# lementary Information
# ing to Tax Reform Measures

December 16, 1987

Tabled in the
House of Commons
by the Honourable Michael H. Wilson
Minister of Finance

Canada

# Supplementary Information Relating to Tax Reform Measures

**December 16, 1987**

**Tabled in the House of Commons by the Honourable Michael H. Wilson Minister of Finance**





Department of Finance Canada
Ministère des Finances Canada

TABLE OF CONTENTS


I INTRODUCTION ..... 1

II MEASURES AFFECTING INDIVIDUALS ..... 5
1. Introduction ..... 5
2. Personal Tax Rate Reductions ..... 7
3. Conversion to Tax Credits of Personal Exemptions and Some Deductions ..... 8
Basic, Married, Equivalent-to-Married, Age ..... 8
Disability, Infirm Dependants, Pension Income, and Medical Expenses ..... 9
Charitable Donations ..... 10
Canada and Quebec Pension Plan Contributions and UI Premiums ..... 11
4. Treatment of Dependent Minor Children ..... 12
Child Credit and Refundable Child Tax Credit ..... 12
Tax Treatment of Family Allowances ..... 13
$500 Income Threshold ..... 14
Impact on Families with Children Aged 18 and Under ..... 15
Dependants Over Age 18 ..... 22
5. Refundable Sales Tax Credit ..... 23
6. Capital Gains of Individuals ..... 24
7. Dividend Gross-up and Tax Credit ..... 27
8. Investment Income Deduction ..... 28
9. Private Pension and RRSP Contribution Limits ..... 29
10. Business Expenses ..... 30
Automobile Expenses ..... 30
Business Meals and Entertainment Expenses ..... 35
Home Office Expenses ..... 37
11. Employment Expenses ..... 38
12. Capital Cost Allowance for Certified Canadian Productions (Films) ..... 39
13. Multiple-Unit Residential Buildings (MURBs) ..... 41
14. Proposals for Treatment of Farming Losses ..... 42
15. Minimum Tax ..... 48
16. Forward Averaging and Block Averaging ..... 49
17. Accelerated Source Deductions ..... 50

III MEASURES AFFECTING CORPORATIONS ..... 51
1. Introduction ..... 51
2. Corporate Tax Rate Reductions ..... 55
3. Investment Income of Private Corporations ..... 57
4. Capital Gains of Corporations ..... 59
5. Elective Year-End for Private Corporations ..... 60
6. Capital Cost Allowances ..... 61
CCA for Manufacturing and Processing Machinery and Equipment ..... 61
Other Changes to the CCA System ..... 64
Put-in-Use Rule ..... 66
7. Investment Tax Credits and Research and Development ..... 69
Research and Development Expenditures ..... 70
8. Flow-Through Shares and Earned Depletion ..... 72
9. Issue Expenses ..... 77
10. Preferred Shares ..... 78
11. Real Estate Interest and Other Soft Costs ..... 79
12. Unpaid Claim Reserve ..... 83
13. Taxation of Financial Institutions ..... 84
Overview ..... 84
Treatment of Doubtful Debts ..... 87
Reserve Transition ..... 89
The Allocation of Loan Losses on Foreign Indebtedness ..... 90
Additional Changes to the Taxation of Financial Institutions ..... 90
Life Insurance Company Taxation ..... 92
Definition of Canadian Investment Income ..... 92
Investment Income Tax ..... 94

IV COMPLIANCE AND ADMINISTRATION ..... 99
1. General Anti-Avoidance Rule ..... 99
2. Specific Rules ..... 104
3. Penalties and Offences ..... 106
4. Information Reporting ..... 108

V SALES TAX INTERIM MEASURES ..... 111
1. Introduction ..... 111
2. Marketing Companies and Tax Shifts to the Wholesale Level ..... 112
3. Fair Market Value ..... 113
4. Tax on Telecommunication Services ..... 114
5. Tax on Cable and Pay Television Services ..... 115
6. Deletion of Paint and Wallpaper from List of Construction Materials ..... 115
7. Federal Sales Tax Credit ..... 115
8. Accelerated Payment of Sales and Excise Taxes ..... 116

9. Sales Tax Rate for Alcoholic Beverages and Tobacco Products ..... 117

VI FISCAL IMPACT ..... 119
1. Direct Impact by Measure ..... 119
2. Impact on Deficit ..... 122
3. Overall Impact on Federal Fiscal Balance ..... 125
4. Rebalancing Federal Tax Revenue Shares ..... 129
5. Fiscal Impact on Provinces ..... 131

Annex: Draft Legislation on General Anti-Avoidance Rule ..... 133

CHAPTER I

INTRODUCTION

On June 18, 1987, the Government of Canada tabled in the House of Commons a White Paper outlining detailed proposals for comprehensive reform of Canada's tax system.

The proposals responded to an increasingly urgent and widely recognized need for reform. Over the past two decades, the accumulation of special measures in all parts of the tax system -- personal and corporate income taxes and sales taxes -- had reached the stage where they undermined tax fairness, damaged opportunities for economic growth and job creation, and seriously reduced the system's stability and its reliability in raising revenues.

The White Paper proposals are designed to improve Canada's tax system so that Canadians will benefit from a fairer, more understandable system that encourages initiative, strengthens growth and job creation, and provides a more reliable and balanced source of revenues to finance essential public services.

To achieve these improvements the government, in the White Paper, proposed lower tax rates, a broadening of the tax base through the restriction of special tax preferences, a reduction in personal income tax brackets from 10 to three, and the conversion of all personal exemptions and some deductions to tax credits.

The first stage of tax reform -- to be implemented in 1988 -- will include changes to the personal and corporate income tax systems and interim changes to the existing federal sales tax. In stage two, the federal sales tax will be replaced by a broad-based multi-stage sales tax, accompanied by a substantial enrichment of the refundable sales tax credit, further income tax reductions for middle-income taxpayers, and removal of the personal and corporate income surtaxes. Stage two is currently being discussed and these ongoing consultations will be instrumental in giving final shape to the proposed new sales tax.

From the outset, consultation has played a major role in tax reform. In developing the White Paper proposals, the government benefited considerably from the insights and recommendations provided by Parliament, representative associations, business, labour and individual Canadians.

When the government tabled the White Paper, interested groups and organizations were again invited to examine the proposals and present their views. The proposals for reforming the personal and corporate income tax system have been the subject of extensive public examination by the House of Commons Committee on Finance and

Economic Affairs and the Senate Committee on Banking, Trade and Commerce. Since June 18 the Minister of Finance, the Minister of State (Finance) and officials of the Finance Department have also met with individuals and representatives of many organizations across the country.

Members of these committees and all Canadians who made submissions to them have made a valuable contribution to the consultative process and to the refinement of the reform proposals.

In their respective reports, both the Commons and Senate committees supported the main thrust of the proposed income tax reforms. While voicing this broad support, both made a number of detailed recommendations for change to specific proposals in the White Paper. These recommendations have been carefully reviewed. Each has been weighed against the stated objectives of tax reform, the need to preserve the overall balance of the reform package, and the need to ensure that the net fiscal effect of tax reform will be neutral.

In response to the views of Canadians, as expressed through the recommendations of the two parliamentary committees and through direct representations, improvements and technical changes to some of the White Paper proposals will be made. These modifications, outlined below, will increase the degree to which tax reform achieves the basic objectives set forth in the White Paper. The fairness of the tax system will be increased as lower- and middle-income families with children receive more benefits. Modifications to some of the corporate income tax proposals will further increase the extent to which the tax system enhances the competitive position of Canadian industry and encourages economic growth and job creation. Consistency of the tax system with other government programs will be maintained.

The White Paper proposals in conjunction with the package of improvements put forward below is fiscally neutral, and tax reform will result in a reliable and balanced system of revenues to finance essential public services. In contrast, many specific proposals put forward in response to the White Paper, while desirable from the point of view of the proponent, would have been quite costly. The aggregate cost of all proposals, in terms of forgone revenue, would have been extremely high. When the proposals identified alternative sources of revenues to offset these revenue losses, these sources often fell short of the amounts required. In other cases, alternative sources of revenues were simply not identified. Adoption of many of the proposals put forward would have meant that the fiscal neutrality of stage one of tax reform would have been compromised or the balance among revenue sources distorted. Some suggestions ran counter to other policy goals of tax reform. With the modifications below, stage one of tax reform will be fiscally neutral: the revenue

reductions on the personal income tax are balanced by revenue increases on the corporate and sales tax so that the deficit over the next four years will not be adversely affected.

## CHAPTER II

## MEASURES AFFECTING INDIVIDUALS

### 1. Introduction

The White Paper set out the following objectives for reform of the personal income tax system:

- the tax system should be fair, progressive, impose little or no burden on those least able to pay, and reduce variations in the tax positions of individuals in similar circumstances;
- the tax system should have a broader base and lower rates, minimizing preferences that permit some high-income individuals to pay little or no tax;
- the tax system should support economic growth and regional development and contribute to Canada's ability to compete in world markets;
- the tax system should be more understandable and less complex;
- the tax system should provide a stable and predictable revenue base.

The proposals set out in the White Paper for personal income tax reform met these objectives. Personal income tax was reduced for eight out of ten taxpayers and nine out of ten elderly taxpayers. All personal tax exemptions and some deductions were converted to credits and many tax preferences were eliminated or restricted. These changes, in conjunction with the revised rate structure, would result in most individuals seeing their tax burden reduced. About 850,000 Canadians, of whom 250,000 are elderly, will no longer have to pay federal income tax.

The consultations indicated widespread support for the general thrust of tax reform and a consensus that the fundamental structure proposed in the White Paper was sound. Therefore, the basic features of the reformed personal income tax system set out in the White Paper remain as stated. The proposed three-rate structure and the conversion of personal exemptions and deductions to tax credits will not be changed. In addition, the proposals on the taxation of capital gains, the dividend gross-up and tax credit, the treatment of private pension and RRSP contributions, and the investment income deduction will be implemented. The proposed treatment of business meals and entertainment expenses and home office expenses is confirmed.

The consultations revealed three areas where modifications would improve the degree to which tax reform would meet its objectives. First, concerns were expressed that, under tax reform, the tax reductions for families with children were not sufficient. Second, the treatment of automobile expenses under tax reform was judged to be too severe for those who must rely on automobiles to earn their livelihood and who therefore have a high business use of their automobile each year. Third, while there was support for the fundamental objectives of the White Paper relating to the tax treatment of farm losses, the proposals with respect to modified accrual accounting were judged to add undue complexity to reporting by farmers. Changes to address these concerns and to make adjustments in some of the other personal income tax measures proposed in June are set out below.

The proposals set out below respond to specific concerns and will improve upon the measures put forth in the White Paper. Any alterations had to be considered within the constraints imposed by the government's determination that stage one of tax reform be fiscally neutral. Therefore, the cost of any modification had to be financed by changes elsewhere in the system. The improvements to the treatment of families with children and automobiles decrease the yield of the personal income tax system and will be financed through increased corporate income taxes on financial institutions and increased sales tax on alcoholic beverages and tobacco products.

2. Personal Tax Rate Reductions

The White Paper proposed a personal income tax structure with three tax brackets instead of the present 10 brackets, and with major reductions in tax rates. The proposed rate structure for 1988 is:

| Taxable income[1] | Federal marginal tax rate (per cent) |
|---|---|
| up to $27,500 | 17 |
| $27,501 - $55,000 | 26 |
| $55,001 and over | 29 |

(1) Taxable income under the current system does not compare directly to taxable income under the reformed system as personal exemptions and certain deductions, which previously reduced taxable income, are converted into tax credits which reduce tax.

This compares with the current 10 tax brackets with federal rates for 1987 rising as high as 34 per cent on taxable incomes of $63,347 or more.

The choice of the appropriate rate structure is not a decision that can be taken in isolation from decisions on other elements of the overall system. The progressivity of the system also depends on such design decisions as whether to have exemptions or credits and the degree to which the tax base is broadened by eliminating special preferences. In addition, of course, the rate structure has significant implications for government revenues.

The Senate committee expressed some concern about the middle (26-per-cent federal) tax rate but made no formal recommendation in this regard. The Commons committee determined that the balance struck by the White Paper proposals was appropriate and it endorsed the new rate structure.

No change in the rate structure set out in the White Paper is proposed.

3. Conversion to Tax Credits of Personal Exemptions and Some Deductions

Basic, Married, Equivalent-to-Married, Age

The White Paper proposed the conversion of these personal exemptions to federal tax credits on the following basis:

| Exemptions | Exemption level in 1988 | Value of exemption at 17% | Federal tax value of proposed credit |
|---|---|---|---|
| | | (dollars) | |
| Basic | 4,270 | 725 | 1,020 |
| Married | 3,740 | 635 | 850 |
| Equivalent-to-married(1) | 3,740 | 635 | 850 |
| Age | 2,670 | 455 | 550 |

(1) Eligible dependants will be either dependants aged 18 and under related to the taxpayer, or the taxpayer's parents or grandparents, or any other person who is related to the taxpayer and who is infirm.

Personal tax credits provide the same reduction of tax payable for all taxpayers, regardless of their income level. The amounts of the personal tax credits are set at levels that more than compensate for the current value of personal exemptions for the two-thirds of taxpayers who are in the 17-per-cent tax bracket. Furthermore, the value of the credits has been set to offset the elimination of certain other deductions used by many Canadians such as the $500 employment expense and the $1,000 investment income deductions. The conversion of exemptions to credits has received broad public support.

It should be noted that in the nine provinces which impose their provincial income tax as a percentage of the federal tax, the total value of the credits against combined federal and provincial tax will be approximately 1 1/2 times the value of the federal credit.

No changes in the amount of these credits as set out in the White Paper are proposed.

Disability, Infirm Dependants, Pension Income, and Medical Expenses

The White Paper proposed that the disability deduction, which would be worth $495 in 1988 at a 17-per-cent tax rate, be converted to a credit of $550. Currently, the unused portion of an individual's disability deduction may be transferred to the individual's spouse, parent or grandparent or, in certain circumstances, to a supporting relative with whom the individual lives. In recognition of the fact that many taxpayers support their disabled parents or grandparents, the White Paper proposed to extend the transferability of the disability credit to children supporting in their home their disabled parents or grandparents.

The pension income deduction is replaced by a pension credit equal to 17 per cent of eligible pension income to a maximum credit of $170 and thus is equivalent to the deduction for all those in the lowest tax bracket. An individual will be allowed to transfer to his or her spouse the unused portion of this credit. The exemption for infirm dependants over age 18 is converted at the 17-per-cent rate to a federal tax credit of $250.

The White Paper also proposed that the medical expense deduction be converted to a credit of 17 per cent of the amount by which eligible expenses exceed a threshold of 3 per cent of net income. It has been noted that the combined effect of converting this deduction to a credit at 17 per cent and retaining the threshold at 3 per cent of net income makes the White Paper proposal particularly stringent for those taxfilers in the high-income brackets who have very large medical expenses. The 3-per-cent threshold means that their medical expenses must be high to qualify. For this reason, it has been decided that the new medical expense credit will apply to qualifying expenses which exceed a threshold of $1,500 or 3 per cent of net income, whichever is less.

As with the conversion of exemptions to credits, the conversion of these deductions has been welcomed. No change, apart from that to the threshold for the purposes of the medical expenses credit, is planned to these White Paper proposals.

Charitable Donations

The White Paper proposed the conversion of the deduction for charitable donations and certain other gifts into a two-tier tax credit: 17 per cent (approximately 26 per cent federal and provincial) on the first $250 of aggregate donations and 29 per cent (approximately 44 per cent federal and provincial) for total donations by an individual above that amount. The maximum charitable contributions in a year eligible for tax assistance will continue to be limited to 20 per cent of a taxpayer's net income (but with no limit in the case of gifts to the Crown or gifts of cultural property). Gifts not claimed in a year may be carried forward for up to five years. The new credit will also apply to gifts carried over from 1987 and prior years.

The conversion from an exemption to a credit responds favourably to the submissions received from voluntary groups. The credit system is structured to provide equal reward for effort in giving by donors in all income brackets in contrast to the present deduction system which provides greater reward for those in the higher income brackets. This proposal was supported by both Parliamentary committees.

In comparing the credit to the deduction, there are three cases to analyze. First, donors in the 17-per-cent bracket will always be at least as well off with the credit as with a deduction and will have a greater incentive to give more than $250. Second, donors in the 26-per-cent tax bracket will have a reduction in federal tax assistance of $22.50 on the first $250 of donations but will have an increased incentive to give in excess of that amount. Third, donors in the 29-per-cent bracket will have a reduction in federal tax assistance of $30 on the first $250 of donations, no matter how much more than $250 they give. In view of the fact that their average giving is $1,490, however, it is doubtful that this reduction will affect their decision to give.

Taxpayers as a whole experience a substantial increase in disposable income as a result of tax reform, and since the decisions to give and how much to give depend very much on income, it is reasonable to expect that some tax savings will be used to increase donations.

As a result of the credit, federal and provincial government revenues will be reduced by an additional $80 million a year and total tax support for charitable giving will be increased to $900 million in 1988. The government will proceed with this initiative as proposed in the White Paper for 1988 and subsequent taxation years.

## Canada and Quebec Pension Plan Contributions and UI Premiums

The White Paper proposed that unemployment insurance (UI) premiums of individuals and the employee portion of Canada and Quebec Pension Plan (CPP/QPP) contributions be converted to a credit at the 17-per-cent rate. The employer portion of CPP/QPP contributions paid by the self-employed was left as a deduction.

The conversion of these deductions to credits provides for the same after-tax cost per dollar of contributions or premiums, regardless of the employee's taxable income. For this reason, the proposal has received widespread support. However, the Commons committee judged that the proposal to leave as a deduction the employer portion of the CPP/QPP contribution paid by the self-employed would add greatly to the complexity of the individual tax return for only a small improvement in equity. As a consequence, the committee proposed that the conversion to a credit of 17 per cent apply to both the employer and employee portions of CPP/QPP contributions paid by the self-employed. The government accepts this recommendation.

Amounts paid by an individual as UI premiums and CPP/QPP contributions on his or her own behalf will be creditable at the 17-per-cent rate for 1988 and subsequent taxation years.

## 4. Treatment of Dependent Minor Children

### Child Credit and Refundable Child Tax Credit

The White Paper proposed to convert the child tax exemption to a federal credit of $65 for dependent children under 18 and to make the credit available in respect of children who turn 18 during the taxation year. This amount of $65 is equivalent to 17 per cent of the estimated family allowance payable in 1988. The value of the combined federal and provincial credits would be approximately $100 per child. This credit was calculated to equal the tax savings that a taxpayer in the 17-per-cent rate bracket would have received from an exemption of $388 per child -- the estimated value of family allowances in 1988. Under current law, the child deduction was scheduled to be reduced each year until it equalled the level of family allowances in 1989.

The conversion from an exemption to a credit for dependent children has generally been well received. However, concern has been expressed over the level of the tax credit provided for children. Both the Commons and Senate committees recommended greater recognition of dependent children in the tax system, although the methods they proposed for achieving this were different.

The Commons committee proposed that the dependent child credit for the third and subsequent children be doubled to $130 per child. The committee also suggested that, in order to make the conversion from exemptions to credits even more progressive and to assist those large families which pay little or no income taxes, the refundable child tax credit should be increased for third and subsequent children -- in effect providing a refund of the dependent child credit for those children. The Senate committee suggested that the proposed $65 dependent child credit be dropped and family allowances be made non-taxable.

The government concurs that improved tax recognition of minor children is desirable and thus will implement three improvements to the White Paper proposals.

First, the refundable child tax credit will be increased by $35 to $559 per child for 1988. Increasing benefits for children in this way directs the benefits to low- and middle-income families, consistent with the government's objective of providing increased assistance to those who need it most. It also ensures that families with incomes below the tax threshold benefit from tax reform. The refundable child tax credit will be further enhanced for children six and under as a result of the child care initiative announced on December 3, 1987 by the Minister of National Health and Welfare.

Second, to improve the tax treatment of larger families, the dependent child credit will be increased to $130 per child for the third and subsequent children aged 18 and under.

Third, family allowances will be required to be reported for taxation purposes by the higher-income spouse, as proposed by the Commons committee. There will be no change to the provisions which determine who receives the family allowance payment.

Tax Treatment of Family Allowances

The White Paper proposed no change to the current rules which require family allowances to be reported in the tax return of the spouse claiming the child tax exemption (or, in future, the dependent child credit).

Under current law, the child tax exemption would be equal to family allowance by 1989 and thus, in effect, would be non-taxable. However, as a result of the conversion from an exemption to a child credit of $65 (a 17-per-cent tax on family allowance equals $65), taxfilers in the 26- or 29-per-cent brackets will face a federal tax rate on family allowance receipts of 9 per cent (26 minus 17) or 12 per cent (29 minus 17). Furthermore, the simple rule of thumb -- that it was always beneficial for the higher-income spouse to report the family allowance and claim the exemption so long as the exemption exceeded the allowance -- would no longer apply in all cases.

To avoid complexity and to increase fairness, the Commons committee has recommended that the family allowance reporting rule be changed so that in all cases the higher-income spouse would be required to report family allowances and to claim the dependent child credit.

In light of the above proposal to increase the refundable child tax credit by $35 per child and to increase the dependent child credit to $130 for the third and subsequent children, the proposal to make family allowances taxable in the hands of higher-income spouse would make the tax system fairer. Hence, the government accepts this proposal by the committee, and proposes that family allowances and the dependent child credit must be reported by the spouse with the higher income.

$500 Income Threshold

In the case of the married and equivalent-to-married credits and the credits for dependants, the White Paper proposed that the spouse or dependant be able to earn up to $500 in net income before the full value of the credit available to the supporting taxpayer would begin to be reduced. The credit would be reduced at a rate of 17 per cent of net income in excess of the $500 threshold.

In reviewing this issue, both the Commons and Senate committees noted that for dependent children, the proposed $500 income threshold represented a significant reduction from the existing threshold. Consequently, both committees proposed substantial increases, the Commons committee to $1,000 and the Senate committee to $2,500. The Commons committee also recommended that the threshold for the married credit be set at $1,000.

The government proposes that the income threshold for the purposes of the credits in respect of the dependent child and infirm credits be established at $2,500. The threshold for the purposes of the married and equivalent-to-married credits will, as originally proposed, be $500, approximately the same as the current threshold.

Impact on Families with Children Aged 18 and Under

The impact of the above improvements, together with other White Paper proposals, is to reduce significantly taxes paid by families with children. This is illustrated in Tables 2.1, 2.3 and 2.5. Tables 2.2, 2.4 and 2.6 present the total federal and provincial tax that would be payable in 1988 by families of different sizes and at different income levels. As the tables make clear, the overall impact of tax reform is to reduce income taxes for all families and to ensure that families with children continue to pay less tax than families with the same total income and income composition but with no children.

Table 2.1

Impact of Personal Income Tax Changes (both Federal and Provincial) on Married One-Earner Couples with Children Aged 18 and Under, 1988

| Income level | No children | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | -105 | -105 | -105 | -105 | -140 | -175 |
| 15,000 | -425 | -450 | -485 | -620 | -755 | -890 |
| 20,000 | -540 | -565 | -585 | -710 | -835 | -960 |
| 25,000 | -725 | -695 | -710 | -830 | -945 | -1,065 |
| 30,000 | -680 | -590 | -590 | -690 | -790 | -905 |
| 40,000 | -405 | -350 | -285 | -375 | -460 | -550 |
| 50,000 | -475 | -395 | -315 | -355 | -415 | -470 |
| 60,000 | -870 | -790 | -710 | -730 | -810 | -865 |
| 75,000 | -1,190 | -1,085 | -980 | -975 | -990 | -1,100 |

Notes: Tax changes include those arising from the conversion of exemptions and deductions into credits, from the modifications to the tax rate structure, and from the increase in the refundable child tax credit.

Taxpayers are assumed to be under age 65, married, to receive earned income, and to claim standard exemptions, deductions and credits. The provincial tax is calculated at an average provincial tax rate of 55 per cent of federal basic tax. As rates of provincial tax vary from province to province, taxpayers in some provinces will experience tax savings that differ from those given above. No provision is made in the calculations for provincial surtaxes and credits, or non-standard exemptions, deductions or credits.

Table 2.2

Federal and Provincial Income Tax Paid by Married One-Earner Couples with Children Aged 18 and Under, 1988

| Income level | No children | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | 0 | -560 | -1,120 | -1,675 | -2,235 | -2,795 |
| 15,000 | 915 | 255 | -400 | -1,160 | -1,920 | -2,680 |
| 20,000 | 2,200 | 1,540 | 885 | 125 | -635 | -1,395 |
| 25,000 | 3,485 | 2,875 | 2,215 | 1,460 | 700 | -60 |
| 30,000 | 5,140 | 4,775 | 4,115 | 3,355 | 2,595 | 1,830 |
| 40,000 | 9,250 | 9,145 | 8,725 | 7,960 | 7,195 | 6,430 |
| 50,000 | 13,355 | 13,255 | 13,150 | 12,565 | 11,805 | 11,040 |
| 60,000 | 17,700 | 17,600 | 17,495 | 17,290 | 16,650 | 15,885 |
| 75,000 | 24,575 | 24,470 | 24,370 | 24,165 | 23,960 | 23,505 |

Note: See notes to Table 2.1.

Table 2.3

Impact of Personal Income Tax Changes (both Federal and Provincial) on Married Two-Earner Couples with Children Aged 18 or Under, 1988

| Income level | No children | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | -15 | -35 | -70 | -105 | -140 | -175 |
| 15,000 | -175 | -160 | -280 | -415 | -540 | -480 |
| 20,000 | -175 | -215 | -245 | -375 | -505 | -640 |
| 25,000 | -250 | -270 | -305 | -430 | -555 | -680 |
| 30,000 | -360 | -250 | -285 | -410 | -535 | -655 |
| 40,000 | -720 | -640 | -520 | -640 | -760 | -880 |
| 50,000 | -1,035 | -915 | -735 | -835 | -935 | -1,035 |
| 60,000 | -1,120 | -975 | -830 | -830 | -915 | -1,005 |
| 75,000 | -1,285 | -1,300 | -1,100 | -1,120 | -1,145 | -1,190 |

Notes: See note to Table 2.1.

Taxpayers are assumed to receive earned income (60% earned by one spouse, 40% earned by the other) and to claim some child care expenses up to $4,000. The amount of child care expenses assumed are $500 per child for families with incomes of $10,000 and $15,000; $1,000 and $1,500 per child for families with incomes of $20,000 and $25,000 respectively; and $2,000 per child for those with incomes of $30,000 and above. Families with more than two children are assumed to claim the same amount of child care expenses as families with two children.

Table 2.4

Federal and Provincial Income Tax Paid by Married Two-Earner Couples with Children Aged 18 or Under, 1988

| Income level | No children | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | 0 | -560 | -1,120 | -1,675 | -2,235 | -2,795 |
| 15,000 | 715 | 60 | -735 | -1,495 | -2,235 | -2,795 |
| 20,000 | 1,945 | 1,020 | 170 | -590 | -1,350 | -2,110 |
| 25,000 | 3,230 | 2,170 | 1,110 | 350 | -410 | -1,170 |
| 30,000 | 4,515 | 3,520 | 2,225 | 1,465 | 705 | -55 |
| 40,000 | 7,080 | 6,445 | 5,295 | 4,535 | 3,775 | 3,015 |
| 50,000 | 10,025 | 9,385 | 8,725 | 7,965 | 7,205 | 6,440 |
| 60,000 | 13,515 | 12,875 | 12,235 | 11,955 | 11,190 | 10,425 |
| 75,000 | 19,130 | 18,205 | 17,495 | 17,290 | 17,085 | 16,430 |

Note: See notes to Table 2.3.

Table 2.5

Impact of Personal Income Tax Changes (both Federal and Provincial) on Single Parents with Children Aged 18 and Under, 1988

| Income level | Single individual | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | -75 | -95 | -70 | -105 | -140 | -175 |
| 15,000 | -170 | -450 | -485 | -620 | -755 | -840 |
| 20,000 | -340 | -545 | -535 | -660 | -790 | -920 |
| 25,000 | -590 | -690 | -655 | -780 | -905 | -1,030 |
| 30,000 | -695 | -740 | -735 | -850 | -970 | -1,090 |
| 40,000 | -535 | -435 | -400 | -490 | -575 | -665 |
| 50,000 | -905 | -350 | -245 | -330 | -415 | -505 |
| 60,000 | -1,300 | -840 | -730 | -770 | -825 | -885 |
| 75,000 | -1,855 | -1080 | -965 | -985 | -1,010 | -1,120 |

Note: See notes to Tables 2.1 and 2.3.

Table 2.6

Federal and Provincial Income Tax Paid by
Single Parents with Children Aged 18 and Under, 1988

| Income level | Single individual | One child | Two children | Three children | Four children | Five children |
|---|---|---|---|---|---|---|
| | | | (dollars) | | | |
| 10,000 | 970 | -560 | -1,120 | -1,675 | -2,235 | -2,795 |
| 15,000 | 2,255 | 225 | -565 | -1,325 | -2,085 | -2,795 |
| 20,000 | 3,540 | 1,375 | 450 | -310 | -1,070 | -1,830 |
| 25,000 | 4,825 | 2,525 | 1,465 | 705 | -55 | -815 |
| 30,000 | 6,485 | 3,960 | 2,590 | 1,830 | 1,065 | 305 |
| 40,000 | 10,590 | 8,425 | 6,985 | 6,220 | 5,455 | 4,690 |
| 50,000 | 14,700 | 12,535 | 11,590 | 10,825 | 10,060 | 9,300 |
| 60,000 | 19,045 | 16,785 | 15,765 | 15,480 | 14,720 | 13,955 |
| 75,000 | 25,915 | 23,660 | 22,640 | 22,435 | 22,230 | 21,575 |

Note: See notes to Tables 2.1 and 2.3.

Dependants Over Age 18

The White Paper proposed that a dependent credit would be available in respect of individuals over 18 only if they were infirm and that the exemption be converted to a $250 credit, which is equivalent to the value of the exemption for taxpayers in the 17-per-cent bracket. In addition, tuition fees will qualify for a credit equal to 17 per cent of tuition and the current $50 per month education deduction becomes a $10 per month credit. The tuition and education credits will become transferable (to a maximum of $600) to a supporting spouse, parent or grandparent. Often a student is unable to make full use of the tuition credit. Making it transferable means that any unused credit will reduce the taxes of the parent, grandparent or spouse supporting the student.

The Commons and Senate committees recommended a $130 credit for dependent children aged 19 to 21. The Commons committee recommended further that the credit be reduced, where the child is a student, dollar for dollar by any tuition fee credits that the student claimed or transferred. For single parents, the committee recommended extending the equivalent-to-married credit of $850 to dependent children aged 19 to 21, similarly reduced by any tuition fee credits claimed or transferred.

Age 18 is now recognized as the age of majority for voting purposes as well as for most federal and provincial social programs. For example, both family allowances and CPP/QPP use age 18 as the upper limit for minor children. Within the federal tax system itself, the refundable sales tax credit treats those over 18 as adults in their own right. Provincially, family law generally recognizes 18 as the age of majority as do provincial social assistance programs. Adopting age 18 as the age of majority for tax purposes harmonizes the tax system with these other laws and policies.

Accordingly, the White Paper proposal to make age 18 the upper limit for the dependent child credit remains unchanged.

5. Refundable Sales Tax Credit

In recognition of the increases in the federal sales tax in stage one of tax reform, the White Paper proposed that the maximum values of the refundable sales tax credit be increased from $50 to $70 per adult and from $25 to $35 per child. In addition, the White Paper increased the income threshold for the sales tax credit by $1,000 to $16,000 -- the income level above which the credit is reduced by $5 for every $100 of additional income. These credit levels will apply for the 1988 and subsequent taxation years.

## 6. Capital Gains of Individuals

The White Paper proposed major base-broadening changes to the taxation of capital gains. These changes provide some of the funds required to reduce tax rates and to provide sufficient credits, through the conversion and enhancement of personal tax exemptions, to achieve the income distribution goals of tax reform. At the same time, the treatment of capital gains would remain favourable and continue to provide individuals with a major incentive to invest in new and growing businesses. The main proposals of the White Paper in this area are discussed below.

Limits on Lifetime Capital Gains Exemptions: The maximum lifetime capital gains exemption for individuals would be limited to a cumulative $100,000 of capital gains on all property other than qualified farm property and shares of small business corporations. Capital gains on qualified farm property would continue to be eligible for the $500,000 cumulative exemption. The lifetime exemption for capital gains on shares of small business corporations would be increased to $500,000 at the beginning of 1988.

A small business corporation is a Canadian-controlled private corporation using substantially all of its assets in an active business carried on primarily in Canada. To be eligible for the exemption, the shares must have been held by the taxpayer or a relation for at least 24 months immediately preceding their disposition.

The maximum capital gains exemption that an individual may claim over his or her lifetime would be restricted to $500,000 of capital gains on all property.

Capital Gains Inclusion Rate: The proportion of capital gain or loss required to be included in computing an individual's taxable capital gain or allowable capital loss would be increased from one-half to two-thirds in 1988 and to three-quarters in 1990. Net capital losses carried over to other years would be adjusted to take into account the prevailing inclusion rates in those years. Capital gains reserves from prior years in respect of properties disposed of after 1984, which are included in income after 1987, would qualify for the capital gains exemption in the year of inclusion. Consequential changes would be made to other provisions -- such as the special deductions designed to provide capital gains treatment for employee stock option benefits, employer shares received from a deferred profit-sharing plan, and shares provided to prospectors and grubstakers -- to reflect the changes to the inclusion rates.

Cumulative Net Investment Losses: In 1988 and subsequent years, taxable capital gains eligible for the lifetime exemption in any year would be reduced by the cumulative amount of net investment losses deducted by the taxpayer after 1987. In computing net investment losses, a number of investment expenses and income sources will be taken into account. The investment expenses include: interest deducted to earn income from property that will yield interest, dividends, rent or other income from property; carrying charges, including interest, with respect to interests in or contributions to partnerships or co-ownership arrangements where the individual is not actively engaged in the business or limited partnerships; losses of any partnership or any co-ownership arrangement described above; deductions attributed to special resource expenditures, and any loss incurred from renting or leasing of real property owned by the individual or a partnership. Investment income will include interest, taxable dividends and other income from property, income from a partnership or co-ownership arrangement described above, and rental or leasing income.

Reaction to the White Paper proposals relating to capital gains taxation has varied, ranging from the view that capital gains should be taxed as ordinary income to the suggestion that the existing rules be left unchanged.

The Commons and Senate committees endorsed the two-thirds level as the appropriate inclusion rate for taxable capital gains for 1988 and 1989 but suggested that it not be increased to three-quarters in subsequent years. The Commons committee suggested that the government study the feasibility of introducing a system of indexation of capital gains for 1990 and subsequent years. As well, it recommended tightening the definition of "qualified farm property" and the small business shares eligible for the exemption, and the exclusion of certain other deductions from the cumulative net investment loss limitation.

Limiting the general lifetime capital gains exemption to $100,000 and the adoption of higher inclusion rates are significant base-broadening measures that will help to finance lower tax rates. The cumulative net investment loss restrictions are needed to prevent avoidance and to ensure that gains are taxable on property in respect of which deductions have been claimed against other income.

The incentives provided by the proposed lifetime capital gains exemption and the continued preferential inclusion rates will contribute to productive investment, job creation and economic growth. In the taxation of income from capital, Canada will remain competitive. The methods of taxation of capital and income from capital differ from country to country. However, when one takes into

account all taxation of capital and income from capital, the Canadian system continues to compare favourably with most other countries. While capital gains will be treated somewhat less advantageously than before tax reform, this change in treatment makes an important contribution to the achievement of tax rate reduction and increased equity of the tax system between taxpayers in similar economic circumstances but with different sources of income. The tax system will continue to give preferential treatment to capital gains and dividends in recognition of the importance of encouraging investment.

The government does not propose to make major changes to the capital gains proposals announced in the White Paper. The suggestion of the Commons committee to further restrict the definition of qualifying shares was not accepted because it would limit the incentive for outside investment in private corporations. There will, however, be some technical changes to the provisions, such as to the definition of "qualified farm property" to ensure that the property was used by the individual or the individual's spouse, child or parent in the business of farming and that such person was actively engaged on a regular and continuous basis in that business. There will also be a modification of the cumulative net investment loss provisions as they apply to resource deductions taken in respect of flow-through shares and passive partnership interests. (See the section in the corporate income tax proposals below relating to flow-through shares and earned depletion.)

Capital gains from dispositions of shares of small business corporations that are being included in income after 1987 through the capital gains reserve mechanism will be eligible for the $500,000 exemption for small business shares where the shares have been disposed of after June 17, 1987. A capital gain reserve brought into income after 1987 in respect of capital gains on small business shares disposed of before June 18, 1987 will qualify for the $100,000 exemption provided for other property.

## 7. Dividend Gross-up and Tax Credit

The dividend gross-up and tax credit system provides recognition of the fact that corporate income from which dividends are paid has already been subject to tax at the corporate level. This system ensures that shareholders will receive credit for some or all of the tax paid by the corporation and, in doing so, reduces or eliminates the double taxation of corporate income which would otherwise occur. The dividend gross-up and tax credit rates are set at levels which attempt to fully integrate the tax payable by Canadian-controlled private corporations and their shareholders on income which qualifies for the small business deduction. Because the small business tax rate is scheduled to decline in 1988, the gross-up and credit will be reduced accordingly to maintain this integration of the personal and corporate tax systems. It was proposed in the White Paper to reduce the dividend gross-up from 33 1/3 per cent of dividends received to 25 per cent in 1988; the federal dividend tax credit would fall correspondingly from 16 2/3 to 13 1/3 per cent of grossed-up dividends and, when provincial tax rates are taken into account, would provide individual shareholders with credit for underlying corporate tax at rates of approximately 20 per cent.

In the consultations, the need to maintain the policy of integration of individual and corporate tax at the small business level was widely recognized.

No changes are contemplated to the proposal in the White Paper.

8. Investment Income Deduction

As part of the main thrust of tax reform to provide reduced tax rates and increased basic personal credits by broadening the tax base, the White Paper proposed the elimination of the $1,000 investment income deduction for individuals. In eliminating this deduction, special care was taken when setting the proposed levels of personal basic credits to ensure that certain types of taxpayers, in particular the elderly, were not adversely affected as a result of tax reform. The Commons committee concurred that the elimination of this deduction is appropriate and will not adversely affect the elderly. In view of these considerations, no changes are contemplated to the White Paper proposal to eliminate this deduction.

## 9. Private Pension and RRSP Contribution Limits

The White Paper proposed to extend the phase-in of the new limits on tax-assisted retirement saving and to postpone the introduction of the new system by one year to 1989. This would affect the timing of increases in the dollar limits on contributions to money purchase pension plans, registered retirement savings plans (RRSPs) and deferred profit sharing plans (DPSPs).

The implementation of the new system of limits according to this revised schedule gave rise to little comment during the consultations. Some argued that the limits are too high and others suggested that tax assistance in this area should also be converted from deductions to credits. The Commons committee noted that there are clearly practical obstacles to a tax credit for private retirement savings plans. Neither the Commons nor Senate committees made recommendations for change in this area.

The government proposes to proceed with the changes proposed. Draft legislation and regulations to implement the new pension and RRSP limits will be released shortly accompanied by comprehensive explanatory notes. Full details will be provided, including the deduction limit changes, the regulations governing the calculation and reporting of pension adjustment amounts and a set of codified pension plan registration rules which will replace the rules currently set out in Revenue Canada's Information Circular 72-13R7. It is the government's intention to table final legislation after plan sponsors and other interested parties have had an opportunity to study and comment on the draft legislation.

10. Business Expenses

Certain expenditures incurred in the course of a business involve items that have both a business use and a personal use. Among these are expenses relating to automobiles, offices in the home and meals and entertainment. In many instances the existing tax rules fail to separate the personal element of these expenditures and thus allow a business deduction for expenses that, in part, represent personal consumption.

In keeping with the objective of broadening the tax base to bring about lower tax rates, the White Paper proposed several changes with respect to such expenses to restrict the deduction for those expenses which have both a business and personal element.

Automobile Expenses

The White Paper proposed several changes to the deduction for the business use of automobiles. The underlying purpose was to restrict the deduction to the incremental cost of the business use of a personal automobile. The proposal recognized that the largest part of the fixed costs of owning an automobile -- depreciation, financing, insurance, and licence costs -- would be incurred by the taxpayer in any event.

During the consultations, four areas of concern relating to automobiles were identified:

- the "one-fifth rule" whereby the deduction for certain fixed costs was limited to one-fifth in cases where business use represented between 20 and 90 per cent of total distance driven;
- the $20,000 ceiling on the cost of an automobile for the purposes of the capital cost allowance (CCA) and lease cost deductions;
- the proposal to eliminate the reduction of the standby charge for employees who are given the use of an employer-owned car and who drive fewer than 1,000 personal kilometers per month; and
- the proposal to exclude insurance, licence and parking costs as deductions.

The Commons and Senate committees recommended against the adoption of the one-fifth rule and proposed that taxpayers be permitted to continue to claim allowable expenses based on the actual proportion of business kilometers driven. The Commons committee recommended that

the amount of the claim for business expenses in respect of automobiles be reduced in all cases by $500 as a means of addressing the personal use issue. Adoption of a $500 threshold on expense claims would have the merit of simplicity, but would depart from the underlying policy purpose of restricting the deduction to the incremental costs attributable to the business use of a personal automobile.

As a result of the consultations, the government proposes the following changes to the tax treatment of automobile expenses in response to the concern over the "one-fifth rule".

Operating expenses will be fully prorated regardless of distance travelled. A fully prorated share of the fixed costs of an employee-owned automobile -- depreciation, interest, licence and insurance costs -- will be deductible when the distance travelled for business purposes exceeds 24,000 kilometers per year. Where business use is less than 24,000 kilometers, the allowable deduction for fixed expenses is less than the fully prorated share, but increases as business use increases. In this case, the prorated share of the fixed costs will be restricted by the ratio of business kilometers to total kilometers to a maximum of 24,000. These changes preserve the fundamental policy reflected in the White Paper proposal, while at the same time responding to the concerns that the original proposal failed to allow a reasonable deduction for individuals using their automobiles for extensive business travel.

In the case of automobiles that are leased, the allowable deduction will be allocated in accordance with the system of proration of fixed costs set out above. Thus the allowable deduction for lease cost, plus licence and insurance costs, will increase as business use increases and will be fully prorated on the basis of business to total use when business travel exceeds 24,000 kilometers per year. It is proposed that the maximum allowable lease cost, before it is prorated on the basis of business use, will be the least of three amounts: the actual monthly lease cost, $600 per month, or the ratio of $20,000 to 85 per cent of the manufacturer's list price times the actual monthly lease cost. This places the deductibility of auto lease costs on the same basis relative to the deductibility of fixed costs for employee-owned automobiles.

A second concern was that the $20,000 limit on the cost of an automobile for purposes of claiming capital cost allowances was too low. As the Commons committee has noted, the arguments for raising the $20,000 limit are not compelling. While there are some cases where it may be appropriate to have an automobile worth more than $20,000 to perform business duties, the $20,000 limit (including provincial sales tax) covers almost all cars other than those with

significant luxury features. Therefore, the $20,000 limit is being retained. However, it is recognized that it will be important to monitor automobile prices and the government will reassess the limit at least every two years.

The third concern raised in the consultations was that the reduced standby charge for an employee who drives fewer than 1,000 personal kilometers per month should not be eliminated as proposed in the White Paper. Given that the standby charge is a benefit that reflects the availability of an automobile for personal use rather than the amount of personal use, no change is contemplated to the White Paper proposal to eliminate the reduced standby charge.

The fourth issue raised in the consultations concerned the disallowance of personal insurance, licence fees and parking charges as allowable expenses. It is proposed that all insurance and licence fees be treated as fixed costs and prorated in the same way as CCA, interest, and leasing expenses. Parking will be fully deductible as a business expense. Finally, it is proposed that reimbursements by an employer of automobile operating expenses, or a reasonable allowance based on distance travelled, will continue to be excluded from the employee's income. However, allowances in excess of 21 cents per kilometer (25 cents in the Yukon and Northwest Territories) will not be deductible to the employer.

The examples in the table below describe the impact of the tax reform proposals on the deduction available for automobiles used in the course of business.

Examples of Amounts of Automobile Expenses
Deductible in Computing Taxable Income

| | (1) Current system | (2) White Paper | (3) Difference (2)-(1) | (4) Proposed system | (5) Difference (4)-(1) |
|---|---|---|---|---|---|
| | | | (dollars) | | |
| Low Total Use: 15,000 km | | | | | |
| 20% business use | 1,630 | 1,300 | -330 | 518 | -1,112 |
| 50% business use | 4,075 | 1,660 | -2,415 | 2,338 | -1,737 |
| 80% business use | 6,520 | 2,020 | -4,500 | 5,408 | -1,112 |
| Moderate Total Use: 30,000 km | | | | | |
| 20% business use | 1,870 | 1,540 | -330 | 828 | -1,042 |
| 50% business use | 4,675 | 2,260 | -2,415 | 3,372 | -1,303 |
| 80% business use | 7,480 | 2,980 | -4,500 | 7,480 | 0 |
| High Total Use: 60,000 km | | | | | |
| 20% business use | 2,350 | 2,020 | -330 | 1,655 | -695 |
| 50% business use | 5,875 | 3,460 | -2,415 | 5,875 | 0 |
| 80% business use | 9,400 | 4,900 | -4,500 | 9,400 | 0 |

Notes:

1. To calculate the deductions, the following computation is made:

Current System

$$\text{Deduction} = \frac{B}{T} (OE + FE)$$

Proposed System

$$\text{Deduction} = \frac{B}{T} \left(OE + \frac{B^*}{T^*} \times FE\right)$$

where

B = business kilometers
T = total kilometers
OE = operating expenses
FE = fixed expense = CCA, interest, lease costs, insurance and licence fees
B* = business kilometers to a maximum of 24,000
T* = total kilometers to a maximum of 24,000

2. For tax purposes of this example, operating expenses (OE) are assumed to be 8¢ per kilometer. Annual fixed costs are calculated as follows:

| | | |
|---|---|---|
| CCA | = | $5,100 based on a $20,000 auto in the second year it is used for the current system and for the new proposals. The amount is $4,200 under the White Paper proposals |
| Interest | = | $1,100 |
| Insurance | = | $ 700 |
| Licence | = | $ 50 |

Business Meals and Entertainment Expenses

Currently, a taxpayer may deduct reasonable expenses for meals and entertainment incurred for business purposes. The present law effectively allows a deduction for some part of expenses that are personal in nature since business meals and entertainment necessarily involve an element of personal consumption.

The White Paper proposed to limit the deduction for these expenses to 80 per cent of their cost. The 80-per-cent limitation would apply to all business meals, including food and beverages, as well as to the cost of meals while travelling or attending a seminar, conference, convention or similar function. As well it would apply to tickets to an entertainment or sporting event, gratuities and cover charges, room rentals to provide entertainment, and the cost of private boxes at sports facilities. Where a taxpayer is reimbursed for the cost of a business meal or entertainment, the 80-per-cent limitation would apply to the person making the reimbursement.

The 80-per-cent limitation would not apply to

- the cost to a restaurant, airline or hotel of providing meals to customers in the ordinary course of business;

- meals or entertainment expenses relating to an event intended primarily to benefit a registered charity;

- the cost of meals or entertainment that is included as a taxable benefit to the employee or where the employer is reimbursed for the cost;

- the cost of meals and recreation provided by an employer for the general benefit of all employees. Executive dining rooms and similar facilities, however, will be subject to the 80-per-cent limitation.

The above rules, which apply to both corporations and individuals, would come into effect for expenses incurred after 1987.

The restriction proposed received general support. It was also noted that similar, and in some cases more severe, restrictions apply in other countries. However, the Commons and Senate committees recommended that these expenses be deductible in full for persons in travel status.

The government gave careful consideration to these suggestions but rejected the notion that out-of-town meals and entertainment should be excluded from the restriction, since they too involve an element of personal consumption. The government intends to proceed with the 80-per-cent limitation on business meals and entertainment expenses as proposed in the White Paper.

Home Office Expenses

The White Paper proposed certain limitations on the deductibility of home office expenses. These changes attempted to separate business costs from expenses that would have been incurred in any event in the normal course of maintaining a home.

Under the proposed rules a self-employed person could claim a prorated portion of expenses such as rent, capital cost allowance, mortgage interest, property taxes and operating costs in respect of a home office only if the space is used exclusively on a regular and continuous basis for the purpose of earning business income. In addition, to qualify for the deduction, the home office would either have to be the taxpayer's principal place of business or be used on a regular basis for meeting clients, customers or patients. Home office expenses incurred in a year would be deductible only to the extent of income in that year from the business for which the home office is used. Deductions that are disallowed as a result of this provision could be carried forward to subsequent years.

No changes are proposed to the rules set out in the White Paper.

11. Employment Expenses

The law currently permits most employees to claim a deduction in respect of employment expenses of 20 per cent of employment income up to a maximum of $500. The White Paper proposed to eliminate this deduction effective for the 1988 and subsequent taxation years. The level established for the enhanced basic personal credit provides a greater tax benefit for individuals with lower incomes than would the personal exemption and the employment expense deduction combined. The government intends to proceed with the measure as proposed in the White Paper.

The government also intends to proceed with the proposal to allow employed musicians a deduction in respect of their musical instruments.

12. Capital Cost Allowance for Certified Canadian Productions (Films)

The White Paper proposed that the rate of capital cost allowance (CCA) applicable to certified productions be reduced from 100 per cent to 30 per cent (both calculated on a declining balance basis and subject to the half-year rule) as a deduction against non-film income. In addition to this rate of CCA, an additional allowance of up to the remaining cost of the film may be claimed against film income.

It was proposed that the new rules come into effect for interests in certified productions acquired after 1987 and that the 100-per-cent rate of CCA would continue to apply to interests in certified productions acquired before 1988, or after 1987 pursuant to a written agreement or prospectus-type document in place before June 18, 1987. The 100-per-cent CCA rate would also continue to apply to interests in certified productions where the interest is acquired before 1988 and the principal photography for the film is completed before July 1, 1988. Transitional relief was also extended to interests in certain subsequent episodes of series productions, earlier episodes of which were governed by the old rules. In addition, CCA claimed in 1988 in respect of certified productions that are eligible for transitional relief and are therefore governed by the old rules, would not be included in the taxpayer's cumulative net investment loss account for the purposes of the capital gains exemption.

The Commons committee recommended that the basic CCA rate for certified productions be changed to 50 per cent calculated on a straight-line basis and subject to the half-year rule. This would permit 25 per cent of the cost of a film to be written off in the year of acquisition.

Following extensive consultations, the government has decided to modify the White Paper proposal by removing the half-year rule in respect of the basic 30-per-cent CCA rate for certified productions. Accordingly, in the year an interest in a certified film production is acquired, it will be eligible for the full CCA rate of 30 per cent as well as for the additional allowance against all certified film income.

With this change, the tax system will provide a significant up-front incentive to invest in certified films as well as a new incentive -- the additional allowance -- which will encourage investors to pool their investments over several certified films. Further, the additional allowance will increase the incentive for investors to make repeat investments in certified films. For example, at the top marginal federal and provincial tax rate after tax reform of

approximately 45 per cent, the maximum tax benefit that would have been available to an investor in the year he makes an investment in a certified film, if no changes at all were proposed for films, would be about 23 cents per dollar invested, even though the taxpayer may have had an income stream from earlier film investments. Under the proposed system, and depending on the revenue stream from current or previous certified film investments, this benefit could increase to as much as 45 cents on the dollar, representing a full write-off of the film investment in the year it is acquired. In the case of an investor who has an income stream from an earlier certified film investment of 70 per cent of his new investment, under the proposed new system and by taking advantage of the additional allowance, the up-front tax benefit to the investor will be approximately 32 cents on the dollar.

The current tax law requires that the depreciable cost of a film interest be reduced by the amount of any revenue guarantee provided in respect of the investment except where the guarantee is certified by the Minister of Communications as being provided by a licensed broadcaster or a bona fide film or tape distributor who deals at arm's length with the investor and the vendor of the film interest. Responding to suggestions made during consultations, the government has decided to remove the arm's-length requirement where the Minister of Communications certifies that the revenue guarantee is bona fide and that the costs of the film have not been inflated to fund the revenue guarantee.

13. Multiple-Unit Residential Buildings (MURBs)

As part of the base broadening aspect of tax reform, the White Paper proposed that the exemption from the rental loss restrictions for MURBs be discontinued immediately for investors who acquired MURBs after June 17, 1987, other than those eligible for grandfathering. Owners of MURBs on June 18, 1987 would continue to be entitled to apply against other income MURB losses generated after claiming capital cost allowance (CCA) only for taxation years ending before 1991. Following this transitional period, these MURBs would be treated in the same way as other rental properties for the purposes of the general rules that deny the deduction of CCA to the extent that the claim gives rise to a rental loss.

As indicated in the report of the Commons committee, the proposed three-year transitional period may not be sufficient to allow recently-acquired MURBs to become profitable, especially where real estate and rental markets are weak.

In view of the concerns expressed, the transitional period will be extended by a further three years. Thus, taxpayers who acquired a MURB before June 18, 1987 will continue to be exempted from the rental loss restrictions for taxation years ending before 1994, rather than only for taxation years ending before 1991, as was originally proposed. This extended transitional period will also apply to taxpayers who acquire a MURB after June 17, 1987 pursuant to an agreement in writing entered into before June 18, 1987, or to the terms of a prospectus, preliminary prospectus, registration statement, offering memorandum or notice filed before June 18, 1987 with a public authority in Canada pursuant to and in accordance with the securities legislation of any province.

## 14. Proposals for Treatment of Farming Losses

The White Paper put forward several proposals concerning the taxation of farm businesses, the majority of which were to start applying to most farm operations in 1988. These proposals provided objective tests for determining the extent to which farm losses could be deducted against other sources of income and introduced new accounting rules for farmers.

These proposals were introduced as a result of two principal concerns. The first involved the increased potential for the special tax provisions available to farmers to be used as a tax shelter mechanism by other taxpayers with high off-farm incomes. These special farm provisions include cash basis accounting, the $500,000 capital gains exemption for farm property, the full deductibility of carrying charges on farm land, the deductibility of certain land clearing and improvement costs as current expenses (with treatment of the resulting increase in value as a capital gain), and an accelerated capital cost allowance rate for certain types of farm buildings.

As reflected in recent court decisions, the current law does not adequately restrict the benefit of these special tax provisions to bona fide farm operations. In view of other tax reform measures which will eliminate many existing tax shelter provisions, the use of farming as a tax shelter by non-farmers could increase significantly . This would call into question existing tax policies for agriculture, and could jeopardize the ability of the government to maintain these tax advantages. The tax reform proposals concerning farming were introduced both to protect the advantages available to agriculture and to maintain the integrity of the tax system in the face of increasing pressure for new tax shelter vehicles.

The second principal concern involved the need to resolve the uncertainty that surrounds the current rules governing the deductibility of farm losses. Section 31 of the Income Tax Act, which contains the restricted farm loss rules, has been a source of difficulty for many years. These rules restrict the amount of farm losses which may be deducted against other sources of income by taxpayers who are in the business of farming but whose "chief source of income for a taxation year is neither farming nor a combination of farming and some other source". These taxpayers, often referred to as part-time farmers, are currently restricted to a maximum deduction of $5,000 of farm losses incurred in a year against other sources of income.

Whether a taxpayer is in the business of farming at all depends on whether he or she has a "reasonable expectation of profit" from farming activities. This is a basic test for determining whether any

activity -- not just farming -- constitutes a business with respect to which losses are deductible for tax purposes, or only a hobby in which case the deduction for losses is denied.

Unfortunately, the subjective nature of the "reasonable expectation of profit" and "chief source of income" tests has made them difficult for farmers to comply with and for Revenue Canada to administer. The White Paper contained a proposal to replace section 31 with objective tests concerning the profitability of the enterprise (the "profit test") and the source of the taxpayer's income (the "gross revenue test"). These tests would allow farmers who are in a loss position in a year to be certain in that year -- and without concern over the result of a future audit based on subjective criteria -- as to how much of their farm loss could be deducted in the year against their other sources of income.

To provide greater certainty for start-up farmers, a special application of these tests was proposed to allow qualifying beginning farmers to deduct their start-up costs for the first four years of the farm operation without restriction.

It was further proposed that the calculation of positive farm income should continue to preserve the tax benefit of cash accounting, but that the calculation of farm losses deductible against other income be brought closer to losses calculated according to normal accounting principles.

To achieve these objectives, the following measures were proposed in the White Paper:

- Two objective tests concerning the deductibility of farm losses were to be introduced: the profit test to determine whether any farm loss could be deducted, and the gross revenue test to determine whether the loss would be fully deductible or restricted to a maximum of $15,000.

- Special rules were proposed to relieve qualifying start-up farmers from the requirement to meet the profit and gross revenue tests for the first four years of the farm operation.

- Farm income and losses were to be calculated on a modified accrual basis with a cash basis reserve to allow positive farm income to be reported on a cash basis. This reserve was to be based on the amount of inventory on hand, accounts receivable and prepaid expenses, less accounts payable, at the end of the year. A special valuation would be provided for race horses and show animals. For the majority of farmers who report positive farm income, these proposals would have retained the tax benefits of cash accounting, although not cash accounting itself.

- Farm losses calculated on the modified accrual basis would be fully deductible against off-farm income by farmers who met both the gross revenue and profit tests.

- Farm losses calculated on the modified accrual basis would be deductible against off-farm income to a maximum of $15,000 by farmers who met the profit test but did not meet the gross revenue test.

The modified accrual accounting proposal was designed to affect the taxes payable by farmers only in years in which they claim cash basis losses. For farmers on a cash basis under the existing system, a deductible loss may be generated by purchasing inventory and supplies, even though these assets are on hand at the end of the year and have retained their value, leaving the taxpayer's economic position unchanged. Because under the proposed change the cash basis adjustment could be claimed only to reduce positive farm income to nil but not below, it would not have been possible to generate losses by purchasing inventory or farm supplies. Losses calculated on the modified accrual basis, however, which would have more closely approximated real economic losses, would be available to offset off-farm income.

In recognition of the special circumstances of farmers, however, the proposed rules would not have required strict adherence to accrual accounting principles -- for example, the determination of the cost of crops grown or animals born on the farm. For the purposes of valuing inventory at the lower of cost or market value, farmers could have considered the cost of farm-produced inventory to be nil, effectively giving a cash basis write-off, rather than allocating direct and indirect costs of the farm operation to the cost of those assets.

In the consultation process, it was apparent that there is agreement in principle both on the need to establish objective tests to determine the deductibility of farm losses and on the objective that taxpayers who are not truly in the business of farming should not have access to advantageous farm tax rules to shelter non-farm income. There was also consensus that only bona fide farmers should have access to favourable farm tax provisions, but that a mechanism better than that of section 31 must be found to determine who is a bona fide farmer.

However, concerns were expressed over the precise mechanism proposed to achieve these objectives. In particular, the proposal requiring all farmers, even those in a profit position, to use the modified accrual accounting method was criticized. A second concern was that the proposed gross revenue test would create an arbitrary and unnecessary distinction between full-time and part-time farmers.

In light of these concerns the government will not proceed at this time with the introduction of new rules concerning the tax treatment of farming losses. On an urgent basis, the government will consult further with farm groups on modifications to the White Paper proposals as set out below. The revised measures will be effective for fiscal periods commencing after December 31, 1988 or after Royal Assent to the legislation giving effect to these measures, whichever is earlier.

To deal with the accounting problem, the Commons committee recommended that farmers be allowed to continue to use cash basis accounting. However, the committee recommended that the deduction for cash basis losses be restricted to a maximum of $10,000 and that this limit be reduced by $1 for each $2 of off-farm income in excess of $30,000. As a result, no cash basis farm losses would be deductible by farmers who had off-farm income in excess of $50,000. The committee recommended, however, that no restriction apply to the deduction of farm losses calculated on an accrual basis but that an election by a taxpayer to report on that basis in one year could not thereafter be changed.

The government understands the desirability of allowing profitable farmers to continue to use the cash basis of accounting and does not propose to proceed with the modified accrual accounting proposals set out in the White Paper. Nevertheless, to curtail the potential for tax shelters, measures must be introduced either to revise cash basis farm losses in such a way that they more accurately reflect true operating losses, or to restrict cash basis losses in some other manner, such as that proposed by the Commons committee. Consultations, therefore, will focus on the committee's recommendation and on the alternative mechanism outlined below. A further description of this alternative mechanism is being provided in a separate release, which is intended to form a basis for the consultations.

The government does have some concerns with the introduction of a limit on the deductibility of cash basis losses based upon a formula approach such as that recommended by the Commons committee. The government is concerned that such an approach may unduly restrict the losses of bona fide farmers who account on a cash basis and would force many farmers with true losses to irrevocably elect full accrual accounting, to their possible detriment.

As an alternative to the Commons committee approach, the government intends to consult on a proposal under which all farmers may continue to account on the cash basis, with special measures that will apply only where a cash basis loss is generated. In such cases, it is proposed that, in a manner similar to the existing flexible livestock inventory election, mandatory rules be introduced to require that the

loss be reduced or eliminated to the extent that the taxpayer still has on hand inventory, the cost of which was deducted in the year or a previous year. In other words, losses could only be deducted to the extent that they exceed the cost or value of inventory on hand at the end of the year. Any loss or portion of a loss disallowed in one year would be carried forward and deducted in calculating income for the next year.

With respect to the concerns about the profit and gross revenue tests proposed in the White Paper, the Commons committee recommended the retention of the "reasonable expectation of profit" test and the establishment of peer review groups to review the operations and plans of farmers in order to determine whether a farm operation has a "reasonable" expectation of profit.

However, recent court decisions have demonstrated the unsatisfactory nature of the "reasonable expectation of profit" test. As well, there has been support in the consultations for new objective rules to provide certainty in this regard. The proposed rule that farm operations will be deemed to have a "reasonable expectation of profit" when they show positive income in three out of seven years has been viewed as a reasonable rule in most cases. The special rule for start-up farmers which would permit them to deduct losses during the first four years of operation, provided that they had a reasonable expectation of meeting the three of seven test over the first seven years, has also received support. The government therefore intends to maintain the White Paper proposal of an objective profit test. However, the government will consult further with the farm community on the precise formulation of this rule, its application to start-up farmers and horse racers, and the phase-in of the rule.

The government remains concerned that, until the objective profits test is fully phased in, excessive losses may be generated by part-time farmers in order to shelter off-farm income. Accordingly it is proposed to retain on an interim basis the gross revenue test proposed in the White Paper, which would restrict to $15,000 the deductibility of the losses of farmers with low farm sales in relation to their off-farm income. This rule will also be the subject of consultation with farm groups before its implementation.

It is not proposed to accept the recommendation for establishment of a peer review group. Farm taxpayers are entitled to have their tax status determined according to the rule of law, as with all other taxpayers, and not by the judgment of other taxpayers. This recommendation would also be difficult to reconcile with the confidentiality requirements of the tax law and would cause considerable uncertainty, delay and expense for farm taxpayers.

Nevertheless, the government is prepared to consider creating a special assessment group in Revenue Canada with farm expertise which may consult with Agriculture Canada and which would specialize on farm assessments.

15. Minimum Tax

The White Paper did not propose any specific changes to the minimum tax.

However, there is a policy concern that the potentially large capital gains that may result from the deemed disposition on death of all of an individual's capital property could result in a minimum tax liability. The government believes that to apply the minimum tax in this situation is inappropriate. In addition, the application of the current provision which allows a three-year carry-back of minimum tax liability from the year in which a taxpayer dies is unduly complex and presents difficult problems for taxpayer compliance.

It is proposed to eliminate the minimum tax for the year of death. In addition, it is also proposed to eliminate the three-year carry-back of minimum tax currently available in respect of deceased taxpayers. These changes are to be effective for the 1987 and subsequent taxation years.

16. Forward Averaging and Block Averaging

As a consequence of the reduction in tax rates and the reduction in the number of tax brackets from 10 to three, the need for forward averaging is substantially reduced. Forward averaging was used by relatively few taxpayers, for the most part those in the higher income brackets, and its elimination would simplify the tax system. Consequently, the White Paper proposed to eliminate this provision. As a transitional measure, forward averaged amounts from 1987 and prior years may be brought back into income until 1997 and will provide the taxpayer with a federal tax credit at the top marginal rate in the year it is claimed. Thus, if $1,000 of forward averaged income was declared in 1988, a federal credit of $290 would be provided.

Given the small numbers who use this provision under the existing structure and the tax simplification that results from ending it, the government intends to proceed with the White Paper proposal to eliminate forward averaging for the 1988 and subsequent taxation years.

The proposal to repeal block averaging, consistent with the repeal of forward averaging for all taxpayers, will be maintained. A number of aspects of the tax reform package minimize the need for the block averaging provision and the impact of its removal. The lowering of marginal tax rates, and the decrease in the number of tax brackets from 10 to only three, substantially reduce the adverse tax consequences of fluctuations in income due to changing farming and fishing conditions. Also, the retention of the full $500,000 capital gains exemption on qualifying farm property and the capital gains reserve mechanism effectively eliminate the need that arose in the past for an averaging provision to smooth out the impact of any large capital gains that may be realized upon the sale of a farm. However, to smooth the transition to the new system, farmers and fishermen currently at any stage of a block period, including those experiencing abnormally low incomes due to temporary adverse conditions, will be permitted to continue to average income until the current block period is completed. Currently, only about 3 per cent of eligible farmers and fishermen elect to block average each year.

17. Accelerated Source Deductions

The White Paper proposed that, commencing in 1990, large employers be required to remit source deductions four times a month. Source deduction remittances would be due three working days after the end of the following periods for deductions made in that period: the 1st to 7th of the month, the 8th to 14th of the month, the 15th to 21st of the month and the 22nd to the end of the month.

The government intends to proceed with this proposal. It will affect only those employers and other payors with average monthly remittances in excess of $15,000. Those below that threshold will continue to pay remittances on the 15th of the month following the month in which the remuneration was paid.

The February 1987 budget proposed that twice-monthly remittances by employers over the $15,000 threshold would apply to all withholdings pursuant to subsection 153(1) of the Act. The draft regulations to implement this measure, released with the technical notes to Bill C-64 on June 5, 1987, restricted the acceleration to withholdings from salaries, wages and commissions. These regulations will be amended as a consequence of administrative problems associated with identifying particular types of withholdings. Accordingly, both the twice-monthly acceleration commencing in 1988 and the further acceleration in 1990 will apply to all withholdings made pursuant to subsection 153(1). This means that, in addition to deductions from salary, wages and commissions, deductions from payments such as retiring allowances, pension benefits and RRSP annuity payments will also be subject to accelerated remittances. This does not in any way affect the recipients of payments from which tax is deducted at source.

CHAPTER III

MEASURES AFFECTING CORPORATIONS

## 1. Introduction

The proposed reforms to the income tax system as they affect corporations were based on the principles guiding overall reform. Of particular relevance for corporate reform were the following objectives:

- The tax system should have a broader base and lower rates. Rates should be lowered to encourage initiative and risk-taking.

- The system should be fairer, and profitable corporations that have been paying little or no tax should pay a fair share.

- The tax system should recognize Canadian realities and priorities. It should contribute to Canada's ability to be internationally competitive. It should be supportive of growth and regional development.

- The tax system should provide a stable revenue base to support public programs.

The corporate tax proposals in the White Paper adhere to these goals. The significant tax rate cuts that have been proposed form the best incentive for productive activity and contribute to our international competitiveness. The number of profitable, non-taxpaying corporations has been significantly reduced. These measures will enhance the achievement of revenue stability. Some $5 billion of additional revenues will be raised from the corporate sector over the next five years which are to be used to fund personal tax rate reductions.

Most importantly, these results have been achieved with a broad degree of consensus about the general thrust of the measures. This does not mean that no concerns have been raised, nor constructive comments made during consultations, but it does mean that the proposals can be introduced, with some modifications responding to these concerns and comments, with confidence that the desired goals are being achieved.

In responding to concerns expressed during the consultations, it must be recognized that there are some significant restraining factors on what can be achieved. As a major trading country, it is crucial that Canada's tax laws do not hinder international competitiveness. A related concern arose with the major change in the international taxation environment during 1987 when the United States moved

rapidly to its new rate structure and reformed tax base. The lower U.S. tax rate created incentives and opportunities for corporations with international operations to recognize income and pay taxes in the U.S. and recognize expenses in Canada even if the income were actually related to Canadian activities. In the period leading up to the June 18, 1987 release of the White Paper, it was clear that decisive action was needed to reduce Canadian statutory rates significantly to maintain competitiveness and avoid revenue loss, quite apart from the importance of such action in achieving other objectives of tax reform.

The existence of a significant number of profitable, non-taxpaying corporations has been a source of concern about the fairness of the corporate tax system. While some firms may be profitable and non-taxpaying in a year because of factors entirely consistent with long-standing tax policy, such as the recognition of past losses or the receipt of non-taxable dividends, a major factor has been the use of incentives or combinations of incentives such as fast write-offs, investment tax credits or the ability to claim deductions for expenses in advance of related revenues for tax purposes.

The reform proposals will make significant inroads in the numbers of profitable non-taxpaying corporations. Some 320,000 corporations were profitable in 1983. Of this total, 210,000 corporations were taxable, while the other 110,000 were non-taxpaying. Had the mature reformed corporate tax system been in place in that year, an additional 50,000 corporations would have been taxable (i.e. a total 260,000 out of 320,000). Some 60,000 would have remained non-taxable.

Some comments were made during consultations to the effect that, while the direction of change was welcome, the results did not go far enough. This often led to proposals for some form of minimum tax to affect the remaining profitable, non-taxpaying corporations.

A detailed examination of the profitable firms which continue to be non-taxpaying indicates that considerable progress on this issue has been made. There are three general reasons why a profitable corporation may not pay tax in a given year: first, the existence of tax incentives; second, the financial position of the firm particularly when viewed over a number of years; and third, the receipt of non-taxable inter-corporate dividends out of income that has already been subject to tax.

In relation to the first reason, tax reform has retained certain tax incentives that clearly reflect national priorities, such as those for encouraging regional development, R&D and small business, and maintaining international competitiveness. The related provisions, such as the regional and R&D investment tax credits, the small business deduction and the manufacturing and processing deduction, all contribute to reduce taxes payable.

The second reason relates to low corporate profitability and the tax treatment of losses. The tax system allows losses incurred in a year by a corporation to be carried back or forward to offset positive taxable income of other years. This recognizes that the profits of any one year may be an inaccurate measurement of ability to pay given the cyclical nature of business profits. It is appropriate and desirable that such losses be allowed in other years when taxes would otherwise be payable.

Third, intercorporate dividends are allowed to be received tax-free because they are paid out of income that has already been subject to tax. This provision ensures that income which is passed through chains of corporations in the form of dividends is subject to tax at only one level. Companies that receive much of their income in the form of dividends, typically holding companies, have been removed from the following figures in order to avoid overstating the number of profitable, but non-taxpaying, corporations.

Among the 60,000 corporations which would not have paid tax under the mature tax reform system in 1983, about 35,000 would be non-taxpaying because of prior year losses. Many of the remaining non-taxpaying corporations have such low profits that a small amount of the incentives remaining after tax reform can result in them being non-taxpaying.

This indicates that tax reform would largely achieve the objective of ensuring that profitable corporations will no longer be non-taxpaying due to significant use of tax incentives in the post-reform system. Some such examples will continue, but these will be because of past losses or the use of the limited number of remaining tax incentives that serve national priorities. As a result, there is no pressing need for a new mechanism such as a minimum tax to force the remaining corporations to pay tax. Inevitably, such an approach would be complex, would impose a serious tax penalty on cyclical industries such as agriculture, forestry, mining and manufacturing, and would offset some of the effect of the remaining incentives in key areas.

The White Paper, while designed to be revenue neutral overall, did propose to increase corporate tax by some $5 billion over the next five years in order to allow additional personal tax rate decreases. This rebalances the relative contribution of individuals and corporations in the payment of income taxes. This was another objective of reform.

To achieve these objectives, base broadening had to be pursued across a broad spectrum of activities and sectors. The measures needed to be extensive and, if the constraints of international competitiveness were to be met, the rate cuts had to come into effect rapidly. This in turn required rapid movement to the broader tax base.

These requirements place significant constraints on the adjustments that can be made in putting forward the final tax reform proposals. As noted earlier, there was general agreement on the direction of change. Nevertheless, most groups consulted suggested modifications which they believed would have beneficial effects in their sector. While most of these requests appeared relatively modest when considered in isolation, nevertheless their aggregate impact would have resulted in a very substantial reduction in corporate income tax revenue. This would have compromised the achievement of the tax reform goals outlined above.

The modifications have been chosen carefully to respond to particular structural problems identified during consultations without compromising the achievement of the objectives of tax reform. In addition, further base-broadening measures are being proposed, to be applied to the financial sector, to raise corporate tax revenues in order to provide funds to enhance the support provided through the tax system to families with children.

## 2. Corporate Tax Rate Reductions

The White Paper proposed reductions in federal corporate tax rates that would provide a general incentive for investment and job-creating activity and would benefit a large number of taxpaying corporations.

These rate reductions would be carried out in conjunction with the removal or restriction of a number of special tax preferences, in line with the tax reform objective of reducing the distortionary influences of the tax system on investment decisions. The move to reduced tax rates and fewer preferences would help to relieve the considerable pressure on the corporate tax system that has built up in recent years from the accumulation of unused losses, deductions and tax credits.

Significant reductions in the statutory tax rates, to start on July 1, 1988, were proposed in the White Paper. The new statutory federal tax rates, net of the 10-per-cent provincial abatement, are outlined in the following table.

Federal Corporate Income Tax Rates

| | Effective July 1 each year | | | |
|---|---|---|---|---|
| | 1988 | 1989 | 1990 | 1991 and subsequent years |
| | (per cent) | | | |
| General rate | 28 | 28 | 28 | 28 |
| Manufacturing income | 26 | 25 | 24 | 23 |
| Small business | 12 | 12 | 12 | 12 |

The main features of changes to the corporate tax rates are:

- A reduction to 28 per cent in the basic federal corporate tax rate effective July 1, 1988.

- Phased reductions to 23 per cent by July 1991 in the federal corporate tax rate applicable to Canadian manufacturing and processing income not eligible for the small business rate. These reductions will be phased in by 1991 to correspond to the phase-in of the lower capital cost allowance rates.

- The establishment effective July 1, 1988 of a single preferential federal corporate tax rate of 12 per cent for income eligible for the small business deduction, including Canadian manufacturing and processing income. The small business rate applies to Canadian active business income of up to $200,000 for each Canadian-controlled private corporation or associated group of such corporations.

There has been significant support for the concept of reducing statutory tax rates and broadening the tax base. Few concerns were raised about the proposed rates or the timing of rate changes. The Commons committee, noting the support of small business groups and after specifically raising questions about the rate for manufacturing and processing income in many of its hearings, recommended adoption of the proposed rate reductions.

The rate changes are being adopted as proposed in the White Paper. The continuation of lower tax rates for small business and manufacturing reflects the government's desire to support the international competitiveness of the manufacturing sector and to promote the growth of small business in Canada. The lower rates will be less distortionary to economic decisions and more equitable among taxpayers. Lower tax rates will provide a general and potent incentive to engage in productive activity that will support economic growth, international competitiveness and job creation.

3. Investment Income of Private Corporations

The government proposes to implement the White Paper proposals relating to the investment income of private corporations, with one adjustment.

One feature of the taxation of private corporations is the integration of their investment income. Canadian-controlled private corporations are subject to tax on such income at the general corporate rate in order to minimize any opportunity for individuals to defer tax by transferring their investment portfolio to corporations which they control; however, this tax may be refunded to the corporation to the extent that it exceeds the tax credit provided to individuals in respect of taxable dividends which they receive from the corporation.

All private corporations are subject to tax under Part IV of the Income Tax Act in respect of certain dividends which they receive. This tax is set at a rate which is approximately equal to the highest personal tax rate on dividend income, and is also imposed in order to prevent individuals from using a corporation to defer their tax liability on such income. Furthermore, this tax is wholly refundable to the corporation when dividends are paid to its shareholders.

In accordance with the objective of maintaining integration of private corporations' investment income, the refundable portion of federal tax payable on investment income earned by Canadian-controlled private corporations after 1987 will be reduced from 25 per cent to 20 per cent of the amount of such income. The rate of tax payable under Part IV of the Act by private corporations on taxable dividends received after 1987 will be reduced from 33 1/3 per cent to 25 per cent. Finally, the rate at which refunds of tax are made to private corporations in respect of dividend distributions made after 1987 will be reduced from $1 for every $3 of dividends paid to $1 for every $4 of such dividends.

The refundable tax accumulated by private corporations in respect of investment or dividend income earned, but not distributed, before 1988 will be reduced by a specified amount in order to maintain the same approximate rate of tax on such income as if it were distributed to the corporation's shareholders before the end of 1987. The amount of this reduction, as set out in the White Paper, is one-third of a private corporation's refundable tax balance as of December 31, 1987 and is based upon a reduction in the total personal tax rate for individuals taxable at the top rate on dividend income from about 33 1/3 per cent to about 25 per cent. However, actual combined federal-provincial tax rates on dividend income may be somewhat higher than those on which the refundable tax reduction are based and, although this reduction does not attempt to account for the

variation of individual tax rates between provinces, a one-third reduction is generally greater than that required to maintain the integration of a private corporation's pre-1988 investment and dividend income. Accordingly, it is proposed that the reduction of a private corporation's refundable tax balance as of December 31, 1987 be set at one-quarter to parallel more closely the actual rate changes applying to dividend income.

Due to the relationship between the taxation of investment income earned by Canadian-controlled private corporations (CCPCs) and that earned by individuals, the general corporate rate reduction which is to take effect on July 1, 1988 will be advanced to the beginning of 1988 with respect to the investment income, including capital gains, of CCPCs to coincide with the effective date of the personal rate reductions. Consistent with this accelerated rate reduction, the capital gains inclusion rate for such corporations will also increase from one-half to two-thirds effective January 1, 1988.

## 4. Capital Gains of Corporations

The changes to the capital gains inclusion rate for corporations as proposed in the White Paper parallel the changes proposed for individuals. The higher inclusion rates would generate significant revenues and thus facilitate the lowering of tax rates. Furthermore, they would make a significant contribution in bringing profitable corporations to a taxpaying position, particularly in the real estate sector.

The White Paper proposed that the proportion of capital gains to be included in a corporation's income be increased from one-half to two-thirds in 1988 and to three-quarters in 1990. However, for the taxation years of corporations (other than Canadian-controlled private corporations) ending before July 1, 1988, the inclusion rate would remain at one-half. For taxation years of such corporations commencing after June 30, 1988, the inclusion rate would increase to two-thirds. The inclusion rate for Canadian-controlled private corporations would increase from one-half to two-thirds for taxation years commencing on or after January 1, 1988 to parallel the corporate tax rate reduction for investment income of CCPCs as of that date. The inclusion rate for all corporations would increase to three-quarters for taxation years commencing on or after January 1, 1990. For taxation years that straddle these dates, the percentage of capital gains to be included in income would be determined on a pro rata basis.

No change is proposed in the capital gains inclusion rate for corporations as set out in the White Paper.

5. Elective Year-End for Private Corporations

A corporation with a taxation year commencing before but ending after the effective date of the proposed increase in the capital gains inclusion rate will be required to determine the taxable portion of any capital gains which it realizes in the year on the basis of the number of days in the year preceding and following the effective date of this change.

In the case of private corporations, the non-taxable portion of capital gains may be distributed to Canadian shareholders as a tax-free capital dividend through the capital dividend mechanism. As a result of the prorating system adopted for the purposes of implementing the increased capital gains inclusion rate, private corporations which dispose of capital property prior to the effective date of the change but in a taxation year which ends after that date would be required to include in income an amount in excess of one-half of any gain thereon and would have a corresponding reduction in the exempt portion of the gain available for distribution to shareholders on a tax-free basis as a capital dividend. To accommodate private corporations that wish to maintain the application of the current system with respect to capital gains realized before the date on which the inclusion rate changes and adopt the reform proposals in their entirety after that time, it is proposed that Canadian-controlled private corporations be permitted to end their taxation year on December 31, 1987 and to commence a new year immediately after that date, and that other private corporations be permitted to undertake the same procedure on June 30, 1988. These respective dates reflect the effective dates of the increase in the capital gains inclusion rate for such corporations.

## 6. Capital Cost Allowances

The accelerated write-offs in the tax system are the result of various fiscal initiatives for encouraging both general and specific investments. As a result, the depreciation deductions allowed under the tax law, as part of the capital cost allowance (CCA) provisions, differ significantly from those used in financial accounting for many assets. The accelerated write-offs have been a major contributor to the narrowness of the tax base and the wide variation in tax burdens among corporations.

The White Paper proposed that write-offs which contribute to low taxation of certain sectors be reduced. The new rates, with appropriate grandfathering and transitional provisions, would be effective for acquisitions after 1987. Assets acquired before 1988 would continue to be written off in the future under current rates.

Reducing the write-off rates in the CCA system is an important step in broadening the corporate tax base to increase corporate revenues to finance tax rate cuts, and to ensure that profitable corporations pay their fair share of tax.

### CCA for Manufacturing and Processing Machinery and Equipment

The accelerated write-off for Class 29 manufacturing and processing machinery and equipment has been one of the major incentives in the CCA system. The White Paper proposed reducing the rate for future acquisitions of most Class 29 assets, after a transition period, to 25 per cent on a declining balance basis. This compares with the present CCA write-off over three years, after taking into account the half-year rule which allows only half the CCA write-off in the year an asset is acquired. After a transition period, acquisitions of assets such as industrial lift trucks, portable rental tools and certain data processing equipment and systems software would revert to Class 10 with a CCA rate of 30 per cent on a declining balance basis.

It is also proposed to extend the half-year rule to special manufacturing tools -- dies, jigs, patterns, moulds, lasts or cutting or shaping parts in a machine.

The White Paper proposed that assets that are to benefit from the 25-per-cent CCA rate be included in a new class, with transitional rates of 40, 35, 30 and 25 per cent for the 1988, 1989, 1990, and 1991 and subsequent calendar years, respectively. For taxation years which straddle a transitional calendar year, the rate applicable to the new class would be prorated based on the number of days of the tax year in each applicable transitional calendar year. Assets currently included in Class 29 which will qualify for Class 10 would

be eligible for a similar transition with rates of 40 per cent in the 1988 calendar year, 35 per cent in calendar 1989 and 30 per cent thereafter. Similar proration rules would apply.

The phased-in reduction of the CCA rate for most manufacturing and processing machinery and equipment to 25 per cent on a declining balance basis is a major feature of the White Paper proposal. Discussion on the appropriate rate has been ongoing since it was first raised as part of an illustrative proposal outlined in the May 1985 discussion paper The Corporate Income Tax System: A Direction for Change. A number of alternatives were raised during the consultative process following the release of the White Paper on June 18, 1987. These included reducing the rate to 30 per cent on a declining balance basis or to 25 per cent on a straight line basis. The 30-per-cent rate was adopted by the Commons committee in its list of recommendations. The alternative proposals were raised in the context of concerns about international competitiveness with the U.S.

Under tax reform the rates of CCA for manufacturing equipment in Canada will be of similar value, on average, to those in the U.S. Depending on the sub-sector, manufacturing assets in the U.S. are written off over five, seven or 10 years. While most types of manufacturing assets are in the seven-year class, the average U.S. write-off period assuming Canadian investment patterns would be slightly longer. The following table compares the present value of the tax depreciation deductions based on $100 invested under the Canadian and U.S. tax systems for manufacturing and processing machinery and equipment acquisitions made after 1990. The table indicates that the additional cost to the Canadian manufacturer averages less than $1 per $100 of investment (a federal-provincial combined tax rate of about 35 per cent times the $2 difference in present value of the deductions). Over the phase-in period, Canadian CCA rates for manufacturing will remain above the average rates in the United States.

Comparison of Present Value of Depreciation Deductions after 1990*

Canada

| | |
|---|---|
| 25-per-cent declining balance basis | = $68 |

United States

| | |
|---|---|
| 5-year class | = $77 |
| 7-year class | = $72 |
| 10-year class | = $65 |
| Average U.S. rate with Canadian investment patterns | $70 |

* Assumes a 10-per-cent discount rate.

Depreciation for tax purposes is just one factor that affects the tax system's impact on international competitiveness. Other features in the tax system are important in assessing international competitiveness. Notwithstanding the reduction in the CCA rate for manufacturing and processing property to 25 per cent, Canada's overall tax treatment of manufacturing under the White Paper proposals would not be uncompetitive with that of other countries, particularly the U.S. This would be achieved by retaining a preferential tax rate on manufacturing income that would be 5 percentage points lower than the general corporate rate, and lower than the average statutory tax rate in the U.S. after including provincial and state income taxes.

Furthermore, other tax system differences, such as the U.S. corporate alternative minimum tax, will improve the competitive position of many Canadian manufacturers undertaking major investment projects. The U.S. alternative minimum tax taxes back some of the difference between U.S. depreciation rates for tax purposes and financial statement purposes.

The proposed 25-per-cent rate of write-off continues to provide an incentive element compared to the economic depreciation for these assets. A degree of acceleration is being retained to acknowledge such factors as international competitiveness, inflation and variations in economic depreciation among the assets.

Reducing the write-off rate would have a number of positive results for the structure of the tax system. Fast write-offs are a major contributor to current problems in the tax system, such as the sheltering of income by the use of tax deductions in excess of costs recognized on financial statements, making many profitable corporations non-taxable. At the same time, some manufacturers did not have sufficient income to benefit from the accelerated write-off. This inability of individual manufacturers to use the write-offs was a major factor responsible for the phenomenon of the trading of tax deductions and losses. This has resulted in a need for frequent, often complex, changes to the Income Tax Act to protect and stabilize revenues.

In view of these considerations, the government proposes to implement the CCA changes proposed in the White Paper. Canadian CCA rates for manufacturing equipment will remain above comparable rates in the United States over the phase-in period. The government will continue to monitor the tax treatment of investments internationally, particularly in the United States. Should significant changes in tax treatment be made abroad which would impair the competitive position of Canadian manufacturers, the government is prepared to make appropriate modifications in response.

Other Changes to the CCA System

The White Paper included proposals for the following reductions in CCA rates for acquisitions after 1987:

- The CCA rate for assets currently described in Class 22, earth moving equipment, would be reduced to 30 per cent from 50 per cent on a declining balance basis. For calendar years 1988 and 1989, transitional rates of 40 per cent and 35 per cent, respectively, would apply. Where tax years differ from the calendar year, the same proration mechanism as described for manufacturing assets would apply.

- The CCA rate for assets currently described in Class 30, satellites, would be reduced to 30 per cent from 40 per cent on a declining balance basis.

- The CCA rate for outdoor advertising signs used to earn rental income, currently described in Class 11, would be reduced to 20 per cent from 35 per cent on a declining balance basis.

- The CCA rate for resource property currently described in Class 10 would be reduced to 25 per cent from 30 per cent on a declining balance basis. Class 10 resource assets include on-site mine buildings and mining equipment, community property, mining machinery and equipment, railway property used in mining, gas or oil well equipment, property used for oil, gas and mineral detection, and heavy crude oil processing equipment.

- The CCA rate for assets currently described in Class 28, resource extraction property acquired for a new mine, would be reduced from 30 per cent to 25 per cent on a declining balance basis. The existing additional allowance up to the income from the new mine or the major mine expansion would be retained, but would not be subject to the half-year rule.

- The CCA rate for drillships and offshore production platforms currently described in Class 7 would be reduced to 25 per cent from 30 per cent on a declining balance basis.

- Costs of mine shafts and main haulage ways or similar underground work undertaken after the start-up of production would be removed from the capital cost allowance system. These costs would be treated as Canadian development expense (CDE) written off at a 30-per-cent declining balance rate rather than depreciated at a 100-per-cent rate in Class 12. Unlike CCA claims, CDE does not reduce the value of the 25-per-cent resource allowance deduction.

- Overburden removal costs incurred after the start-up of production would be treated as operating costs and deductible as a current expense rather than being depreciable at 100 per cent as part of Class 12.

- The CCA rate for buildings currently described in Class 3 would be reduced to 4 per cent from 5 per cent on a declining balance basis. Post-1987 additions and alterations to a building eligible for the 5-per-cent rate would still be entitled to that rate to the extent of the lesser of either $500,000 or 25 per cent of the building's capital cost at December 31, 1987, or the date of completion of its construction, whichever is later.

- The CCA rate for property currently described in Class 2, public utility and other similar property, would be reduced to 4 per cent from 6 per cent on a declining balance basis.

An election to classify property in separate classes would be provided for acquisitions after 1987 of earth-moving equipment and outdoor advertising signs. The current system provides for separate classes for satellites and certain pipelines and other assets. Under particular circumstances these assets can experience abnormal depreciation due to location or use. The separate class election would allow a terminal loss to be realized if the asset in the separate class is disposed of or abandoned and actual depreciation in excess of that allowed for tax purposes has occurred. The generation of a terminal loss results under the separate class provision since costs of the individual assets for which an election is made are not pooled. Under the general pooling of assets, applicable to most classes, terminal losses are recognized only when all the assets in the class have been disposed of. The election must be made in the tax return for the first year in which the taxpayer is entitled to claim CCA in respect of the asset.

The White Paper proposals for changes to these CCA provisions were not a major issue of discussion during the consultative process. There was broad recognition that, with the proposed tax rate reductions, base broadening should include a reduction in the accelerated write-offs of the depreciable assets identified. The Commons committee did not recommend changes to these CCA proposals.

No change is proposed in these rates as set out in the White Paper.

Put-in-Use Rule

The White Paper proposed the introduction of a put-in-use rule to determine the taxation year in which CCA and investment tax credits (ITCs) may first be claimed in respect of an acquisition of property by a taxpayer.

A put-in-use rule achieves a better matching of income and expenses. Under current rules, expenses may be recognized well in advance of the associated revenues. Where equipment is bought and stockpiled, considered to be acquired before delivery, or where interim costs are incurred on assets that take a long time to construct, tax deductions for depreciation can commence in advance of the beginning of a revenue flow from the asset and in advance of deductions for accounting purposes. The proposed rule would reduce this mismatching of revenues and expenses and be more consistent with accounting rules and the practices in respect of tax depreciation for many industrialized countries.

The White Paper proposed that taxpayers may not start claiming CCA and investment tax credits until the earlier of either the year an asset is put in use or the year in which the construction of an asset by or on behalf of the taxpayer is completed and it is thus ready for use. Buildings which were not completed would be considered to be put in use in the year in which substantially all of the building was used for its intended purpose. The rule would also apply to major renovations.

The put-in-use rule would apply to property acquired and renovation costs incurred after 1989. The half-year rule would continue to apply in the fiscal period in which the asset is recognized for tax purposes. The White Paper recognized that the proposal might have an impact on large projects with long lead times (particularly in the resource sector) and suggested that some relief might be required.

Two major areas of concern were raised during the consultations. The first reflected the concerns mentioned in the White Paper with respect to the impact of the proposal on after-tax rates of return and the cash flow requirements for projects having a lengthy construction period. Often these concerns were linked to international competitiveness and the possibility that the rule could create a tax disadvantage for longer term projects in sectors such as petrochemicals, forest products or the resource sector. Various suggestions were made to reduce the impact of the proposal on projects with lengthy pre-production phases. For example, the Commons committee recommended that an asset be deemed to be put in use 24 months after it is acquired if it has not in fact been put in use by that time.

The second general area of concern revolved around definitional issues, principally as to when an asset could be considered to be put in use. If an asset was fully available for service but not actually in service for a variety of reasons, would it be considered to have been put in use for purposes of the rule? How are the rules to apply if an asset is partially in use or part of a multi-stage project? What would occur if an asset is abandoned before being put in use? A variety of proposals were made which generally had the intent of moving the rule closer to a concept of available for service. The Commons committee referred to its proposal in this regard as a "put-in-place" rule.

After considering these concerns, the government proposes that, for property acquired after 1989, taxpayers may not claim CCA and ITCs until the property is available for use for the purpose of earning income from a business or property. This rule will also apply for the purpose of determining when an expenditure on scientific research and experimental development related to the acquisition of a capital asset will be considered to have been made.

The concept of "available for use" is somewhat broader than a strictly interpreted "put-in-use" rule and more consistent with the concept as outlined in the White Paper as it applied to buildings. It is recognized that this concept leads to questions of how it would be applied in particular industries or situations. For the rule to be applied in a fair and consistent manner, further clarification of its operation will be undertaken. It is, for example, the intention that farm equipment that has been acquired, delivered and is ready for performing its function in a year would be considered to be available for use. The detailed technical discussions required to codify this approach were not possible during the consultation process, where attention was focused on the broader issues. Therefore, consultations on these technical areas will be carried out during the coming year. The need for such technical consultations was one reason for the 1990 implementation date for the proposal made in the White Paper.

In addition, to reduce the potential impact of the rule upon projects with long construction periods, a property will be considered to be available for use and qualify for capital cost allowance, investment tax credits and R&D deduction at the earlier of either the time at which the property is first available for use for the purpose of producing income from a business or property, or 24 months after the date at which the property was acquired by the taxpayer. Where the property is not available for use to produce income from a business or property before the taxation year which includes the time which is 24 months after it was acquired, the half-year CCA rule will not apply in the first year in which CCA is deductible in respect of the property.

The proposal being made recognizes the concerns brought forward during the consultations concerning the impact of the proposal on longer-term construction projects. It adopts the measure proposed by the Commons committee and goes further in providing that the half-year rule not apply where the claiming of related capital cost allowances has been delayed for two years after acquisition.

Finally, if a property is lost or abandoned before it would otherwise have been considered to be available for use, and there is no reasonable expectation of the taxpayer recovering the property, the property will be treated as being available for use for capital cost allowance and ITC purposes at that time.

The effect of these changes and clarifications to the rule is consistent with the purpose of the proposal as outlined in the White Paper and so will not result in significantly lower revenues than were expected at the time of the White Paper.

## 7. Investment Tax Credits and Research and Development

The White Paper proposed a reduction in the rates of investment tax credits (ITCs) for property acquired after 1988. The Atlantic Canada investment tax credit rate would fall from 20 to 15 per cent, the special investment tax credit rate from 40 to 30 per cent and the Cape Breton investment tax credit rate from 60 to 45 per cent. The rates of these investment tax credits were to be reduced in line with the reduction in the corporate tax rates, thereby maintaining the same relative incentive to invest in these regions.

The rates of the high-cost exploration credit and the research and development (R&D) tax credits were left unchanged at their existing levels in the White Paper. By maintaining the rates of the R&D tax credits at their current levels while income tax rates are being reduced, the relative benefit of these tax credits is increased, providing enhanced tax credit support for the R&D sector. This reflects the government's commitment to the support of R&D in Canada.

No changes are proposed to the investment tax credit rates as set out in the White Paper.

The White Paper proposed to limit the amount of ITCs which may be claimed in a year to 50 per cent of federal tax otherwise payable (subject to a base amount of $24,000 for individuals and, in the case of corporations, the federal income tax otherwise payable on the corporation's income eligible for the small business deduction). As a means of ensuring that profitable corporations pay some tax, this proposal was directed towards one of the important objectives of tax reform: to provide greater fairness in the tax system. Currently, profitable corporations may completely eliminate their federal tax liability by claiming ITCs. This would not be possible under the tax reform proposals for larger corporations subject to the ITC claiming limitation. However, in view of this new limitation, the carry-forward period for unclaimed ITCs earned after April 19, 1983 is proposed to be extended from seven years to 10 years.

The limitation represents a balancing of objectives in tax reform: namely, to promote certain activities through tax credits and to ensure that profitable corporations pay some tax.

A number of industry associations argued that the ITC limitation proposal was too stringent. In particular, the R&D industry argued that the proposal would reduce the effectiveness of ITCs as an incentive to perform industrial research and reduce the amount of R&D performed in Canada. The Commons and Senate committees recommended that R&D tax credits be exempted from the 50-per-cent claiming limitation.

The consultative process revealed that the proposal would have a somewhat greater impact on the level of taxes paid in R&D intensive sectors than was anticipated at the time of the White Paper. It is thus possible to relax the rule without reducing revenues below those anticipated. In order to moderate the impact of the proposal on R&D intensive companies while ensuring that profitable corporations pay some tax, the government proposes to limit the amount of ITCs claimed in a year to 75 per cent of federal taxes otherwise payable (subject to a base amount for individuals and small corporations). The proposal to lengthen the carry-forward period for ITCs will be maintained. In the light of the information received during the consultations, this would represent a better balance in the objectives of tax reform. Companies would be allowed to use more tax credits than under the original proposal but profitable corporations would still be required to pay tax. This modified proposal is comparable with tax law in the U.S., where the general business credit (which includes the U.S. research credit) is subject to an ITC claiming limitation of 75 per cent of tax liability over $25,000.

The White Paper also proposed to end the refundability of ITCs for large firms at the end of 1987, one year earlier than scheduled. However, refundability would be extended indefinitely at its current rate of 40 per cent for small corporations and individuals.

The White Paper further proposed that buildings no longer qualify for the R&D incentives, although machinery and equipment and structures used for R&D, other than buildings, will still qualify for the R&D incentives. The combination of the 100-per-cent write-off and the R&D tax credit provides a substantial subsidy for assets of an enduring nature, such as buildings, which depreciate slowly over time. Further, buildings initially used for R&D purposes can subsequently be converted to other non-R&D uses, while the same is not true for structures used for research and development. Finally, this proposal would bring the tax treatment of R&D buildings in Canada more into line with that found in the other major industrialized countries.

R&D industry associations argued that this proposal might have a detrimental effect on R&D performed in Canada. However, the Commons committee saw no reason to disagree with the White Paper proposal. No change is being made to the White Paper proposal for buildings used for R&D purposes. Consequential changes are proposed in the qualification for R&D treatment of payments made to certain third parties with respect to the acquisition of buildings.

Research and Development Expenditures

With any tax incentive, it is essential to ensure that the maximum possible benefits accrue to those for whom the incentive was intended and that these benefits are delivered in a cost-efficient manner. In the

case of the R&D tax incentives, the intended beneficiaries are those taxpayers who actually perform the R&D which generated these benefits, or on whose behalf that R&D was performed, provided that the R&D is related to a business of the taxpayer. Accordingly, amendments to the R&D incentive provisions are proposed to prevent the transfer of R&D expenditures as a form of tax shelter.

It is proposed to strengthen the requirement that, to qualify for these incentives, expenditures on R&D must be related to a business of the taxpayer. For these purposes, the performance of R&D itself will not be considered to be a business of the taxpayer to which the R&D is related unless all or substantially all of the taxpayer's revenue is derived from the prosecution of R&D. Other changes are proposed to ensure that partnerships cannot be used as an R&D tax shelter vehicle. Details of these changes are outlined in the draft legislation.

## 8. Flow-Through Shares and Earned Depletion

The existing flow-through share provisions in the Income Tax Act allow a principal-business corporation to renounce resource expenditures to its shareholders under certain circumstances. The renounced expenditures are then treated as if they had been incurred directly by the shareholder. Certain types of resource expenditures qualify for an extra deduction in excess of actual costs. This extra deduction is called earned depletion and can be used in the calculation of either personal or corporate income taxes.

The flow-through share provisions in the Act which provide an incentive for resource companies that wish to raise equity financing would be retained in the White Paper proposals. However, several of the corporate and personal tax reform proposals would have an effect on the decision of companies to issue, and investors to purchase, flow-through shares. The reduction in the top personal marginal tax rate as well as the changes to the taxation of capital gains would reduce the influence that tax benefits would have on the choice of an investor between flow-through shares and alternative investment opportunities.

The phase-out of the earned depletion allowances and the corporate tax rate reductions would also affect flow-through share markets. On the one hand, corporations would recalculate a reduced value for the tax deductions renounced to the shareholder and would thus be willing to issue flow-through shares with a reduced premium over market value. However, the investors would no longer be able to deduct more than 100 per cent of the cost of the share when the earned depletion allowances are phased out.

The White Paper also proposed to broaden the existing rules in respect of "prescribed shares", i.e. shares that cannot qualify for flow-through treatment. The tax reform proposal would deny flow-through share treatment where there are specified types of guarantees and/or entitlements. Resource expenditures incurred through partnerships would also be made subject to the "at risk" rule. This rule limits the deduction in respect of a partner's share of resource expenditures incurred by a partnership to the amount of the investment the partner had "at risk".

Since the White Paper was released there have been extensive consultations undertaken with resource companies, industry associations, provincial governments, investment dealers and the representatives of several partnerships which have acted as intermediaries in flow-through share transactions. There was a widespread concern expressed that the impact of the proposed personal and corporate tax reform proposals would eliminate flow-through share financing.

During the consultations a number of suggestions were put forward for consideration. Most of the suggestions acknowledged that the removal of the earned depletion allowances was consistent with the overall philosophy and direction of corporate tax reform. Many of the submissions focused on increasing the adjusted cost basis (ACB) for flow-through shares as a technical adjustment to reduce the impact of tax reform. This proposal has been made by the Senate committee. The current income tax treatment requires that flow-through shares have a nil ACB. This treatment is consistent with that of other flow-through mechanisms such as partnerships and joint exploration corporations. The nil ACB is in recognition that a full income tax deduction is taken for the cost of acquisition. The result is that, for most taxpayers, all proceeds of disposition are treated as a capital gain.

The Commons committee rejected the suggestion to increase the ACB as well as other suggestions as being "contrary to fundamental tax concepts, inequitable, inefficient or unacceptably complex". The government concurs with the conclusion with respect to the increase of the ACB, but is proposing the changes outlined below.

The government proposes to modify the manner in which the resource deductions taken in respect of flow-through shares and passive partnership interests affect an individual's eligibility for the capital gains exemption under the operation of the cumulative net investment loss rules. The White Paper proposed that the total value of these deductions would be included in the calculation of the individual's cumulative net investment loss. This amount would typically exceed the taxable portion of the proceeds of disposition of the shares due to the earned depletion deduction, the premium typically paid on flow-through share purchases, and the non-taxable portion of capital gains. This could result in a situation wherein a flow-through share purchase and sale within a year might deny a capital gains exemption for capital gains made on other investments for an individual who would otherwise qualify. In recognition of the concern about the impact this interaction may have in these circumstances, the government is proposing to modify the investment loss rules as they apply to deductions taken in respect of flow-through shares and passive partnership interests. It is proposed that deductions taken with respect to earned depletion not be added to an individual's cumulative net investment loss. It is also proposed that only 50 per cent of the deductions arising from flow-through shares or passive partnership interests be included in the determination of the net investment loss. This modification would imply that, in most circumstances, the amount added to an individual's cumulative net investment loss pool resulting from the flow-out of resource deductions will be less than the underlying value of the flow-through share or the passive partnership interest. This would reduce the possibility of investments in flow-through shares or partnerships restricting access to the capital gains exemption for other capital gains of the investor.

The following table illustrates the impact of the change on a potential purchaser of a flow-through share. The investor is assumed to have a 44-per-cent combined federal and provincial marginal tax rate and to be eligible for the capital gains exemption. The investor is assumed to be incurring mining Canadian exploration expense (CEE) eligible for earned depletion at the 16 2/3-per-cent rate.

Interaction of Flow-Through Shares
and Capital Gains Exemption

| | Full CNIL impact | Modified CNIL impact |
|---|---|---|
| | (dollars) | |
| Cost of share | 100 | 100 |
| Tax savings | 51 | 51 |
| Net cost of share | 49 | 49 |
| Proceeds from sale of share | 80 | 80 |
| Tax on proceeds | 23 | 23 |
| Net proceeds | 57 | 57 |
| Addition to CNIL | 117 | 50 |
| Taxable capital gain on sale | 53 | 53 |
| Net addition to CNIL | 64 | -3(1) |
| Potential tax on other capital gains | 28(2) | -1 |
| Return net of tax on other capital gains | 29(3) | 58 |

(1) $3 is the amount of the proceeds on the sale of the share that would be eligible for the capital gains exemption.

(2) This amount is the tax value of the net addition to CNIL, i.e. the potential tax which would be payable on other capital gains as a consequence of the flow-through share transactions illustrated.

(3) This amount is the net return on the flow-through share investment assuming that the above tax on other capital gains is in fact paid.

Representations were made that the phased reductions in earned depletion should occur at a slower rate and at year-end rather than mid-year. The government now proposes to extend the phase-out period in which expenditures can qualify for earned depletion so that eligible expenditures made during the period July 1, 1989 to December

31, 1989 will be eligible to earn depletion at 16 2/3 per cent. This change will allow an additional six months during which expenditures will qualify for earned depletion. Under the 60-day rule certain exploration expenses incurred during the first 60 days of 1990 may also be eligible to earn depletion at 16 2/3 per cent. The extension of the earned depletion allowance phase-out would provide significant incentives for flow-through share financing by junior mining and oil and gas companies until the end of 1989. Similar changes will be proposed in respect of the Canadian Exploration and Development Incentives Program to phase it out over approximately the same period as earned depletion.

The government announced on August 31, 1987 a technical adjustment to the new proposed prescribed share rules. Additional time was provided under certain circumstances for shares to qualify under the pre-tax reform definition. The government has also undertaken to modify the prescribed share definition to ensure that entitlements to a grant under the Canadian Exploration and Development Incentives Program do not disqualify a share for flow-through treatment.

The income tax provisions in place after the phase-out of earned depletion at the end of 1989 would continue to provide a meaningful incentive to resource companies. They would permit resource companies to issue equity on a more favourable basis than common shares issued by other types of corporations. Nevertheless, the government recognizes the importance of sustained resource development activity to certain regions of the country and is concerned that adequate levels of activity be maintained during cycles of economic downturn in the industry. The Commons committee suggested that tax incentives or government subsidies may be necessary as temporary measures during periods of depressed prices or economic downturns to ensure the survival of exploration activities in Canada. The government concurs and would examine what temporary assistance might become necessary in such circumstances.

## 9. Issue Expenses

Expenses of issuing securities or debt, such as underwriting commissions, sellers' fees, legal and accounting fees, registrars' and transfer agents' fees, printing expenses and filing fees, are of a capital nature, but are deductible in the year incurred because of specific provisions in the tax law. To achieve a better matching of expenses and revenues, the White Paper proposed that the deduction of these expenses be amortized. It was also noted that the immediate deductibility of such expenses had been used to add to the tax advantage of some tax-motivated investments.

The White Paper proposed that deduction of expenses relating to the issue of shares, partnership interests and trust units be amortized over a five-year period. The deduction of expenses related to borrowing funds would be amortized over the greater of five years or the term of the debt obligation including any renewal periods. The new rules were to apply to issue expenses and other costs incurred after 1987 with respect to issues after that date.

Concerns raised in the consultation period related to the possibility that longer-term debt issues would be discouraged. There were also questions raised as to possible avoidance of the intention of the proposal by sophisticated persons with the need for regular financings. The Commons committee indicated that it accepted the need to more closely match revenues and expenses and not encourage tax shelter financing. However, it proposed that more neutral treatment of the expenses of issuing debt and other securities could be achieved by making the amortization period a maximum of five years.

The government is therefore proposing that all issue expenses incurred after 1987 be deductible in equal portions over five years. If the borrowings for which the issue expenses were incurred are repaid in a year (otherwise than as part of a refinancing), the remaining expenses are to be deductible in that year. This maintains the basic concept of the White Paper proposals while responding to concerns about non-neutrality among different types of instruments.

## 10. Preferred Shares

Accompanying the issuance of the White Paper on June 18, 1987, proposed rules for the taxation of dividends paid on preferred shares were introduced in the form of draft legislation. These rules are designed to eliminate the benefits from the use of preferred shares as a form of after-tax financing. By issuing preferred shares in lieu of debt, non-taxpaying corporations are able to transfer the tax benefit of accumulated losses, deductions and tax credits to the holders of the preferred shares, generally taxable corporations, resulting in a significant loss of tax revenues to government. The volume of preferred share issues has increased significantly in recent years as unused deductions, losses and credits have grown. The level of such financing in Canada is greater than in other jurisdictions because of the special tax treatment of dividends.

The system introduced on June 18, 1987 proposed that taxes be levied on dividends paid on preferred shares issued after that date. These rules are described in detail in the June 18, 1987 release.

Since June 18, comments on the proposed rules have been received from a number of individuals and corporations as well as from various industry associations. The system proposed has been thoroughly reviewed in light of the representations received and changes are being proposed as outlined in the revised draft legislation. Further limitations on the access of financial institutions to preferred shares have been introduced in order to ensure such corporations begin to pay tax. The net effect of the other proposed changes is to improve the effectiveness of the rules in preventing the erosion of federal tax revenues, while at the same time providing greater flexibility for the use of preferred shares for non-tax purposes by smaller companies.

## 11. Real Estate Interest and Other Soft Costs

The White Paper identified a number of cases where business expenses that are currently fully deductible in a year could more appropriately be capitalized and amortized over the life of the asset or deducted when related revenue is earned. Two cases where changes were proposed were in respect of deductions allowed for interest on vacant land and so-called "soft costs" of real estate developers.

The White Paper proposed that the existing rules, which require that certain carrying charges in respect of vacant land be capitalized rather than deducted, be extended to carrying charges in respect of vacant land owned in the business of the sale or development of land and to vacant land held in, but not used in, the course of other businesses. As well, it was proposed that the rules which require taxpayers to capitalize construction period "soft costs" be extended to land development corporations.

While the new rules were to commence to apply to vacant land carrying charges and construction period "soft costs" incurred after December 31, 1987, a five-year transition period was proposed. The percentage of costs subject to the rule would be 20 per cent of the relevant costs in calendar year 1988 and the percentage included in each subsequent calendar year would rise by 20 percentage points, reaching 100 per cent after 1991. These percentages would be prorated for fiscal periods straddling a calendar year-end.

The major area of discussion during the consultation process was in respect of the proposal to capitalize carrying costs on vacant land. A variety of concerns were raised. There was opposition to what was seen as a special provision applying to carrying costs in respect of real estate inventory. More technical concerns were also cited, such as cases where the cost base including capitalized carrying costs would exceed fair market value, raising the need for valuation and possible assessment and appeal. The fact that, due to provincial and municipal regulatory provisions applicable to the industry, many developers cannot control their carrying periods was also put forward as a concern. A common denominator in many of the consultative presentations was that the rule would apply more heavily to the smallest builders rather than the larger, more diversified companies. The Commons and Senate committees proposed that carrying costs on vacant land continue to be deductible. In its place, the Commons committee recommended an alternative minimum tax on the industry.

The proposal to capitalize "soft costs" during the construction period received less comment. Some commentators suggested that self-constructed rental properties would be particularly affected by the proposal and some relief should be provided by capitalizing both land-related and building-related soft costs to the cost of the

building. The Commons and Senate committees supported this modification. It was also observed that, unlike the case for vacant land, incidental revenues earned during the construction period of a building could not be offset by carrying costs.

Several issues were raised repeatedly during consultations and deserve further comment. While these views were often strongly held, they did not place the proposals in the context of general tax reform.

One persistent concern raised was that the measures proposed were intended to address the non-taxpaying status of a number of the largest real estate companies in the country and failed to recognize their potential impact on smaller and medium-sized companies, where the cash flow implications would be most severe. Two key factors must be considered in response to this. First, both large and small real estate companies have lower than average tax rates when compared to companies of similar size in other sectors. Second, both large and small real estate companies will benefit from the significant tax rate cuts under tax reform to the extent they are taxpaying. In these circumstances, base broadening has been directed at all segments of the industry, just as base broadening is being extended to other low-taxed sectors.

A second concern relates to the fact that interest will be required to be capitalized on the real estate sectors' inventory although such costs are generally deductible for other industries. It was argued that this represents a singling out of the real estate sector. There are several factors that should be considered in assessing these concerns. The requirement that carrying costs of vacant land be capitalized already applies to land not used, or held, in the course of carrying on a business. There has thus been a recognition in the tax system that special rules may be necessary for real property. For most industries normal turnover of inventories within a year automatically yields a matching of interest deductions and related income. For the most part, industries with high levels of inventories, such as wholesale trade, are relatively highly taxed. On the other hand, interest expenses on vacant land may be deducted years before the income is recognized on the sale of the property. This confers a substantial timing advantage on land inventory holdings not available to most other industries. As a consequence, in the real estate industry the use of up-front interest expenses to shelter income from past projects is one of the reasons for the real estate sector paying a relatively low rate of tax. In the absence of the change, many firms in the industry with low effective tax rates would benefit from the tax rate cut without contributing to the base broadening of tax reform.

Finally, there is concern in the sector that the proposal would restrict cash flow and lead to a reduction in the scale of activity in the sector. These concerns typically are based on analysis of a single project. They are not directly relevant for an ongoing taxpaying firm undertaking a series of projects. For such firms, the tax rate cut will offset some of the effects of the measure. Moreover, the interest which had been capitalized on a particular project would be available to be deducted against the income from the sale. Analysis of a sample of actual smaller firms confirm that increases in the level of tax are no larger than those facing the corporate sector generally and so are unlikely to have a major impact on either price levels or activity in the sector.

The White Paper did recognize, however, that without adjustment the proposal could have a substantial impact in the early years of its implementation. Thus, a five-year transition period was proposed at that time.

It is proposed that the requirements to capitalize carrying charges of vacant land, and construction period "soft costs", be implemented as outlined in the White Paper subject to the following clarifications and modifications:

- Carrying charges on vacant land in a year may be deducted to the extent of any income from the land in the year.

- For corporations whose principal business is the leasing, rental or sale, or the development for lease, rental or sale, of real property, an additional amount of carrying charges incurred in a year on vacant land will be deductible up to the product obtained when $1 million is multiplied by a prescribed rate of interest for the year. This additional deduction must be shared by related corporations in a manner similar to the existing rules applicable to the small business deduction and must be adjusted for short taxation years.

- The five-year phase-in of the requirement to capitalize the remainder of vacant land carrying costs over the 1988 to 1992 calendar years will be prorated for any taxation year that does not coincide with a calendar year in the transitional period based upon the number of days in each calendar year rather than on the expenditures incurred in those calendar years.

- For all taxpayers, all "soft costs" incurred after 1987 relating to the construction of a building which must be capitalized, including such costs as property taxes on land, will be included in the cost of the building under construction and will, accordingly, be eligible for capital cost allowance.

These changes respond to the concerns raised in the consultations that small corporations affected by the proposal may have more difficulty in operating under the proposed rules, particularly in periods of market weakness. As a consequence, the base amount of deductible carrying charges for a year ($1 million times the prescribed rate of interest for the year) is being proposed. The modifications to the rules for building period "soft costs" also represent changes that respond to specific concerns that building-period "soft costs" related to land would not be recognized until the eventual sale of the property.

12. Unpaid Claim Reserve

The White Paper proposed to discount the unpaid claim reserves of property and casualty insurance companies and life insurance companies in order to more properly reflect the expected future liability facing each company. The Commons committee recommended acceptance of the principle of discounting with respect to the unpaid claim reserve. The committee, however, recommended that the implementation of discounting be deferred until the Superintendent of Financial Institutions is satisfied that such claims reserves are at appropriate levels.

The government believes that the five-year transition period for the change in reserve levels should provide sufficient time for this review and for any consequent changes to be implemented. Thus, the government proposes to proceed with the implementation of the discounting of unpaid claims. The government will work closely with industry and the Canadian Institute of Actuaries in the technical implementation of the discounting proposal to ensure that an appropriate result is achieved in an administratively feasible manner.

## 13. Taxation of Financial Institutions

### Overview

The White Paper proposed significant changes in the taxation of financial institutions. These changes were directed at two main ends. These were, first, to ensure that financial institutions pay a fair share of tax, and second, to bring the taxation of different financial institutions onto a more consistent basis across the sector in the face of the deregulation that is underway. This would make the tax system fairer and raise significant revenues in order to allow substantial tax rate reductions for both individuals and taxpaying corporations.

The White Paper's reform proposals on the taxation of financial institutions were in three general areas:

- the treatment of reserves either for future liabilities (policy reserves) or for an estimated revaluation of assets (reserve for doubtful debts),

- the definition of income for Canadian multinational insurers as well as a number of technical changes related to insurance taxation, and

- the taxation of the investment income of life insurance companies that is currently untaxed under the income tax system.

Concerns have been raised that those financial institutions that have been successful in reducing taxes to zero in the past will be able to continue to avoid paying tax in the future.

For the banks and trust companies, the primary reason for their low liability has been the purchase of after-tax financial instruments such as preferred shares. Dividends received by corporations are not taxable due to the intercorporate dividend deduction. Interest, on the other hand, is taxable. Thus, the institutions have accepted the lower yield associated with dividends on shares, in place of earning the higher pre-tax rates of interest on loans. The net result has been lower financing costs to borrowers and a substantial reduction of tax paid by the financial institutions. In the case of the Small Business Bond and Small Business Development Bond programs, this arrangement has been explicitly sanctioned and encouraged by the government.

While life insurance companies have participated in the after-tax financing market to some extent, they have been able to exploit clear deficiencies in the existing law. Many insurance companies have paid little or no tax since the investment income tax was repealed in 1978.

The White Paper proposals have been explicitly designed to bring low-taxpaying financial institutions into a taxable position in three important ways.

First, most of the after-tax instruments that have reduced the taxes paid by banks and trust companies will be maturing over the next two or three years. The new rules applying to preferred shares should ensure that these instruments are largely replaced by fully taxable interest-bearing debt. These provisions are being further tightened for financial institutions with respect to new purchases of preferred shares issued before the new rules came into effect.

Second, the reductions in reserves allowed for tax purposes will raise the taxable income of such corporations on an ongoing basis. More importantly, the transition provisions for these changes will raise significant extra revenues from the sector over the next five years and have been explicitly designed to advance as much as possible the date when such corporations begin to pay tax. This is accomplished by fully offsetting any loss carry-forwards and other unused discretionary deductions such as capital cost allowances against the amounts in respect of which transitional relief is being provided. These provisions result in an inclusion in taxable income of about $4.5 billion with a federal tax value of some $1.2 billion to reduce or eliminate loss carry-forwards and increase taxes paid by these institutions.

Third, the major defects related to the taxation of insurance companies have been addressed.

Discussions over the summer on the allocation of loan losses in foreign branches of banks and the implications of tax reform on the tax treatment of special provisions for losses on transborder claims have led to further proposals in this area as part of tax reform. These are consistent with the Commons committee suggestion that methods be studied for the allocation by country of loan losses.

Further changes will be pursued actively over the coming year, focusing on the foreign tax credit system and the use of reinsurance contracts. The changes in the foreign tax credit system will lead to tax payments by the banks over and above those estimated in the White Paper, and the changes to reinsurance will ensure that the revenue increases projected from the insurance industry are realized.

The Commons committee and others have suggested that a minimum tax be placed on financial institutions to ensure future tax revenue. Minimum taxes not related to income, by their nature, have the potential to be unfair and discriminatory. An alternative tax, applied to a base other than business income, has the potential to tax institutions at times when they are experiencing real economic

losses. The need for the level of tax to be linked to income was recognized in the Commons committee report which applied a cap of 28 per cent of the Canadian proportion of world-wide income for calculating liabilities under its proposed minimum tax.

It is thus generally preferable to move, as the government proposes, to deal directly with problems in the income tax system. Significant levels of tax are expected to be raised from financial institutions as a result of tax reform. In this case, minimum taxes would not generate the level of incremental revenues that they might otherwise appear to offer in the medium term and so do not provide an ongoing source of funds.

Nevertheless, the government recognizes that some currently profitable financial institutions might continue to be non-taxpaying in the first year or two of tax reform as remaining loss carry-forwards are used up and holdings of after-tax financing reach maturity. Therefore it is proposed to extend a modified form of the existing capital tax on deposit-taking institutions as a tax creditable against corporate income tax. This tax will generate revenues in the first two years of the reform period, with these revenues being offset in later years as the institutions pay significant levels of corporate income taxes. This will further accelerate the taxes paid by financial institutions.

The following table shows the federal tax value of base broadening from the changes proposed in the White Paper, supplemented by the changes noted above. The table reflects not only the specific changes made to the rules for reserves and the taxation of life insurance companies, but also the impact on these institutions of changes to preferred shares, capital gains, and the other more general tax changes. Under current economic projections, tax reform will result in significant levels of tax being paid by financial institutions.

Estimated Federal Value of Corporate Income Tax Base-Broadening for Financial Institutions Resulting from Tax Reform Proposals, 1988-1992

| | 1988 | 1989 | 1990 | 1991 | 1992 | Total |
|---|---|---|---|---|---|---|
| | (millions of dollars) | | | | | |
| Banks and other deposit-taking institutions | 260 | 350 | 500 | 660 | 720 | 2,490 |
| Insurance companies | 150 | 240 | 300 | 320 | 380 | 1,390 |
| Total | 410 | 590 | 800 | 980 | 1,100 | 3,880 |

The government is committed to ensure that profitable financial institutions pay levels of tax consistent with their economic circumstances. It believes that the major changes to the income tax system being proposed will be effective and are the best way to achieve this goal. The government will actively monitor the tax position of the major financial institutions as tax reform is implemented to verify that appropriate levels of tax are paid by them in the future. The government will carefully consider the report of the Commons committee and is prepared to make further changes, either in the regular corporate income tax or alternative mechanisms, if necessary.

Treatment of Doubtful Debts

The White Paper proposed that the tax system treat the doubtful debts of financial intermediaries in a uniform fashion across sectors, based on the actual loss experience of the taxpayer. This approach is consistent with the regulatory reform applicable to financial institutions and the need to prevent tax deferral opportunities in establishing loan loss reserves. In those cases where a doubtful debt reserve is established by examining individual loans, a prescribed recovery rate would be applied in order to eliminate the deferral of tax arising from the difference between the prudential level of the reserve and actual loss experience.

In the consultation process, both the Commons committee and the industry associations representing the trust companies and credit unions recognized the need for a reduction in doubtful debt reserves of taxpayers using formulas in sections 33, 137, 137.1 and 138 of the Income Tax Act, but generally called for the continuation of the formula approach employed under the current law. A number of groups argued that the prescribed recovery rate be eliminated on the grounds that, over the course of the business cycle, provisions are as likely to understate as overstate the actual loss experience of financial institutions. The choice of a single rate might also create inequities arising from the different recovery rates experienced by individual financial institutions.

The Senate committee recommended that a provision for loan losses be allowed only when the loan has been established to be uncollectable. This would be similar to the provision enacted as part of the tax reform in the United States. The government believes, however, that this would delay the recognition of loan losses beyond the time an economic loss actually accrues to the financial institutions.

It was further noted that the provision permitting a doubtful debt reserve which will be effective for all financial intermediaries after tax reform did not include some financial instruments currently offered by these institutions. In particular, loans acquired from another financial institution and "off-balance-sheet" instruments such as bankers' acceptances, letters of credit, and guarantees are currently omitted.

The government has concluded that the White Paper proposals with respect to doubtful debts should be implemented. Continuation of the formula approach, even at a reduced rate, would still lead to the deferral of tax for those taxpayers whose loss experience is less than the formula's parameters. The typical loss experience varies greatly across various types of loans.

The government proposes a prescribed recovery rate on doubtful debts that are determined on a loan-by-loan basis. A single prescribed recovery rate is proposed due to the administrative complexity of introducing different rates according to type of asset held by a financial institution. The government will continue to monitor the recoveries of provisions taken by financial institutions on individual loans and will also be examining the audits of doubtful debts undertaken for both regulatory and tax purposes in establishing an appropriate prescribed recovery rate in future periods.

With respect to financial instruments such as bonds, debentures, mortgages, hypothecs and agreement of sale and similar forms of indebtedness previously covered under the Minister's Rules for banks or sections 33, 137, 137.1 and 138 for other financial intermediaries that are not technically included in the current provision for a doubtful debt reserve under paragraph 20(1)(l), the government proposes to include generally those financial instruments issued or acquired in the ordinary course of business. A doubtful debt reserve will also be provided for off-balance-sheet financing agreements such as loan guarantees, bankers' acceptances, etc. involving arm's-length persons. The government will continue to review the tax treatment of transactions involving non-arm's-length parties in the context of its overall review of the taxation of foreign income of financial institutions.

Reserve Transition

The White Paper recognized that the major changes proposed to the reserves of financial intermediaries could have a significant cash impact on particular financial institutions. Consequently, a five-year transition was proposed which would apply to the change in the level of reserves resulting from the tax reform proposals and would take into account tax losses and other unutilized discretionary tax deductions available to a financial institution. The change in the level of reserves would be brought back into income in the first year of tax reform, to the extent of unutilized deductions and losses, and the balance would be brought into income over the period 1989 to 1992.

The Commons committee supported the transition proposals. However, individual industry groups raised a number of concerns. It was argued that transition should be based solely on the impact of the reserve changes, and hence be available regardless of the existence of unused losses and deductions. For example, given the large special provision for losses on transborder claims taken by the banks since June 18, the loss carry-forward related to this provision will offset much of their transitional relief. Some associations called for a 10-year transition, as had been the case following changes to reserves implemented in 1972.

One of the objectives of tax reform was to ensure that profitable corporations pay tax. Consequently, the government believes that the transition should be provided only after the accumulated losses and deductions of the financial institution have been offset. If a financial institution has tax losses sufficient to offset the impact of the reserve changes, transition relief is not needed.

The government proposes to implement the transition mechanism as outlined in the White Paper. Account will be taken of the deemed 1971 reserves of credit unions and the deemed 1968 reserves of life insurance companies in determining the amount of reserves to be brought into income.

The Allocation of Loan Losses on Foreign Indebtedness

Since the publication of the White Paper, the banks have significantly raised their provisions on loans to countries designated by the Superintendent of Financial Institutions. It has been necessary to integrate these special provisions for losses on transborder claims (SPLTC) into the White Paper proposals. The government has been careful to ensure that the decrease in value of these loans recognized by the banks in their financial statements is treated for tax purposes in a manner consistent with the tax reform proposals. For example, a doubtful debt provision in respect of loans booked in subsidiaries will not be allowed in the post-reform period.

The movement from the rules administered by the Superintendent of Financial Institutions to a reserve-based system for tax purposes under tax reform and the size of the SPLTC provisions taken by the banks also have significant implications for the foreign tax credits of the banks. The government will be examining the taxation of foreign income as it relates to the banks to ensure that the system of foreign tax credits is consistent with the government's tax reform objectives.

Additional Changes to the Taxation of Financial Institutions

Two additional proposals, over and above those included in the White Paper, are being made to increase the level of tax paid by the large deposit-taking institutions, i.e., the largest banks and trust companies. The first proposal is an extension of capital tax applying to deposit-taking institutions which was in place in 1986 and 1987. Second, an in-depth examination of the taxation of the foreign income of the banks and other financial institutions will be conducted in the next year to complement changes made to the allocation of loan losses as part of tax reform.

Payments made under the new capital tax will be creditable against the regular federal income tax of the financial institution with a carry-back provision of three years (but not before 1988) and a carry-forward provision of seven years. The current capital tax is levied at a rate of one per cent on capital in excess of $300 million. The threshold for paying the tax will be reduced to $200 million of capital. No tax will be levied on institutions with capital less than this threshold. The current rate of one per cent will apply to capital in the $200 to $300 million range with an increased rate of 1.25 per cent applying to capital in excess of $300 million.

Reduced levels of capital tax will occur in subsequent years as more financial institutions begin to pay the regular income tax. Once all of the banks and trust companies have returned to a taxable position,

it is unlikely that any amounts would be collected from the capital tax. Even in the event of an unusually large loan loss in the future, no tax would likely be collected due to the carry-back provisions of the tax. Nevertheless, the capital tax will provide a backstop to the regular income tax to prevent the income tax from a large bank or trust company falling to zero over a prolonged period of time.

The tax will not be applied to large insurance companies. The extensive changes proposed under tax reform for this sector should ensure that significant tax revenues will be collected over the next five years. However, the tax position of all of the large financial corporations will be monitored closely over the next few years to ensure that the tax reform changes will be effective.

The second proposal, not originally in the White Paper, relates to the taxation of foreign income of financial intermediaries with a special focus on the foreign tax credit provisions claimed by the major banks and the use of reinsurance as a tax avoidance vehicle by insurance companies.

Issues related to the allocation of loan losses and their impact on foreign tax credit claims of banks have already arisen in the context of the discussions this past summer concerning the tax treatment of the increased deductions for Third World loan losses. Further changes will be required to ensure an appropriate measurement of income against which foreign taxes can be credited. These changes will increase the amount of taxes paid by banks.

Finally, the review of the taxation of foreign income of banks and other financial intermediaries will examine the apportionment of both costs and income between domestic and foreign operations. An examination of this type has already occurred for multinational insurance companies with the changes reflected as part of the tax reform proposals.

## Life Insurance Company Taxation

### Definition of Canadian Investment Income

Life insurance corporations are taxed under special rules in the Income Tax Act with Regulations reflecting the unique characteristics of the industry. Life insurance corporations are not taxed on their world income as are other corporations because of the diverse forms of taxation applied to this sector internationally. Instead, there are special rules to determine the amount of underwriting income, gains on the sale of property and gross investment income attributable to the Canadian insurance business of resident multinational life insurance corporations and non-resident insurance corporations.

The rules for determining gross investment revenue and gains on the sale of property to be included in income for Canadian tax purposes require the computation of a Canadian Investment Fund (CIF). Corporations are required to fill the CIF by designating to the CIF investment property and non-investment property used or held in a Canadian business. The gross investment revenue from the designated assets is reported as Canadian income. These rules were seriously deficient in several areas and enabled the major life insurance companies to avoid paying income tax in Canada. For example, insurers could understate income related to their Canadian business by designating assets with lower yields.

The tax reform proposals are designed to correct these deficiencies.

The White Paper indicated that other related changes to the Income Tax Act would be made which would be discussed with the industry. Among these measures were technical changes to the proposed treatment of policy loans, superficial losses, and the deduction of experience rating refunds.

Extensive discussions have been held with the Canadian Life and Health Insurance Association (CLHIA) on the White Paper proposals and the related technical changes to the Income Tax Act. The basic structure outlined in the White Paper will be adopted. The discussions have been useful in refining the detailed implementation of the new rules.

The White Paper proposed that a minimum amount of net investment revenue (gross investment revenue less related interest and other expenses) must be attributed to the Canadian businesses carried on by an insurer. Thus, an insurer would no longer be able to designate its lower-yielding assets or assets with lower-taxed revenues to avoid paying tax.

The minimum amount of net investment revenue required from investment property designated would be the average net investment returns on all Canadian investment property held by the insurer. The net investment revenue target would be compared with the net investment revenue generated by the investment property actually designated by the insurer to its Canadian Investment Fund. Canadian investment property is to be defined in the Income Tax Regulations.

Any difference between this minimum amount and the net investment revenue generated by investment property designated will be required to be included in income for tax purposes. No additional designations of property will be required to generate this income.

If designated assets generate more revenues than the minimum amount required in a taxation year, the taxpayer will be permitted to carry the excess forward for a period of seven years. The amount carried forward will reduce or eliminate the amount required to be added to income in a year when the net revenue from designated assets does not reach the minimum revenue target.

In calculating the minimum required net investment revenue, the insurer will apply an average return on foreign investment property to foreign investment property designated where the value for the year of such property designated to the CIF exceeds 5 per cent of the CIF. The insurer can elect to use the average return on Canadian investment property for all investment property if the value for the year of foreign assets designated is less than 5 per cent of the CIF. A deduction for foreign taxes paid on income derived from foreign assets designated as being used or held in the Canadian business is under consideration.

The limit on designations of rental real estate investments proposed in the White Paper will not be implemented. Instead, a form of interest income imputation on vacant land and property under development will be applied to all insurers. The current rules limiting the qualification of vacant land held for over two years as investment property will be repealed.

The equity limit rules for limiting the designation of Canadian equity property will be retained in the computation of the minimum investment revenue amount. Multinational corporations could otherwise meet the CIF requirement with Canadian equity property and not pay tax due to the inter-corporate dividend deduction. However, in order to make the rules more balanced across all insurers carrying on business in Canada, the equity limit will be modified to be the greater of 8 per cent of the CIF or the limit as calculated under the current rules for resident multinational life insurers.

Policy loans will be treated in a neutral way as proposed by the CLHIA and as recommended by the Commons committee.

The CLHIA and the report of the Commons committee identified a potential loss of federal income tax revenues through reinsurance arrangements that are designed explicitly to avoid paying income tax. The report recommended a general anti-avoidance clause be implemented such as provided in the U.S Internal Revenue Code. The clause proposed by the committee could, however, affect bona fide reinsurance arrangements. The area of reinsurance is currently under review by the Department of Finance.

The Commons committee report also suggested that bond and mortgage trading profits and losses be amortized over the remaining lifetime of the security for all financial institutions. This proposal would represent a fundamental change to the Income Tax Act affecting all financial institutions and will therefore require future consideration before any action is taken.

Investment Income Tax

The White Paper proposed that a tax of 15 per cent be reintroduced on the investment income of life insurance corporations. The tax would be similar to the investment income tax on life insurers that was in place between 1969 and 1978. The proposal was intended to reduce the tax preference given to the life insurance sector. Insurance companies receive income on undistributed funds accumulating with respect to life insurance policies which is untaxed or benefits from a prolonged tax deferral under the current rules.

The original investment income tax (levied under Part XII of the Income Tax Act) was withdrawn in 1978 because of the introduction of the $1,000 investment income deduction for individuals, which upset the balance between competing forms of savings at that time. In the context of tax reform where a number of specific preferences, including the $1,000 investment income deduction, are being eliminated or reduced, and also in the context of the deregulation of the financial sector which will promote competition among different financial institutions, it is appropriate to reintroduce this form of tax in order to provide for a fair treatment across different financial sectors and investment instruments.

The tax is appropriately imposed at the company level, as the corporation is the recipient of the income earned on funds accumulating within life insurance policies. If a policy is surrendered, a portion of the accumulated income is taxed in the hands of the policyholder. A deduction for such portion of this income would be allowed in computing the investment income tax base at the company level to prevent double taxation. The tax will effectively reduce the amount of tax deferral on investment income building up within life insurance policies.

The report of the Commons committee recommended that the tax not be implemented. The report was concerned that revenues from the tax would be significantly lower than projected in the White Paper. In part, the committee's concerns reflected an analysis of a preliminary version of the proposal prior to technical discussions with the industry. Significant revenues will result from the investment income tax as described below, although they will be somewhat lower than those estimated in the White Paper. The committee and the industry have suggested that an appropriate estimation of the revenues that would arise from an investment income tax should be based on the existing accrual rules for determining the amount of income on non-exempt life insurance policies. The accrual rules, however, were designed for a different purpose and significantly understate the level of tax to be raised from an appropriately structured investment income tax at the company level.

Insurance companies earn investment income with respect to the accumulated and undistributed premiums which they have received on insurance policies. Typically, this income is not made available to the policyholder until the accumulated income received by the company exceeds the up-front costs of selling the policy. In a general way, the accrual rules are related to the amounts made available to the policyholder and effectively allow for an up-front deduction of the expenses incurred in selling (a more detailed explanation is contained in the response to the report of the Commons committee). In measuring the income received by the company, however, expenses should be recognized over the period that the income is earned. Thus, the accrual rules would result in a mismatching of income and expenses leading to a prolonged deferral of tax.

In the absence of an investment income tax, this income would continue to be received on a tax-deferred basis by the insurance company. The tax outlined below, which provides appropriate recognition of costs associated with this income, would tax this flow of income and would raise approximately $175 million in 1988 if it were fully phased in. This reflects the significant value of the tax preference currently given to life insurance companies.

The Senate committee recognized that this tax deferral on the income received by insurance companies with respect to funds accumulating under life insurance policies is a tax preference. Nevertheless, it recommended that the tax preference be maintained. The government believes that the Senate committee's goals of encouraging private savings for retirement are better and more fairly served though the provision of tax-assisted pension vehicles, rather than providing special tax treatment for one form of financial instrument.

The government intends to proceed with the implementation of an investment income tax.

The White Paper set out in a general way the structure of the proposed tax. The following elaboration reflects the technical discussions held with the industry:

. Deductions will be allowed in computing the investment income tax base for expenses associated with earning Canadian investment income and for a portion of the income from the Canadian life insurance business of the insurer determined under Part I of the Income Tax Act reduced by any losses of other years which have been deducted in computing the insurer's taxable income for the year.

. The portion of the income of the life insurer from its Canadian life insurance business deductible in computing the tax base will be that portion of the income which is considered to relate to the investment business, as opposed to the underwriting activity. For the purposes of this allocation, the income of the insurer from its Canadian life insurance business will include the taxable amount in respect of gains realized in respect of all property used or held in its life insurance business in Canada, since such gains will also be included in the gross investment income subject to the tax.

. A portion of the general and administrative costs applicable to the non-segregated life insurance business will be deductible in computing the tax base to recognize that these expenses are recovered from both the insurance underwriting business and the investment business of the corporation.

. Investment income attributable to the annuity business of life insurance corporations will be excluded from the tax base, because the investment income of annuities is subject to current taxation at personal tax rates under the accrual rules. Similarly, the investment income attributable to fixed contractual arrangements entered into before January 1, 1988 and to registered life insurance policies will be excluded from the tax base.

. The investment income attributable to annuities, grandfathered policies and registered plans will be determined using the average reserve liabilities of the company. Such income will be excluded after deducting expenses related to earning investment income, a portion of the general and administrative expenses and a portion of the Part I income of the corporation, as described above.

. A deduction will also be allowed for a specified percentage of the net commissions and premium taxes that relate to the life insurance business other than the excluded business -- annuities,

registered and grandfathered policies. This percentage will reflect the amounts related to the investment portion of the insurance contract. The specified percentage will also take into account the appropriate amortization of expenses over the life of a typical policy.

- As proposed in the White Paper, amounts that are required to be included in the income of policyholders with respect to their policies -- other than annuities or grandfathered or registered policies -- will be deductible in computing the tax base.

- Life insurance corporations will be permitted to deduct the amount of their investment income tax in calculating their Part I income. This will require a circular tax calculation because the Part I income will also be deductible by the corporation in calculating its investment income tax. These circular calculations were also made under the previous investment income tax.

- A seven-year carry-forward will be provided if there is a loss in the taxation year as computed under the tax.

As proposed in the White Paper, the tax will be phased in at 3 per cent in 1988; 6 per cent in 1989; 9 per cent in 1990; 12 per cent in 1991 and 15 per cent in 1992.

CHAPTER IV

COMPLIANCE AND ADMINISTRATION

## 1. General Anti-Avoidance Rule

The introduction of a general anti-avoidance rule is an important feature of tax reform. It is an essential element in protecting the expanded tax base against further erosion and stabilizing income tax revenues. As the government indicated in the White Paper, the process of action and reaction produced by the introduction of specific tax measures and the aggressive response by taxpayers in attempting to avoid such measures has to be curtailed. Moreover, equity requires that firm measures be taken to block sophisticated strategies designed to yield tax advantages that were not intended by Parliament.

In the recent past, the government has introduced detailed rules to deal with specific types of tax avoidance transactions, many of which were announced in press releases. For example, new rules have recently been implemented to prevent contrived transactions that result in a misuse of the provisions of the Income Tax Act dealing with capital dividend account and refundable dividend tax on hand. Such detailed anti-avoidance rules are often necessary since it is highly uncertain that the existing legislation and case law are sufficient to prevent strictly tax-motivated transactions.

The proliferation of such technical anti-avoidance rules, however, presents a number of difficulties. Apart from the added complexity that they generate, these rules tend to create other loopholes and they generally do not apply to transactions carried out before the rule is announced.

The implementation of an effective general anti-avoidance rule is intended to deal more strongly with the problem of contrived tax-avoidance transactions. Unlike its major trading partners, Canada does not have such a general rule either in judicial or legislative form. The existing rule contained in section 245 is of limited application. It deals only with deductions used in computing income and is based on the concept of artificiality, the meaning of which has often varied, as has been pointed out during the consultation process.

The adoption of a business purpose test, as proposed in the White Paper, is designed to restrict the provisions of the Income Tax Act to real economic transactions and to deny their application to tax-motivated transactions designed to utilize them to obtain benefits not intended in the Act.

Generally, the rule as proposed in the White Paper provided that an avoidance transaction, as defined, would be ignored for tax purposes and that the tax situation of a taxpayer would then be determined as is reasonable in the circumstances. The definition of an avoidance transaction introduced as statutory concepts the business purpose test and the step transaction doctrine. Special provisions were included to allow third parties affected by an avoidance transaction to request adjustments of a relieving nature. A general provision indicated that the purpose of the new rule was to counter artificial tax avoidance.

Detailed explanatory notes were also provided to reduce the uncertainty that might result from the introduction of the rule. It was also indicated that one or more interpretation bulletins or circulars would be issued by Revenue Canada on the application of the new rule.

During the consultation process it became clear that many taxpayers and advisers share the view that the current situation is unsatisfactory. However, concerns were expressed about the proposed rule.

Some critics challenged the necessity for a new general anti-avoidance rule, arguing that all the necessary tools to control abusive avoidance schemes effectively were on hand in the current legislation and case law. Many others, including the Commons committee, recognized the need for a more effective rule, but questioned the particular techniques chosen in the White Paper.

Most of the representations, however, focused on the scope and operation of the new rule. The most commonly expressed concern related to the uncertainty it would generate. It was argued that the business purpose test is inappropriate because it is foreign to our law, that it does not deal effectively with family transactions, and that the existing jurisprudence favours an "object and spirit" approach. It was further argued that the new rule allows too much discretion in favour of the Minister of National Revenue in ignoring the transaction and adjusting the tax consequences "as is reasonable in the circumstances". Another concern related to a perceived discrepancy between the technical notes and the proposed legislation; the plain words of the legislation, it was said, were more strict and less accommodating than the notes suggested. The relieving aspect of the "purpose" provision in the proposed rule was questioned and requests were made for clear exemptions from the rule for specific incentive provisions and a broad range of legitimate tax planning transactions.

With respect to the administration of the new rule, it was argued that its broad scope would hamper normal commercial transactions, put stress on the rulings process and place considerable power in the

hands of assessors. A related argument was that, because of the untested scope of the rule, its application could vary considerably depending on the individual assessor responsible for its application in particular circumstances. Finally, representations were received on the propriety of imposing penalties for avoidance transactions.

While these representations identified a number of aspects meriting reconsideration, the government remains convinced of the need for a general anti-avoidance rule and thus intends to implement such a rule. However, it proposes important improvements to the draft proposals in the White Paper. These are reflected in the draft amendments and explanatory notes set out in the Annex to this paper. The most significant of these improvements are described below.

- The "notwithstanding" provision: Subsection 245(1) of the original draft stated that it applied "notwithstanding any other provision of this Act". Concern was expressed that this might result in the new rule denying legitimate use of explicit provisions of the Act such as incentives and tax-free rollovers. This was not intended. It was intended, however, that the new rule may apply to an avoidance transaction even where a taxpayer is in literal compliance with specific provisions of the Act. The government proposes elimination of the "notwithstanding" provision in the revised text, to clarify that the new rule would not supplant other provisions of the Act but would apply together with these other provisions to require economic substance in addition to literal compliance with the words of the Act.

- Consequential adjustments: The effect of the original draft rule, when applied to an avoidance transaction, would be to allow the tax consequences of the transactions to be determined as is reasonable in the circumstances, ignoring the transaction. The reference in that draft to income, taxable income, tax or other amount payable or refundable would not directly cover a number of amounts, such as the adjusted cost base of property or the paid-up capital of shares, that may have to be adjusted following an avoidance transaction. Moreover, to say that the tax consequences are to be determined by ignoring the avoidance transaction would not always be appropriate. In some cases the transaction and its tax effects might have to be maintained vis-à-vis certain persons. To clarify the first point, a definition of tax consequences to any person is proposed in

the revised text. The second point is met by providing that the effect of the rule is to deny a tax benefit rather than to ignore the tax consequences that would otherwise flow from the transaction.

- Business purpose test: The definition of "avoidance transaction" in the original proposed draft would exclude transactions carried out primarily for bona fide business purposes. On a strict interpretation of the expression "business purpose", it might be considered that this exception would not apply to transactions, such as family transactions, even if they are not primarily tax-motivated, since they are not carried out for "business". To resolve this widely-expressed concern, the government proposes that the test be reformulated to refer to a primary purpose "other than obtaining the tax benefit".

- General purpose provision: Subsection (6) of the original draft rule was a purpose provision of a general nature. To clarify and to emphasize that the new rule is not intended to affect genuine transactions with economic substance that are consistent with the object and purpose of the Act, a specific provision is made in the revised text with respect to transactions that may reasonably be considered not to result in a misuse or abuse of the Act read as a whole.

- Adjustment provisions: A number of technical points have been recognized with respect to the provisions of the original draft rule that allow a third party to request an adjustment. These provisions are revised to allow requests for adjustments following a determination of the Minister of National Revenue as well as following an assessment, and to clarify when such request may be made. A procedure is established for determinations by the Minister of tax consequences that do not require an assessment. Moreover, an extension to the period for requesting an adjustment is provided. For the actual change, reference should be made to the revised draft and explanatory notes.

- Explanatory notes: Due to the special importance of the explanatory notes with respect to the proposed rule, and the concerns raised about whether they could be legitimately referred to as aids to interpretation, it is proposed to authorize the courts to have recourse to such notes in interpreting the rule.

- Avoidance transaction: In the original draft the definition of an avoidance transaction to which the rule applies was not an exclusive one. This implied that transactions other

than the two specified in the rule might be included. In the revised draft, the word "includes" is changed to "means" to allay concerns as to the scope of the new rule.

- Other: Various technical changes are being introduced to clarify the operation of the new rule. New words are added to avoid circularity problems in subsection (2) and to ensure that indirect tax benefits are included. The necessity for the reduction, deferral or refund to be a "significant" reduction, deferral or refund is eliminated because of the confusion expressed as to the meaning of significant, and because the rule is by its own nature limited to abusive tax avoidance.

- The White Paper had raised the possibility of penalties for abusive avoidance transactions. The government will not proceed with a penalty provision.

For more details reference should be made to the revised draft of section 245 and the revised explanatory notes in relation thereto. Prior to the implementation of the rule Revenue Canada, Taxation will provide further information as to the intended operation of the rule.

2. Specific Rules

a) Anti-avoidance

The White Paper indicated that the specific anti-avoidance rules of the Act needed to be reviewed as part of the new approach against abusive tax avoidance schemes. The review of existing specific anti-avoidance provisions is not yet completed. A complete overhaul is needed to correct perceived weaknesses and anomalies in these rules and to eliminate or adjust such rules where they are inappropriate having regard to the new general anti-avoidance rule. All the specific anti-avoidance rules and related provisions, such as the associated corporation and the related person rules, will be reviewed to ensure their effectiveness and their consistency with the new general anti-avoidance rule. This process will yield a consultation draft to be issued in 1988.

b) Technical rule re: transfer of business assets to a corporation before a sale of shares

The White Paper proposed the addition of a specific rule to ensure that a transfer of a business through a sale of shares is not treated as a sale of the underlying business assets.

In the absence of a specific provision of the Act to the contrary, proposed section 245 might apply to treat the sale of the shares of a subsidiary corporation by its parent as a sale of the underlying property rather than as a share sale where all of the business assets of the parent were transferred by it to the subsidiary shortly before the shares were sold. Since there is no policy reason to treat the share sale differently depending on when the business assets were incorporated, it is proposed to add a rule to the Income Tax Act to ensure that in these cases the shares of the subsidiary would be capital property to the parent and that the transaction would not be treated as a sale of the business assets.

The proposed rule will provide that the shares of a wholly-owned subsidiary will constitute capital property where they were issued in exchange for all or substantially all of the property used in a business previously carried on by the parent. The proposed rule will not apply where the business is not transferred -- for example, if only some of the assets used in a business were transferred on a rollover transaction by the parent to the subsidiary but the business itself was retained.

In these circumstances, if the series of transactions resulted in a significant tax reduction and the rollover of the assets could be considered to be part of the series of transactions in which the shares were sold, the rollover could be characterized as a step transaction. In this case, the rollover could be challenged under either paragraph 245(3)(a) or (b).

A similar rule will be provided to permit individuals to incorporate business assets in order to qualify for the proposed increase in the lifetime capital gains exemption to $500,000 after 1987 for shares of a small business corporation.

3. Penalties and Offences

Some of the existing fines, imprisonment and penalty provisions for violation of the Income Tax Act fail to achieve their objective because they are perceived as insignificant and therefore do not act as a deterrent, while others, although sufficient to prevent most non-compliance cases, do not effectively deter chronic abusers.

The White Paper proposed to change several offence and penalty provisions, generally in order to increase the amount of the fine, prison sentence or penalty that can be imposed for a failure to comply with the provisions of the Act. In addition, some provisions contain penalties which, while sufficient in most cases, do not deter chronic abusers. Therefore, a new concept of a two-tier penalty was proposed in the White Paper to ensure that the penalty imposed on a taxpayer for a first failure to comply would generally not be greater than in the existing legislation, while a penalty imposed for a second failure by the taxpayer within a specific period of time would be more substantial.

During the consultation process, support was expressed for measures to improve compliance. However, it was submitted that certain increases to the amount of penalties and fines were excessive, particularly in view of the complexity of the filing requirements. In particular, the additional penalty of 50 per cent of the interest charged for late or deficient instalments was criticized on grounds that instalments are estimates and the amount due in a particular year may be impacted by a reassessment of the previous year's income, and the Commons committee recommended this penalty not be implemented.

After careful consideration, the government intends to proceed with the White Paper proposals subject to the following modifications. First, the additional penalty to be introduced for late or deficient tax instalments will apply only to the portion of the interest charge that exceeds $1,000; this will ensure that minor errors of computation of instalment tax will not trigger the application of this penalty. Second, the two-tier penalty that is introduced with respect to the failure to withhold or deduct or remit or pay an amount of tax at source will apply only to the second or subsequent occurrence in the same calendar year rather than the preceding three taxation years. This modification will reduce the administrative complexities that could have resulted from the original proposal.

Recent studies indicate growing non-compliance with the provisions of the Act. Stronger fines and penalty provisions will encourage compliance and the new concept of a two-tier penalty system will be more effective in discouraging chronic offenders. In addition, the improved compliance experienced in other countries as a result of imposing a higher level of fines supports the government's proposal to increase the fines for these offences.

4. Information Reporting

To ensure a better reporting of income by all taxpayers and to provide more effective means of identifying potential tax avoidance, new reporting requirements were proposed by the White Paper. The additional information collected will assist in ensuring that income is properly reported and, in the case of international transactions, that transfer prices are not unreasonable.

The White Paper proposed that:

- individuals be required to supply their social insurance number to any person or partnership in connection to all information returns relating to the individual that are required to be made by that person or partnership under the Act;

- a reporting requirement be introduced to require investment dealers and financial institutions to report sales on behalf of the taxpayer of shares, precious metals, commodities and other investments generating income or capital gains if the gross proceeds of such sales exceed a prescribed amount in the year;

- a new provision be introduced requiring partnerships to file an annual information return on behalf of the partnership;

- a new provision be introduced requiring the identification of tax shelters, and also requiring a taxpayer who claims a deduction, credit or other amount as a result of the acquisition of a tax shelter security, to report the identification number of the tax shelter in his or her tax return in order to qualify for the deduction;

- Revenue Canada be authorized to require the production of foreign-based information that is relevant to the Canadian tax treatment of a transaction, and that a taxpayer failing to do so would be prohibited from introducing the information covered by the request in a Canadian court;

- a prescribed form similar to the U.S. Form 5472 be required to be filed by corporations carrying on business in Canada that engage in transactions with foreign entities; and

- the statutory limit for the tax assessments relating to cross-border transactions be extended for a reasonable period beyond the current three-year period.

Consultations will continue with respect to many technical aspects of these proposals that have been identified as deserving further refinement. The government believes that these changes will ensure better taxpayer reporting and compliance in keeping with the objective of equity. Draft legislation to be issued in the new year will provide a further opportunity to discuss some of the technical aspects of these proposals.

CHAPTER V

SALES TAX INTERIM MEASURES

## 1. Introduction

The need to replace the current manufacturers' sales tax is widely acknowledged. The White Paper announced that a new sales tax system will be introduced as stage two of tax reform. The proposed multi-stage tax will be fairer for individuals and will remove the bias against Canadian products in both foreign and domestic markets. The government is now consulting on these proposals and is examining with the provinces one option for that system -- a national sales tax.

Until the new sales tax can be implemented, however, the White Paper proposed a number of interim measures relating to the existing federal sales tax. These measures were designed to raise additional revenues, to reduce some of the competitive distortions that now exist, and to reduce opportunities for tax avoidance. Together with corporate tax measures, the interim sales tax measures will raise additional revenues to enable the government to lower personal income taxes.

This section sets out these proposals including the modifications that are being made as a result of consultations.

## 2. Marketing Companies and Tax Shifts to the Wholesale Level

To address the competitive distortions that arise from legislative deficiencies in the fair price provisions of the Excise Tax Act, the government made two proposals. First, where a manufacturer sells goods primarily through a related person, the government proposed that that person be deemed to be the manufacturer of all such goods sold by him and liable for tax on his sale price. In addition, to reduce competitive distortions in the markets for household chemicals, toys, games, sporting goods, sound recordings and tapes, the government proposed to tax these products at the sale-to-retailer trade level.

While the competitive distortions caused by the existing legislation are clearly acknowledged by all, both the Commons and Senate committees expressed concern that the proposed marketing company provisions and the shifts to the wholesale level for most products would cause new distortions and thus recommended the proposals be dropped.

However, action to deal with the problems addressed by these proposals is required in order to prevent severe erosion of sales tax revenues in the near future. Thus, the government will act to deal with deficiencies in the existing law. However, to allow time for refinement of the measures proposed in the White Paper, the government proposes to delay their implementation until July 1, 1988.

The government acknowledges that some further refinement of the proposals is required to minimize any distortions that might result from these proposals. Submissions from taxpayers and other interested persons concerning the impact of these proposals will be taken into account as development of the measures continues. Details of the measures will be announced as soon as possible.

The proposal to shift the sales tax on pet litter to the wholesale trade level, effective January 1, 1988, will proceed as originally announced.

3. Fair Market Value

In the White Paper, it was indicated that the current fair price provisions of the Excise Tax Act would be modified so that in cases of non-arm's-length sales (where the manufacturer is making substantial sales to independent persons) the tax will apply to the fair market value of the non-arm's-length sales, a value readily determinable by reference to the prices charged to independent buyers.

The government intends to proceed with this proposal. Accordingly, the authority of the Minister of National Revenue to determine the value of a product for federal sales tax purposes will be replaced with valuation rules based on fair market value concepts effective January 1, 1988.

The fair market value rules will apply to non-arm's-length sales and goods taken by a taxpayer for his own use, to non-arm's-length purchases by licensed wholesalers, and to diversions by way of sale, lease or appropriation to a non-exempt use by unlicensed persons. The fair market value concept will also be applied in other circumstances where it is difficult to determine the value for tax, for example, when goods are leased by the taxpayer rather than sold.

The Governor-in-Council will be authorized to issue regulations providing for the valuation methods to be used in determining the fair market value of goods and services in particular cases. Until such regulations are promulgated, taxpayers should be guided by the valuation methods set out in Revenue Canada, Taxation Information Circular 87-2 on international transfer pricing and other international transactions, sections 47 to 55 of the Customs Act, and the OECD Report on Transfer Pricing and Multinational Enterprises.

## 4. Tax on Telecommunication Services

In the White Paper, the government proposed that a 10-per-cent tax be applied to amounts charged for telecommunication services provided on or after January 1, 1988. This proposal was supported as an interim measure by both the Commons and Senate committees.

The government intends to proceed with this tax effective January 1, 1988. Following discussions with both carriers and users, it has been determined that the tax will apply to local business telephone, long distance telephone, cellular telephone, telegram and telegraph, data and text transmissions, mobile radio, radio-paging, audio and video program transmissions, leased lines and circuits, and other sales of telecommunication transmission capacity. Charges for the commencement or termination of a taxable service will also be taxable.

Residential telephone services, other than long distance, will be exempt from the tax. Additional services legally available from a variety of sources, including data processing, data storage and information services, will be exempt when provided with basic telecommunication services for a separate charge. Persons who merely purchase taxable services for enhancement and resale will be treated as users of the services they purchase.

All terminal equipment and related service charges will be exempt from the tax. Other equipment that is not terminal-related will be taxable when provided in conjunction with a taxable telecommunication service unless it is also available in the open market from a supplier other than the person providing the telecommunication service.

The tax will be payable by the purchaser of the service and collected by the supplier as agent for the Minister of National Revenue.

This tax is projected to raise approximately $870 million in 1988. It is the intent of the government that this tax be removed in stage two of tax reform.

5. Tax on Cable and Pay Television Services

Also as proposed in the White Paper, effective January 1, 1988, the rate of tax applicable to cable and pay television services will be increased from 8 to 10 per cent.

6. Deletion of Paint and Wallpaper From List of Construction Materials

The White Paper proposed that certain construction materials currently taxed at the reduced rate of 8 per cent be taxed at the general rate of 12 per cent. The affected goods are paint, varnish, stain, and similar coatings and finishes, and wallpaper and similar coverings for interior walls. This change will be implemented effective January 1, 1988.

7. Federal Sales Tax Credit

The White Paper proposed that the federal refundable sales tax credit be increased by $20 per adult and $10 per child. This increase has been supported during the consultation process and will be implemented as proposed. For the 1988 taxation year the credit will be $70 per adult and $35 per child. The income threshold, above which the credit is reduced by 5 per cent of income of the individual or family claiming the credit, will be increased by $1,000 to $16,000.

## 8. Accelerated Payment of Sales and Excise Taxes

The White Paper proposed that the collection of federal sales and excise taxes be accelerated, effective April 1988, to achieve improved cash management and ongoing savings in public debt charges.

The Commons committee agreed with this proposal. However, representations from the private sector indicated that it would be difficult for some large taxpayers to determine the appropriate payment under the precise method proposed. A number of other issues pertaining to the receipt of instalment payments by the Receiver General, the date of receipt of returns by the Minister of National Revenue and the definition of the last business day also arose during the consultations.

The government will proceed with the acceleration of payments effective April 1988, taking into account the representations made in the consultations. In particular, to accommodate the imposition of twice-monthly remittances of the tax to the existing accounting systems of large taxpayers, the government proposes to implement an instalment payment system in which taxpayers would make instalment or estimated payments on the dates proposed in the White Paper and submit monthly returns by the end of the month following the month of sale.

9. Sales Tax Rate for Alcoholic Beverages and Tobacco Products

To compensate for sales tax revenues forgone by not implementing the proposals with respect to related marketing companies and to the shift of tax to the wholesale level, and, in part, for personal income tax revenues forgone through increases in the credit for dependent children, the Commons committee recommended a surcharge of 3 per cent on federal sales tax payable excluding the telecommunications services tax.

Rather than impose the surcharge of 3 per cent on all sales tax as recommended by the Commons committee, the government proposes to raise the existing rate of federal sales tax on alcoholic beverages and tobacco products from 15 to 18 per cent effective January 1, 1988. This will raise approximately $175 million per year and, in conjunction with the proposed extension of the capital tax on deposit-taking financial institutions, pay for the increased child credits and other changes to the personal income tax.

CHAPTER VI

FISCAL IMPACT

## 1. Direct Impact by Measure

The reformed tax system will contribute to responsible fiscal management. The risks of revenue erosion over time have been lessened by reducing or eliminating preferences and introducing more effective anti-avoidance provisions. The proposals contained in the White Paper have been designed to be fiscally neutral with respect to the budgetary position of the government over the years 1988-89 to 1991-92 when the measures will be fully phased in. Additional revenues are not required in stage two of tax reform to "pay for" stage one.

Similarly, a fundamental constraint on the modifications to the White Paper arising out of the consultation process was that the modifications on balance be neutral with respect to the fiscal position of the government. Table VI-1 presents, measure by measure, the impact of the modifications discussed above for each of the taxation years 1988 to 1992.

Table VI-1 indicates that, over this period, changes to the personal income tax measures relating to the increased benefits for families with children and modifications to the automobile expense rules will reduce personal income tax revenues by annual amounts rising from $200 million in 1988 to $250 million by 1992. Changes to corporate income tax measures, including the extension of the capital tax to deposit-taking institutions and the proposed modification of taxation of foreign income of banks, will increase corporate income tax revenues on average over this period by about $50 million a year. Revenues from the federal sales tax on alcoholic beverages and tobacco products will increase by about $175 million a year.

Table VI-1
Federal Revenue Impact of the Modifications
to the White Paper Proposals

| Measures | Taxation Year Estimates | | | | |
|---|---|---|---|---|---|
| | 1988 | 1989 | 1990 | 1991 | 1992 |
| | (millions of dollars) | | | | |
| Personal Income Tax Measures | | | | | |
| Modification to the automobile expense rules | -50 | -55 | -60 | -65 | -70 |
| Elimination of the half-year rule on film CCA | -2 | -2 | -2 | -3 | -3 |
| Three-year extension for existing MURBs and extension of earned depletion to end of 1989 | 0 | -10 | 0 | -30 | -30 |
| Conversion of CPP deduction for self-employed to a credit | 8 | 8 | 9 | 9 | 10 |
| Child benefit measures | | | | | |
| - $35 increase in the refundable child tax credit | -160 | -160 | -160 | -160 | -160 |
| - increase in the child credit from $65 to $130 for third and subsequent children | -40 | -40 | -40 | -40 | -40 |
| - make family allowances reportable by higher-income spouse | 50 | 50 | 50 | 50 | 50 |
| - increase threshold on dependant credits | -6 | -6 | -7 | -7 | -7 |
| Total child benefit impact | -156 | -156 | -157 | -157 | -157 |
| Total personal income tax changes | -200 | -215 | -210 | -246 | -250 |

Table VI-1 (Cont'd)

| | | | | | |
|---|---|---|---|---|---|
| **Corporate Income Tax Measures** | | | | | |
| Relief to small firms on interest capitalization on land | -2 | -3 | -5 | -7 | -10 |
| Put-in-use rule changes | 0 | 0 | 0 | 0 | -25 |
| Relaxation of investment tax credit restriction to 75% | 0 | -10 | 0 | 5 | 15 |
| Extension of earned depletion until end of 1989 | 0 | -15 | 0 | 0 | 0 |
| Life insurance investment income | -15 | -25 | -38 | -53 | -62 |
| Introduce a creditable capital tax and modify tax treatment of foreign income of banks | 120 | 125 | 95 | 70 | 105 |
| Total corporate income tax changes | 103 | 72 | 52 | 15 | 23 |
| **Sales Tax Measures** | | | | | |
| Modification to the sales tax on marketing companies | -150 | 0 | 0 | 0 | 0 |
| Increase tax rate on alcoholic beverages and tobacco products | 175 | 175 | 175 | 175 | 175 |
| Total sales tax changes | 25 | 175 | 175 | 175 | 175 |
| Total impact on federal revenues | -72 | 32 | 17 | -56 | -52 |

2. Impact on Deficit

Panel A of Table VI-2 presents the direct revenue and expenditure impacts of the modifications to the White Paper proposals on a fiscal year basis. To be consistent with the fiscal impacts presented in the White Paper, the fiscal impacts of the modifications are presented on the basis of the economic and fiscal assumptions underlying the White Paper.

In total, the modifications to the White Paper reduce personal income tax revenues by $120 million in fiscal year 1988-89, rising to $220 million by 1991-92. The corporate income tax changes result in higher collections of $115 million in fiscal year 1988-89, declining to $20 million by 1991-92. On a net basis, the impact on the deficit of the personal and corporate income tax modifications is virtually neutral in 1988-89. However, in 1989-90, the total direct revenue impacts of these modifications would, in the absence of other tax measures, result in an increase in the deficit of $145 million, rising to $200 million by 1991-92 as the tax measures become fully phased in over this period. As well, these measures also result in slightly higher expenditures under Established Programs Financing to the provinces as the value of tax points is reduced.

The delay in the introduction of sales tax measures dealing with the problems of related marketing companies from January 1 to July 1, 1988, will impact negatively on the deficit outcome for 1988-89. However, the increase in the sales tax rate on alcoholic beverages and tobacco products is estimated to increase revenues by about $175 million per year and ensure that the fiscal impact of the modifications to the White Paper is basically neutral.

Table VI-2
Fiscal Implications of Modifications to Stage One of Tax Reform

| A. Total Direct Revenue and Expenditure Impacts of the Personal and Corporate Tax Measures | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|
| | | (millions of dollars) | | |
| Revenue impacts | | | | |
| Net personal income tax changes | -120 | -215 | -215 | -220 |
| Net corporate income tax changes | 115 | 70 | 40 | 20 |
| Total net income tax revenue changes | -5 | -145 | -175 | -200 |
| Expenditure impacts | | | | |
| Increased payments under Established Programs Financing and equalization | 10 | 10 | 10 | 15 |
| B. Related Revenue Measures | | | | |
| Changes to the federal sales tax (FST) | | | | |
| Shift in federal sales tax to wholesale level for selected items and change in the treatment of marketing companies | -125 | - | - | - |
| Increase tax rate on tobacco and alcoholic beverages | 175 | 175 | 175 | 175 |
| Total net revenue changes | 50 | 175 | 175 | 175 |

Table VI-2 (Cont'd)

| | | | | |
|---|---|---|---|---|
| Increase (+) or decrease (-) in deficit due to modifications to stage one of tax reform | -35 | -20 | 10 | 40 |

## 3. Overall Impact on Federal Fiscal Balance

Table VI-3 presents the revised direct revenue and expenditure impacts of all measures in stage one of tax reform. Most of the personal income tax changes will be fully implemented in the 1988 taxation year. However, as the withholding tables are not to be adjusted to reflect these changes until July 1, 1988, the net fiscal impact of the personal income tax changes is somewhat reduced in 1988-89, with offsetting refund payments in 1989-90. By 1991-92, the tax reform measures will reduce personal income tax revenues by approximately $2.6 billion per annum.

As a result of the corporate income tax measures in stage one of tax reform, net additions to corporate income tax revenues will grow from about $0.6 billion in 1988-89 to $1.5 billion by 1991-92 as the measures become fully phased in.

The personal and corporate income tax measures will also result in higher transfer payments to provinces of about $350 to $400 million per year under the equalization and the Established Programs Financing programs.

The total direct revenue and expenditure impacts of the personal and corporate income tax measures will result in an increase in the deficit of about $1.5 billion in 1988-89 and $3.7 billion in 1989-90. Beyond this two-year transition period, the effects of these changes will be to increase the deficit by about $1.5 billion per year.

Responsible fiscal management requires that the fiscal impact of the personal and corporate income tax changes be offset. Additional revenues are to be raised through the broadening of the present sales tax base and through selected sales tax increases. The impact of these tax changes on low-income families and individuals will be offset through an increase in the refundable sales tax credit. As well, measures are being put in place to limit some of the tax avoidance opportunities and major competitive distortions that now exist in the present sales tax system. Actions are also being taken to accelerate the collection of sales and excise taxes, income taxes collected at source and quarterly personal income tax instalments.

As a result of these related measures, the cumulative fiscal impact of stage one of tax reform on the deficit and net debt over the 1988-89 to 1991-92 period is negligible.

Table VI-3
Fiscal Implications of Stage One of Tax Reform*

| A. Total Direct Revenue and Expenditure Impacts of the Personal and Corporate Tax Measures | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|
| | | (millions of dollars) | | |
| Revenue impacts | | | | |
| Personal income tax | | | | |
| Conversion of exemptions to credits and marginal tax rate reductions | -2,205 | -5,960 | -4,640 | -4,945 |
| Base-broadening and other measures | 380 | 1,905 | 2,080 | 2,315 |
| Net personal income tax reductions | -1,825 | -4,055 | -2,560 | -2,630 |
| Corporate income tax | | | | |
| Tax rate reductions | -635 | -1,545 | -1,645 | -1,665 |
| Base-broadening measures | 1,280 | 2,240 | 2,850 | 3,210 |
| Net corporate income tax increases | 645 | 695 | 1,205 | 1,545 |
| Total net revenue reductions | -1,180 | -3,360 | -1,355 | -1,085 |
| Expenditure impacts | | | | |
| Increased payments under Established Programs Financing and equalization | 350 | 370 | 395 | 410 |

Table VI-3 (Cont'd)

B. Related Revenue Measures

| | | | | |
|---|---|---|---|---|
| Changes to the federal sales tax (FST) and the refundable sales tax credit | | | | |
| Shift in federal sales tax to wholesale level for selected items and change in the treatment of marketing companies | 170 | 310 | 315 | 330 |
| 10 per cent on specified telecommunications and cable services | 870 | 945 | 1,000 | 1,055 |
| Tax at general rate on paint and wallpaper | 60 | 60 | 65 | 65 |
| Increase tax rate on tobacco and alcoholic beverages | 175 | 175 | 175 | 175 |
| Increase in refundable sales tax credit by $20 per adult and $10 per child | -120 | -150 | -155 | -160 |
| Net increase in FST revenues | 1,155 | 1,340 | 1,400 | 1,465 |
| Tax liability management | | | | |
| Acceleration of source deductions and quarterly instalments of personal income tax | | 1,100 | | |
| Acceleration of sales and excise tax payments | 1,600 | | | |
| Total revenue increases resulting from tax liability management | 1,600 | 1,100 | | |

Table VI-3 (Cont'd)

| | | | | |
|---|---|---|---|---|
| Total net revenue increases | 2,755 | 2,440 | 1,400 | 1,465 |
| Increase (+) or decrease (-) in deficit due to stage one of tax reform | -1,225 | 1,290 | 350 | 30 |

* based on June 1987 economic assumptions.

## 4. Rebalancing Federal Tax Revenue Shares

In the absence of tax reform, the increasing reliance on personal income taxes would have continued. As shown in Table VI-4, the tax measures in the first stage of tax reform will lower the share of personal income taxes and increase the shares of both corporate income and sales taxes. Based on the White Paper economic assumptions, the share of corporate income taxes will increase from a low of 15.6 per cent in 1987-88 to 17.2 per cent by 1991-92. The second stage of tax reform will bring about a further rebalancing of the shares of the main tax revenues as the federal sales tax is replaced by a broad-based multi-stage sales tax, accompanied by a substantial enrichment of the refundable sales tax credit, additional personal income tax reductions and the removal of the personal and corporate income surtaxes.

Table VI-4
Structure of Main Federal Tax Revenues

| Fiscal Periods | Personal income tax | Corporate income tax | Federal sales tax | Total |
|---|---|---|---|---|
| | | (per cent) | | |
| Historical | | | | |
| 1971-72 to 1975-76 | 57.6 | 22.9 | 19.5 | 100.0 |
| 1976-77 to 1980-81 | 59.4 | 23.3 | 17.3 | 100.0 |
| 1981-82 to 1985-86 | 64.6 | 19.0 | 16.4 | 100.0 |
| Current Year Projection | | | | |
| 1987-88 | 65.1 | 15.6 | 19.4 | 100.0 |
| Stage One of Tax Reform | | | | |
| 1991-92 | 62.7 | 17.2 | 20.1 | 100.0 |

Note: Details may not add due to rounding.

5. Fiscal Impact on Provinces

The changes to the measures set out in the White Paper will have only a minimal impact on provincial revenues. The major change -- the improvement in child tax credits -- includes an increase in the refundable child tax credit, the cost of which is entirely borne by the federal government. Similarly, the extension of the capital tax on banks affects only federal revenues. The net impact of other income tax changes is very small.

The changes to the federal sales tax to increase the tax on tobacco products and alcoholic beverages are likely to provide additional revenues to provinces. Since provinces apply their taxes and markups to the price of tobacco products and alcoholic beverages inclusive of the federal sales tax, provincial revenues can also be expected to increase. These increases should offset any negative impact on provincial revenues of personal and corporate income tax changes.

As described in the White Paper, provinces will benefit in 1988-89 from an acceleration of payments under the income tax collection agreements. Corresponding assistance will be provided to Quebec to the extent it harmonizes its income tax system with the reformed federal system.

The personal income tax revenue guarantee program under the Fiscal Arrangements Act does not apply to the tax reform changes, since that program is based on the concept of notification. It applies only if provincial revenues are significantly reduced by federal personal income tax changes introduced in the same year in which they become effective. In the case of tax reform, provinces were consulted in the development of the tax reform measures and informed of them in the year prior to their coming into effect. Nonetheless, in order to remove any possible future uncertainty in this regard, notice has been given today of clarifying amendments to the Fiscal Arrangements Act.

## DRAFT LEGISLATION
## GENERAL ANTI-AVOIDANCE RULE

A discussion draft of a proposed new section 245 of the Act, the new general anti-avoidance rule, was attached to the June 18, 1987 White Paper together with detailed explanatory notes.

Following the consultation process, a number of changes have been made to proposed section 245. The nature of these changes was fully described in chapter IV.

A revised draft of proposed section 245, including consequential amendments to sections 152, 167 and 246, is set out in this annex together with a revision of the explanatory notes.

GENERAL ANTI-AVOIDANCE RULE

EXPLANATORY NOTES

Clause 1
General anti-avoidance rule

ITA
245

New section 245 of the Act is a broad general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

New section 245 replaces the existing subsection 245(1), which applies only to transactions resulting in deductions relevant in computing income. The wording of the new provision is intended to encompass all types of abusive and artificial tax avoidance schemes including the types to which existing subsection 245(1) already applies. It is an important supplement to the tools that may be used by Revenue Canada to counter abusive tax avoidance transactions.

Transactions that comply with the object and spirit of other provisions of the Act read as a whole will not be affected by the application of this general anti-avoidance rule. For example, a transaction that qualifies for a tax-free rollover under an explicit provision of the Act, and that is carried out in accordance not only with the letter of that provision but also with the spirit of the Act read as a whole, will not be subject to new section 245. However, where the transaction is part of a series of transactions designed to avoid tax and results in a misuse or abuse of the provision that allows a tax-free rollover, the rule may apply. If, for example, a taxpayer, for the purpose of converting an income gain on a sale of property into a capital gain, transfers the property to a shell corporation in exchange for shares and subsequently sells the shares, the proposed section would ordinarily apply.

The proposed rule applies as a provision of last resort after the application of the other provisions of the Act, including specific anti-avoidance measures.

ITA
245(1)

New subsection 245(1) of the Act defines certain expressions used in section 245 relating to avoidance transactions and in proposed subsection 152(1.11) relating to determinations.

Generally, for the purposes of section 245, a transaction, to be an avoidance transaction, must result in a "tax benefit". This expression is defined as a reduction, avoidance or deferral of tax or other amount payable under the Act or an increase in a refund of tax or other amount under the Act. The references in this definition to "other amount payable under this Act" and "other amount under this Act" are intended to cover interest, penalties, the remittance of source deductions, and other amounts that do not constitute tax.

Where a transaction is an avoidance transaction, new subsection 245(2) provides that the tax consequences to any person shall be determined as is reasonable in the circumstances in order to deny the tax benefit that would otherwise result from that transaction. The expression "tax consequences" is defined as the income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to any person under the Act as well as any other amount, such as the adjusted cost base of a property or the paid-up capital of a share, which is relevant for the purposes of the computation of the income or other above-mentioned amount.

The term "transaction" is defined to include an arrangement or event.

ITA
245(2)

New subsection 245(2) of the Act provides that where a transaction is an avoidance transaction, the tax consequences to a person, as defined in proposed subsection 245(1), are to be determined as is reasonable in the circumstances in order to deny the tax benefit of that transaction. For this purpose, the definition of "avoidance transaction" is provided in new subsection 245(3) and is subject to the limitation provided by new subsection 245(4).

If a transaction is an avoidance transaction, the tax consequences are determined as is reasonable in the circumstances in order to deny the tax benefit. Where subsection 245(2) applies, Revenue Canada, Taxation is required to determine the tax consequences in order to deny the tax benefit on a basis that is reasonable in the circumstances. New subsection 245(5) provides a non-exhaustive list of what may be done to achieve that result. In many cases the manner in which this should be accomplished will be obvious or will be provided for in the Income Tax Act. However, the "reasonable basis"

approach adopted in subsection 245(2) recognizes that it is not possible to exhaustively prescribe the appropriate tax consequences for the range of avoidance transactions to which the rule might apply.

ITA
245(3)

New subsection 245(3) of the Act, subject to the limitation provided by subsection 245(4), contains the definition of "avoidance transaction". Under new subsection 245(2), if a transaction is an avoidance transaction, the tax consequences to any person are determined as is reasonable in the circumstances in order to deny the tax benefit resulting from that transaction.

Under new paragraph 245(3)(a), a transaction that, but for section 245, would result, directly or indirectly, in a tax benefit is considered to be an avoidance transaction unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than for the purposes of obtaining the tax benefit.

New paragraph 245(3) refers to "bona fide purposes other than to obtain the tax benefit" rather than to "bona fide business purposes", as originally proposed, because the latter expression might be found not to apply to transactions which are not carried out in the context of a business, narrowly construed. The vast majority of business, family or investment transactions will not be affected by proposed section 245 since they will have bona fide non-tax purposes.

Where a transaction is carried out for a combination of bona fide non-tax purposes and tax-avoidance, the primary purposes of the transaction must be determined. This will likely involve weighing and balancing the tax and non-tax purposes of the transaction. If, having regard to the circumstances, a transaction is determined to meet this non-tax purposes test, it will not be considered to be an avoidance transaction. Thus a transaction will not be considered to be an avoidance transaction because, incidentally, it results in a tax benefit or because tax considerations were a significant, but not the primary, purpose for carrying out the transaction.

Ordinarily, transitory arrangements would not be considered to have been carried out primarily for bona fide purposes other than the obtaining of a tax benefit. Such transitory arrangements might include an issue of shares that are immediately redeemed or the establishment of an entity, such as a corporation or a partnership, followed within a short period by its elimination.

Paragraph 245(3)(b) recognizes that one step in a series of transactions may not by itself result in a tax benefit. Thus, where a taxpayer, in carrying out a series of transactions, inserts a transaction that is not carried out primarily for bona fide non-tax purposes and the series results in a tax benefit, that tax benefit may be denied under subsection 245(2). This is accomplished by expressly defining an avoidance transaction in proposed subsection 245(3)(b) as including a step transaction (a step transaction being one that is part of a series of transactions) in a series that, but for proposed section 245, would result directly or indirectly in a tax benefit, unless that transaction has primary non-tax purposes. For that purpose, reference may be made to existing subsection 248(10) of the Act which provides that a series of transactions includes any related transactions or events completed in contemplation of the series.

Thus, where a series of transactions would result in a tax benefit, that tax benefit will be denied unless the primary objective of each transaction in the series is to achieve some legitimate non-tax purposes. Therefore, in order not to fall within the definition of "avoidance transaction" in subsection 245(3), each step in such a series must be carried out primarily for bona fide non-tax purposes.

Subsection 245(3) does not permit the "recharacterization" of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes. It is recognized that tax planning -arranging one's affairs so as to attract the least amount of tax- is a legitimate and accepted part of Canadian tax law. If a taxpayer selects a transaction that minimizes his tax liability and this transaction is not carried out primarily to obtain a tax benefit, he should not be taxed as if he had engaged in other transactions that would have resulted in higher taxes.

ITA
245(4)

New subsection 245(4) of the Act contains an important limitation to the application of section 245. Even where a transaction results, directly or indirectly, in a tax benefit and has been carried out primarily for tax purposes, section 245 will not apply if it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse of the provisions of the Act read as a whole. This measure is intended to apply where a taxpayer establishes that a transaction carried out primarily for tax purposes does not, nonetheless, constitute an abuse of the Act.

Subsection 245(4) recognizes that the provisions of the Income Tax Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax. It also recognizes, however, that a number of provisions of the Act either contemplate or encourage transactions that may seem to be primarily tax-motivated. The so-called "butterfly" reorganization is a good example of such transactions. It is not intended that section 245 will apply to deny the tax benefits that result from these transactions as long as they are carried out within the object and spirit of the provisions of the Act read as a whole. Nor is it intended that tax incentives expressly provided for in the legislation would be neutralized by this section.

Where a taxpayer carries out transactions primarily in order to obtain, through the application of specific provisions of the Act, a tax benefit that is not intended by such provisions and by the Act read as a whole, section 245 should apply. This would be the case even though the strict words of the relevant specific provisions may support the tax result sought by the taxpayer. Thus, where applicable, section 245 will override other provisions of the Act since, otherwise, its object and purpose would be defeated.

Subsection 245(4) draws on the doctrine of "abuse of rights" which applies in some jurisdictions to defeat schemes intended to abuse the tax legislation. It refers to an abuse of the Act read as a whole as well as to a misuse of some specific provisions. For instance, a transaction structured to take advantage of technical provisions of the Act but which would be inconsistent with the overall purpose of these provisions would be seen as a misuse of these provisions. On the other hand, a transaction may be abusive having regard to the Act read as a whole even where it might be argued, on a narrow interpretation, that it does not constitute a misuse of a specific provision. Thus, in reading the Act as a whole, specific provisions will be read in the context of and in harmony with the other provisions of the Act in order to achieve a result which is consistent with the general scheme of the Act.

Therefore, the application of new subsection 245 must be determined by reference to the facts in a particular case in the context of the scheme of the Act. For example, the attribution provisions of the Income Tax Act set out detailed rules that seek to prevent a taxpayer from splitting income among a spouse and minor children. A review of the scheme of these provisions indicates that income splitting is only of concern in transactions involving spouses or children under 18 years of age. The attribution rules are not intended to apply to other transactions such as gifts to adult children. This can be discerned from a review of the scheme of the Act, its relevant provisions and permissible extrinsic aids. Thus a straightforward gift from a parent to his adult child will not be

within the scope of section 245 either because it is made primarily for non-tax purposes or because it may reasonably be regarded as not being an abuse of the provisions of the Act. If, however, the gift is made so that the adult child acquires an investment and, through a series of transactions, disposes of it and subsequently transfers the proceeds, including any income therefrom, to the parent, proposed section 245 should apply where the purpose of the transaction is the reduction, avoidance or deferral of tax.

As another example, "estate freezing" transactions whereby a taxpayer transfers future growth in the value of assets to his children or grandchildren will not ordinarily be avoidance transactions to which the proposed rules would apply despite the fact that they may result in a deferral, avoidance or reduction of tax. Apart from the fact that many of these transactions may be considered to be primarily motivated by non-tax considerations, it would be reasonable to consider that such transactions do not ordinarily result in a misuse or abuse given the scheme of the Act and the change to the attribution rules proposed in the Ways and Means Motion tabled in the House in June, 1987 to accommodate estate freezes.

Another example involves the transfer of income or deductions within a related group of corporations. There are a number of provisions in the Income Tax Act that limit the claim by a taxpayer of losses, deductions and credits incurred or earned by unrelated taxpayers, particularly corporations. The loss limitation rules introduced on January 15, 1987 to apply on a change of control of a corporation represent an important example. These rules are generally restricted to the claiming of losses, deductions and other amounts by unrelated parties. There are explicit exceptions intended to apply with respect to transactions that would allow losses, deductions or credits earned by one corporation to be claimed by related Canadian corporations. In fact, the scheme of the Act as a whole, and the expressed object and spirit of the corporate loss limitation rules, clearly permit such transactions between related corporations where these transactions are otherwise legally effective and comply with the letter and spirit of these exceptions. Therefore, even if these transactions may appear to be primarily tax-motivated, they ordinarily do not fall within the scope of section 245 since they usually do not result in a misuse or abuse.

However, not all inter-company transactions within a related corporate group will necessarily be outside the scope of the anti-avoidance rule. There may be circumstances where new section 245 would apply -for example:

- where the transaction results in the deduction of the same amount twice,

- where the transactions are entered into to make two or more corporations related only for the purpose of avoiding a loss limitation, or

- where the transaction otherwise attempts to abuse the loss limitation rules.

ITA
245(5)

Where new subsection 245(2) applies, Revenue Canada, Taxation is required to determine the tax consequences in order to deny the tax benefit on a basis that is reasonable in the circumstances. For that purpose, by virtue of new subsection 245(5), Revenue Canada, Taxation may among other things

- disallow all or part of any deduction in computing income, taxable income, taxable income earned in Canada or tax payable,

- allocate all or part of any deduction, income, loss or other amount to any person,

- recharacterize a payment or other amount, or

- ignore the tax effects that would otherwise result from the application of other provisions of the Act.

For example, payments under an agreement that may in legal form be a lease may be characterized as proceeds of disposition of property where, having regard to the agreement as a whole, it would be reasonable to establish the tax results of that transaction as if it were a sale.

As another example, assume that, in contemplation of an arm's length sale, an asset is transferred on a tax-free basis, under a rollover provision of the Act, to a related corporation, the shares of which are subsequently sold. New subsection 245(2) could be applied if the sale to the related corporation is found to be an avoidance transaction. The appropriate tax treatment might be to treat the taxpayer as having sold the property directly to the ultimate purchaser. Further, it might be appropriate in this situation for Revenue Canada, Taxation under subsection 245(2) to approve, through a determination under subsection 152(1.11), an increase in the cost base of the shares of the related corporation in order to prevent the taxation of the sale proceeds of disposition twice, once when the property was sold and again when the taxpayer disposes of the shares. In that case, Revenue Canada would ignore the effect of the rollover provision in order to allow this increased cost base.

A taxpayer has the right to dispute, through the ordinary notice of objection and appeal procedures, not only the determination that a transaction is an avoidance transaction, but also the reasonable determination of the appropriate tax consequences.

ITA
245(6) to (9)

In determining, under new subsection 245(2) of the Act, the reasonable tax consequences to any person in order to deny the tax benefit of an avoidance transaction, Revenue Canada may make adjustments of a relieving nature. New subsection 245(6) introduces a mechanism that allows a person to request such adjustments.

Under new subsection 245(6), where proposed subsection 245(2) applies with respect to a transaction and, consequently, a taxpayer has been assessed or reassessed or a determination has been made under proposed subsection 152(1.11) with respect to that person, another person is entitled to request that the Minister of National Revenue apply subsection 245(2) in his case in order to make adjustments of a relieving nature with respect to the same transaction.

A request for adjustment may be made by that other person within 90 days after the day of mailing to the taxpayer of a notice of assessment, reassessment or determination, as the case may be. Amendments to section 167 of the Act allow that other person to make an application to the Tax Court of Canada for a time extension in the circumstances considered in existing subsection 167(5).

Subsection 245(6) does not apply to a taxpayer who has already been assessed or in respect of whom a determination pursuant to subsection 152(1.11) has been made by the Minister of National Revenue under section 245 because this taxpayer is in a position to request the appropriate adjustments through the objection and appeal mechanisms provided by other provisions of the Act.

New subsection 245(7) of the Act provides that a person may not rely on subsection 245(2) in order to determine his income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to any person under the Act as well as any other amount under the Act which is relevant for the purposes of the computation of the foregoing, except through a request for adjustment under subsection 245(6). This prevents a person from using the provisions of subsection 245(2) in order to adjust his income, or any of the above-mentioned amounts, without requesting that adjustment following the procedure set out in subsection 245(6).

New subsection 245(8) of the Act provides the powers that the Minister may exercise on the receipt of a request made under subsection 245(6). Where such a request is made, the Minister shall, with all due dispatch, consider that request and either reject or accept it and accordingly assess, reassess or make a determination under proposed subsection 152(1.11). If the request is rejected, the taxpayer shall be notified by registered mail. Subsection 245(8) allows the Minister to make a reassessment even where the three-year limit provided by subsection 152(4) would otherwise apply. This, however, only applies where a taxpayer has made a request for such reassessment and is therefore of relieving nature.

New subsection 245(9) of the Act provides that certain provisions of Part I of the Act relating to objections and appeals are applicable to the rejection of a request made pursuant to subsection 245(6).

ITA
245(10)

New subsection 245(10) of the Act provides that in interpreting proposed section 245, recourse may be had to the explanatory notes provided by the Minister of Finance. These explanatory notes are to be published in the Canada Gazette on the coming into force of the section.

Express mention of the possibility of referring to these explanatory notes stresses the contribution they can make to the interpretation of the general anti-avoidance rule enacted by proposed section 245. Since the distinction between abusive tax avoidance and legitimate tax mitigation may sometimes be difficult to make, reference to the notes can provide a useful indication of the scope and context of proposed subsection 245.

New subsection 245(10) is not a major change to the normal rules applicable for the interpretation of statutes and, in particular, for the utilization of extrinsic aids. Rather, given the importance of the change in direction which the proposed approach signals, it is intended to underscore that recourse to such aids is permissible.

Clause 2
Determination pursuant to section 245

ITA
152

Section 152 of the Act deals with assessments and determinations of losses by the Minister.

New subsection 152(1.11) is consequential on the introduction of a new general anti-avoidance rule in section 245.

This subsection allows determinations to be made by the Minister of National Revenue with respect to amounts, such as an adjustment to the adjusted cost base of a property and the paid-up capital of a share, as a consequence of the application of the general anti-avoidance rule in new section 245. Where new subsection 245(2) applies with respect to an avoidance transaction, such amounts may be determined as is reasonable in the circumstances in order to deny the tax benefit. These adjustments may not affect the amount of income, taxable income or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to a person, until a number of years after the avoidance transaction. Therefore, in many cases, these adjustments can not be made through an immediate assessment or reassessment.

The Minister is forced to make a determination under new subsection 152(1.11) only when a request is made under proposed subsection 245(6). Absent such request, the Minister may choose to wait until it can assess a person to determine the tax situation of that person under subsection 245(2). For example, where an avoidance transaction would otherwise result in an inappropriate increase of the capital cost of a depreciable property, the Minister can rely on subsection 152(1.11) to make a determination of the undepreciated capital cost of the class to which that property belongs or, provided the taxpayer does not request such a determination, he can wait until capital cost allowance is claimed in respect of that class to make an assessment denying part or all of that allowance.

Where the Minister makes a determination under subsection 152(1.11), he must, with all due dispatch, send a notice of the determination to the person affected by it.

New subsection 152(1.12) of the Act prevents the determination of an amount from being made under subsection 152(1.11) where this amount only affects the computation of income, taxable income or taxable income earned in Canada of tax or other amount payable by, or amount refundable to a person for prior taxation years. In effect, this provision prevents a determination from being made with respect to a taxpayer who has already been assessed or could be assessed through the application of subsection 245(2) with respect to a particular transaction.

The amendments to existing subsections 152(1.2) and 152(1.3) of the Act are consequential on the introduction of new subsection 152(1.11). Following the amendment to subsection 152(1.2), certain provisions of Part I of the Act relating to objections and

appeals are applicable to a determination made pursuant to subsection 152(1.11). The effect of the amendment to subsection 152(1.3) is that a determination made under subsection 152(1.11) is binding on both the taxpayer and the Minister, subject to the taxpayer's right to appeal from that determination and to the Minister's power to make a redetermination.

Clause 3
Application for time extension

ITA
167

Section 167 of the Act deals with applications to the Tax Court of Canada for an order extending the time for serving a notice of objection or appealing to the Tax Court of Canada.

The amendments to that section are consequential on the introduction in new subsection 245(6) of a mechanism allowing taxpayers to request adjustments following the application of the new general anti-avoidance rule provided for in new subsection 245(2). By virtue of the amendments to subsections 167(1), (2) and (5), the time period during which a request may be made under subsection 245(6) may be extended in the same way and under the same conditions that an extension of time may be requested for serving a notice of objection or appealing to the Tax Court of Canada.

Clause 4

ITA
246

Clause 4 is strictly consequential on the replacement of existing subsection 245(1) of the Act by new section 245. Since existing subsections 245(1.1), (2) and (3) of the Act do not relate to the new general anti-avoidance rule, they are renumbered as subsections 246(1), (2) and (3).

GENERAL ANTI-AVOIDANCE RULE

DRAFT LEGISLATION

1. Subsection 245(1) of the said Act is repealed and the following substituted therefor:

Definitions

"245.(1) In this section and in subsection 152(1.11),

"tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;

"tax consequences" to a person means the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount; and

"transaction" includes an arrangement or event.

General anti-avoidance provision

(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny the tax benefit that, but for this section, would result, directly or indirectly, from that transaction.

Avoidance transaction

(3) An avoidance transaction means any transaction:

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit, or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Provision not applicable

(4) For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not, but for this section, result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act read as a whole.

Determination of tax consequences

(5) Without restricting the generality of the foregoing,

(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part;

(b) any such deduction, any income, loss or other amount or part thereof may be allocated to any person;

(c) the nature of any payment or other amount may be recharacterized; and

(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in order to determine the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result directly or indirectly from an avoidance transaction.

Request for adjustments

(6) Where with respect to a transaction

(a) a notice of assessment, reassessment or additional assessment involving the application of subsection (2) with respect to the transaction has been sent to a person, or

(b) a notice of determination pursuant to subsection 152(1.11) has been sent to a person with respect to the transaction

any person (other than a person referred to in paragraph (a) or (b)) shall be entitled, within 90 days after the day of mailing of the notice, to request the Minister to make an assessment, reassessment or additional assessment applying subsection (2) or a determination applying subsection 152(1.11) with respect to that transaction.

Exception

(7) Notwithstanding any other provision of this Act, the tax consequences to any person, following the application of this section, shall only be determined through a notice of assessment, reassessment, additional assessment or a determination pursuant to subsection 152(1.11) involving the application of this section.

Duties of Minister

(8) Upon receipt of a request by a person under subsection (6), the Minister shall, with all due dispatch, consider the request, and

(a) on the basis of that request and notwithstanding subsection 152(4), assess, reassess or make an additional assessment or determination pursuant to subsection 152(1.11) with respect to that person, or

(b) reject the request and thereupon notify the person of his rejection by registered mail.

Provisions applicable

(9) Paragraphs 56(1)(l) and 60(o) and Division I and J, as they relate to an assessment or a reassessment and to assessing or reassessing tax, are applicable, with such modifications as the circumstances require, to the rejection of a request made pursuant to subsection (6) as if it were an assessment.

Recourse to Explanatory Notes

(10) In interpreting this section, recourse may be had to any explanatory notes thereto provided by the Minister of Finance who shall cause such notes to be published in the Canada Gazette forthwith on the coming into force of this section."

2.(1) Section 152 of the said Act is amended by adding thereto, immediately after subsection (1.1) thereof, the following subsections:

Determination pursuant to section 245

"(1.11) Where at any time the Minister ascertains the tax consequences to a person by reason of subsection 245(2) with respect to a transaction, he shall, where subsection 245(8) requires him to make a determination pursuant to this subsection, or, in any other case, he may

(a) determine any amount that is relevant for the purposes of computing the income, taxable income or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to the person under this Act, and

(b) with all due dispatch, send a notice of determination to the person stating the amount so determined.

Idem

(1.12) No determination of an amount may be made with respect to a person under subsection (1.11) at a time where that amount is relevant only for the purposes of computing the income, taxable income, or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to the person under this Act for a taxation year ending before that time. "

(2) Subsections 152(1.2) and (1.3) of the said Act are repealed and the following substituted therefor:

Provisions applicable

"(1.2) Paragraphs 56(1)(l) and 60(o), this Division and Division J, as they relate to an assessment or a reassessment and to assessing or reassessing tax, are applicable, with such modifications as the circumstances require, to a determination or a redetermination and to determining or redetermining amounts under this Division, except that subsections (1) and (2) are not applicable to determinations made under subsections (1.1) and (1.11) and, for greater certainty, an original determination of a taxpayer's non-capital loss, net capital loss, restricted farm loss, farm loss or limited partnership loss for a taxation year may be made by the Minister only at the request of the taxpayer.

Determination binding

(1.3) For greater certainty, where the Minister makes a determination of the amount of a taxpayer's non-capital loss, net capital loss, restricted farm loss, farm loss or limited partnership loss or makes a determination under subsection (1.11) with respect to a taxpayer, the determination is (subject to the taxpayer's rights of objection and appeal in respect of the determination and to any redetermination by the Minister) binding on both the Minister and the taxpayer for the purpose of calculating the income, taxable income or taxable income earned in Canada of, tax or other amount payable by, or amount refundable to the taxpayer, as the case may be, for any other year."

3.(1) Subsections 167(1) and (2) are repealed and the following substituted therefor:

Application to Tax Court of Canada for time extension

"167.(1) Where no objection to an assessment under section 165, appeal to the Tax Court of Canada under section 169 or request under subsection 245(6) has been made or instituted within the time limited by that provision for doing so, an application may be made to the Tax Court of Canada for an order extending the time within which a notice of objection may be served, an appeal instituted or a request made, and the Court may, if in its opinion the circumstances of the case are such that it would be just and equitable to do so, make an order extending the time for objecting, appealing and making a request and may impose such terms as it deems just.

Idem

(2) The application referred to in subsection (1) shall set forth the reasons why it was not possible to serve the notice of objection, institute the appeal to the Court or make the request under subsection 245(6), as the case may be, within the time otherwise limited by this Act for so doing.

(2) Subsection 167(5) of the said Act is repealed and the following substituted therefor:

When order to be made

"(5) No order shall be made under subsection (1) or (4)

(a) unless the application to extend the time for objecting, appealing or making the request, as the case may be, is made within one year after the expiration of the time otherwise limited by this Act for objecting to or appealing from the assessment in respect of which the application is made or for making the request under subsection 245(6), as the case may be;

(b) if the Tax Court of Canada or Federal Court has previously made an order extending the time for objecting to or appealing from the assessment or making the request, as the case may be, and

(c) unless the Tax Court of Canada or Federal Court is satisfied that

(i) but for the circumstances mentioned in subsection (1) or (4), as the case may be, an objection, appeal or request would have been made or instituted within the time otherwise limited by this Act for doing so,

(ii) the application was brought as soon as circumstances permitted it to be brought, and

(iii) there are reasonable grounds for objecting to or appealing from the assessment or making the request."

4. Subsections 245(1.1), (2) and (3) of the said Act are renumbered subsections 246(1), (2) and (3).