation by prescribing the corporation in the *Income Tax Regulations*. Where the prescribed corporation is a Crown agent, subsection 27(1) of the Act treats any income it earns or loss it incurs as its own income or loss, rather than Her Majesty's. This provision is amended in two respects. First, the rule is

broadened to apply to all federal Crown corporations, not only those that have been prescribed. This does not impose tax on a corporation that has not been prescribed, but it does ensure that such a corporation's income or loss is appropriately measured when, for example, it ceases to be exempt from tax and is subject to the rules in subsection 149(10) of the Act.

The second change to subsection 27(1) provides that not only business and property income, but also the ownership of property itself, is attributed to the corporation. New paragraph 27(1)(*b*) of the Act specifies that Part I applies as though any property, obligation or debt of any kind held, administered, entered into or incurred by a prescribed federal Crown corporation as a Crown agent were instead a property, obligation or debt of the corporation itself. This ensures, for example, that capital gains and losses realized in respect of Crown property it administers are included in computing a Crown corporation's income.

For most purposes, this amendment applies to taxation years that begin after April 26, 1995. There are, however, certain exceptions. Amendments to Parts I.3, IV.1, VI and VI.1 of the Act provide that section 27 applies to those Parts. For those purposes, the amendment applies as of the dates those parts themselves took effect.

Clause 83

Farming or Fishing Business

ITA
28(1)

Section 28 of the Act provides rules concerning the computation of income for farmers and fishermen who use the cash method of accounting for income tax purposes.

Paragraph 28(1)(*d*) of the Act is amended to eliminate the reference in the paragraph to subsection 80(17) of the Act, strictly as a consequence of the repeal of that subsection.

This amendment applies to taxation years that end after February 21, 1994.

Paragraph 28(1)(*e*) of the Act is amended to provide that payments (other than for inventory) that reduce cash-basis income of a farming or fishing business for a year do not include prepaid expenses relating to a taxation year of the business that is two or more taxation years after the year of payment.

New paragraph 28(1)(*e*.1) of the Act provides a deduction in a taxpayer's taxation year for amounts paid in a previous taxation year by the taxpayer where the amounts would be deductible in computing income for the current taxation year from the taxpayer's business of farming or fishing if that income were not computed in accordance with the cash method. To be deductible by a taxpayer, the amount is required to have been paid by the taxpayer in a preceding taxation year in the course of carrying on the business of farming or fishing and cannot be deductible in computing the income of the business for any other taxation year.

Amended paragraph 28(1)(*e*) and new paragraph 28(1)(*e*.1) apply to amounts paid after April 26, 1995 except amounts paid pursuant to written agreements made by the payer on or before April 26, 1995.

Clause 84

Death of Partner or Proprietor

ITA
34.1(9)

Section 34.1 of the Act provides for an adjustment to business income when an individual has a non-calendar year end (i.e., according to the "alternative fiscal period method"). New subsection 34.1(9) of the Act provides that, where an individual dies after that fiscal period, with the result that a second fiscal period ends in the taxation year, a similar adjustment of income in respect of the second fiscal period must be added to the business income for the year of death (to be reported in the income tax return filed pursuant to subsection 150(1) of the Act), if the individual's legal representative so elects or has elected otherwise to file a separate return of income under subsection 150(4) of the Act. In this way, the income for the year of death will reflect both the addition under subsection 34.1(9) and the deduction under subsection 34.1(3) of the

Act, where the taxpayer's legal representative elects to include the income from the second fiscal period in a separate return. A consequential amendment to subsection 150(4) will require the late individual's legal representative to deduct the amount included under subsection 34.1(9) in respect of the individual on the separate return filed in respect of the second period that ended in the year pursuant to subsection 150(4).

Subsection 34.1(9) is applicable to 1996 and subsequent taxation years, except that for the 1996 and 1997 taxation years a representative that files a subsection 150(4) return has the option of not adding an amount to income under subsection 34.1(9) and likewise deducting it from income on the subsection 150(4) return.

Clause 85

Reserve for December 31, 1995 Income -
Death of Partner or Proprietor

ITA
34.2(8)

Section 34.2 of the Act provides for a 10-year transitional inclusion in respect of "December 31, 1995 income" when a taxpayer had a fiscal period ending in 1995 other than on December 31, 1995. New subsection 34.2(8) of the Act allows the legal representative of an individual who dies in a year to claim, in the return of income for the year of death, the reserve that would otherwise have been available pursuant to subsection 34.2(4) of the Act. An amendment to subsection 150(4) of the Act will require that the amount deducted under subsection 34.2(8) be reported as income on the separate return required under subsection 150(4).

Subsection (8) is applicable to 1996 and subsequent taxation years.

Clause 86

Scientific Research and Experimental Development

ITA
37

Section 37 of the Act sets out the rules for the deduction of expenditures incurred by a taxpayer on scientific research and experimental development (SR&ED) performed both inside and outside Canada.

Subclause 86(1)

ITA
37(1)

Subsection 37(1) of the Act provides that a taxpayer may deduct from the taxpayer's business income in respect of a taxation year certain amounts expended for SR&ED. Subparagraph 37(1)(*a*)(iii) of the Act allows the deduction of payments made by the taxpayer to a corporation resident in Canada and exempt from tax because of paragraph 149(1)(*j*) of the Act where certain conditions are met. That subparagraph applies only where the taxpayer is a corporation. However, an amendment was made to the French version of that provision when the statute that introduced that provision into the Act (that is, S.C. 1991, c. 49) was revised by the Statute Revision Commission in chapter 7 of the Statutes of Canada, 1994 (Schedule II). The expression "société de personnes" was then erroneously substituted for the word "corporation". This amendment substitutes the word "société" for the expression "société de personnes".

This amendment applies to taxation years that end after November 1991, as these are the taxation years to which the amendment made to subparagraph 37(1)(*a*)(iii) in the Fifth Supplement of the Revised Statutes of Canada, 1985 applies.

Subclause 86(2)

Time for Election

ITA
37(10)

Subsection 37(10) of the Act requires that an election made by a taxpayer under clause 37(8)(*a*)(ii)(B) of the Act in respect of SR&ED incurred in a taxation year be filed when the taxpayer first files a prescribed form under subsection 37(11) of the Act for that year. The coming-into-force of this requirement is amended to refer, instead, to the time at which the taxpayer first files a prescribed form for a taxation year under subsection 37(1) of the Act (rather than subsection 37(11)) for the period during which the filing requirement referred to under current subsection 37(11) was incorporated into subsection 37(1). That period commenced February 21, 1994 and ended with the last taxation year of a taxpayer beginning before 1995.

Subclause 86(3)

ITA
37(13)(*b*)

Subsection 37(13) of the Act deems certain work that would not otherwise be considered to be SR&ED to be SR&ED for the purposes of sections 37, 127 and 127.1 of the Act.

Subsection 37(13) is amended consequential on the introduction of the definition "scientific research and experimental development" in subsection 248(1) of the Act.

This amendment applies to taxation years that begin after 1995.

Clause 87

Scientific Research and Experimental Development - Additional Allowance

ITA
37.1 to 37.3

Section 37.1 of the Act provides an additional deduction for expenditures in respect of scientific research and experimental development carried on in Canada by a corporation. This has generally not been available since 1983. Subsection 37.1(3) of the Act, however, continues to require the recapture of this allowance for current dispositions of "research property" notwithstanding the research property may not have earned the additional allowance. Section 37.1, as well as sections 37.2 and 37.3, which are application sections in respect of section 37.1, are repealed for the 1995 and subsequent taxation years.

Clause 88

Exempt Capital Gains Balance in Respect of Flow-Through Entity

ITA
39.1(1)

The exempt capital gains balance of an individual for a taxation year in respect of a flow-through entity represents the unclaimed balance of the capital gains that were included in computing the individual's income as a result of elections made under subsection 110.6(19) of the Act in respect of the individual's interest in, or shares of the capital stock of, the entity.

An individual's exempt capital gains balance in respect of a flow-through entity for a taxation year is reduced by amounts claimed in previous years under subsections 39.1(2) to (6) of the Act to reduce capital gains otherwise determined on dispositions of interests in, or shares of the capital stock of, the entity or taxable capital gains or capital gains flowed out to the individual by the entity.

The definition "exempt capital gains balance" is amended, applicable to the 1994 and subsequent taxation years, to provide that an individual's exempt capital gains balance in respect of a flow-through entity for a taxation year is also reduced by amounts included in the description of the new variable "F" included in the formula in this definition. This amendment is relevant in respect of flow-through entities that are trusts described in paragraphs (*g*) to (*j*) of the definition of "flow-through entity" in subsection 39.1(1) of the Act. These trusts are:

- certain trusts governed by employees profit sharing plans,
- certain trusts created to hold shares of the capital stock of corporations for the benefit of their employees,
- certain trusts established for the benefit of creditors to secure certain debt obligations, and
- certain voting trusts where the purpose of the trust is to provide for the exercise of voting rights attached to shares held by the trust.

As a result of this amendment, where the flow-through entity is a trust described in paragraphs (*g*) to (*j*) of the definition of "flow-through entity" and the trust distributed property in a previous year to the individual in satisfaction of all or a portion of the individual's interests in the trust, the variable "F" will reduce the individual's exempt capital gains balance in respect of the trust for the year by the total of all amounts included in the cost of the property to the individual because of elections by the individual under new subsection 107(2.2) or new paragraph 144(7.1)(*c*) of the Act. (For further information, reference may be made to the commentary on new subsection 107(2.2) and new paragraph 144(7.1)(*c*)).

Clause 89

Capital Gains and Losses - General Rules

ITA
40

Section 40 of the Act provides rules for determining an individual's capital gain or capital loss for a taxation year arising from the disposition of property.

Subclause 89(1)

ITA
40(2)(*e*)

Paragraph 40(2)(*e*) of the Act provides that a corporation's loss with respect to property disposed of by it to a person that controls the corporation, or to another corporation controlled by the same person that controls the first corporation, is nil. The circumstances to which paragraph 40(2)(*e*) may have previously applied will be covered by new subsection 40(3.3) of the Act. Paragraph 40(2)(*e*) is therefore repealed with the coming-into-force of new subsection 40(3.3).

Subclause 89(2)

ITA
40(2)(*h*)(i)

Paragraph 40(2)(*h*) of the Act provides for certain adjustments to a taxpayer's loss otherwise determined from the disposition of shares of the capital stock of a corporation that was controlled by the taxpayer at any time in the taxpayer's taxation year in which the disposition occurred. The amendment to this paragraph simply clarifies that a corporation's loss from the disposition of a controlled corporation's shares is subject to adjustment to take account of previous dispositions of property by the controlled corporation to any other corporation, including the shareholder corporation. The coming-into-force of this amendment is the same as that of new subsections 40(3.3) to (3.6) of the Act.

Subclause 89(3)

Deemed Gain for Certain Partners

ITA
40(3.1)

Subsection 40(3.1) of the Act provides that a member of a partnership is considered to have realized a gain equal to the "negative adjusted cost base" of the members' interest at the end of the fiscal period if the member is a limited partner or was since becoming a partner, a "specified member of the partnership". The English version of this provision is restructured so as to clarify any ambiguity in its application. Generally, this amendment applies after February 21, 1994.

Subclause 89(4)

Specified Member of a Partnership

ITA
40(3.131)

New subsection 40(3.131) of the Act provides an anti-avoidance rule that applies where one of the main reasons that a member of a partnership was not a specified member of the partnership since becoming a member of the partnership is to avoid the application of the "negative" adjusted cost base rule in subsection 40(3.1) of the Act.

In such cases, the member will be considered, for the purpose of subsection 40(3.1), to have been a specified member of the partnership at all times since becoming a member of the partnership. This subsection applies after April 26, 1995.

Subclause 89(5)

ITA
40(3.14)(*b*)

Subsection 40(3.14) of the Act provides an extended definition of "limited partner" for the purpose of determining whether a member's interest in a partnership is subject to the negative adjusted cost base rule in subsection 40(3.1) of the Act.

Paragraph 40(3.14)(*b*) of the Act is clarified to ensure that it applies where a member of a partnership, or a person not dealing at arm's length with the member, is entitled to receive certain amounts or obtain certain benefits referred to in paragraph 96(2.2)(*d*) of the Act, either immediately or in the future and either absolutely or contingently. This amendment applies to fiscal periods that end after November 1994.

Subclause 89(6)

Loss on Certain Transfers

ITA
40(3.3) and (3.4)

New subsections 40(3.3) and (3.4) of the Act set out rules that defer losses on certain dispositions of non-depreciable capital property. Under new subsection 40(3.3), these rules apply where (1) a corporation, trust or partnership has disposed of a non-depreciable capital property, (2) the transferor or a person "affiliated" with the transferor acquires the transferred property or an identical property (either of which is termed the "substituted property") during the period that begins 30 days before and ends 30 days after the disposition, and (3) at the end of that period, the transferor or an affiliated person owns the substituted property.

Where these conditions are met, new subsection 40(3.4) provides that no loss may be recognized on the transfer. Instead, any loss is deferred until the earliest of the following events:

- a subsequent disposition of the property to a person that is neither the transferor nor a person affiliated with the transferor (provided

that for 30 days after that later disposition neither the transferor nor an affiliated person owns the substituted property or an identical property acquired after the beginning of the 61-day period described above);

- a deemed disposition of the property under section 128.1 of the Act (change of residence) or subsection 149(10) of the Act (change of taxable status);

- in the case of a corporation, an acquisition of the corporation's control;

- where the substituted property is a debt or a share, a deemed disposition under section 50 of the Act; or

- where the transferor is a corporation, a winding-up of the transferor (other than a winding-up to which subsection 88(1) of the Act applies).

The closing words of new subsection 40(3.4) clarify the result where a transferor partnership ceases to exist after a disposition, but before any of the events that would trigger recognition of the deferred loss. Where a partnership would otherwise cease to exist after a disposition to which subsection 40(3.4) applies, the partnership is treated for the purposes of paragraph 40(3.4)(*b*) of the Act as not having ceased to exist, and each person who was a member of the partnership at the time of the disposition is treated as having remained a member of the partnership. This deemed continuation of the partnership (and of the membership of each partner) continues until the time that is immediately after the first of the events that trigger the partnership's loss.

New subsections 40(3.3) and (3.4) replace subsection 85(4) of the Act, insofar as subsection 85(4) applied to transfers of non-depreciable capital property. Subsection 85(4) operated to the same effect in denying the recognition of a loss on the transfer of such property to persons such as a corporation controlled by the transferor or a person that controlled the transferor. However, these new subsections differ from subsection 85(4) in two material respects. First, they do not apply to transfers by individuals other than trusts, but can, as a result of the adoption of the definition of "affiliated persons" in new section 251.1 of the Act (see the commentary on that

section for a fuller description), have application to transfers of non-depreciable capital property transferred to individuals, corporations and partnerships in cases where subsection 85(4) would not have applied.

Second, the denied loss is not added to either to the cost of any shares held by the transferor in the transferee after the disposition, or to the cost to the transferee of the transferred property. Instead, the loss is preserved in the transferor's hands to be deducted as a loss from the transferred property when it is no longer owned by an affiliated person, when it is deemed to have been disposed of under other provisions of the Act, or when control of a corporate transferor is acquired. (An exception arises in the case of shares of a corporation's capital stock that are disposed of to that corporation. See new subsection 40(3.6) of the Act.)

New subsection 40(3.3) and (3.4) apply to dispositions of property that take place after April 26, 1995, subject to certain exceptions. These are found in clause 247, and generally exclude transactions in progress before April 27, 1995. Readers should refer to the notes to clause 247 of this bill for more detail.

Deemed Identical Property

ITA
40(3.5)

New subsection 40(3.5) of the Act sets out four special rules that apply for the purposes of the loss deferral rule in new subsection 40(3.4) of the Act.

First, paragraph 40(3.5)(*a*) of the Act provides that a right to acquire a property (other than a right that is security for a debt or similar obligation) is treated as being identical to the property.

Second, paragraph 40(3.5)(*b*) of the Act treats a share that is acquired in exchange for another share under any of sections 51, 85.1, 86 or 87 of the Act as identical to that other share.

Third, paragraph 40(3.5)(*c*) of the Act clarifies the result where the property that gives rise to a deferred loss under new subsection 40(3.4) of the Act is a share of a corporation that is

subsequently merged with one or more other corporations (except where the preceding paragraph already applies to the share) or is wound up into its parent corporation. In such a case, the surviving corporation – that is, the corporation formed on the merger or the parent corporation – is treated as continuing to own the share as long as that surviving corporation is affiliated with the transferor.

Loss on Shares

ITA
40(3.6)

Although new subsection 40(3.4) of the Act applies to most dispositions of non-depreciable capital property to affiliated persons, new subsection 40(3.6) of the Act applies special rules where the property is a share of the capital stock of a corporation and is disposed of to that corporation. Provided that the corporation acquiring its own shares is affiliated with the shareholder immediately after the acquisition, any loss that would otherwise arise with respect to the transaction is denied and the amount of that loss is instead added by paragraph 40(3.6)(*b*) of the Act to the adjusted cost base to the shareholder of other shares owned by it in the acquiring company.

New subsection 40(3.6) applies to dispositions that take place after April 26, 1995, subject to certain exceptions. These are found in clause 247 of this bill, and generally exclude transactions in progress before April 27, 1995. Readers should refer to the notes to clause 247 for more detail.

Subclause 89(7)

Additions to Taxable Canadian Property

ITA
40(9)

As a result of changes to the definition of "taxable Canadian property" in paragraph 115(1)(*b*) of the Act, certain properties acquired before April 26, 1995 will have become taxable Canadian properties on that date. New subsection 40(9) of the Act sets out a rule for computing a taxpayer's gain or loss on such a property. The rule prorates the amount of the gain or loss determined without

reference to the subsection, according to the number of months the taxpayer held the property before May 1995.

New subsection 40(9) applies after April 26, 1995.

Clause 90

Exchanges of Property

ITA
44

Section 44 of the Act allows a taxpayer to defer the recognition of a capital gain on property under certain conditions.

Subclause 90(1)

ITA
44(1)

Subsection 44(1) of the Act allows a taxpayer who realizes a capital gain on the disposition of certain property to defer the gain to the extent that the taxpayer reinvests the proceeds of disposition in a replacement property within a certain period of time.

This amendment to subsection 44(1) is consequential on the amendments to subsection 44(5) of the Act. Generally, the condition in subsection 44(1) requiring a taxpayer to acquire a property as a replacement for the taxpayer's former property, is transferred to subsection 44(5). For additional details see the commentary on the amendments to subsection 44(5).

This amendment applies to dispositions of former properties that occur after the 1993 taxation year.

Subclause 90(2)

ITA
44(5)

Subsection 44(5) of the Act describes the conditions under which a capital property acquired by a taxpayer will be a replacement property for the purposes of subsection 44(1) of the Act.

Subsection 44(5) is amended in two ways. First, new paragraph 44(5)(*a*) of the Act provides that a particular property will not be considered to be a replacement property unless it is reasonable to conclude that the property was acquired by the taxpayer to replace the former property.

Second, former paragraph 44(5)(*a*), which is new paragraph 44(5)(*a*.1) of the Act, is clarified to refer to the acquired property being "used by the taxpayer or a person related to the taxpayer" for the same or a similar use to which the taxpayer or a person related to the taxpayer put the former property. A property acquired by a taxpayer is not necessarily denied replacement property treatment simply because it is used by a related person rather than by the taxpayer. This can occur, for example, where a taxpayer rents the acquired property to a related person who uses it in the same or similar business. For additional details, see the commentary on the amendments to subsections 13(4) and (4.1) and subsections 14(6) and (7) of the Act.

These amendments apply to dispositions of former properties occurring after the 1993 taxation year.

Clause 91

Gain when Small Business Corporation Becomes Public

ITA
48.1(1)(*a*)(ii)

Section 48.1 of the Act allows the owner of qualified small business corporation shares to use the capital gains exemption under subsection 110.6(2.1) of the Act in respect of those shares when the

corporation becomes a public corporation because its shares are listed on a prescribed stock exchange in Canada. Such a shareholder may elect to be treated as having disposed of the shares immediately before the change in the corporation's status, in order to realize all or any part of any latent capital gain on the shares. The shareholder is then treated as having reacquired the shares at a cost equal to their deemed proceeds of disposition.

Subsection 48.1(1) is amended as a consequence of a change in the definition of "Canadian-controlled private corporation" (CCPC) in subsection 125(7) of the Act. In order to be a small business corporation as defined in subsection 248(1) of the Act, a corporation must, among other things, be a CCPC. Since the revised CCPC definition will deny CCPC status not only to any corporation any of the shares of which are listed on a Canadian exchange, but also one with shares listed on a foreign exchange, such a corporation will no longer qualify as a small business corporation, and its shares will no longer be eligible for the capital gains exemption. The amended version of subparagraph 48.1(1)(*a*)(ii) of the Act ensures that the election under section 48.1 is available in such a case.

Not only will shareholders of corporations that are newly listed on prescribed Canadian or foreign exchanges be able to make the election, but also those whose corporations were already listed on foreign exchanges on January 1, 1996, when the revised CCPC definition takes effect. If a corporation's shares were listed on that date, and the corporation was a small business corporation on December 31, 1995, an election under section 48.1 will be treated as having been made in a timely manner provided it is made before the end of the third month following the month in which this amendment receives Royal Assent.

Clause 92

Convertible Property

ITA
51(1)

Section 51 of the Act generally permits a tax-deferred transfer of property where a taxpayer exchanges capital property that is a share or a convertible bond, debenture or note of a corporation for capital property that is another share of the capital stock of the corporation. This subsection is amended to ensure that the exchange is made with the corporation and not with another shareholder of the corporation. This amendment applies to exchanges that occur after June 20, 1996 other than exchanges that occur before 1997 pursuant to agreements in writing made on or before June 20, 1996.

Clause 93

Cost of Shares to Subsidiary

ITA
52(7)

Section 52 of the Act sets out rules for determining the cost of certain property for the purposes of measuring any gain or loss on its disposition. Subsection 52(7) of the Act applies where a corporation disposes of Canadian branch property to its subsidiary wholly-owned corporation under special rules provided in Part XIV of the Act. This provision is amended, as a consequence of changes to Part XIV, to update its reference to subsection 219(1) of the Act and to extend to dispositions other than those to subsidiary wholly-owned corporations. For more information on the transfers to which subsection 52(7) applies, readers should consult the notes to amended subsection 219(1).

This amendment applies to taxation years that begin after 1995.

Clause 94

Adjustments to Cost Base

ITA
53

Section 53 of the Act sets out rules for determining the adjusted cost base of capital property for the purposes of calculating any capital gain or loss on its disposition.

Subclauses 94(1) and (2)

ITA
53(1)(*f*.1), (*f*.11) and (*f*.2)

Paragraph 53(1)(*f*.1) of the Act provides for an increase in computing the adjusted cost base to a taxable Canadian corporation of property transferred to the corporation, equal to the capital loss denied to the transferor because of paragraphs 40(2)(*e*) or (*e*.1) or subsection 85(4) of the Act. Paragraph 53(1)(*f*.11) of the Act provides that a capital loss denied under paragraph 40(2)(*e*.1) on the transfer of a property is, to the extent that it is not reflected under paragraph 53(1)(*f*.1), similarly added to the adjusted cost base to the transferee of the property. Paragraph 53(1)(*f*.2) of the Act simply records within subsection 53(1) the adjusted cost base addition provided under paragraph 85(4)(*b*) of the Act – that is, where subsection 85(4) applies to deny a loss on a disposition of property to a corporation and instead adds the amount of the loss to the cost to the transferor of shares in the corporation.

The amendments to these paragraphs limit the application of references to paragraphs 40(2)(*e*) and subsection 85(4) to cases in which the property in question was acquired before 1996, reflecting the repeal of those provisions with respect to property acquired after 1995. In addition, paragraph 53(1)(*f*.2) is amended to add a reference to new paragraph 40(3.6)(*b*) of the Act, which is described above in commentary relating to amendments to section 40 of the Act.

Subclause 94(3)

ITA
53(1)(*r*)

New paragraph 53(1)(*r*) of the Act is added consequential on the elimination of the $100,000 lifetime capital gains exemption for gains that are realized after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) of the Act for recognizing gains accrued to the end of that day. Where an individual recognizes a capital gain accrued to that time on an interest in, or a share of the capital stock of, a flow-through entity (as defined in subsection 39.1(1) of the Act), the amount of the gain is credited to a special account referred to as the individual's exempt capital gains balance in respect of the entity. Claims may be made against this account to reduce gains that are flowed out to the individual by the entity for taxation years that end before 2005 and gains realized on dispositions of interests in or shares of the entity for those years.

New paragraph 53(1)(*r*) increases an individual's adjusted cost base of each interest in, or share of the capital stock of, a flow-through entity described in any of paragraphs (*a*) to (*f*) of the flow-through entity definition by a pro rata portion of the amount of the individual's unused exempt capital gains balance in respect of the entity where the individual disposes of all interests in and shares of the capital stock of the entity. For the purpose of determining the unused portion of the individual's exempt capital gains balance in respect of the entity, the balance for the year is reduced by the total of the total of all reductions in the year in capital gains because of the balance and 4/3 of the total of all reductions in the year in taxable capital gains or business income because of the balance that arise because of dispositions by the individual or because of dispositions by the entity that are flowed out to the individual.

New paragraph 53(1)(*r*) will benefit individuals in circumstances in which interests in or shares of a flow-through entity have declined in value since February 22, 1994. New paragraph 53(1)(*r*) is available only in respect of dispositions before 2005. After 2004, paragraph 53(1)(*p*) of the Act increases the adjusted cost base of the individual's remaining interests in, or shares of the capital stock of, a flow-through entity by the unused portion of the individual's exempt capital gains balance in respect of the entity at that time.

New subsection 53(1)(*r*) applies to the 1994 and subsequent taxation years.

Subclause 94(4)

ITA
53(2)(*c*)(i)(C)

Subparagraph 53(2)(*c*)(i) of the Act reduces a taxpayer's adjusted cost base of a partnership interest by the taxpayer's share of losses of the partnership that are not included in the taxpayer's limited partnership losses. Clause 53(2)(*c*)(i)(C) of the Act provides that any loss of the partnership is to be determined without reference to subsections 112(3.1) and (4.2) of the Act. Under those subsections, a taxpayer's share of a partnership loss from the disposition of corporate shares can be reduced by certain dividends received by the taxpayer on the shares. Clause 53(2)(*c*)(i)(C) is amended in two respects.

First, the reference to subsection 112(4.2) is changed to a reference to subsection 112(4.2) as it read in its application to dispositions of property before April 27, 1995. This modification is necessary because, effective for dispositions of property after April 26, 1995, amended subsection 112(4.2) does not apply to partnership losses.

Second, the clause is amended consequential upon the amendment to subsection 100(4) of the Act which provides that a loss from the disposition of an interest in the partnership may be reduced where the interest is held by another partnership. Amended clause 53(2)(*c*)(i)(C) provides that in computing a taxpayer's adjusted cost base of an interest in the partnership which disposed of the interest in the other partnership, the loss arising from the disposition is to be determined without reference to the loss reduction under subsection 100(4). Therefore, the full amount of any loss arising from the disposition of an interest in a partnership is taken into account in computing the adjusted cost base of a partnership interest under subparagraph 53(2)(*c*)(i).

This amendment applies after April 26, 1995.

Subclause 94(5)

ITA
53(2)(*c*)(i.3)

Subparagraph 53(2)(*c*)(i.3) of the Act provides for a decrease in the adjusted cost base of a taxpayer's interest in a partnership to the extent of any limited-recourse indebtedness of the taxpayer that can reasonably be considered to have been used to acquire the partnership interest. This paragraph is amended to exclude from its application partnership interests that are tax shelter investments, consequential on the introduction of new section 143.2 of the Act. New section 143.2 provides for the reduction of the amount of certain expenditures of a taxpayer to the extent that a "limited-recourse amount" can reasonably be considered to relate to the expenditure (e.g., in respect of a taxpayer's tax shelter investment). For further details, reference may be made to the commentary on new section 143.2.

Generally, this amendment applies to indebtedness of a taxpayer arising after September 26, 1994.

Subclause 94(6)

Recomputation of Adjusted Cost Base on Transfers and Deemed Dispositions

ITA
53(4)

Subsection 53(4) of the Act provides rules that affect the computation of the adjusted cost base to a taxpayer of any "specified property" (as defined in section 54 of the Act). The rules in subsection 53(4) apply where the proceeds of disposition of a specified property are determined under any one of a number of provisions in the Act set out in the subsection. Where this is the case and the adjusted cost base of the specified property was reduced under paragraph 53(2)(*g*.1) of the Act as a consequence of a forgiveness of debt, subsection 53(4) generally provides for the adjusted cost base to continue to be reduced under that paragraph. The only significance of this subsection is with respect to the potential future application of section 80.03 of the Act which, in certain cases, recaptures reductions previously taken under paragraph 53(2)(*g*.1) in computing the

adjusted cost base of specified property on a future disposition of such property.

Subsection 53(4) is amended to eliminate the reference in the subsection to paragraph 85.1(1)(*a*) of the Act, which covers share-for-share exchanges. This means that reductions made under paragraph 53(2)(*g*.1) in computing the adjusted cost base to a transferor of shares exchanged under paragraph 85.1(1)(*a*) will no longer be of any relevance. The change recognizes that section 85.1 of the Act involves arm's length transactions and that a transferee may not be able to obtain information with respect to adjustments under paragraph 53(2)(*g*.1).

This amendment applies to taxation years that end after February 21, 1994.

Subclause 94(7)

Recomputation of Adjusted Cost Base on Other Transfer

ITA
53(5)

Subsection 53(5) of the Act applies where specified property is disposed of by a person or a partnership (referred to below as the "vendor") to another person or partnership (referred to below as the "transferee") with whom the vendor does not deal at arm's length, or with whom the vendor would not deal at arm's length if the assumptions set out in paragraph 80(2)(*j*) of the Act were made. Where this is the case, and subsection 53(4) of the Act does not apply to the disposition, there is deducted under subsection 53(5) in computing the adjusted cost base to the transferee, the amount, if any, by which

- the total amounts previously deducted under paragraph 53(2)(*g*.1) of the Act in computing the adjusted cost base to the vendor of that property

exceeds

- the capital gain from the disposition of that property, determined without reference to subsection 100(2) of the Act and any reserves claimed by the vendor.

Any amount deducted under subsection 53(5) in computing the adjusted cost base of a property is also added at the same time under this subsection in computing that adjusted cost base.

Subsection 53(5) is amended to provide that, for the purpose of that subsection, a right referred in paragraph 251(5)(*b*) of the Act that is a right of the transferee to acquire the specified property from the vendor or a right of the transferee to acquire other property as part of a transaction or event or series of transactions and events that includes the disposition of the specified property will not create a non-arm's length relationship between the vendor and the transferee.

This amendment applies to taxation years that end after February 21, 1994.

Clause 95

Capital Gains and Losses - Definitions

ITA
54
"superficial loss"

Section 54 of the Act contains various definitions that apply for the purposes of subdivision C – Taxable Capital Gains and Allowable Capital Losses. One of the definitions found in section 54 is that of "superficial loss". Pursuant to paragraph 40(2)(*g*) of the Act, a taxpayer's loss from the disposition of property, to the extent that it is a superficial loss, is considered to be nil.

The amendments to this definition delete the description, within the definition itself, of the group of persons and partnerships whose connection with a taxpayer would render any loss on the transfer of property by the taxpayer to a member of that group a superficial loss. As amended, the definition will apply where the taxpayer is

"affiliated" with the transferee – using the tests set out in new section 251.1 of the Act. (See the commentary on section 251.1 for further information.)

The amendments also add the following to the list of exclusions from the superficial loss definition:

- a disposition by a corporation whose control is acquired within the following 30 days;

- a disposition by a person who becomes or ceases to be exempt from tax under Part I of the Act within the following 30 days; and

- any disposition to which new subsection 40(3.4) of the Act applies (see the commentary on that subsection for further details), or to which subsection 69(5) of the Act applies.

The acquisition of a right to acquire property may give rise to a superficial loss. The amendments to the definition provide that a right to acquire a property (other than a right that is security for a debt or similar obligation) is treated for this purpose as a property that is identical to the property.

Finally, the reference to subsection 85(4) of the Act is removed from the definition to reflect the fact that the subsection is being repealed.

These amendments apply to dispositions of property that take place after April 26, 1995, subject to certain exemptions. These are found in clause 247 of this bill, and generally exclude transactions in progress before April 27, 1995. Readers may refer to the notes to clause 247 for more detail.

Clause 96

Avoidance

ITA
55

Section 55 of the Act deals with certain tax avoidance transactions.

Subclause 96(1)

ITA
55(1)
"permitted redemption"

Subsection 55(1) of the Act contains definitions that are relevant for the purpose of section 55 of the Act. The definition "permitted redemption" is relevant in determining whether paragraph 55(3)(*b*) of the Act will apply to protect a dividend received in the course of a divisive corporate reorganization from the application of subsection 55(2) of the Act.

Paragraph (*a*) of the definition "permitted redemption" is amended, effective for dividends received after February 21, 1994, to include the dividend resulting from a redemption or purchase for cancellation by the distributing corporation of all shares of its capital stock owned, immediately before the distribution, by a transferee corporation in relation to the distributing corporation.

Paragraph (*b*) of the definition "permitted redemption" is amended, effective for dividends received after February 21, 1994, to include not only the dividend resulting from a redemption or purchase for cancellation of shares of the capital stock of a transferee corporation held by a distributing corporation, but also the dividend resulting from a redemption or purchase for cancellation of shares of the capital stock of a corporation that immediately after the redemption or purchase is a wholly owned subsidiary of the transferee corporation. This change is intended to allow for the indirect distribution of property to a transferee corporation via a transfer to its subsidiary which, after the transfer and as part of the reorganization, is wound up into the transferee corporation.

Subclause 96(2)

ITA
55(1)
"safe-income determination time"

A new term "safe-income determination time" which is relevant for the purposes of new subsection 55(2) and paragraph 55(5)(*a*) of the Act is added to subsection 55(1) of the Act effective for dividends

received after June 20, 1996. The safe-income determination time for a transaction or event or a series of transactions or events means the time that is the earlier of the time that is immediately before the payment of a dividend as part of the transaction, event or series and the time that is immediately after the earliest disposition or increase in interest described in any of new subparagraphs 55(3)(*a*)(i) to (v) of the Act.

Subclause 96(3)

Deemed Proceeds or Capital Gain

ITA
55(2)

Subsection 55(2) of the Act is an anti-avoidance provision directed against arrangements designed to use the inter-corporate dividend exemption to unduly reduce a capital gain on a sale of shares. It treats the dividend in these situations either as proceeds from the sale of the shares or as a capital gain and not as a dividend received by the corporation.

Subsection 55(2) does not apply where the gain that has been reduced can be attributed to the share's portion of the income ("safe income") earned or realized by any corporation after 1971 and before the transaction or event or the commencement of the series of transactions or events that results in a disposition of property, or an increase in corporate interest, referred to in paragraph 55(3)(*a*) of the Act. Safe income is protected from the application of subsection 55(2) because this income has been subject to corporate income tax and should therefore be allowed to be paid as a tax-free dividend to other Canadian corporations.

Subsection 55(2) of the Act is amended, applicable to dividends received after June 20, 1996 to provide a new later cut-off point for the period (currently at the time of the transaction or the commencement of the series) for determining safe-income. The new cut-off point is referred to as the "safe-income determination time" for the transaction or event or the series of transactions or events and is defined in subsection 55(1) of the Act. Reference may be made to the commentary on subsection 55(1) for further information on the

meaning of "safe-income determination time". Subsection 55(2) is also amended to add a reference to subsection 112(2) of the Act.

New subsection 55(2) of the Act provides that safe income of a corporation will be determined as income earned or realized by a corporation after 1971 and before the "safe-income determination time" as defined in subsection 55(1). Safe income now includes the income arising up to the earlier of the time that is immediately after the earliest disposition or increase in interest described in any of subparagraphs 55(3)(*a*)(i) to (v) and the time that is immediately before the earliest time that a dividend is paid as part of the transaction, event or series. New subsection 55(2) applies to dividends received after June 20, 1996.

Subclause 96(4)

Application

ITA
55(3)(*a*),(3.01)(*a*) to (*e*)

Subsection 55(3) of the Act sets out circumstances in which subsection 55(2) of the Act does not apply to dividends. Paragraph 55(3)(*a*) of the Act provides an exemption from the application of subsection 55(2) for dividends received in certain related-party transactions. In particular, paragraph 55(3)(*a*) exempts dividends received as part of a series of transactions or events that does not result in a disposition of property to, or a significant increase in interest in any corporation of, any person who is not related to the corporation that received the dividend. Paragraph 55(3)(*a*) is amended to allow for, amongst other things, certain dispositions of money as well as of property for proceeds equal to the fair market value at the time of disposition. Therefore a deemed dividend arising on a redemption of shares received on a transfer of property under section 85 of the Act to a related corporation for sale outside the related group may now be exempted from the application of subsection 55(2) as may a disposition of money on the payment of dividends.

In particular, subsection 55(2) will not apply to dividends received by a corporation (the "dividend recipient") if as part of a transaction or

event or a series of transactions or events in which the dividend was received there was not at any particular time

- a disposition of property to a person or partnership who was an unrelated person immediately before the particular time other than a disposition of

    (1) money for the payment of dividends or the reduction of paid-up capital of shares, and

    (2) property for proceeds that are not less than its fair market value at the time of disposition;

- a increase in the total direct interest in any corporation of one or more persons or partnerships who were unrelated persons immediately before the particular time unless the increase resulted from a disposition of shares of a corporation for proceeds of disposition that are not less than the fair market value of those shares at the time of the increase;

- a disposition to a person or partnership who was an unrelated person immediately before the particular time of shares of the corporation that paid the dividend (the "dividend payer") or property more than 10 per cent of the fair market value of which was at any time during the series derived from the shares of the dividend payer;

- after the time the dividend was received, a disposition to a person or partnership who was an unrelated person immediately before the particular time of shares of the dividend recipient or property more than 10 per cent of the fair market value of which at any time during the series is derived from shares of the dividend recipient; and

- a significant increase in the total of all direct interests in the dividend payer of one or more persons or partnerships who were unrelated persons.

New paragraph 55(3.01)(*a*) of the Act sets out the meaning of "unrelated person" for the purpose of new paragraph 55(3)(*a*). An "unrelated person" means a person (other than the dividend recipient) to whom the dividend recipient is not related or a partnership any

member of which (other than the dividend recipient) is not related to the dividend recipient.

As well, new subsection 55(3.01) of the Act sets out for the purposes of new paragraph 55(3)(*a*) the consequences of an amalgamation of corporations or a winding-up of a subsidiary corporation to which subsection 88(1) of the Act applies. New paragraph 55(3.01)(*b*) of the Act provides that the corporation formed on an amalgamation is treated as a continuation of its predecessors. New paragraph 55(3.01)(*c*) of the Act provides that when there is a winding-up of a subsidiary corporation into its parent to which subsection 88(1) of the Act applies, the parent is treated as a continuation of the subsidiary.

New paragraph 55(3.01)(*d*) of the Act provides that the proceeds of disposition, for the purposes of applying the tests in new paragraph 55(3)(*a*), will be determined without reference to "paragraph 55(2)(*a*)" in paragraph (j) of the definition of "proceeds of disposition" in section 54 of the Act.

New paragraph 55(3.01)(*e*) of the Act sets out for the purpose of paragraph 55(3)(*a*) of the Act the circumstances in which a non-resident will be treated as having disposed of property for proceeds that are less than its fair market value. This will be the case where the gain or loss from the disposition (at fair market value) is recognized for purposes of taxation neither in Canada nor in the non-resident's home country.

The following examples illustrate the application of new paragraph 55(3)(*a*):

EXAMPLE 1 ... ARM'S LENGTH ASSET SALE

A corporation (Buyerco) wishes to acquire from an unrelated corporation (Sellco) a particular asset (the target asset). Sellco transfers, on a tax-deferred basis under section 85 of the Act, the target asset to Buyerco. In consideration for the transferred asset Buyerco issues to Sellco preferred shares with an adjusted cost base to Sellco equal to the tax cost of the transferred asset immediately before the transfer. The paid-up capital of the preferred shares does not exceed their adjusted cost base to Sellco which is the adjusted cost base of the transferred property and the

redemption amount of the preferred shares is equal to the fair market value of the transferred property. Such preferred shares with a high redemption value and low paid-up capital are commonly referred to as "High/Low Shares".

Result: Buyerco and Sellco are not related and the disposition of the target asset was not for proceeds of disposition equal to the fair market value at the time of disposition. The test in subparagraph 55(3)(a)(i) is not met. The dividends arising on the redemption by Buyerco of the High/Low Shares are therefore not eligible for the exemption in paragraph 55(3)(a).

EXAMPLE 2 ... IN-HOUSE LOSS UTILIZATION

A corporation (Parentco) has two wholly-owned subsidiary corporations (Profitco) and (Lossco). Profitco owns, amongst other things, all the shares of a subsidiary corporation (Target) which it wishes to sell to an unrelated person. The fair market value of the shares of Target exceeds their adjusted cost base to Profitco and therefore Parentco wants the gain which will arise on the disposition of those shares to be realized in Lossco rather than Profitco. Profitco transfers, on a tax-deferred basis under section 85 of the Act, the Target shares to Lossco in consideration for High/Low Shares of Lossco. Lossco then sells the shares of Target to the unrelated person for proceeds of disposition equal to the fair market value of the shares. The High/Low shares of Lossco are then redeemed.

Result: All five of the tests in new paragraph 55(3)(a) are met and therefore the dividends arising on the redemption by Lossco of the High/Low shares are not subject to subsection 55(2).

EXAMPLE 3 ... A REDEMPTION OF A MINORITY SHAREHOLDER INTEREST

A corporation (ACo) and an unrelated corporation (BCo) own 60 per cent and 40 per cent respectively of a third corporation (XCo). XCo redeems its shares held by BCo.

Result: Any dividends arising on the redemption by XCo of its shares held by BCo are not eligible for the exemption in paragraph 55(3)(a).

- *The redemption of the XCo shares held by BCo is a disposition of property to an unrelated person for proceeds of disposition less than fair market value at the time of disposition. The test in new subparagraph 55(3)(a)(i) is not met;*

- *There is a significant increase in ACo's (unrelated person's) total direct interest in XCo (the dividend payer) as a result of a disposition (redemption) of the shares of XCo for proceeds of disposition less than fair market value. The test in new subparagraph 55(3)(a)(ii) is not met;*

- *There is a disposition of the shares of XCo to XCo which is a person unrelated to BCo (the dividend recipient). The test in new subparagraph 55(3)(a)(iii) is not met; and*

- *There is a significant increase in the total direct interest in XCo by ACo, a person unrelated to BCo. The test in new subparagraph 55(3)(a)(v) is not met.*

EXAMPLE 4 ... A REDEMPTION OF A MAJORITY SHAREHOLDER INTEREST

A corporation (ACo) and an unrelated corporation (BCo) own 40 per cent and 60 per cent respectively of the shares of a third corporation (XCo). XCo redeems its shares held by BCo.

Result: Any dividends arising on the redemption by XCo of its shares held by BCo are not eligible for the exemption in paragraph 55(3)(a).

- *There is a significant increase in ACo's (an unrelated person's) direct interest in XCo (the dividend payer) as a result of a disposition of the shares of XCo for proceeds of disposition less than fair market value. The test in new subparagraph 55(3)(a)(ii) is not met; and*

- *There is a significant increase in the total direct interest in XCo by ACo which is a person unrelated to BCo. The test in new subparagraph 55(3)(a)(v) is not met.*

EXAMPLE 5 ... A CORPORATE REORGANIZATION AND ARM'S LENGTH ASSET SALE

A corporation (BuyerCo) owns all the shares of another corporation (SubCo). Buyerco acquires all the shares of a third corporation (Target) for fair market value. Target owns all the shares of two corporations - T1Subco and T2Subco. Target transfers, on a tax-deferred basis under section 85 of the Act, all the shares of T2Subco to SubCo in consideration for High/Low Shares of SubCo. SubCo subsequently redeems the High/Low Shares. Target sells the shares of T1Subco to a third party for proceeds of disposition equal to fair market value at the time of the disposition.

Result: The dividends arising on the redemption by SubCo of its shares held by Target are not subject to subsection 55(2). The tests in new paragraph 55(3)(a) are met.

EXAMPLE 6 ... A TRANSFER OF ASSETS WITHIN A GROUP OF RELATED CORPORATIONS

The shares of a corporation (ACo) are owned 49 per cent by XCo and 51 per cent by MCo. ACo owns all the shares of SubCo. The shares of another corporation BCo are owned 49 per cent by YCo and 51 per cent by MCo. ACo transfers, on a tax-deferred basis under section 85 of the Act, all the shares of SubCo to BCo in consideration for High/Low Shares of BCo. BCo redeems its shares held by ACo.

Result: The dividends arising on the redemption by BCo of its shares held by ACo are not subject to subsection 55(2). This was not a disposition of property to an unrelated party; therefore, the test in new subparagraph 55(3)(a)(i) is met. YCo has increased its indirect interest in SubCo but not its direct interest in SubCo; therefore the test in new subparagraph 55(3)(a)(ii) is met. The tests in new subparagraphs 55(3)(a)(iii),(iv) and (v) are also met.

EXAMPLE 7 ... INTERNAL CORPORATE REORGANIZATION

MCo is a public corporation that is widely held. MCo owns all the shares of two other corporations YCo and XCo. On July 15, 1996, MCo incorporates Topco and transfers, on a tax-deferred

basis under section 85, all the shares of XCo to Topco in consideration for High/Low Shares of Topco. Each share of MCo held by the public is exchanged for a corresponding share of Topco. Topco is now the parent of MCo. Topco redeems the High/Low Shares.

Result: The dividends arising on the redemption by Topco of its shares held by MCo are subject to subsection 55(2). There is a significant increase in the total direct interest of the former shareholders of MCo in Topco, the dividend payer. The tests in new subparagraphs 55(3)(a)(ii) and (v) are not met.

Subject to specified grandfathering set out in (i) and (ii) below, new paragraph 55(3)(*a*) and new subsection 55(3.01) apply to dividends received by a corporation after February 21, 1994. Grandfathering is provided for dividends received in the following circumstances:

(i) dividends received before June 20, 1996 or under an arrangement substantially advanced, as evidenced in writing, before June 20, 1996 provided item (ii) below does not apply;

and

(ii) dividends received on shares issued before June 20, 1996 provided the corporation elects in writing before the end of the fourth month after the month in which new paragraph 55(3)(*a*) and new subsection 55(3.01) become law or in its tax return for the year in which the dividend was received.

Where the circumstances in item (i) exist, new subparagraphs 55(3)(*a*)(ii) and (v) will be read as:

"(ii) a significant increase (other than as a consequence of a disposition of shares of the capital stock of a corporation for proceeds of disposition that are not less than their fair market value) in the interest in any corporation of one or more persons who were unrelated persons immediately before the particular time,"

and

"(v) a significant increase in the interest in the dividend payer of one or more persons who were unrelated persons immediately before the particular time; or"

Where the circumstances in item (ii) exist, the Act will be read without reference to new subsection 55(3.01) and paragraph 55(3)(*a*) will be read as:

"(*a*) unless the dividend was received as part of a transaction or event or series of transactions or events that resulted in

(i) a disposition of any property to a person with whom the dividend recipient was dealing at arm's length, or

(ii) a significant increase in the interest in any corporation of any person with whom the dividend recipient was dealing at arm's length; or"

As well, where the circumstances in item (ii) exist, subsection 55(4) and paragraph 55(5)(*e*) will be read as follows:

1. Subsection 55(4) will be read as it read for dividends before February 22, 1994, and

2. Paragraph 55(5)(*e*) will provide that in determining whether two or more persons deal with each other at arm's length

– a brother and a sister will be treated as dealing with each other at arm's length and not related to each other, and

– persons who are otherwise related to each other solely because of a right referred to in paragraph 251(5)(*b*) of the Act will be treated as not related to each other.

Subclause 96(6)

ITA
55(3.1)(*c*)

A dividend received by a corporation to which subsection 55(2) of the Act would, but for the butterfly reorganization exemption in paragraph 55(3)(*b*) of the Act, apply will be denied the protection of

paragraph 55(3)(*b*) under subsection 55(3.1) of the Act where the conditions set out in any of paragraphs 55(3.1)(*a*) to (*d*) exist.

Paragraph 55(3.1)(*c*) of the Act denies the protection of paragraph 55(3)(*b*) for a dividend received by a transferee corporation where, as part of the series of transactions or events that include the receipt of the dividend, certain described property with a fair market value greater than 10 per cent of the fair market value, at the time of distribution, of the property received by the transferee corporation on the distribution of property as part of the butterfly reorganization, becomes property of a partnership or of a person who is not related to the transferee. The described property is composed of the following three types:

1. property received by the transferee on the distribution;

2. property more than 10 per cent of the fair market value of which is attributable to distributed property; and

3. property to which more than 10 per cent of the fair market value of the distributed property can be attributed.

Clause 55(3.1)(*c*)(ii)(B) of the Act is amended to clarify that the 10 per cent fair market value test for the second type of property is to be determined by reference to distributed property other than money and indebtedness that is not convertible into other property. The amendment also ensures that the second type of property includes property the value of which is attributable to property described in the third type. New clause 55(3.1)(*c*)(ii)(B) of the Act applies to dividends received after April 26, 1995 except that the clause will be read without reference to clause (C) for acquisitions of property before June 20, 1996 or at any time pursuant to a written agreement made before June 20, 1996.

Clause 55(3.1)(*c*)(ii)(C) is amended applicable to dividends received after April 26, 1995 to alter the description of the third type of property. The third type of property will be composed of property to which the fair market value of the distributed property can be wholly or partly attributed.

Subclause 96(7)

ITA
55(3.1)(*d*)

A dividend received by a corporation to which subsection 55(2) of the Act would, but for the butterfly reorganization exemption in paragraph 55(3)(*b*) of the Act, apply will be denied the protection of paragraph 55(3)(*b*) under subsection 55(3.1) of the Act where the conditions set out in any of paragraphs 55(3.1)(*a*) to (*d*) exist.

Paragraph 55(3.1)(*d*) of the Act denies the protection of paragraph 55(3)(*b*) for a dividend received by the distributing corporation where, as part of the series of transactions or events that include the receipt of the dividend, certain described property with a fair market value greater than 10 per cent of the fair market value, at the time of distribution, of the property owned by it immediately before the distribution and not disposed of by it on the distribution, is acquired by a partnership or a person who is not related to the distributing corporation.

The described property is composed of the following three types:

1. property retained by the distributing corporation immediately after the distribution;

2. property more than 10 per cent of the fair market value of which is attributable to property retained by the distributing corporation; and

3. property to which more than 10 per cent of the fair market value of the property retained can be attributed.

Clause 55(3.1)(*d*)(ii)(B) of the Act is amended to clarify that the 10-per-cent fair market value test for the second type of property is to be determined by reference to retained property other than money and indebtedness that is not convertible into other property. The amendment also ensures that the second type of property includes property the value of which is attributable to property described in the third type. Clause 55(3.1)(*d*)(ii)(B) is also amended to ensure that the wording is consistent with the wording in clause 55(3.1)(*c*)(ii)(B) of the Act. New clause 55(3.1)(*d*)(ii)(B) of the Act applies to

dividends received after April 26, 1995 except that the clause will be read without reference to clause (C) for acquisitions of property before June 20, 1996 or at any time pursuant to a written agreement made before June 20, 1996.

Clause 55(3.1)(*d*)(ii)(C) of the Act is amended applicable to dividends received after April 26, 1995 to make the wording consistent with the wording in clause 55(3.1)(*c*)(ii)(C) of the Act.

Subclause 96(8)

ITA
55(3.2)

Subsection 55(3.2) of the Act sets out a number of interpretative rules for the purpose of paragraph 55(3.1)(*b*) of the Act. New paragraph 55(3.2)(*h*) of the Act provides that each corporation that is a shareholder and specified shareholder of a distributing corporation at any time during the course of a series of transactions or events, a part of which includes a distribution, will be treated as a transferee corporation in relation to the distributing corporation. New paragraph 55(3.2)(*h*) applies to dividends received after June 20, 1996 other than dividends received in the course of a reorganization that was carried out pursuant to a series of transactions or events substantially advanced, as evidenced in writing, before June 21, 1996 or that was required on June 20, 1996 to be carried out pursuant to a written agreement made before June 21, 1996. For this purpose, a reorganization is considered not to be required to be carried out where the parties to the agreement can be relieved of the requirement if there is a change to the Act.

EXAMPLE

The shares of a Canadian corporation (ZCo) are owned 50 per cent by XCo and 50 per cent by YCo. XCo is owned 50 per cent by ACo and 50 per cent by BCo. A third corporation, PCo, acquires the shares of XCo from ACo and BCo. During the course of a butterfly reorganization, ZCo distributes 50 per cent of its property to YCo. After the reorganization, XCo owns all the shares of ZCo the distributing corporation.

This reorganization does not qualify for the butterfly exemption in paragraph 55(3)(b) because of the application of subparagraph 55(3.1)(b)(ii) and new paragraph 55(3.2)(h). Under new paragraph 55(3.2)(h), XCo is a transferee corporation in relation to the distributing corporation, ZCo. Control of XCo was acquired by PCo during the course of the series of transactions which included the distribution of ZCo's property to YCo.

Subclause 96(9)

Interpretation of "Specified Shareholder" Changed

ITA
55(3.3)

New subsection 55(3.3) of the Act provides that for the purposes of subparagraph 55(3.1)(*b*)(i) and paragraph 55(3.2)(*h*) of the Act, the definition of "specified shareholder" in subsection 248(1) of the Act is to be read as including a reference to "or of any other corporation that is related to the corporation and that has a significant direct or indirect interest in any issued shares of any class of the capital stock of the corporation" rather than the reference to "or of any corporation that is related to the corporation". New subsection 55(3.3) ensures that in determining whether a person is a specified shareholder of a particular corporation for the purposes of subparagraph 55(3.1)(*b*)(i) and paragraph 55(3.2)(*h*), only shareholdings "above" the particular corporation and not "below" it are to be considered. In other words, in determining a person's specified shareholder status in a particular corporation, you consider the person's shareholdings in related corporations that have a significant direct or indirect interest in the particular corporation.

New subsection 55(3.3) applies to dividends received after 1996.

Subclause 96(10)

ITA
55(5)(*a*)

Subsection 55(5) of the Act sets out application provisions for the purposes of section 55 of the Act. Paragraph 55(5)(*a*) of the Act provides that the portion of the capital gain that is attributable to

income expected to be earned or realized by a corporation after the receipt of a dividend referred to in subsection 55(2) of the Act, shall be deemed to be a portion of a capital gain attributable to anything other than income. Paragraph 55(5)(*a*) is amended for dividends received after June 20, 1996 as a consequence of the changes to subsection 55(2) of the Act and the introduction of the new term "safe-income determination time" in subsection 55(1) of the Act. Amended paragraph 55(5)(*a*) provides that the portion of the capital gain that is attributable to income expected to be earned or realized by a corporation after the safe-income determination time will be considered to be a portion of a capital gain attributable to anything other than income.

Subclause 96(11)

ITA
55(5)(*c*)

Paragraph 55(5)(*c*) of the Act provides that the income earned or realized by a corporation for the period in which it was a private corporation is its income otherwise determined for the period without deducting amounts under section 37.1 or paragraph 20(1)(*gg*) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952. Paragraph 55(5)(*c*) is amended, effective for the 1995 and subsequent taxation years as a consequence of the repeal of section 37.1 of the Act.

Clause 97

Amounts Included in Income

ITA
56(1)

Section 56 of the Act lists certain types of income that are required to be included in computing the income of a taxpayer from sources other than property, business and employment.

Subparagraph 56(1)(*a*)(iv) of the Act is amended to add a reference to the *Unemployment Insurance Act* (to ensure that amounts received

under that Act remain taxable) and to the relevant parts of the new *Employment Insurance Act* under which comparable benefits are paid.

Paragraph 56(1)(*b*) of the Act contains a formula to determine whether certain child support amounts are to be included in the income of the recipient. The variable B of the formula represents the child support amounts receivable under agreements or orders after their commencement days. This amendment ensures that amounts receivable on the commencement day of an agreement or order will also be included in the formula.

Subparagraph 56(1)(*l*)(ii) of the Act is amended to add a reference to the Canada Employment and Immigration Commission and the *Unemployment Insurance Act*, in recognition of the fact that a reimbursement of costs could be in relation to the procedure under that act.

New paragraph 56(1)(*r*) of the Act requires that certain amounts received as earnings supplements under government-sponsored projects or as financial assistance under programs established by the Canada Employment Insurance Commission or under similar programs established by other government entities or organizations pursuant to agreements with the Commission to be included in computing the recipient's income.

Paragraph 56(1)(*u*) of the Act is also amended to clarify that it does not apply to payments required to be included in income under another provision of the Act.

The amendments to subparagraphs 56(1)(*a*)(iv) and 56(1)(*l*)(ii) are deemed to have come into force on June 30, 1996. The amendment to paragraph 56(1)(*b*) applies to amounts received after 1996. New subparagraphs 56(1)(*r*)(ii) and (iii) come into force on June 30, 1996, while subparagraph 56(1)(*r*)(ii) applies to the 1993 and subsequent taxation years.

Clause 98

Support Payments

ITA
56.1(1)

Section 56.1 of the Act treats certain support payments made to third parties for the benefit of an individual who is a spouse, former spouse, or a parent of a payer's child as having been received by the individual so that the payments are included in the individual's income. This amendment corrects an error in the French version of the preamble to that section.

This amendment applies to amounts received after 1996.

Clause 99

Other Deductions

ITA
60

Section 60 provides for a variety of deductions in computing income, many of which relate to certain income inclusions required under section 56.

Subclause 99(1)

ITA
60(*b*)

Paragraph 60(*b*) of the Act contains a formula to determine whether certain child support may be deducted in computing the payer's income. The variable B of the formula represents the child support amounts payable under agreements or orders after their commencement days. This amendment ensures that amounts payable <u>on</u> the commencement day of an agreement or order will also be included in the formula.

This amendment applies to amounts paid after 1996.

Subclause 99(2)

Transfer of Refund of Premium under RRSP

ITA
60(*l*)

An individual is generally required to include in income any amount received out of a deferred income plan, such as a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF). However, if the amount received is an amount described in subparagraph 60(*l*)(v) of the Act, the individual can claim an offsetting deduction under paragraph 60(*l*) of the Act up to the lesser of the amount received and the total of any qualifying payments made by the individual. A qualifying payment is a payment made into an RRSP or a RRIF or a payment made to acquire an annuity contract described in subparagraph 60(*l*)(ii) of the Act.

Three types of annuity contract are described in subparagraph 60(*l*)(ii). Each one has either a term or guaranteed period that is determined by reference to the age of the taxpayer making the qualifying payment or of the taxpayer's spouse. Subparagraph 60(*l*)(ii) is amended to clarify that the relevant age in each case is the age <u>in whole years</u> of the relevant person at the time that the annuity is acquired.

Subparagraph 60(*l*)(ii) is also amended to clarify the length of the guaranteed period in the case of a life annuity described in clause 60(*l*)(ii)(A) of the Act. Where an annuitant is married, the length of this period cannot exceed 90 years minus the lesser of the age of the annuitant and the age of the annuitant's spouse.

These amendments, which apply to 1989 and subsequent taxation years, make the wording of subparagraph 60(*l*)(ii) consistent with the wording of new paragraph (*c*.1) of the definition "qualified investment" in subsection 146(1) of the Act.

Subclauses 99(4),(5) and (7)

ITA
60(*n*), (*o*) and (*v*.1)

Paragraphs 60(*n*), (*o*) and (*v*.1) of the Act are amended to ensure that repayments made under the former *Unemployment Insurance Act* continue to be deductible. This amendment is deemed to have come into force on June 30, 1996.

Subclause 99(6)

RCA Distributions and Dispositions

ITA
60(*t*) and (*u*)

Paragraph 60(*t*) of the Act provides a deduction to offset amounts that a taxpayer is required to include in income under paragraph 56(1)(*x*) or (*z*) or subsection 70(2) of the Act in respect of payments from a retirement compensation arrangement (RCA). In general, the deduction is limited to the amount of the taxpayer's undeducted contributions to the RCA plus any amounts paid or received by the taxpayer to acquire or dispose of an interest in the RCA.

Paragraph 60(*t*) is amended to deal with the transfer of an amount in respect of a taxpayer from one RCA (the "transferor plan") to another RCA (the "transferee plan") under subsection 207.6(7) of the Act. That subsection eliminates any requirement for the taxpayer to include the transferred amount in income under paragraph 56(1)(*x*) or (*z*). It also denies the taxpayer any deduction that might otherwise be available under paragraph 8(1)(*m*.2) of the Act in connection with the payment to the transferee plan or under paragraph 60(*t*) or (*u*) in connection with the payment from the transferor plan. (See the commentary under subsection 207.6(7) for further details.)

Paragraph 60(*t*) is amended so that, when there is a transfer in respect of a taxpayer under subsection 207.6(7), the amount that can be deducted under that paragraph in connection with payments ultimately received from the transferee plan is increased by the portion of the transfer that would have been deductible if the transferred amount had

been paid to the taxpayer. Similarly, the amount that the taxpayer can deduct in connection with payments subsequently received from the transferor plan (in the event the taxpayer retains an interest in the plan) is reduced by the same amount. This allows the relief provided under that paragraph to be carried forward to the transferee plan. Paragraph 60(*t*) is also amended to disregard any other RCA contributions made by way of a transfer under subsection 207.6(7) in determining the amount that can be deducted under that paragraph in connection with the plan.

Paragraph 60(*u*) of the Act provides a deduction to offset amounts that a taxpayer is required to include in income under paragraph 56(1)(*y*) of the Act on disposing of an interest in an RCA. In general, the deduction is limited to the amount of the taxpayer's undeducted contributions plus amounts paid to acquire the interest in the RCA less amounts deducted under paragraph 60(*t*) in connection with the RCA. The amendments to paragraph 60(*u*) are identical to the amendments to paragraph 60(*t*).

These amendments apply to the 1996 and subsequent taxation years.

Clause 100

Support Payments

ITA
60.1

Section 60.1 of the Act treats certain support payments to third parties for the benefit of an individual who is a spouse, former spouse or a parent of a payer's child as having been received by that person so that the payments are deductible from the income of the payer. This amendment corrects an error in the French version of the preamble to that section.

This amendment applies to amounts received after 1996.

Clause 101

Deduction for Insolvency

ITA
61.3(1) and (2)

Subsections 61.3(1) and (2) of the Act provide deductions for corporations with respect to amounts included in income under subsection 80(13) of the Act because of the application of the debt forgiveness rules.

Subsections 61.3(1) and (2) are amended to eliminate the reference in the subsections to subsection 80(17) of the Act, strictly as a consequence of the repeal of that subsection.

These amendments apply to taxation years that end after February 21, 1994.

Clause 102

Moving Expenses

ITA
62(3)(*f*)

Section 62 of the Act provides a deduction for the qualifying moving expenses of an individual who moves to a new residence in Canada in order to take up employment or start a business. Subsection 62(3) of the Act defines moving expenses to include, among other items, taxes imposed on the transfer or registration of title to a new residence where an individual sells an old residence as a result of the move.

This amendment to paragraph 62(3)(*f*) of the Act, which applies to moving expenses incurred after 1990, clarifies that the deduction in respect of taxes, fees and duties imposed on the transfer or registration of title to a new residence does not include any value-added tax, such as the goods and services tax, imposed on the purchase of that residence.

Clause 103

Child Care Expenses

ITA
63(3)

Section 63 of the Act provides rules concerning the deductibility of child care expenses in computing an individual's income. Subsection 63(3) of the Act contains the definition "earned income". In any year, an individual is not allowed to deduct child care expenses that exceed two-thirds of earned income for that year.

This amendment to the definition "earned income" adds to that income base amounts included in income under new paragraph 56(1)(*r*) of the Act. These amounts represent certain employment earnings supplements received under federal government projects.

This amendment applies to 1993 and subsequent taxation years.

Clause 104

Exploration and Development Expenses

ITA
66

Section 66 of the Act provides rules with respect to Canadian and foreign exploration and development expenses.

Subclauses 104(1) and (2)

ITA
66(4)(*b*)

Subsection 66(4) of the Act sets out the deduction that may be claimed for foreign exploration expenses. The deduction that may be claimed for a taxation year is a minimum of 10 per cent of the undeducted balance of such expenses at the end of the year, but a higher amount (up to the undeducted balance) may be claimed to the

extent of the taxpayer's specified foreign-source resource income. For this purpose, the closing words of paragraph 66(4)(*b*) of the Act provide that the foreign resource income is determined without reference to deductions under subsections 66(1), (3) and (4), section 65 and subsections 66.1(2) and (3) of the Act.

This amendment, which applies to taxation years that end after May 6, 1974, moves the closing words of paragraph 66(4)(*b*) to become the closing words of subparagraph 66(4)(*b*)(ii) of the Act. This clarifies that the rule contained in these closing words applies only for the purpose of computing a taxpayer's specified foreign-source resource income.

Subclause 104(3)

ITA
66(11.4)

Subsection 66(11.4) of the Act applies where there is an acquisition of control of a corporation that was not a principal-business corporation immediately before the 12-month period preceding that acquisition of control. Under this rule, any Canadian or foreign resource property acquired by the corporation in that period is considered to have been acquired at the time control is acquired for the purpose of calculating the corporation's foreign exploration and development expenses, cumulative Canadian development expense and cumulative Canadian oil and gas property expense.

Paragraph 66(11.4)(*b*) of the Act is amended as a consequence of the introduction of the concept of "affiliated persons" in new section 251.1 of the Act. (See the commentary to new section 251.1 for further information.) Subsection 66(11.4) formerly contained an exception from its application where the property in question was owned before the 12-month period described above by the corporation whose control was acquired, by a partnership of which the corporation was a majority interest partner, or by a person or persons related to the corporation. As amended, this exception will apply where the property was owned by a person that was affiliated with the corporation, within the meaning that would be assigned by new section 251.1 if that section were read without reference to the extended definition of "controlled" in subsection 251.1(2).

Amended subsection 66(11.4) applies after April 26, 1995.

Subclause 104(4)

Early Change of Control

ITA
66(11.5)

Where a corporation referred to in subsection 66(11.4) of the Act was formed shortly before it underwent an acquisition of control, the exception provided in that subsection for transfers among related persons may not apply. Specifically, the acquired property will not be able to meet the test of having been owned by the corporation or by a related person throughout the period that starts immediately before the twelve month period before the acquisition of control and that ends when the corporation acquires the property.

Subsection 66(11.5) of the Act is a rule that ensures the appropriate result under subsection 66(11.4) in such a case. Subsection 66(11.5) treats a newly-formed corporation as having been in existence from the time immediately before the twelve month period to the time immediately after it was formed, and as having been related during that time to the persons to whom it was related from its formation until the acquisition of control.

Subsection 66(11.5) is amended, as a consequence of the amendment of subsection 66(11.4), to use the new test of affiliation rather than the test of being related. This amendment applies to acquisitions of control that occur after April 26, 1995.

Subclause 104(5)

ITA
66(12.66)

Subsections 66(12.6) and (12.601) of the Act permit a principal-business corporation to renounce Canadian exploration expenses (CEE) and Canadian development expenses (CDE) to a flow-though shareholder. A corporation may only renounce CEE or CDE incurred by it on or before the effective date of the renunciation. For the purposes of these subsections, where a number

of stated conditions are met, subsection 66(12.66) of the Act treats CEE and CDE incurred in the first 60 days of a calendar year as having been incurred at the end of the preceding calendar year.

Subsection 66(12.66) is amended so that this "lookback" rule also applies for the purposes of paragraph 66(12.602)(*b*). Under this paragraph, a corporation may only renounce CDE under subsection 66(12.601) to the extent of the corporation's cumulative CDE on the effective date of the renunciation. The amendment ensures that, where the effective date of the renunciation by a corporation is the last day of a calendar year, CDE incurred in the first 60 days of the following calendar year is taken into account for the purposes of computing cumulative CDE under paragraph 66(12.602)(*b*) of the Act.

This amendment applies to expenses incurred after 1992.

Subclause 104(6)

ITA
66(12.75)(*c*)

Subsection 66(12.75) of the Act sets out penalties for the late filing of specified documents and for the late renunciations of resource expenses in connection with flow-through share financings.

In order for a late renunciation to have any effect, the renouncing corporation is required under subsection 66(12.741) of the Act to pay a penalty in respect of the renunciation. A cross reference in paragraph 66(12.75)(*c*) is amended to ensure that this paragraph applies for the purposes of determining this penalty. The penalty in respect of a late renunciation is equal to the lesser of $15,000 and the greater of $100 and .25 per cent of the amount renounced.

This amendment applies to renunciations purported to be made after February 1993.

Subclause 104(7)

ITA
66(15)
"Canadian exploration and development expenses"

Subsection 66(15) of the Act defines "Canadian exploration and development expenses". Under paragraph (*c*) of the definition, such expenses include a cost incurred before May 7, 1974 for a "Canadian resource property".

The definition is amended to clarify that the cost of Canadian resource property acquired before 1972 is not included as a Canadian exploration and development expense. This amendment, which applies to taxation years that begin after 1984, is consequential on a broadening of the definition "Canadian resource property" in 1985 to include specified property acquired before 1972.

Clause 105

Successor Rules - Acquisition from Tax-Exempt

ITA
66.6

Subsections 66.6(1) and (2) of the Act provide special exceptions to the resource property successor rules in subsection 29(25) of the *Income Tax Application Rules* (ITAR) and section 66.7 of the Act. The exceptions apply where a corporation has, after July 19, 1985, acquired all or substantially all of the Canadian resource properties of a tax-exempt person. This amendment simplifies and consolidates both subsections. Under amended section 66.6, a corporation that acquires all or substantially all of a tax-exempt's Canadian resources will not be subject to ITAR subsection 29(25) or subsections 66.7(1) to (5) of the Act in respect of that acquisition. The amendment applies to acquisitions that take place after April 26, 1995 other than acquisitions occurring before 1996 that were required by a written agreement made before April 27, 1995.

Clause 106

Exploration and Development Expenses - Successor Rules

ITA
66.7

Section 66.7 of the Act includes what are commonly known as the "successor rules" with respect to resource properties and expenditures. Under subsection 66.7(10) of the Act, certain of these rules apply in modified form to a corporation that has undergone an acquisition of control or has ceased to be exempt from tax under Part I of the Act on its taxable income.

Subclauses 106(1) to (5)

ITA
66.7(1) to (5)

Subsections 66.7(1) to (5) of the Act allow a corporation to claim deductions with respect to Canadian exploration and development expenses, foreign exploration and development expenses, Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses incurred by one or more other taxpayers, where property has been acquired by the corporation in circumstances to which the successor rules apply.

Paragraphs 66.7(1)(*b*), (2)(*b*), (3)(*b*), (4)(*b*) and (5)(*b*) of the Act are amended to eliminate the reference in the paragraphs to subsection 80(17) of the Act, strictly as a consequence of the repeal of that subsection.

These amendments apply to taxation years that end after February 21, 1994.

Subclause 106(6)

ITA
66.7(10)(*b*)

Paragraph 66.7(10)(*b*) of the Act is amended so that it will not apply to corporations that cease to be taxable after April 26, 1995. This change forms part of a set of amendments to the tax treatment of corporations that become or cease to be taxable. More details are provided in the notes to amended subsection 149(10) of the Act.

Subclause 106(7)

ITA
66.7(10)(*c*.1)

New paragraph 66.7(10)(*c*.1) of the Act applies where a corporation no longer owns any foreign resource property at the time of the acquisition of its control or its change in tax-exempt status. In these circumstances, the corporation is deemed to own a foreign resource property immediately before the acquisition of control or change in tax-exempt status. As a consequence, because of paragraph 66.7(10)(*c*) and subsection 66.7(2) of the Act, "streamed income" from Canadian resource properties owned immediately before the acquisition of control or change in tax-exempt status can be used so that up to 10 per cent of the undeducted balance of foreign exploration expenses can be claimed by the corporation under subsection 66.7(2) of the Act.

This amendment applies to taxation years that end after February 17, 1987.

Clause 107

Inadequate Consideration

ITA
69

Section 69 of the Act provides a series of rules dealing primarily with transactions entered into between non-arm's length persons or on non-arm's length terms.

Subclause 107(1)

ITA
69(2) and (3)

Subsections 69(2) and (3) of the Act are, respectively, designed to prevent the overstatement of deductions and the understatement of revenues in computing the income of a taxpayer as a result of the misstatement of the prices charged (commonly known as "transfer prices") in transactions with a non-resident person with whom the taxpayer does not deal at arm's length. This is accomplished by re-stating the transfer prices for tax purposes so that they reflect the prices that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length.

Subsections 69(2) and (3) are repealed effective for taxation years that begin after 1997, as a consequence of the introduction of proposed new subsection 247(2) of the Act.

Subclauses 107(2) and (3)

ITA
69(5)

Subsection 69(5) of the Act sets out rules to ensure that, where property is appropriated by a shareholder on the winding-up of a corporation, the property is to be treated as having been transferred at its fair market value with the consequent recognition of any resulting income or loss on the transfer. The amendment to paragraph 69(5)(*a*) of the Act, which applies to windings-up that begin after 1995,

deletes the reference to paragraph 40(2)(*e*) of the Act and is strictly consequential on the repeal of that provision. The amendment replacing paragraphs 69(5)(*d*) and (*e*) of the Act with a new paragraph (*d*), which applies subject to a transitional provision to windings-up that begin after April 26, 1995, deletes the references to paragraph 40(2)(*e*) and to subsections 85(4) and (5.1) of the Act, which are also being repealed. It also adds references to new subsections 13(21.2), 14(12), 18(13), 40(3.4) and 40(3.6) of the Act to ensure that those provisions do not apply with respect to windings-up dealt with under subsection 69(5).

Subclauses 107(4) and (5)

ITA
69(11) and (13)

Subsection 69(11) of the Act is an anti-avoidance rule that is intended to prevent a vendor from disposing of property on a tax-deferred basis as part of a series of transactions one of the main purposes of which is to obtain the benefit of tax deductions or other entitlements available to a specified person (as defined in subsection 69(12) of the Act) in respect of a subsequent disposition of the property within 3 years of the original disposition. Where it applies, subsection 69(11) denies the benefit of the rollover on the original disposition by deeming the vendor's proceeds of disposition to be equal to the fair market value of the property disposed of.

Subsection 69(11) of the Act is amended to ensure that it does not apply to a taxpayer for certain deductions in respect of the lifetime capital gains exemption for qualified small business corporation shares. New paragraph 69(11)(a) of the Act provides that a tax deduction does not include a deduction under subsection 110.6(2.1) of the Act where the deduction is in respect of a capital gain arising from the disposition of a share acquired by the taxpayer as a result of an acquisition under subsection 85(3) or 98(3) of the Act.

In the following example, assume all of the steps are done as part of the series of transactions which include a tax-deferred rollover of business assets and the purpose of the series of transactions is to access the capital gains exemption. A (an individual) owns an interest in a Canadian partnership, (ABC). All of ABC's assets are used in carrying on an active business in Canada. ABC incorporates

a new taxable Canadian corporation (Newco) and transfers on a tax-deferred basis all of its assets to Newco in accordance with subsection 85(2) of the Act. ABC is wound up in accordance with subsection 85(3) of the Act. On the wind-up of ABC, A receives shares of Newco. A's shares of Newco are "qualified small business corporations shares" within the meaning of the definition of such shares in subsection 110.6(1) of the Act. A sells the shares of Newco to an arm's length purchaser for fair market value. A deducts an amount in respect of the lifetime capital gains exemption under subsection 110.6(2.1) of the Act in respect of the capital gain realized on the disposition of the Newco shares. New subsection 69(11) ensures that it does not apply to ABC so as to treat ABC as having disposed of its assets to Newco for fair market value proceeds rather than on a tax-deferred basis.

Subsection 69(11) is further amended. New paragraph 69(11)(*b*) of the Act denies the rollover on the original disposition where one of the main purposes of the series of transactions is to use the tax-exempt status of any person to shelter from tax under Part 1 any income arising on a subsequent disposition of the property.

As well, new subsection 69(11) replaces the 3-year limitation for the subsequent disposition of the property with a provision, which permits the subsection to apply if the subsequent disposition or an arrangement for the subsequent disposition is made within the 3-year period.

Subsection 69(11) is also amended to delete the reference to specified person and to use instead the concept of affiliated person introduced in new section 251.1 of the Act. (See the commentary to new section 251.1 for further information.) As amended, subsection 69(11) will not apply where, on a transfer of property, any tax deductions or entitlements that may apply on a subsequent disposition of the property are those available to a person that would be affiliated with the vendor of the property if the affiliation test set out in new section 251.1 were read without reference to the extended definition of "controlled" in subsection 251.1(3) of the Act.

As a consequence of this last amendment to subsection 69(11), subsection 69(12) of the Act - which defined the term "specified person" - is being repealed and subsection 69(13) renumbered to take the place of subsection 69(12). New subsection 69(12) allows the

Minister of National Revenue to assess or reassess at any time the tax, interest and penalties, if any, payable as a consequence of the application of subsection 69(11) where arrangements to sell the property have been made within 3 years of the original disposition.

Subject to a special grandfathering provision, these amendments apply to a disposition that is part of a series of transactions that begin after April 26, 1995.

New Taxpayer

ITA
69(14)

The addition of new subsection 69(14) follows from amended subsection 69(11)'s use of the affiliated person concept. This new subsection prevents inappropriate effects where, because a taxpayer came into existence as part of the series of transactions described in subsection 69(11), the taxpayer might not be considered to meet the affiliation test immediately before the series began.

For example, the taxpayer described in subsection 69(11) may be a corporation that is formed on an amalgamation as part of the series of transactions. Although new subsection 251.1(2) will ordinarily treat the taxpayer as being affiliated with the predecessor corporations, it will not clearly treat the taxpayer as having been affiliated with any other corporation with which it is affiliated after it is formed. Subsection 69(11) may thus apply, even though the taxpayer has transferred the property in question to a person with whom it was affiliated when it came into being.

New subsection 69(14) treats a taxpayer that comes into existence during the subsection 69(11) series of transactions or events as having existed immediately before the series, and as having been affiliated with every person with whom it is affiliated (otherwise than because of a right referred to in paragraph 251(5)(*b*)) when it comes into existence.

This new provision applies on the same basis as the amendments to subsection 69(11) described above.

Clause 108

Death of a Taxpayer

ITA
70

Section 70 of the Act provides certain rules that apply on the death of an individual.

Subclause 108(1)

ITA
70(3)

Subsection 70(3) of the Act deals with "rights or things" transferred to certain beneficiaries of a deceased individual within a specified time.

An amendment was made to paragraph 70(3)(*b*) in the Fifth Supplement of the Revised Statutes of Canada, 1985 to make the paragraph gender neutral. The pronouns "his" and "he", which originally referred to a beneficiary or other such persons, were erroneously replaced with the word "taxpayer" in the English version of the Act. This amendment replaces the word "taxpayer" with the correct term: "beneficiary or person".

This amendment applies to taxation years that end after November 1991, as these are the taxation years to which the amendment made in the Fifth Supplement of the Revised Statutes of Canada, 1985 applies.

Subclause 108(2)

ITA
70(10)
"share of the capital stock of a family farm corporation"

Subsection 70(10) of the Act contains definitions that are relevant for the purposes of the spousal and intergenerational rollover provisions in sections 70 and 73 of the Act. The existing definition "share of the capital stock of a family farm corporation" requires that the

corporation's farm property be used by certain persons principally in the course of carrying on the business of farming in Canada in which the owner of the share or a parent, spouse or child of the owner is actively engaged in regular and continuous basis. Subparagraph (*a*)(i) of that definition indicates that those persons include, among others, the owner of the share, the corporation and any other corporation a share of the capital stock of which was a share of the capital stock of a family farm corporation of that owner.

The definition is being amended to add new subparagraph (*a*)(i.1). New subparagraph (*a*)(i.1), which applies to the 1994 and subsequent taxation years, allows the property to be used by a corporation controlled by a corporation referred to in subparagraph (*a*)(i). This allows the property used in the qualifying farm business of one corporation to be held by that corporation or by a controlled subsidiary of that corporation.

Clause 109

Seizure of Debtor's Property

ITA
79(1) "creditor"

Subsection 79(1) of the Act defines a number of words for the application of the rules applicable to situations where a creditor seizes the property of a debtor. The amendment to the French version of the definition "creditor" corrects a discrepancy between the two versions of that definition the purpose of which is not to narrow the common meaning of the word "creditor" but rather to enlarge it. Therefore, the word "comprend" is added to the French version of that definition. The coming-into-force of the amendment is similar to the one that applies to the introduction of this definition.

Clause 110

Claim for Debts

ITA
79.1(8)

Subsection 79.1(8) of the Act prohibits any deduction by a creditor in respect of the principal amount of a debtor's debt on account of bad or doubtful debts where property was acquired by the creditor in respect of the debt. Subsection 79.1(8) is amended as a consequence of the introduction of new paragraph 20(1)(*l*) of the Act to refer to uncollectible debts and impaired debts. New subsection 79.1(8) applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(*l*) apply to those years.

Clause 111

Debt Forgiveness

ITA
80

Section 80 of the Act sets out the existing rules that apply where an obligation of a debtor to pay an amount is settled or extinguished for less than its principal amount and the amount for which it was issued.

Subclause 111(1)

ITA
80(1)
"unrecognized loss"

The amount of a debtor's "unrecognized loss", as defined in subsection 80(1) of the Act, can be used to offset the amount otherwise included under subsection 80(13) of the Act in computing the debtor's income. Subject to exceptions where there has been an acquisition of control, a debtor's "unrecognized loss" is equal to total capital losses from the disposition of property that are denied under subparagraph 40(2)(*g*)(ii) of the Act.

The definition "unrecognized loss" in subsection 80(1) is amended to clarify that a debtor's "unrecognized loss" is determined with reference to dispositions by the debtor of property.

This amendment applies to taxation years that end after February 21, 1994.

Subclause 111(2)

ITA
80(2)(*g*) and (*g*.1)

Subsection 80(2) of the Act provides a number of rules that apply for the purpose of the debt forgiveness rules in section 80 of the Act. Paragraph 80(2)(*g*) of the Act provides that the amount paid in satisfaction of a debt issued by a corporation and payable to a person is, where any part of the consideration for the settlement of the debt is a share issued by the corporation (other than an excluded security), considered to equal the fair market value of the share plus any increase in the fair market value of other shares owned by the person that results from the settlement of the debt. A corporate debtor is also considered to have paid an amount in satisfaction of a debt where the debtor does not issue any share, to the extent that an increase in the fair market value of shares of the capital stock of the debtor that are owned by the creditor results from the settlement of the debt.

Subsection 80(2) is amended, applicable to taxation years that end after February 21, 1994, so that existing paragraph 80(2)(*g*) is split into two rules. Under amended paragraph 80(2)(*g*), a corporate debtor is considered to have paid an amount in satisfaction of a debt equal to the fair market value of a share, where that share is issued by the debtor as consideration for the settlement of the debt. Under new paragraph 80(2)(*g*.1) of the Act, a corporate debtor is considered to have paid an amount equal to the increase in value of shares of the capital stock of the debtor that are owned by the creditor (other than those shares issued as consideration for the settlement of the debt) to the extent that the increase in value is as a consequence of the settlement of the debt. The main difference between existing paragraph 80(2)(*g*) and new paragraphs 80(2)(*g*) and (*g*.1) is that the new paragraphs do not limit the amount that is considered to have

been paid in satisfaction of a debt because of any non-share consideration that is given by a debtor.

Subclause 111(3)

ITA
80(13)B(*b*)

Where a commercial obligation issued by a debtor is settled, 75 per cent (or, where the debtor is a partnership, 100 per cent) of the debtor's unapplied forgiven amount after the application of subsections 80(3) to (12) of the Act is added in computing the debtor's income. However, the net amount included in computing the debtor's income under subsection 80(13) of the Act is subject to a number of adjustments specified in subsection 80(13).

One of these adjustments in respect of a settlement is the addition of the amount determined for B in subsection 80(13). B is currently defined as the lesser of two amounts. The first amount is the total designated under subsection 80(11) in respect of the settlement. The second amount is the total of:

- the "residual balance" (as determined under subsection 80(14) of the Act) in respect of the settlement, and

- the amount, if any, by which the amount determined for C (i.e., specified amounts transferred to a related person under section 80.04 of the Act) exceeds the amount determined for A (i.e. unapplied forgiven amount after the application of subsections 80(3) to (12)).

As a consequence of the amended definition of "residual balance" in amended subsection 80(14), a transfer under new section 80.04 in respect of a settlement of debt will no longer give rise to a lower residual balance as of the time of settlement. Accordingly, the second amount referred to above in respect of a settlement is now simply described as equal to the residual balance as of the time of the settlement.

This amendment applies to taxation years that end after February 21, 1994.

Subclause 111(4)

ITA
80(14) and (14.1)

Subsection 80(14) of the Act defines the expression "residual balance". In general terms, a debtor's "residual balance" is equal to the total of income tax attributes (other than those described in subsection 80(11) of the Act) of certain corporations and partnerships related to the debtor (which are referred to as "directed persons") remaining after the settlement of a commercial obligation issued by the debtor, taking into account the application of section 80.04 of the Act in respect of that settlement. The expression "directed person" is defined in subsection 80(1) of the Act.

Subsection 80(14) is amended, in conjunction with the introduction of subsection 80(14.1) of the Act, to provide a simpler manner of determining a debtor's "residual balance", which produces essentially the same results. In cases where only one commercial obligation issued by a debtor is settled in a taxation year, a debtor's "residual balance" is now equal to the total income tax attributes (other than those described in subsection 80(11)) of the debtor's directed persons remaining before taking into account the application of section 80.04 in respect of a settlement of a commercial obligation issued by the debtor MINUS the portion of the forgiven amount in respect of the obligation that represents the amount determined for A in subsection 80(13) of the Act in respect of the settlement. The total income tax attributes referred to above are now defined as "gross tax attributes" in new subsection 80(14.1), as described in greater detail below. A further simplification in describing the "residual balance" is achieved by referring in all relevant cases to the amounts determined for A, B and C in subsection 80(13) rather than any resulting income inclusions, which avoids the need for adjustments to take into account the 75-per-cent inclusion rate under subsection 80(13) for debtors (other than partnerships).

Under new subsection 80(14.1), the "gross tax attributes" of directed persons is equal to the maximum total forgiven amount that could be applied under subsections 80(3) to (10) and (12) in respect of the settlement of notional commercial obligations that are deemed to have been issued by each of those directed persons. "Gross tax attributes" are calculated at any time in a debtor's taxation year on the

assumption that the notional obligations referred to above had been settled at that time and that the forgiven amount in respect of each of those settlements is equal to the total forgiven amounts determined at and before the time and in the year. Apart from the fact that tax attributes of directed persons at the time of the settlement of debt issued by the debtor are determined in respect of the debtor before taking into account agreements under section 80.04 in respect of that settlement, new subsection 80(14.1) corresponds very closely to existing paragraph 80(14)(a) of the Act.

More specifically, the "residual balance" under subsection 80(14) at any time in a taxation year in respect of a commercial obligation issued by a debtor is computed as follows:

- ADD, under paragraph 80(14)(*a*), the "gross tax attributes" of directed persons at that time in respect of the debtor;

- SUBTRACT, under paragraph 80(14)(*b*) of the Act, the amount determined for A in subsection 80(13) in respect of the settlement; and

- Where there has been a previous settlement in the same year of a commercial obligation issued by the debtor, SUBTRACT under paragraphs 80(14)(*c*) and (*d*) all amounts each of which is:

  - the amount, if any, by which the amount determined for A in subsection 80(13) in respect of another such settlement exceeds the amount determined for C in respect of that settlement,

  - the amount determined for A in subsection 80(13) for a directed person of the debtor, to the extent that it arises because of an agreement under section 80.04 in respect of another such settlement, or

  - the amount specified in an agreement under section 80.04 in respect of another such settlement, where the agreement is not with a directed person of the debtor, and

  - with respect to another such settlement, the least of

    (i) the total of all amounts designated under subsection 80(11) in respect of that settlement,

(ii) the residual balance at the time of that settlement, and

*(iii) the amount, if any, by which the sum of the amounts determined for A and B in subsection 80(13) in respect of that settlement exceeds the amount determined for C in respect of that settlement.

New paragraph 80(14)(*c*) is, in substance, almost identical to existing paragraphs 80(14)(*d*) and (*e*). New paragraph 80(14)(*d*) is, in substance, almost identical to existing paragraph 80(14)(*f*). The only significant difference is the addition of clause 80(14)(*d*)(iii), which is denoted by the asterisk above and illustrated in example 5, below.

These amendments apply to taxation years that end after February 21, 1994.

The following examples illustrate the operation of these amendments. Except for example 5, the same end results are achieved under the existing and new provisions.

EXAMPLE 1

Debtco issued a commercial obligation to a bank for $150,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $120,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $70,000. The full $150,000 of debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $20,000 and designates $80,000 under subsection 80(11) as a reduction in the ACB of the Opco shares. Opco uses the $20,000 to reduce its UCC from $70,000 to $50,000.

Results:

1. The residual balance at the time of the settlement is nil, determined as follows:

- *Add $70,000, which is the $70,000 UCC, and*

- *Subtract $70,000 under paragraph 80(14)(b), which is the amount determined for A in subsection 80(13) ($150,000 - $80,000)*

2. As a consequence, the amount included under subsection 80(13) in computing Debtco's income is equal to $37,500, determined as follows:

- *Add $70,000 under the description of A in subsection 80(13), which is the remaining unapplied forgiven amount ($150,000 - 80,000),*

- *Add nil under the description of B in subsection 80(13), as the residual balance is nil,*

- *Subtract the $20,000 specified amount under the description of C in subsection 80(13), and*

- *Multiply the remainder ($50,000) by 3/4.*

EXAMPLE 2

Same as example 1, except that the amount designated under subsection 80(11) is $100,000 rather than $80,000.

Results:

1. The residual balance at the time of the settlement is $20,000, determined as follows:

- *Add $70,000, which is the $70,000 UCC, and*

- *Subtract $50,000 under paragraph 80(14)(b), which is the amount determined for A in subsection 80(13) ($150,000 - $100,000).*

2. As a consequence, the amount included under subsection 80(13) in computing Debtco's income is equal to $37,500, determined as follows:

- *Add $50,000 under the description of A in subsection 80(13), which is the remaining unapplied forgiven amount ($150,000 - 100,000),*
- *Add the $20,000 residual balance under the description of B in subsection 80(13),*
- *Subtract the $20,000 specified amount under the description of C in subsection 80(13), and*
- *Multiply the remainder ($50,000) by 3/4.*

EXAMPLE 3

Debtco issued two commercial obligations to a bank for $90,000 and $60,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $120,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $70,000. The $90,000 debt is fully forgiven. Subsequently, in the same taxation year, the $60,000 debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $20,000 with respect to the first settlement. In addition, an amount of $20,000 is designated under subsection 80(11) with respect to the first settlement. Subsequently, an amount of $60,000 is designated under subsection 80(11) with respect to the second settlement. (Note: this example is, in substance, the same as example 1.)

Results:

1. As in example 1, the residual balance at the time of the first settlement is nil. This is computed as follows:

- *Add $70,000, which is the $70,000 UCC, and*
- *Subtract $70,000 under paragraph 80(14)(b), which is the amount determined for A in subsection 80(13) ($90,000 - $20,000).*

2. The residual balance at the time of the second settlement is also nil, computed as follows:

- *Add $50,000, which is the $70,000 UCC minus the $20,000 amount specified in an agreement under section 80.04 before that time, and*

- *Subtract $50,000 under subparagraph 80(14)(c)(i), which is the amount determined for A in subsection 80(13) in respect of the settlement before that time ($90,000-$20,000) that exceeds the amount determined for C in that subsection in respect of that settlement ($20,000).*

3. Given the residual balance in each case is equal to nil, the income inclusion under subsection 80(13) is equal to $37,500 with respect to the first settlement (3/4 x ($90,000 - $20,000 - $20,000)) and $0 with respect to the second settlement. This is consistent with example 1. In the event that a higher total amount is designated under subsection 80(11), the results will be consistent with example 2.

EXAMPLE 4

Debtco issued a commercial obligation to a bank for $200,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $220,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $120,000. The full $200,000 of debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $30,000 and designates $200,000 under subsection 80(11) as a reduction in the ACB of the Opco shares. Opco does not use the $30,000 to reduce its UCC.

Results:

1. The residual balance at the time of the settlement is $120,000, which is the $120,000 UCC. No amount is subtracted under paragraph 80(14)(b) because the remaining unapplied amount under the description of A in subsection 80(13) is nil ($200,000-$200,000).

2. As a consequence, the amount included under subsection 80(13) in computing Debtco's income is equal to $67,500, determined as follows:

- *Add nil under the description of A in subsection 80(13), which is the remaining unapplied forgiven amount ($200,000-$200,000),*
- *Add $120,000 under the description of B in subsection 80(13), as it is the lesser of the amount designated under subsection 80(11) ($200,000) and the residual balance ($120,000),*
- *Subtract the $30,000 specified amount under the description of C in subsection 80(13), and*
- *Multiply the remainder ($90,000) by 3/4.*

EXAMPLE 5

Debtco issued two commercial obligations to a bank for $90,000 and $110,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $220,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $120,000. The $90,000 debt is fully forgiven. Subsequently, in the same taxation year, the $110,000 debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $30,000 with respect to the first settlement. Opco does not use the $30,000 to reduce UCC. In addition, an amount of $90,000 is designated under subsection 80(11) with respect to the first settlement. Subsequently, an amount of $110,000 is designated under subsection 80(11) with respect to the second settlement. Note: this example is, in substance, the same as example 4.

1. As in example 4, the residual balance at the time of the settlement is $120,000, which is the $120,000 UCC. No amount is subtracted under paragraph 80(14)(b) because the remaining unapplied amount under the description of A in subsection 80(13) is nil ($90,000-$90,000).

2. The residual balance at the time of the second settlement is $30,000, computed as follows:

- *Add $120,000, which is the $120,000 UCC (the $30,000 amount specified in the agreement under section 80.04 in respect of the first settlement is not relevant under subsection 80(14.1) because Subco did not use it to reduce the UCC),*

- *Subtract $30,000 under subparagraph 80(14)(c)(ii), which is the amount determined for A in subsection 80(13) for Subco because of the agreement made under section 80.04 in respect of the first settlement, and*

- *Subtract $60,000 under paragraph 80(14)(d)(iii), which is the least of the amount designated under subsection 80(11) in respect of the first settlement ($90,000), the residual balance at the time of the first settlement ($120,000) and the sum of the amounts determined for A and B in subsection 80(13) in respect of the first settlement minus the amount determined for C in respect of first settlement ($0 + $90,000 - $30,000 = $60,000).*

3. The income inclusion under subsection 80(13) is equal to $45,000 with respect to the first settlement (3/4 x ($0 + $90,000 - $30,000)) and $22,500 with respect to the second settlement (3/4 x ($0 + $30,000 - $0)). This is consistent with example 4.

Subclause 111(5)

ITA
80(17)

Subsection 80(17) of the Act applies in certain cases where a deduction is claimed under section 61.3 of the Act in computing the income of a corporation. Subsection 80(17) is designed to provide a corporation which claims a deduction under section 61.3 with an incentive to enter into agreements under section 80.04 of the Act with related corporations and partnerships in order to have the tax attributes of those corporations or partnerships reduced.

In order to reduce the complexity associated with the debt forgiveness rules, subsection 80(17) is being repealed.

This amendment applies to taxation years that end after February 21, 1994.

Clause 112

Definitions

ITA
80.03

Section 80.03 sets out rules that are designed to preserve the effectiveness of the debt forgiveness rules under section 80 of the Act, in the event that section 80 has resulted in a reduction of the adjusted cost base of a share, partnership interest or trust interest.

Subclause 112(1)

ITA
80.03(1)

Subsection 80.03(1) of the Act defines a number of expressions used in the section.

Subsection 80.03(1) is amended to eliminate the definition of "taxable dividend" for the purposes of section 80.03 of the Act. This amendment is strictly consequential on the repeal of subsection 80.03(4) of the Act, described below.

This amendment applies to taxation years that end after February 21, 1994.

Subclause 112(2)

ITA
80.03(4) to (6)

Subsections 80.03(4) to (6) of the Act apply where a corporation disposes of capital property that is a share or a partnership or trust interest. In certain cases, tax consequences arise for the corporation based on adjustments to the adjusted cost base to the corporation arising because of section 80 and dividends received by the corporation.

In order to reduce the complexity associated with the debt forgiveness rules, subsections 80.03(4) to (6) are being repealed. It is noted, however, that the general anti-avoidance rule in section 245 may apply to some of the cases where subsection 80.03(4) was applicable.

These amendments apply to taxation years that end after February 21, 1994.

Subclauses 112(3) and (4)

ITA
80.03(7)

Subsection 80.03(7) of the Act allows a person to treat a capital gain that would otherwise arise under subsection 80.03(2) or (4) of the Act as a forgiven amount for the purposes of section 80 of the Act, to the extent that the person so designates. The designation is made in a prescribed form filed with a person's income tax return for the taxation year that includes the time of the disposition that gave rise to the application of subsection 80.03(2) or (4).

Subsection 80.03(7) is amended to eliminate the references to subsection 80.03(4). This amendment is strictly consequential on the repeal of subsection 80.03(4).

This amendment applies to taxation years that end after February 21, 1994.

Clause 113

Agreement - Settlement of Debt

ITA
80.04

Section 80.04 of the Act provides rules that allow a debtor to enter into an agreement with an eligible transferee in order for the debtor to minimize the tax consequences to the debtor under section 80 of the Act from the settlement of a debt issued by the debtor.

Subclauses 113(1) and (2)

ITA
80.04(5) and (5.1)

Subsection 80.04(5) of the Act contemplates that property may be acquired by an eligible transferee from the debtor as consideration for such an agreement. Under that subsection, neither the eligible transferee nor the debtor is required to add any amount or benefit in computing income only because of the acquisition of the property or because of the entering into the agreement under section 80.04 of the Act.

Paragraph 80.04(5)(*d*) of the Act is replaced by new subsection 80.04(5.1) of the Act. New subsection 80.04(5.1) provides that, for the purpose of Part I of the Act, a benefit is not considered to have been conferred on a debtor as a consequence of an agreement under section 80.04 between the debtor and an eligible transferee. Unlike paragraph 80.04(5)(*d*), the new subsection applies whether or not property is acquired by an eligible transferee as consideration for entering into an agreement filed under section 80.04.

This amendment applies to taxation years that end after February 21, 1994.

Subclause 113(3)

ITA
80.04(10)

Section 80.04 of the Act provides rules that allow a debtor to enter into an agreement with an eligible transferee in order for the debtor to minimize the tax consequences to the debtor under section 80 of the Act from the settlement of a debt issued by the debtor. Subsection 80.04(10) of the Act provides that a debtor is liable to pay all or part of its eligible transferee's taxes, interest and penalties for taxation years ending in the 10 calendar years ending after the settlement of the debt, that is subject of an agreement under section 80.04.

Paragraph 80.04(10)(*a*) of the Act is amended to provide that the debtor is liable only for taxation years ending in the 4 calendar years ending after the settlement of the debt.

This amendment applies to taxation years that end after February 21, 1994.

Clause 114

Dividends from Canadian Corporations

ITA
82(1)

Subsection 82(1) of the Act provides that taxable dividends received by a taxpayer from a corporation resident in Canada are included in computing the taxpayer's income. It also generally provides an extra 1/4 gross-up of the amount of such dividends from taxable Canadian corporations, which is added in computing the income of an individual. Section 121 of the Act provides a dividend tax credit equal to 2/3 of the amount an individual is required to include in income as a gross-up. For this purpose, an individual includes a trust (other than a trust that is a registered charity).

Subsection 82(1) is amended to provide that the gross-up for a taxation year does not apply to taxable dividends received by a trust

in the year from a taxable Canadian corporation, to the extent that such dividends are included in computing the income of a non-resident beneficiary under the trust. As a consequence, the calculation of the trust's dividend tax credit will not be affected by whether or not the trust designates amounts under subsection 104(19) of the Act in respect of non-resident beneficiaries.

The rationale for this amendment is that the dividend tax credit is aimed at Canadian residents, whose income tax rates under Part I are generally higher than the withholding rates for non-residents under Part XIII. The purpose of this amendment is to prevent trusts with non-resident beneficiaries from obtaining access to the dividend tax credit in connection with income allocated to those beneficiaries that has not been flowed-out to those beneficiaries under subsection 104(19).

This amendment applies to taxation years that end after April 26, 1995.

Clause 115

Non-arm's Length Sales of Shares

ITA
84.1

Subclauses 115(1) to (3)

ITA
84.1(2)

Subsection 84.1(2) of the Act provides, amongst other things, rules for determining a taxpayer's adjusted cost base of shares for the purposes of subsection 84.1(1) of the Act. Subsection 84.1(2) of the Act is restructured.

Subclauses 115(4)

Rules for para. 84.1(2)(*a*.1)

ITA
84.1(2.01)

Paragraph 84.1(2)(*a*.2) of the Act is repealed and is included in new subsection 84.1(2.01) of the Act.

New paragraph 84(2.01)(*b*) of the Act treats a share as having been acquired by a taxpayer in a non-arm's length transaction for the purposes of paragraph 84.1(2)(*a*.1) of the Act where the taxpayer has elected under subsection 110.6(19) of the Act to recognize all or part of the gain accrued to February 22, 1994 on the share. This amendment, which applies to the 1994 and subsequent taxation years, ensures that an election under subsection 110.6(19) in respect of a share will not increase the holder's adjusted cost base of the share for the purposes of section 84.1.

New paragraph 84.1(2.01)(*c*) of the Act provides that for the purpose of paragraph 84.1(2)(*a*.1) where, at any time after 1971, a share owned by a particular person has, as a result of one or more transactions between other persons not dealing at arm's length, become vested in one of those other persons, the particular person and the other person will be treated, at any time, as not dealing at arm's length with each other. This is so regardless of the fact that the person and the other person may have never coexisted. New paragraph 84.1(2.01)(*c*) of the Act is clarifying and ensures, amongst other things, that the test for non-arm's length status is continuous running from generation to generation with that continuity being severed only upon an arm's length disposition. New paragraph 84.1(2.01)(*c*) applies in respect of the determination of the adjusted cost base of a share after the June 20, 1996.

EXAMPLE

Assume Ms. A was born in 1980 and that Ms. A is the daughter of Mr. A. Mr. A 's mother (Mrs. A) died in 1979. On her death, Mr. A acquired her shares of MCo which were owned by Mrs. A at the end of 1971. In 1994, Mr. A disposes of his MCo shares to Ms. A. In July 1996, Ms. A transfers the MCo shares to her

holding company. For the purpose of determining the adjusted cost base of the shares of MCo to Ms. A, Ms. A and the late Mrs. A are treated as dealing at non-arm's length. Therefore, the adjusted cost base of the MCo shares will be reduced by the amount, if any, of the excess of the V-Day value of the shares over the cost of the shares to the late Mrs. A on January 1, 1972.

Subclauses 115(5)

Rules for para. 84.1(2)(*b*)

ITA
84.1(2.2)

Paragraphs 84.1(2)(*c*) and (*e*) of the Act are repealed and included in new subsections 84.1(2.2) of the Act.

Clause 116

Transfer of Property to Corporation by Shareholder

ITA
85

Section 85 of the Act applies to transfers on a tax-deferred basis of certain properties by a taxpayer to a taxable Canadian corporation in exchange for shares.

Subclause 116(1)

Transfer of Property to Corporation from Partnership

ITA
85(2)

Subsection 85(2) of the Act provides that the rules in subsection 85(1) of the Act will apply to and allow a partnership to transfer certain properties to a taxable Canadian corporation on a tax-deferred basis in exchange for shares of the corporation. The amendment changes the scope of subsection 85(2) to make it more

closely parallel the scope of subsection 85(1.1) of the Act. A property that is inventory and an interest in real property or an option in respect of real property is excluded from subsection 85(2), as is a mark-to-market property held by a financial institution. However, a specified debt obligation held by a financial institution is expressly included.

The amendment applies to dispositions that occur after June 20, 1996.

Subclauses 116(2) to (5)

ITA
85(4) to (5.1)

Subsection 85(4) of the Act applies where a taxpayer disposes of capital property or eligible capital property to a corporation that is controlled by the taxpayer, the taxpayer's spouse or a person or group of persons by whom the taxpayer is controlled. Although, as discussed below, this subsection is to be repealed with effect after April 26, 1995, an amendment is being made to correct its application for the period between June 1988 and April 26, 1995.

Specifically, paragraph 85(4)(*b*) of the Act provides that, where the transferor of property owns shares of the transferee, any capital loss or deduction under paragraph 24(1)(*a*) of the Act that is denied because of subsection 85(4) is to instead be added to the transferor's adjusted cost base of those shares. Paragraph 85(4)(*b*) currently provides that addition is to equal the difference between the cost amount of the property and the eligible capital amount resulting from its sale. However, the cost amount of eligible capital property represents its full cost rather than only the 75 per cent thereof that is added to a taxpayer's cumulative eligible capital, whereas the eligible capital amount arising on the disposition of eligible capital property takes into account only 75 per cent of the proceeds therefrom. This amendment corrects paragraph 85(4)(*b*) by providing that any cost base addition arising in respect of a transfer of eligible capital property is to be limited to the difference between its cost amount to the transferor and 4/3 of the resulting addition to the transferor's eligible capital amount.

The repeal of subsection 85(4) reflects the addition of new subsection 14(12) of the Act, which applies with respect to transfers

of eligible capital property, and of new subsections 40(3.4) and (3.6) of the Act, which apply to transfers of non-depreciable capital property. Subsection 85(5.1) of the Act, which applied to transfers of depreciable capital property, is also repealed, its replacement being found in new subsection 13(21.2) of the Act. A consequential amendment to subsection 85(5) of the Act deletes the reference to subsection 85(5.1).

The repeal of subsections 85(4) and (5.1), and the amendment to subsection 85(5), apply to dispositions that take place after April 26, 1995, subject to certain exceptions. These are found in clause 247 of this bill, and generally exclude transactions in progress before April 27, 1995. Readers should refer to the notes to clause 247 for more detail.

Clause 117

Amalgamations

ITA
87

Section 87 of the Act sets out rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation.

Subclause 117(1)

Superficial Losses

ITA
87(2)(*g*.3) and (*g*.4)

In general terms, new subsections 13(21.2), 14(12) and 40(3.4), along with amendments to section 18 of the Act, apply where property is transferred to a person with whom the transferor is affiliated (the concept of affiliated persons is introduced in new section 251.1 of the Act), and the tax cost of the property to the transferor exceeds its value at the time of its transfer. Where these conditions exist, any loss that would otherwise arise on the disposition is denied, but can

be subsequently recognized when, for example, the transferred property is sold to a person that is not affiliated with the transferor.

New paragraph 87(2)(*g*.3) of the Act treats a new corporation formed on an amalgamation as a continuation of each of its predecessors for the purpose of applying these subsections to property disposed of before the amalgamation took place. Thus a new corporation created on an amalgamation would, for example:

- be entitled under subsection 13(21.2) to make annual capital cost allowance claims (or to claim a terminal loss) in respect of a loss denied to a predecessor on the transfer of depreciable property;

- be considered under subsection 14(12) to own eligible capital property in respect of a business that was carried on by a predecessor; and,

- with respect to each of subsections 13(21.2), 14(12), 18(15) and 40(3.4), be permitted to recognize any loss of a predecessor that was denied under those provisions where control of the new corporation is acquired.

New paragraph 87(2)(*g*.4) of the Act provides that for the purposes of the deemed share ownership rule in new paragraph 40(3.6)(*c*) of the Act, the new corporation formed on an amalgamation is treated as the same as, and a continuation of, each predecessor corporation. For more information, readers should refer to the notes to new subsection 40(3.6).

These amendments apply to amalgamations that occur after April 26, 1995. Under paragraph 88(1)(*e*.2) of the Act, they will also apply to windings-up under subsection 88(1) of the Act that begin after that date.

Subclause 117(2)

Prepaid Expenses and Matchable Expenditures

ITA
87(2)(*j*.2)

Paragraph 87(2)(*j*.2) of the Act provides that a corporation formed as a result of an amalgamation is considered to be a continuation of its predecessor corporations for the purposes of subsection 18(9) (prepaid expenses), subsection 18(9.01) (premium paid under group life insurance policies) and paragraph 20(1)(*mm*) (cost of injected substance used to recover petroleum, natural gas or related hydrocarbons) of the Act. Paragraph 87(1)(*j*.2) is amended, effective November 18, 1996, so that it also applies for the purpose of new section 18.1 (i.e., to a right to receive production to which a matchable expenditure relates) of the Act.

Subclause 117(3)

Part I.3 and Part VI Tax

ITA
87(2)(*j*.91)

A corporation that is liable to tax under Part I.3 of the Act for a taxation year may deduct in computing that liability its Canadian surtax payable for the year, and may deduct any unused surtax credits against its Part I.3 liability for any of the seven following and three previous years. Similarly, a corporation liable to tax under Part VI of the Act can reduce that liability by its Part I tax payable for the year, and can carry any excess Part I liability forward seven and back three years. For the purposes of these carryforwards, paragraph 87(2)(*j*.91) of the Act treats the new corporation formed on an amalgamation as the same corporation as, and a continuation of, each of its predecessors. The paragraph is amended to clarify that it affects neither the fiscal period of any corporation nor the tax payable by any predecessor corporation. New paragraph 87(2)(*j*.91) applies to amalgamations occurring after April 26, 1995 and, by virtue of paragraph 88(1)(*e*.2) of the Act, to windings-up beginning after that date.

Subclause 117(4)

Film or Video Productions

ITA
87(2)(*j*.94)

Paragraph 87(2)(*j*.94) of the Act deems a corporation formed on an amalgamation to be a continuation of each predecessor corporation for the purposes of the Canadian film and video production tax credit in section 125.4 of the Act. The paragraph is amended to apply also for the purposes of the film or video production services tax credit in new section 125.5 of the Act, applicable to amalgamations that occur and windings-up that begin after October 1997.

Subclause 117(5)

ITA
87(2)(*l*.21)

Paragraph 87(2)(*l*.21) of the Act provides that section 61.3 and subsection 80.01(10) of the Act apply to an amalgamated corporation as if the amalgamated corporation were the same as, and a continuation of, each of the predecessor corporations.

Paragraph 87(2)(*l*.21) is amended to add a reference to the definition "unrecognized loss" in subsection 80(1) of the Act, as a consequence of which an unrecognized loss from a disposition of a property by a predecessor corporation can survive an amalgamation under section 87 of the Act and be used under subsection 80(13) of the Act by the corporation formed on the amalgamation.

This amendment applies to taxation years that end after February 21, 1994.

Subclause 117(6)

Taxable Dividends

ITA
87(2)(*x*)

For the purposes of the stop-loss rules in subsections 112(3) to (4.3) of the Act, paragraph 87(2)(*x*) of the Act treats dividends received on a share by a predecessor corporation as having been received on the share by the new corporation with the same character and deductibility they had for the predecessor corporation.
Paragraph 87(2)(*x*) is modified in three ways.

First, the purposes for which the provision applies are changed to correspond to the renumbering of the stop-loss rules in section 112 of the Act.

Second, subparagraph 87(2)(*x*)(ii) of the Act is amended by changing the references to capital dividend and life insurance capital dividend to a dividend (other than a taxable dividend). This change ensures that all dividends (other than dividends deemed to be taxable dividends because of subsection 83(2.1) of the Act) in respect of which an election was made under subsection 83(2) of the Act – and not simply those which were supported by the dividend-paying corporation's capital dividend account – are captured by the effect of this paragraph.

Existing paragraph 87(2)(*x*) does not take into account the period of ownership of the share by a predecessor corporation. Consequently, the stop-loss rules may apply if the new corporation disposes of the share within 365 days of the amalgamation although the rules would not have applied had a predecessor corporation disposed of the share. Therefore, the third change to paragraph 87(2)(*x*) adds new subparagraph 87(2)(*x*)(iii) of the Act to provide that a new corporation is deemed to have owned a share throughout the period during which the share was owned by a predecessor corporation.

The effect of the coming-into-force provision for amended paragraph 87(2)(*x*) is that the first two amendments described above will apply to dispositions that occur after April 26, 1995, and

the third amendment will apply to the 1994 and subsequent taxation years.

Subclause 117(7)

ITA
87(2)(*y*.1)

Paragraph 87(2)(*y*.1) of the Act provides for the flow-through of the net "preferred-earnings amount" of each predecessor corporation to the new corporation formed on an amalgamation. A corporation's preferred-earnings amount was defined in former subsection 181(2) of the Act and was a measure of a corporation's income earned in taxation years beginning after 1982 that was subject to the reduced small business rate of tax. Dividends paid out of the preferred-earnings amount were subject to a 12.5 per cent corporate distributions tax under former Part II of the Act.
Paragraph 87(2)(*y*.1) is repealed as a consequence of the previous repeal of the Part II tax. This amendment applies to taxes payable for taxation years that begin after 1986.

Subclause 117(8)

Mutual Fund and Investment Corporations

ITA
87(2)(*bb*)

Paragraph 87(2)(*bb*) of the Act provides rules that apply in calculating the capital gains dividend account and refundable capital gains tax on hand of a mutual fund corporation or an investment corporation formed as a result of an amalgamation.
Paragraph 87(2)(*bb*) is being amended to update the reference therein to the components of the definition "capital gains dividend account" in subsection 131(6) of the Act. This amendment applies to amalgamations that occur after 1991. However, where an amalgamation occurred after 1991 and before February 23, 1994, a transitional provision applies that provides the appropriate reference to the components of the definition "capital gains dividend account" in subsection 131(6) as it read during that period.

Flow-Through Entities

ITA
87(2)(*bb*.1)

New paragraph 87(2)(*bb*.1) is added to the Act as a consequence of the elimination of the $100,000 lifetime capital gains exemption for dispositions that occur after February 22, 1994 and the introduction of the election mechanism in subsection 110.6(19) of the Act for recognizing gains accrued to the end of that day. If an individual elects to recognize a capital gain accrued to that time on an interest in, or a share of a capital stock of, a flow-through entity (as defined in subsection 39.1(1) of the Act), the amount of the gain is credited to a special account referred to as the individual's exempt capital gains balance in respect of the entity. Claims may be made against this account to reduce gains that are flowed out to the individual by the entity for taxation years before 2005 and gains realized on dispositions of interests in or shares of the entity in those years.

New paragraph 87(2)(*bb*.1) provides that the exempt capital gains balance of an individual in respect of a flow-through entity that is an investment corporation, a mortgage investment corporation or a mutual fund corporation before an amalgamation in which the corporation is a predecessor corporation is carried over to the new corporation formed on the amalgamation provided that the new corporation is also an investment corporation, a mortgage investment corporation or a mutual fund corporation, respectively.

New paragraph 87(2)(*bb*.1) applies in respect of amalgamations that occur after 1993.

Subclause 117(9)

Continuation of Corporation

ITA
87(2)(*qq*)

Paragraph 87(2)(*qq*) of the Act treats the corporation formed on an amalgamation as the same corporation as, and a continuation of, each of its predecessors, for the purposes of computing the new corporation's investment tax credits and employment tax credits. The

paragraph is amended, for amalgamations occurring after April 26, 1995, to delete the reference to employment tax credits and to clarify that the provision affects neither the fiscal period of any corporation nor the tax payable by any predecessor corporation.

Subclause 117(10)

ITA
87(2.1)(*b*)

Subsection 87(2.1) of the Act allows the corporation formed on an amalgamation to deduct the unclaimed losses of its predecessors, subject to the restrictions on the use of losses imposed by section 111 (loss carryovers) and subsection 149(10) (changes in tax status) of the Act. This amendment, which is consequential on the amendment of subsection 149(10), replaces the reference in paragraph 87(2.1)(*b*) of the Act to paragraph 149(10)(*d*) with a reference to paragraph 149(10)(*c*). The amended paragraph applies to any corporation that becomes or ceases to be exempt from tax after April 26, 1995.

Subclause 117(11)

Vertical Amalgamations

ITA
87(2.11)

Subsection 87(2.11) of the Act treats the corporation formed on what is commonly known as a "vertical amalgamation" (the amalgamation of a corporation and one or more of its subsidiary wholly-owned corporations) as the same corporation as, and a continuation of, the former parent corporation, for the purposes of section 111 and Part IV of the Act. By allowing losses incurred by the amalgamated corporation to be carried back to the former parent, subject to the rules in section 111, the provision conforms the effect of a vertical amalgamation to what would have resulted if the predecessor subsidiary had instead been wound up into its parent under subsection 88(1) of the Act.

This amendment adds to the list of purposes for which the new corporation will be treated as the same corporation as, and a

continuation of, the former parent company. In addition to section 111 and Part IV of the Act, these include: section 126 (foreign tax credits), subsections 127(5) to (26) (investment tax credits), subsections 181.1(4) to (7) (deductions of unused surtax against Part I.3 tax) and subsections 190.1(3) to (6) (deduction of unused Part I tax against Part VI tax) of the Act. The amendment thus allows various tax attributes to move from the surviving corporation - the one formed on the amalgamation - back to the predecessor parent, much as they could if the companies had reorganized through a winding-up.

This amendment applies to amalgamations occurring after April 26, 1995.

Subclause 117(12)

ITA
87(9)(*a*.5)

Subsection 87(9) of the Act provides rules for "triangular amalgamations" – amalgamations in which shares of a parent corporation are issued in exchange for shares of the merging predecessors. New paragraph 87(9)(*a*.5) of the Act provides rules that allow new subsection 87(10) of the Act to apply in the case of a triangular amalgamation. New subsection 87(10) is a rule that deems certain shares to have been listed on a prescribed stock exchange. For more information, readers should consult the notes to that provision.

Specifically, new paragraph 87(9)(*a*.5) allows either the new corporation formed on the amalgamation or the parent corporation to be the issuer of the deemed listed share. It also modifies the requirement, in new paragraph 87(10)(*b*), that the new corporation be a public corporation: where the deemed listed shares are issued by the parent, it is the parent that must be a public corporation.

New paragraph 87(9)(*a*.5) applies to amalgamations that occur after April 26, 1995. A transitional version of the paragraph applies to amalgamations that occur before 1998. The transitional version has substantially the same effect as that described here, except that it preserves the requirement, in new paragraph 87(10)(*b*), that the new

corporation be a public corporation (subject to the special transitional rule described in the notes to new subsection 87(10)).

Subclause 117(13)

Share Deemed Listed

ITA
87(10)

As a result of changes to the definition of "taxable Canadian property" in paragraph 115(1)(*b*) of the Act, shares of a public corporation that are not listed on a prescribed stock exchange are taxable Canadian property. In the course of certain amalgamations, a predecessor corporation's listed shares may temporarily be replaced by unlisted shares of the new corporation. New subsection 87(10) of the Act treats those temporary shares as having themselves been listed, provided the new corporation is a public corporation and the new shares are redeemed, acquired or cancelled by the new corporation within 60 days after the amalgamation. This deemed listing applies for the purposes of subsections 115(1) and 116(6) of the Act, and for the definition of "qualified investment" in subsections 146(1) and 146.3(1) and section 204 of the Act.

New subsection 87(10) applies to amalgamations that occur after April 26, 1995. Where an amalgamation occurs before July 1996, new subsection 87(10) applies whether or not the new corporation formed on the amalgamation is a public corporation (assuming the other requirements of the provision are met).

Vertical Amalgamations

ITA
87(11)

New subsection 87(11) of the Act is generally effective in respect of a vertical amalgamation occurring after 1994 to which subsection 87(1) of the Act applies. These provisions provide a new corporation formed on the amalgamation of a parent and one or more of its subsidiary wholly-owned corporations with the option of increasing its cost of certain capital property acquired by it on the amalgamation. This increase in the new corporation's cost is the

same as the increase that would be available to the parent if the subsidiary had been wound up into the parent and subsection 88(1) of the Act had applied to the winding-up .

New subsection 87(11) relies upon subsection 88(1) and new subsection 88(1.7) of the Act to determine the type of property that qualifies for the increase and the amount of the increase in respect of each such property. As well, new subsection 87(11) relies upon subsection 88(1) to determine the parent's proceeds of disposition arising from the parent's disposition of the subsidiary's shares on the amalgamation. New subsection 87(11) applies to amalgamations that occur after 1994 unless the amalgamation occurs before June 20, 1996 and the new corporation elects not to have it apply to the amalgamation in the tax return for the year of the parent that ended immediately before the amalgamation or within 90 days after any assessment or reassessment of tax payable for that year. Any paragraph 88(1)(*d*) designation filed by the new corporation by the end of the third month after the month in which subsection 87(11) becomes law will be considered to have been filed with the new corporation's return of income for its first taxation year.

Clause 118

Winding-up of a Corporation

ITA
88(1)

Section 88 of the Act deals with the tax consequences arising from the winding-up of a corporation. Subsection 88(1) of the Act provides rules that apply where a subsidiary has been wound up into its parent corporation provided that both corporations are taxable Canadian corporations and the parent owns not less than 90 per cent of the issued shares of each class of the subsidiary's capital stock.

Subclause 118(1)

Right to receive production

ITA
88(1)(*a*)(i)

Paragraph 88(1)(*a*) of the Act provides rules for determining the proceeds of disposition of a subsidiary's property a on wind-up to which subsection 88(1) applies. Subparagraph 88(1)(*a*)(i) of the Act is amended to provide nil proceeds of the disposition of a subsidiary's right to receive production to which a matchable expenditure relates. This effectively results in a rollover of a subsidiary's right to receive production to its parent. This subsection applies after November 17, 1996.

Subclause 118(2)

ITA
88(1)(*c*)(v)

Subparagraph 88(1)(*c*)(v) of the Act provides that an increase in cost base will not be available with respect to property transferred to a subsidiary by the parent or by any person or partnership that was not, otherwise than by reason of a right referred to in paragraph 251(5)(*b*) of the Act, dealing at arm's length with the parent. Therefore, property transferred to a corporation by a subsequent purchaser of the corporation will not qualify for this increase on the winding-up of the corporation into the purchaser. This subparagraph is amended to restrict its application to property so transferred as part of the series of transactions in which the parent last acquired control of the subsidiary. It also is amended to include substituted property. New subparagraph 88(1)(*c*)(v) applies to windings-up that begin after 1996.

Subclauses 118(3) and (4)

ITA
88(1)(*c*)(vi)

Paragraph 88(1)(*c*) of the Act provides that the cost to the parent corporation of each property distributed to it on the winding-up of the subsidiary is equal to the subsidiary's proceeds of disposition of the

property plus, where the property is not an "ineligible property", an amount determined under paragraph 88(1)(*d*) of the Act in respect of that property. An ineligible property is defined in paragraph 88(1)(*c*) and consists of four types of property. The fourth type of property stops taxpayers from circumventing the restrictions against the so-called "purchase butterfly" reorganization in subsection 55(3.1) of the Act by means of a series of transactions that effectively result in a sale of part of a corporation's assets to an arm's length corporation on a tax-deferred basis.

Subparagraph 88(1)(*c*)(vi) of the Act which describes the fourth type of ineligible property targets property that is subsequently disposed of by the parent as part of the series of transactions in which the parent acquired control of the subsidiary and the property, or any substituted property, is acquired by one of the following:

A. any person (other than a specified person) who, at any time during the series and before the parent acquired control of the subsidiary, was a specified shareholder of the subsidiary,

B. two or more persons (other than specified persons) who, at any time during the series and before control of the subsidiary was last acquired by the parent, owned, in total, such number of shares as would, if they were owned by one person, make that person a specified shareholder of the subsidiary,

C. a corporation (other than a specified person) of which any person who was a specified shareholder of the subsidiary is a specified shareholder, or

D. a corporation (other than a specified person) where persons described in B whose shares, if owned by one person, would have made that person a specified shareholder of the corporation.

New subparagraph 88(1)(*c*)(vi) of the Act broadens the scope of the fourth type of ineligible property to include all property distributed to the parent on the winding-up of the subsidiary where as part of the series of transactions or events that includes the winding-up any property distributed to the parent on the winding-up, or any other property acquired in substitution thereof, is acquired by a person described in any of A to D above. New subparagraph 88(1)(*c*)(vi) of the Act applies to windings-up that begin after June 20, 1996 other

than those that are part of an arrangement that was substantially advanced, as evidenced in writing, by that date.

Sub-subclause 88(1)(*c*)(vi)(B)(III)2 of the Act describes the corporation referred to in D above. This sub-subclause is amended to restrict its application to those situations in which shares of the corporation acquiring the property were acquired by the shareholder as part of the series of transactions that includes the winding-up of the subsidiary. This provision applies to windings-up that begin after June 20, 1996 other than those that are part of an arrangement that was substantially advanced, as evidenced in writing, by that date.

Subclause 118(5)

ITA
88(1)(*c*.2)(iii)

New subparagraph 88(1)(*c*.2)(iii) of the Act provides that for the purposes of paragraph 88(1)(*c*.2) and subparagraph 88(1)(*c*)(vi) of the Act, the definition of "specified shareholder" in subsection 248(1) of the Act is to be read as including a reference to "or of any other corporation that is related to the corporation and that has a significant direct or indirect interest in any issued shares of any class of the capital stock of the corporation" rather than the reference to "or of any corporation that is related to the corporation". New subparagraph 88(1)(*c*.2)(iii) also provides that a corporation is considered not to be a specified shareholder of itself. New subparagraph 88(1)(*c*.2)(iii) ensures that in determining whether a person is a specified shareholder of a particular corporation for the purposes of paragraph 88(1)(*c*.2) and subparagraph 88(1)(*c*)(vi) of the Act only shareholdings "above" the particular corporation and not "below" it are to be considered. In other words, in determining a person's specified shareholder status in a particular corporation, the person's shareholdings in related corporations that have a significant direct or indirect interest in the particular corporation are considered. New subparagraph 88(1)(*c*.2)(iii) applies to windings-up that begin after November 1994.

Subclause 118(6)

ITA
88(1)(*c*.3) to (*c*.6)

Subparagraph 88(1)(*c*)(vi) of the Act treats a property acquired by the parent on the winding-up of a subsidiary as an ineligible property where the property is subsequently disposed of by the parent as part of the series of transactions in which the parent acquired control of the subsidiary and the property, or any property substituted therefor, is acquired by a non-qualifying person. A non-qualifying person includes a person who owned more than 10 per cent of the shares of a class of the subsidiary before the parent acquired control of the subsidiary. New paragraph 88(1)(*c*.3) of the Act applies for the purposes of clause 88(1)(*c*)(vi)(B) of the Act which refers to property distributed to the parent on the winding-up of the subsidiary or property substituted therefor. New subparagraphs 88(1)(*c*.3)(i) and (ii) of the Act respectively provide that property acquired by a person the fair market value of which is

- wholly or partly attributable to a particular property or properties (other than a specified property as defined in new paragraph 88(1)(*c*.4) of the Act), or

- determinable primarily by reference to the fair market of a particular property or properties, or to any proceeds from the disposition of a particular property or properties

will be considered to be property acquired by the person in substitution for the particular property or properties where the property is owned by the person at any time after the acquisition of control of the subsidiary. This ensures that only such property owned by a non-qualifying person after the acquisition of control of the subsidiary by the parent will be considered substituted property for the purposes of clause 88(1)(*c*)(vi)(B). New paragraph 88(1)(*c*.6) of the Act sets out the time at which control of a corporation will be considered to have been acquired where control of that corporation is acquired pursuant to a court approved plan of arrangement.

An example of property the fair market value of which is determinable primarily by reference to the fair market value of a particular property would be a share or debt the terms of which

provide for a value that is dependent upon or tracks the proceeds from the disposition of the particular property. In addition, in a situation where at the end of the series the vendor holds a majority of the shares of a corporation substantially all of the value of which is attributable to property distributed on the winding-up, the value of those shares will be considered to be determinable primarily by reference to the fair market value of that property.

New paragraph 88(1)(*c*.3) also provides that (in addition to a specified property) property described in new subparagraphs 88(1)(*c*.3)(iii), (iv) and (v) will not be considered to be substituted property.

New subparagraph (iii) provides that money received as consideration for the disposition of a particular property or properties will not be considered to be property acquired in substitution therefor.

New subparagraph (iv) provides that substituted property that was not owned by a person at any time after the acquisition of control of the subsidiary by the parent will not be considered to be property acquired in substitution for the particular property or properties.

New subparagraph (v) provides that if a property is described in subparagraph 88(1)(*c*.3)(i) only because a specified property was received by a person as consideration for the acquisition of a subsidiary's share that property will not be considered to be property acquired in substitution for the particular property or properties.

New paragraph 88(1)(*c*.3) applies to windings-up that begin after February 21, 1994; however a transitional rule is provided for windings-up that began before June 21, 1996.

New subparagraph 88(1)(*c*.4) of the Act provides the meaning of specified property for the purpose of new subparagraphs 88(1)(*c*.3)(i) and (v). A specified property is a property that may be acquired by a person during the series of transactions contemplated in new subparagraph 88(1)(*c*)(vi) without that acquisition tainting the winding-up. In other words, an acquisition of such property during the series, that includes the acquisition of control of the subsidiary by the parent and the winding-up of the subsidiary into the parent, will not in and by itself cause the capital property distributed to the parent on the winding-up to be ineligible for the step-up in cost provided for

under paragraph 88(1)(*c*) of the Act. New paragraph 88(1)(*c*.4) of the Act applies to windings-up that begin after February 21, 1994; however a transitional rule is provided for windings-up that began before June 21, 1996.

A specified property is

- a share of the parent received as consideration for the acquisition of a share of the subsidiary by the parent or by a corporation that was a specified subsidiary corporation of the parent immediately before the acquisition (specified subsidiary corporation is defined in new paragraph 88(1)(*c*.5) of the Act);

- an indebtedness issued by the parent as consideration for the acquisition of a share of the subsidiary by the parent;

- a share of a taxable Canadian corporation received as consideration for the acquisition of a share of the subsidiary by the taxable Canadian corporation or by the parent where the parent was a specified subsidiary corporation of the taxable Canadian corporation immediately before the acquisition;

- an indebtedness of a taxable Canadian corporation that was issued by it as consideration for the acquisition of a share of the subsidiary by the taxable Canadian corporation or by the parent where the parent was a specified subsidiary corporation of the taxable Canadian corporation immediately before the acquisition;

- where the subsidiary was formed on the amalgamation of two or more predecessor corporations at least one of which was a subsidiary wholly-owned corporation of the parent, a share of the subsidiary that was issued on the amalgamation in exchange for a share of the predecessor and that was redeemed, acquired or cancelled by the subsidiary for money immediately after the amalgamation; and

- where the subsidiary was formed on the amalgamation of two or more predecessor corporations at least one of which was a subsidiary wholly-owned corporation of the parent, a share of the parent that was issued on the amalgamation in exchange for a share of the predecessor corporation and that was redeemed,

acquired or cancelled by the parent for money immediately after the amalgamation.

New paragraph 88(1)(*c*.5), which generally applies to windings-up that begin after February 21, 1994, provides the meaning of a specified subsidiary corporation for the purpose of new paragraph 88(1)(*c*.4). A particular corporation is a specified subsidiary corporation of another corporation at any time where the other corporation holds at that time shares of the particular corporation

- that give the shareholder 90 per cent or more of the votes that could be cast under all circumstances at the annual shareholders meeting, and
- having 90 per cent or more of the fair market value of all the issued shares of the capital stock of the particular corporation.

The following examples illustrate the application of new paragraphs 88(1)(*c*.3), (*c*.4) and (*c*.5):

Loss Consolidation

EXAMPLE 1...

Assume Vco, a taxable Canadian corporation, owns 100 per cent of the shares of Lco and 41 per cent of the shares of Tco, a taxable Canadian corporation. The fair market value of the Tco shares owned by Vco is in excess of Vco's cost of those shares. Bco has made a take-over offer for all the shares of Tco. In anticipation of the sale, Vco transfers the Tco shares to Lco on a tax-deferred basis under section 85 of the Act and on the transfer takes back shares of Lco. Lco disposes of the Tco shares to Bco for proceeds equal to the fair market value of the shares. Lco receives money as consideration for the Tco shares. Bco intends to wind up Tco and to step-up the cost of the capital property distributed to it on the winding-up as provided for under paragraph 88(1)(c) of the Act.

Result: New subparagraph 88(1)(c.3)(i) of the Act ensures that the Lco shares acquired by Vco and the Tco shares acquired by Lco will not be considered substituted property for the purposes of

clause 88(1)(c)(vi)(B) of the Act with the result that such shares in and by themselves will not cause the capital property distributed to Bco on the winding-up of Tco to be ineligible property for the purposes of the step-up in paragraph 88(1)(c) of the Act.

EXAMPLE 2 ...

Assume the same facts as in EXAMPLE 1 except that Lco receives money and shares of Bco as consideration for the Tco shares. Substantially all of the consideration received by Lco for its Tco shares is money.

Result: New subparagraph 88(1)(c.3)(i) and the definition "specified property" in new subparagraph 88(1)(c.4)(i) of the Act ensure that the Bco shares acquired by Lco as consideration for the Tco shares will not be considered to be substituted property for the purpose of clause 88(1)(c)(vi)(B) of the Act. New subparagraph 88(1)(c.3)(v) of the Act ensures that the Lco shares acquired by Vco on Vco.'s transfer of the Tco shares to Lco will not be considered to be substituted property for the purpose of clause 88(1)(c)(vi)(B) of the Act. Therefore such shares (the Bco shares and the Lco shares), in and by themselves, will not cause the capital property distributed to Bco on the winding-up of Tco to be ineligible property for the purposes of the step-up in 88(1)(c) of the Act.

Safe Income Crystallization

EXAMPLE 1...

Assume Sco, a taxable Canadian corporation, owns 15 per cent of Tco, a publicly-traded taxable Canadian corporation. Pco makes a takeover offer for all the shares of Tco. In anticipation of the sale of the shares of Tco, Sco incorporates Newco and transfers on a tax-deferred basis under section 85 of the Act all of its Tco shares to Newco in exchange for Newco shares. The adjusted cost base and the paid-up capital of the Newco shares are increased by an amount equal to the so-called "safe income" attributable to the Tco shares that Sco had at the time of the transfer. Sco sells the Newco shares to Pco and receives cash. Pco intends to wind up Newco and to step-up the cost of the capital property (the Tco shares) distributed to it on the

winding-up of Newco. as provided for under paragraph 88(1)(c) of the Act.

Result: New subparagraph 88(1)(c.3)(iv) of the Act ensures that the Newco shares acquired by Sco will not be considered substituted property for the purposes of clause 88(1)(c)(vi)(B) of the Act with the result that such shares, in and by themselves, will not cause the capital property distributed to Pco on the winding-up of Newco to be ineligible property for the purposes of the step-up in paragraph 88(1)(c) of the Act.

Amalgamation Squeeze-Out

EXAMPLE 1...

Assume Aco is a publicly-traded taxable Canadian corporation. Mco. is a wholly-owned subsidiary of Aco. Mco offers to purchase all the shares of Tco. Tco is also a publicly-traded taxable Canadian corporation. In exchange for the shares of Tco, Mco offers the shareholders of Tco a payment of only cash; of cash and shares of Aco; or of only shares of Aco. Under no circumstance, will the Tco shareholders acquire a majority of the shares of Aco. At the option of the Tco shareholder, the shares of Aco may be acquired on a tax deferred basis pursuant to section 85 of the Act. Under the takeover offer, Mco acquires 75 per cent of the shares of Tco. The non-tendering shareholders hold the remaining 25 per cent of the Tco shares. Mco and Tco amalgamate to form NewTco and the non-tendering shareholders receive redeemable preferred shares of NewTco in exchange for their shares of Tco. The preferred shares are redeemed for cash immediately after the amalgamation. Aco intends to wind up NewTco and to step-up the cost of the capital property distributed to it on the winding-up of NewTco as provided for under paragraph 88(1)(c) of the Act.

Result: New subparagraphs 88(1)(c.3)(i) and (c.4)(i) and new paragraph 88(1)(c.5) of the Act ensure that any Aco shares received by the shareholders of Tco in exchange for their shares of Tco acquired by Mco will not be considered to be substituted property for the purposes of clause 88(1)(c)(vi)(B) of the Act . New subparagraphs 88(1)(c.3)(i) and (c.4)(v) of the Act ensure that the shares of NewTco acquired by the shareholders of Tco

> *will not be considered to be substituted property for the purpose of clause 88(1)(c)(vi)(B) of the Act. Therefore such shares (the Aco shares and the NewTco shares), in and by themselves, will not cause the capital property distributed to Aco on the winding-up of NewTco to be ineligible property for the purpose of the step-up in paragraph 88(1)(c) of the Act.*

New paragraph 88(1)(*c*.6) of the Act provides that for the purpose of new paragraph 88(1)(*c*.3) and notwithstanding subsection 256(9) of the Act, where control of a corporation is acquired pursuant to articles of arrangement, control will be treated as having been acquired at the end of the day the arrangement becomes effective. New paragraph 88(1)(*c*.6) applies to windings-up that begin after February 21, 1996; however a transitional rule is provided for windings-up that began before June 21, 1996.

Subclause 118(7)

ITA
88(1)(*d*)

Paragraph 88(1)(*d*) of the Act determines for the purpose of paragraph 88(1)(*c*) of the Act the amount by which a parent corporation may increase the cost of capital property acquired by it on the winding-up of its subsidiary. This paragraph also includes an interpretation provision, which provides that where a parent corporation has been formed after the time that any other corporation with which the parent did not deal at arm's length at any time prior to the winding-up was formed, the parent corporation will be considered to have existed since the existence of the other corporation and to have not been dealing at arms' length with the other corporation since that time. This interpretation provision in paragraph 88(1)(*d*) is repealed effective for windings-up that begin after February 21, 1994 and added to new subsection 88(1.7) of the Act.

Subclause 118(8)

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

Paragraph 88(1)(*d*.1) of the Act provides that certain rules in the Act and in the *Income Tax Application Rules* are not to apply to a winding-up governed by subsection 88(1). This amendment deletes the reference in paragraph 88(1)(*d*.1) to subsection 85(5.1) of the Act, which is being repealed, and adds references to new subsections 13(21.2) and 14(12) of the Act. These changes are, subject to a transitional provision, applicable to windings-up that begin after April 26, 1995.

Subclause 118(9)

ITA
88(1)(*d*.2) and (*d*.3)

Paragraph 88(1)(*d*.2) of the Act applies in determining the time that a taxpayer last acquired control of a subsidiary for the purposes of the rules permitting a parent corporation to obtain, on the winding-up of the subsidiary, an increase in the cost of a capital property (other than an ineligible property) owned by the subsidiary at the time that the parent last acquired control of the subsidiary. This paragraph applies where control of a subsidiary was acquired from a person, or group of persons, with whom the person, or group of persons, who acquired control did not deal at arm's length. Where control of the subsidiary is acquired by the person, or group, because of a bequest or inheritance, the person or group, will be considered to have dealt at arm's length with the person who bequeathed the shares of the subsidiary.

New paragraphs 88(1)(*d*.2) and (*d*.3) of the Act ensure that if control of a subsidiary corporation is acquired by a person or group (the "acquiror") as a consequence of the death of an individual, the acquiror will be considered to have last acquired control of the subsidiary immediately after the individual's death from a person who dealt at arm's length with the acquiror. New paragraphs 88(1)(*d*.2) and (*d*.3) apply to windings-up that begin after December 20, 1991.

Subclauses 118(10) and (11)

ITA
88(1)(*e*.2)

Paragraph 88(1)(*e*.2) of the Act provides for the flow-through of a subsidiary's net "preferred-earnings amount" to its parent on a winding-up to which subsection 88(1) of the Act applies. A corporation's preferred-earnings amount was defined in former subsection 181(2) of the Act and was used in determining the amount of corporate distributions tax payable under former Part II of the Act. The reference to subparagraph 87(2)(*y*.1) in subsection 88(1)(*e*.2) is deleted, and subparagraphs 88(1)(*e*.2)(xiv) and (xv) are repealed, as a consequence of the previous repeal of the Part II tax. These amendments apply on windings-up that commence after June 1995.

Subclause 118(12)

ITA
88(1.7)

Paragraph 88(1)(*d*) of the Act determines for the purpose of paragraph 88(1)(*c*) of the Act the amount by which a parent corporation may increase the cost of capital property acquired by it on the winding-up of its subsidiary. Paragraph 88(1)(*d*) also includes an interpretation provision which provides that where a parent corporation has been formed after the time that any other corporation with which the parent did not deal at arm's length at any time prior to the winding-up was formed, the parent corporation will be considered to have existed since the existence of the other corporation and to have not been dealing at arm's length with the other corporation since that time. Effective for windings-up that begin after February 21, 1994, this interpretation provision is removed from paragraph 88(1)(*d*) and is included in new subsection 88(1.7) of the Act.

New subsection 88(1.7) is consequential on the 1994 amendments that resulted in the addition of the definition "ineligible property" to paragraph 88(1)(*c*).

Clause 119

Definition - Canadian Corporation

ITA
89(1)

Paragraph (*d*) of the French version of the definition "Canadian corporation" in subsection 89(1) of the Act is amended to correct the reference to the time at which each of the corporations from which a new corporation is formed through the amalgamation, merger or other reorganization of the former corporations has to have been a Canadian corporation. The word "quelconque" is therefore substituted for "donné".

The amendment is effective as of June 15, 1994, that is the date when the discrepancy between the French and English versions of paragraph (*d*) of that definition was introduced.

Clause 120

Disposition of Shares in Foreign Affiliate

ITA
93(4)

Subsection 93(4) of the Act applies where a Canadian taxpayer or a foreign affiliate of a Canadian taxpayer (the "vendor") has acquired shares of one foreign affiliate on the disposition of shares of another foreign affiliate. Any capital loss realized by the vendor on the disposition is denied and added to the vendor's adjusted cost base of the shares of the acquired affiliate.

This amendment deletes the reference in subsection 93(4) to subsection 85(4) of the Act (which is being repealed), and adds a reference to new subsection 40(3.3) of the Act (which largely replaces subsection 85(4) insofar as it applied to non-depreciable capital property).

The amendment applies to dispositions that take place after April 26, 1995, subject to certain exceptions. These are found in clause 247 of

this bill and generally exclude transactions in progress before April 27, 1995. Readers should refer to the notes to clause 247 for more detail.

Clause 121

Offshore Investment Fund Property

ITA
94.1(2)

Section 94.1 of the Act contains an anti-avoidance provision that applies where a taxpayer acquires an "offshore investment fund property" and certain other conditions are satisfied. Where this is the case, an additional amount is added in computing the taxpayer's income. The additional amount for a taxation year is generally equal to the "designated cost" of the property multiplied by the average prescribed rate of interest for the year, minus any other income of the taxpayer from the property for the year.

The "designated cost" to a taxpayer of an offshore investment fund property is, pursuant to the description of A in the formula in the definition, determined by reference to its cost amount. Because of the description of D in the formula, the "designated cost" of property held by a taxpayer at the end of 1984 (or the end of 1985 where subsection 94.1(3) of the Act applies) is increased to the extent that its fair market value exceeded its cost amount at that time.

The description of A is amended in two ways. First, the adjustments to the adjusted cost base of capital property arising because of the debt forgiveness rules in section 80 of the Act are to be ignored for the purposes of computing the "designated cost" of the property. This change applies to taxation years ending after April 26, 1995. Second, the cost of a property is to be computed without reference to subparagraph 53(2)(*c*)(i.3) and new section 143.2 of the Act, which may apply when determining the cost of a taxpayer's partnership interest or the cost of a taxpayer's tax shelter investment, respectively. This change applies after September 26, 1994.

The description of D in the definition is amended, for taxation years that commence after June 20, 1996 so that it does not apply only to

cases in which a taxpayer has held the property since the end of 1984 (or since the end of 1985 where subsection 94.1(3) of the Act applies). In other cases, the value determined for D is the total of two amounts. The first amount is the fair market value of the property at the time the taxpayer acquired it minus the cost amount to the taxpayer of the property at that time. The second amount is the total of all amounts that would have been included in the designated cost of the property because of additional amounts that would have been included in the taxpayer's income under this section if the designated cost of the property when originally acquired included the excess of its fair market value at that time over its cost to the taxpayer at that time. This amendment is intended to ensure an appropriate designated cost of an offshore investment fund property where the property is acquired by the taxpayer at a cost that is less than the property's fair market value.

Clause 122

Foreign Accrual Property Income

ITA
95

Section 95 of the Act defines a number of terms and provides certain rules that apply for the purposes of subdivision i of Division B in Part I of the Act, which relates to shareholders of non-resident corporations.

Subclauses 122(1) to (4)

ITA
95(1)
"excluded property"

The amendment to paragraph (*a*) of the French version of the definition "excluded property" in subsection 95(1) of the Act clarifies that the reference to the expression "income from an active business" refers to the definition of that expression in subsection 95(1). The expression "revenu provenant d'une entreprise exploitée activement" is therefore substituted for "revenu d'une entreprise exploitée

activement", the former expression being defined in subsection 95(1). This amendment applies on Royal Assent.

"foreign accrual property income"

Subsection 94.1(1) of the Act contains an anti-avoidance provision relating to investors in offshore investment funds. That subsection applies where a taxpayer has invested in an offshore investment fund and one of the main reasons for the investment was to reduce or defer the tax liability that would have applied to the income generated from the underlying assets of the fund if such income had been earned directly by the taxpayer. In such a case the taxpayer is required to include an amount in income determined by applying the prescribed rate of interest to the designated cost of the interest in the fund. This rule also applies, with modifications, in computing the foreign accrual property income of a controlled foreign affiliate of a taxpayer. Those modifications are set out in the description of C in the formula in the definition of "foreign accrual property income" in subsection 95(1) of the Act.

The description of C in the definition "foreign accrual property income" in subsection 95(1) of the Act is being amended to add new paragraphs (*c*) and (*d*) thereto.

When subsection 94.1(1) is applied in respect of a taxpayer resident in Canada, paragraph 94.1(1)(*a*) excludes a controlled foreign affiliate of the taxpayer from the class of non-resident entities that are offshore investment fund properties in respect of which subsection 94.1(1) may apply. This is the case since the controlled foreign affiliate's investment income is already subject to accrual taxation under the provisions relating to foreign accrual property income. Where the description of C in the definition "foreign accrual property income" applies so that subsection 94.1(1) is read as being applicable to a controlled foreign affiliate of a taxpayer resident in Canada (i.e. subsection 94.1(1) is read such that the controlled foreign affiliate is the taxpayer referred to therein) it is appropriate to exclude other controlled foreign affiliates of the taxpayer resident in Canada from the class of non-resident entities that are offshore investment fund properties in respect of which subsection 94.1(1) may apply.

New paragraph (*c*) of the description of C provides that, in computing the foreign accrual property income of a controlled foreign affiliate of

a taxpayer resident in Canada arising under subsection 94.1(1), that subsection does not apply to include an amount in the income of the affiliate in respect of an investment in another controlled foreign affiliate of the same taxpayer resident in Canada. This amendment applies to taxation years that end after November, 1991.

New paragraph (*d*) of the description of C provides a modification to paragraph 94.1(1)(*g*). Subsection 94.1(1) may include in a taxpayer's income an amount determined by applying the prescribed rate of interest to the designated cost of the interest in the offshore investment fund property. In order to prevent double taxation, the amount required under subsection 94.1(1) to be included in the taxpayer's income is reduced under paragraph 94.1(1)(*g*) by distributions or other amounts in respect of the property (other than capital gains) that are required by any other provision of the Act to be included in the taxpayer's income for the relevant year.

Where the description of C applies so that subsection 94.1(1) is read as being applicable to a controlled foreign affiliate of a taxpayer resident in Canada, it is intended that paragraph 94.1(1)(*g*) reduce the amount included in the controlled foreign affiliate's income only by distributions or other amounts in respect of the property that increase the foreign accrual property income of the affiliate that is included in the income of the taxpayer resident in Canada to the extent of that taxpayer's share thereof. No more is required to prevent double taxation. New paragraph (*d*) of the description of C is added for greater certainty specifically to exclude from the reduction provided by paragraph 94.1(1)(*g*) any income of the controlled foreign affiliate of the taxpayer resident in Canada that is not included in the controlled foreign affiliate's foreign accrual property income for the relevant year. For this purpose, the value of C is treated as nil to eliminate circularity in applying this new paragraph.

New paragraph (*d*) of the description of C in the definition of "foreign accrual property income" in subsection 95(1) applies to taxation years that begin on or after June 20, 1996.

"lending of money"

The definition of "lending of money" is relevant for the purpose of the definition of "investment business". "Lending of money" by a person (the lender) is defined to include

- the acquisition of trade accounts receivable of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such trade accounts receivable,

- the acquisition of loans made by and lending assets of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such loans or lending assets,

- the acquisition of foreign resource properties of other persons (the borrower) other than resource properties that are rents or royalties payable by persons that do not deal at arm's length with the lender, and

- the sale by the lender of loans or lending assets or an interest in loans or lending assets where the loans or lending assets were owing by persons that deal at arm's length with the lender.

The definition "lending of money" is being amended such that the definition "lending asset" in subsection 248(1) of the Act will be read without the words "but does not include a prescribed property" for the purpose of the lending of money definition. The effect of this amendment is to permit a debt instrument purchased by a foreign affiliate to qualify as a lending asset notwithstanding that it may have represented inventory to the person from whom it was acquired.

This amendment generally applies to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, if there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, this amendment will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year that begins after 1994 to begin earlier than if there had been no change in the affiliate's taxation year, this new definition will remain applicable for taxation years that begin after 1994. For taxation years that end before October 1997 the reference to "prescribed property" in the definition of "lending asset" will be read as "prescribed security". This change is consequential on the introduction of the new definition of "lending asset" in subsection 248(1).

"trust company"

Subsection 95(1) of the Act is amended to add thereto the definition of "trust company". This definition will be relevant for the purposes of subparagraph 95(2)(l)(iv), paragraphs 95(2.1)(*a*) and (2.3)(*a*) and paragraph (*b*) of the definition "indebtedness" in subsection 95(2.5) of the Act. This definition provides that a trust company includes a corporation that is resident in Canada that is a "loan company" as defined in subsection 2(1) of the *Canadian Payments Association Act*.

This new definition applies to taxation years of a foreign affiliate that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, this new definition will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, this new definition will remain applicable for taxation years that begin after 1994.

Subclause 122(5)

ITA
95(2)(*g*.1)(ii)

Paragraph 95(2)(*g*.1) of the Act clarifies that, for the purposes of computing foreign accrual property income (FAPI) of a foreign affiliate, the rules in section 80 of the Act will apply with respect to obligations settled or extinguished that relate to FAPI. However, many of the debt forgiveness rules are ignored for this purpose.

Subparagraph 95(2)(*g*.1)(ii) of the Act is amended to eliminate the reference therein to subsection 80(17) of the Act, consequential on the repeal of that subsection.

This amendment applies to taxation years that end after February 21, 1994.

Clause 123

Partnerships and their Members

ITA
96

Section 96 of the Act provides general rules for determining the income or loss of a partnership and its members.

Subclauses (1) to (4)

ITA
96(2.2)

Subsection 96(2.2) of the Act defines the "at-risk amount" of a limited partner for the purposes of determining deductible losses and tax credits allocated to the partner. Subsection 96(2.2) is amended in four ways.

The starting point in the calculation of a partner's at-risk amount is the adjusted cost base of the partner's interest. However, if an amount of limited-recourse indebtedness is used to acquire a partner's partnership interest, that amount is deducted from the cost of the interest under subparagraph 53(2)(*c*)(i.3) or under new subsection 143.2(6) of the Act. Paragraph 96(2.2)(*c*) of the Act, however, also reduces the at-risk amount by certain loans owing to the partnership. Paragraph 96(2.2)(*c*) is, therefore, amended to ensure that the reduction under new subsection 143.2(6) of the Act is not deducted a second time under that paragraph in computing the partner's at-risk amount. This amendment applies after November 1994.

Paragraph 96(2.2)(*d*) of the Act provides a reduction in computing a partner's at-risk amount for any amount or benefit to which a limited partner, or a person not dealing at arm's length with the partner, is or may be entitled, where the amount or benefit is intended to protect the partner or person from any loss in respect of the partner's investment. Paragraph 96(2.2)(*d*) is amended consequential on new section 143.2 of the Act to specifically refer to "a loan or any other form of indebtedness" as being a type of amount or benefit to which that paragraph applies. Subparagraph 96(2.2)(*d*)(vi) of the Act

ensures, however, that paragraph 96(2.2)(*d*) does not apply in respect of an indebtedness where the cost of a limited partner's partnership interest has already been reduced under new subsection 143.2(6). Reference may be made to the commentary accompanying new section 143.2 of the Act. This amendment applies after November 1994.

Subparagraphs 96(2.2)(*d*)(iv) and (v) of the Act are repealed. Subparagraph 96(2.2)(*d*)(iv) provided an exception from the application of paragraph 96(2.2)(*d*) for agreements to dispose of a partnership interest for an amount not exceeding the fair market value of the interest. Subparagraph 96(2.2(*d*)(vi) provided an exception from the application of paragraph 96(2.2)(*d*) in the case of certain types of gross revenue guarantees. Generally, the repeal of subparagraphs 96(2.2)(*d*)(iv) and (v) applies to partnership interests acquired by a taxpayer after April 26, 1995.

The portion of subsection 96(2.2) after subparagraph (*d*)(vii) is amended consequential on the introduction of new section 143.2 of the Act. Paragraph 96(2.2)(*e*) of the Act provides that, where a taxpayer described in paragraph 96(2.2)(*d*) has a right to exchange a partnership interest to which paragraph (*d*) applies for some other property, the owner of the partnership interest is considered to be entitled to an amount or benefit protecting the partner from loss to the extent of the fair market value of the other property at the time at which the at-risk amount is being computed. This amendment clarifies that paragraph 96(2.2)(*e*) applies where the taxpayer entitled to exchange all or any part of the partner's partnership interest is a person not dealing at arm's length with the taxpayer. Similarly, paragraph 96(2.2)(*f*) of the Act provides that, where a taxpayer's borrowing in respect of a partnership interest is guaranteed or otherwise backed by a security or similar indemnity, or covenant, provided by the partnership or a person or partnership not dealing at arm's length with the partnership, an at-risk reduction is required under subsection 96(2.2) in respect of the outstanding balance of the borrowing. In addition to clarifying that paragraph 96(2.2)(*f*) applies where the guarantee is provided to a person not dealing at arm's length to the taxpayer, paragraph 96(2.2)(*f*) is also amended to remove the reference to the partnership or a person or partnership not dealing at arm's length with the partnership. Generally, this amendment applies to partnership interests acquired after April 26, 1995.

Subclause 123(5)

Limited Partner

ITA
96(2.4)

Subsection 96(2.4) of the Act provides an extended definition of "limited partner" which is relevant for the purposes of restrictions on partnership investment tax credits and losses.

In addition to grammatical changes to subsection 96(2.4), paragraph 96(2.4)(*b*) of the Act is amended to clarify its application in circumstances where a member of a partnership, or a person not dealing at arm's length with the member, is entitled to receive an amount or obtain a benefit referred to in certain parts of paragraph 96(2.2)(d), either immediately or in the future and either absolutely or contingently. This amendment applies to fiscal periods that end after November 1994.

Subclause 123(6)

Agreement or Election of Partnership Members

ITA
96(3)

Subsection 96(3) of the Act provides rules that apply if a member of a partnership makes an election under certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such case, the election will be valid only if it is made on behalf of all the members of the partnership and the member had authority to act for the partnership.

Subsection 96(3) is amended to treat an election filed by a member under section 15.2 and new subsections 249.1(4) and (6) of the Act in the same way as other elections referred to in subsection 96(3). This amendment generally applies to fiscal periods that end after December 2, 1992.

Clause 124

Contribution of Property to Partnership

ITA
97

Subsection 97(2) of the Act provides the rules which allow a person to transfer certain types of properties on a tax-deferred "rollover" basis to a partnership. The amendment to this subsection deletes the reference to subsection 85(5.1) of the Act (which is being repealed), and adds a reference to new subsection 13(21.2) of the Act (which replaces subsection 85(5.1)).

Subsection 97(3) of the Act currently denies a deduction for any capital loss realized by a majority interest partner on the transfer of property to a partnership. The term "majority interest partner" is defined in subsection 97(3.1) of the Act.

Subsection 97(3) is being repealed as a consequence of the introduction of new subsection 40(3.3) of the Act. Under subsection 40(3.3), a loss arising on the transfer of property to a partnership of which the transferor is a majority interest partner will continue to be denied at that time. However, that loss will no longer be added to the adjusted cost base of any interest held by the transferor in the partnership but will, instead, be deferred until the earliest of certain events (described in the commentary to subsection 40(3.3)).

A definition of majority interest partner is also being added to section 248(1) of the Act, thus enabling subsection 97(3.1) to be repealed.

The amendments to section 97 of the Act apply to dispositions that take place after April 26, 1995, subject to certain exceptions. These are found in clause 247 of this bill, and generally exclude transactions in progress before April 27, 1995. Readers should refer to the notes to clause 247 for more detail.

Clause 125

Disposition of a Partnership Interest

ITA
98.1(1)(*a*)

Section 98.1 of the Act provides rules that apply to a taxpayer who ceases to be a member of a partnership but continues to have a residual interest in the partnership. Paragraph 98.1(1)(*a*) of the Act provides, among other things, that the residual interest will be considered to be an interest in the partnership and the partner will be considered not to have disposed of that interest unless the taxpayer ceases to be a resident of Canada or the taxpayer dies.

Paragraph 98.1(1)(*a*) is amended, as a consequence of the elimination of the $100,000 lifetime capital gains exemption, to add a reference to section 110.6. This amendment deems a disposition of the residual interest to occur where the taxpayer elects to recognize gains in respect of the partnership interest that accrued to the end of February 22, 1994 thereby obtaining the benefit of the exemption in respect of those gains. Amended paragraph 98.1(1)(*a*) applies to the 1994 and subsequent taxation years.

Clause 126

Loss Relating to Interest in a Partnership

ITA
100(4)

In certain circumstances, subsection 100(4) of the Act reduces the capital loss of a corporate partner arising from the corporation's disposition of a partnership interest. The capital loss otherwise determined is reduced to the extent that the corporation's share of the partnership's loss would have been reduced under subsection 112(3.1) or (4.2) of the Act. Subsections 112(3.1) and (4.2) are stop-loss rules which reduce a partner's share of a partnership loss arising from the partnership's disposition of shares of the capital stock of a corporation. The loss reduction is equal to certain dividends received on the shares and distributed to the partner. Subsections 112(3.1) and

(4.2) would not apply to reduce a partner's loss where, instead of the partnership disposing of the corporate shares, the partner disposes of its interest in the partnership. Subsection 100(4) ensures that the capital loss from the disposition of the partnership interest is reduced to reflect the amount of any capital loss that would have been denied in respect of the shares held by the partnership in a notional disposition of the shares at their fair market value. For the purposes of calculating the loss reduction, the provision also treats the partnership's fiscal period as having ended immediately before the disposition of the partnership interest.

The provision is amended so that a loss from the disposition of an interest in a partnership may be reduced where the interest is held by another partnership. The amended provision applies in circumstances where amended subsection 112(3.1) would have applied to reduce a partner's share of a partnership loss arising from the disposition of a share held by any partnership. Since amended subsection 112(3.1) does not reduce losses at the partnership level, a capital loss reduction under amended subsection 100(4) will apply only at the individual or corporate partner level. Accordingly, where amended subsection 112(3.1) would have applied to reduce a partner's share of a partnership loss arising from the disposition of a corporate share held by another partnership, amended subsection 100(4) will reduce the partner's capital loss arising from the disposition of an interest in the second partnership. For the purposes of calculating the loss reduction, the partnership is treated as having disposed of the corporate shares at their fair market value and the fiscal period of all partnerships are treated as having ended immediately before the disposition of the partnership interest.

Subsection 100(4) is also amended to remove the reference to subsection 112(4.2) of the Act because amended subsection 112(4.2) does not apply to shares held by partnerships.

Amended subsection 100(4) applies to dispositions that occur after April 26, 1995.

Clause 127

Trusts and their Beneficiaries

ITA
104

Section 104 of the Act provides rules governing the tax treatment of trusts and their beneficiaries.

Subclause 127(1)

ITA
104(4)(*a*)

Subsection 104(4) of the Act contains provisions that relate to what is generally referred to as the "21-year deemed realization" rule for trusts. Subparagraph 104(4)(*a*)(i.1) of the Act, which deals with certain spousal trusts, refers to paragraph 70(5.2)(*d*) or (*f*) of the Act. Those paragraphs were amended by the Statutes of Canada 1994, chapter 21 (Bill C-27), which restructured subsection 70(5.2) of the Act. This amendment to subparagraph 104(4)(*a*)(i.1) updates the corresponding references so that they correctly reflect that restructuring. It applies to acquisitions and dispositions that occur after 1992, the same period to which the corresponding amendment to subsection 70(5.2) applies.

Subclause 127(2)

ITA
104(6)

Subsection 104(6) of the Act generally permits a trust to deduct in a taxation year any trust income payable to a beneficiary under the trust.

Subsection 104(6) is amended to provide that, once a trust governed by an RRSP or RRIF is no longer exempt from tax after the death of the RRSP or RRIF annuitant, only trust income actually paid to a beneficiary in a taxation year is deductible in computing income. Because subsection 104(13) of the Act does not apply to trusts

governed by RRSPs and RRIFs, such amounts paid would be included in income under subsection 146(8) or 146.3(5) of the Act.

This amendment applies to the 1996 and subsequent taxation years.

Subclause 127(3)

Late, Amended or Revoked Election

ITA
104(14.01) and (14.02)

Subsection 104(14) of the Act provides for a joint election by a trust and a preferred beneficiary under the trust that allows an amount not exceeding the beneficiary's share of the trust's accumulating income to be deducted in computing the income of the trust and included in computing the income of the beneficiary. Ordinarily, the election is required by subsection 2800(2) of the *Income Tax Regulations* to be filed within 90 days after the end of the trust's taxation year in respect of which the election is made. For the trust's taxation year that includes February 22, 1994, the filing deadline is extended to coincide with the filing deadline for the capital gains election under subsection 110.6(19) of the Act. Section 104 of the Act is amended, applicable to trusts' taxation years that include February 22, 1994, by adding new subsections 104(14.01) and (14.02) of the Act.

New subsection 104(14.01) extends the filing deadline for a preferred beneficiary election, and allows such an election to be amended or revoked, where the late or amended election or the revocation is made solely because of a late or amended capital gains election or the revocation of a capital gains election. In these circumstances, the filing deadline for the preferred beneficiary election or the amendment or revocation thereof is extended to coincide with the filing of the late or amended capital gains election or the revocation of the capital gains election, as the case may be.

New subsection 104(14.02) provides that an election or an amended election made in accordance with subsection 104(14.01) will be considered to have been made within the prescribed time for making the election provided for in subsection 104(14), and that the revoked election will be considered, except for the purposes of subsections 104(14.01) and (14.02), to have never been made.

Subclause 127(4)

Designation in Respect of Non-Taxable Dividends

ITA
104(20)

For the purposes of certain loss limitation rules in the Act, subsection 104(20) of the Act requires a trust to designate the non-taxable dividends that are received by the trust and subsequently distributed to the trust's beneficiaries. The amendment to this provision is consequential on the amendments to the loss limitation rules in section 112 of the Act and the addition of paragraph 107(1)(*d*) to the Act. The amended loss limitation rules and new paragraph 107(1)(*d*) are added to the list of purposes of the Act for which designations will be considered to have been made under subsection 104(20).

This amendment applies after April 26, 1995.

Subclause 127(5)

Late, Amended or Revoked Designation

ITA
104(21.01) to (21.03)

Subsection 104(21) of the Act permits a trust to designate in its return of income for the year a portion of its net taxable capital gain as a taxable capital gain of a beneficiary of the trust.

Section 104 of the Act is amended, applicable to taxation years that include February 22, 1994, by adding proposed new subsections 104(21.01), (21.02) and (21.03) of the Act.

New subsection 104(21.01) allows a trust that has filed its return of income for the year which includes February 22, 1994 to subsequently designate an amount under subsection 104(21), or amend or revoke a designation made thereunder, where such designation, amendment or revocation is solely because of changes to the election made under subsection 110.6(19) of the Act and subsection 110.6(25), (26) or (27) of the Act applies to those changes.

The trust must file such designation, amendment or revocation, and an amended return for the year, with the amended or revoked election under subsection 110.6(25), (26) or (27) of the Act.

New subsection 104(21.02) provides that a designation, amendment or revocation referred to in subsection 104(21.01) that affects an amount determined in respect of a beneficiary under subsection 104(21.2) may only be made where the trust makes the corresponding changes to an amount designated under subsection (21.2) in respect of the beneficiary. The trust must file these changes with the Minister at the same time as the trust files the changes under subsection 104(21.01).

New subsection 104(21.03) provides that a designation, amended designation or revocation of an amount by a trust under subsection 104(21) or (21.2) that is in accordance with subsection 104(21.01) will be considered to have been made in the trust's return of income for the year that includes February 22, 1994. The designation that is revoked shall be deemed, but for the purposes of this subsection and subsections 104(21.01) and (21.02), to have been made in that return of income.

Clause 128

Dispositions Related to Trusts

ITA
107

Section 107 of the Act provides rules relating to the acquisition and disposition of interests in, and property of, trusts.

Subclause 128(1)

ITA
107(1)(*c*) and (*d*)

Subsection 107(1) of the Act contains special rules that apply to the disposition of an interest in a trust. Paragraph 107(1)(*c*) of the Act is a "stop-loss" rule which reduces a corporate beneficiary's capital loss from the disposition of an interest in a trust. The loss otherwise

realized by the beneficiary is reduced by all dividends designated under subsection 104(19) or (20) of the Act by the trust in respect of the beneficiary. In computing the amount of loss reduction, dividends that reduced a capital loss of the beneficiary from a previous disposition of an interest in the same trust are excluded. Where a trust realizes a loss on the disposition of a share, the stop-loss rules in section 112 of the Act may apply to reduce the loss otherwise determined by the amount of certain dividends received by the trust on the share. However, these stop-loss rules would not apply where a beneficiary which holds a capital interest in the trust disposes of the interest and realizes a loss that can be attributed to the reduced value of shares held by the trust. Paragraph 107(1)(*c*) ensures that the appropriate loss reduction is made in such circumstances.

Paragraph 107(1)(*c*) is amended so that it applies to reduce the loss, not merely the capital loss, from the disposition of a capital interest in a trust. This amendment applies to dispositions that occur after 1997.

Paragraph 107(1)(*c*) is amended in its application to taxable dividends received by corporate beneficiaries so that only those taxable dividends that are deductible by the beneficiary will be applied to reduce the loss from the disposition. This amendment applies to dispositions that occur after April 26, 1995.

Paragraph 107(1)(*c*) is also amended so that it applies to other taxpayers (except for members of partnerships who are dealt with under new paragraph 107(1)(*d*) of the Act). Where the beneficiary is another trust, all amounts designated under subsection 104(19) or (20) in respect of the beneficiary will reduce the beneficiary's capital loss from the disposition of an interest in the trust which designated the dividends. Consistent with the exclusion for mutual fund trusts from the stop-loss rules in amended subsection 112(3.2) of the Act, this rule does not apply to a beneficiary trust which is a mutual fund trust. Where the beneficiary is a natural person, only amounts designated under subsection 104(20) in respect of the beneficiary will reduce a capital loss from the disposition of an interest in the trust. These amendments apply to dispositions that occur after April 26, 1995.

New paragraph 107(1)(*d*) provides similar rules where a partnership realizes a loss from a disposition of an interest in a trust. However,

since the partnership which disposes of the share is treated as a flow-through entity, the loss reduction is performed at the partner level. The new provision does not apply to reduce the loss of a partnership that is a member of another partnership and applies only where the partner is a corporation or individual (other than a mutual fund trust). Accordingly, where a partnership is a member of another partnership which realizes a loss from the disposition of a trust interest, the loss of the partners of the first partnership may be reduced under new paragraph 107(1)(*d*). These amendments apply to dispositions that occur after April 26, 1995.

Subclause 128(2)

Cost of Capital Interest in a Trust

ITA
107(1.1)

Subsection 107(1.1) of the Act provides, for the purposes of subsection 107(1) of the Act, that the cost of a capital interest in a trust will be nil, except where the interest is acquired from the previous capital beneficiary of the trust or where the interest is issued to taxpayer for consideration equal to the fair market value of the trust interest. Subsection 107(1.1) is amended as a consequence of the elimination of the $100,000 lifetime capital gains exemption to add a reference to an election made under new subsection 110.6(19) of the Act. This amendment ensures that where a taxpayer makes an election to recognize gains in respect of the taxpayer's capital interest accrued to the end of February 22, 1994 and the trust does not elect in respect of any property of the trust, the taxpayer's cost of that interest will be the amount determined in respect thereof under paragraph 110.6(19)(*a*). New subsection 107(1.1) applies to the 1994 and subsequent taxation years.

Subclause 128(3)

ITA
107(2)(*b*)

Paragraph 107(2)(*b*) of the Act is amended, applicable to distributions after 1993, to permit an additional amount determined under new subsection 107(2.2) of the Act to be included in the cost of property

distributed to a beneficiary of a trust described in paragraph (*h*), (*i*) or (*j*) of the definition "flow-through entity" in subsection 39.1(1) of the Act in satisfaction of all or a portion of the beneficiary's interest in the trust. A trust described in paragraph (*h*), (*i*) or (*j*) of the definition "flow-through entity" in subsection 39.1(1) is also a prescribed trust under section 4800.1 of the *Income Tax Regulations* for the purpose of subsection 107(2) of the Act.

Subclause 128(4)

Other Distributions

ITA
107(2.1)

Subsection 107(2.1) of the Act sets out rules that apply on a distribution of property, by a trust other than a personal or a prescribed trust, in satisfaction of all or part of a beneficiary's capital interest. The subsection is amended to clarify that it does not apply to a disposition that forms part of a qualifying exchange under section 132.2 of the Act. A qualifying exchange is a tax-deferred transfer of property from one mutual fund to another, and includes the disposition by investors in the transferor fund of their shares or units of that fund in exchange for units of the transferee fund.

To coincide with the introduction of section 132.2, this amendment applies to distributions made after June 1994.

Subclause 128(5)

Flow-Through Entity

ITA
107(2.2)

New subsection 107(2.2) of the Act is consequential on the elimination of the $100,000 lifetime capital gains exemption for gains arising on dispositions that occur after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) of the Act for recognizing gains accrued to that date. Where an individual recognizes a capital gain accrued to that date on an interest in, or a share of the capital stock of, a flow-through entity (as defined in

subsection 39.1(1) of the Act), the amount of the gain is credited to a special account referred to as the individual's exempt capital gains balance in respect of the entity. Claims may be made against this account to reduce gains that are flowed out to the individual by the entity for taxation years before 2005 and gains realized on dispositions of interests in or shares of the entity for those years.

A beneficiary of a trust described in paragraph (*h*), (*i*) or (*j*) of the definition "flow-through entity" in subsection 39.1(1) may elect under subsection 110.6(19) and establish an exempt capital gains balance in respect of the trust. Distributions of property from such a trust to a beneficiary occur on the rollover basis set out in subsection 107(2) of the Act.

New subsection 107(2.2) is available to provide an addition to the cost to the beneficiary of each distributed property determined under paragraph 107(2)(*b*) of the Act to permit the beneficiary potentially to benefit from an undepleted exempt capital gains balance in respect of the trust. A beneficiary of a trust described above who receives a distribution of property, other than money, in satisfaction of all or a portion of the beneficiary's interests in the trust may file an election with Revenue Canada in respect of a particular property received.

The amount designated in the election in respect of a particular property must not exceed the lesser of two amounts. The first amount is the beneficiary's exempt capital gains balance in respect of the trust for the year minus the total of all reductions in capital gains in the year because of the beneficiary's exempt capital gains balance, 4/3 of all reductions in taxable capital gains in the year because of the beneficiary's exempt capital gains balance and all amounts included because of subsection 107(2.2) in the cost of other property received by the beneficiary in the year. The second amount is the fair market value of the particular property minus the amount deemed to be the cost of the particular property under paragraph 107(2)(*b*). Thus the cost of a property cannot be bumped to an amount higher than its fair market value under this provision. An election in respect of a property received by the beneficiary must be filed in prescribed form by the beneficiary's filing-due date for the taxation year in which the property was received.