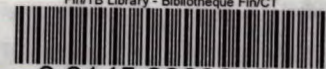


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87-101

LEGISLATION ON PREFERRED SHARE FINANCING Tabled

The Minister of Finance, the Honourable Michael H. Wilson, tonight tabled in the House of Commons a Notice of a Ways and Means Motion proposing legislation to reduce the significant loss of corporate tax revenue arising from after-tax financing through the use of preferred shares. This will be accomplished through the application of a special tax on dividends payable on preferred shares.

Mr. Wilson said, "Measures to reduce the tax advantages of after-tax financing arrangements using preferred shares are a critical step in achieving the broadened corporate tax base required to fund personal income tax reductions".

The revenue loss associated with after-tax financing arrangements is linked to the buildup of unused accelerated deductions and tax credits over the last decade. As a consequence, many profitable corporations are not subject to tax on their earnings, although they are in a position to pay dividends out of their earnings. Because of the special relief provided in the tax system to both individual and corporate shareholders, the rate of dividends on preferred shares is significantly lower than the rate of interest on debt. While the relief at the shareholder level is appropriate to alleviate the double taxation of corporate earnings, such relief is difficult to justify where the earnings from which dividends are paid have not been taxed. In these circumstances the use of preferred shares rather than debt becomes a form of after-tax corporate financing. While the corporation benefits in terms of lower financing costs, the cost of this benefit is borne in large measure by the federal and provincial governments through reduced tax revenues.

The volume of preferred share issues in Canada has increased significantly in recent years as unused deductions, losses and credits have grown. The level of such financing in Canada is much greater than in other jurisdictions because of the special tax treatment of dividends. Most other jurisdictions that provide shareholder relief for dividends have introduced some mechanism to reduce the advantage of after-tax financing for non-taxpaying companies.

The new provisions address the after-tax financing aspect of preferred shares by introducing a special tax on preferred share dividends. A corporation will be able to offset the tax on its dividends against the regular

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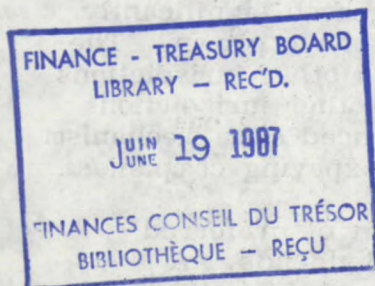
corporate tax on its earnings. Thus, corporations that have earnings subject to tax and therefore gain no advantage from after-tax financing, will be unaffected by the new tax. The tax will impact only on those non-taxpaying corporations that pay dividends on preferred shares. The tax will apply to dividends paid in a year in excess of a \$500,000 threshold. Thus, the tax will not apply to most small corporations. However, the new system will ensure that tax is paid by larger corporations where relief is provided to the dividend recipient. The new tax will not affect existing shares. It will be payable only with respect to preferred shares issued after 8:00 p.m. June 18, 1987, subject to certain transitional relief for share issues in progress. The tax will be applicable to dividends paid after December 31, 1987.

"It is important that the new tax on preferred share dividends not interfere with the financing arrangements of small businesses or make them more complex. I have, therefore, introduced an exemption targeted at such business." the Minister added.

Exemptions will be provided to ensure that the new tax does not apply where preferred shares are used primarily for non-tax reasons. In particular, the tax has been designed to exempt smaller corporations, start-up venture capital situations and private investment arrangements where preferred shares are used to recognize different rights and interests of investors. No tax will be payable on dividends paid to shareholders who also have a significant common equity interest in the payer corporation and on dividends paid by flow-through investment vehicles.

This initiative is consistent with a series of measures the government began in 1984 to limit the transfer of unused losses and accelerated deductions to unrelated taxpayers. Previous measures included the introduction of at risk rules applied to limited partnerships, restrictions on carve-out arrangements, the collateralized preferred share rules, and the loss trading restrictions.

The Minister also released draft legislation together with explanatory technical notes and other descriptive material relating to the new tax on preferred shares.



TAXATION OF PREFERRED SHARES
GENERAL NOTES ON PROPOSED REGIME

Introduction

The tax on preferred shares has been designed to reduce the tax advantages for non-taxpaying corporations associated with preferred share financings in a manner that is consistent with other structural features of the Canadian income tax system. At the same time, a number of special features have been incorporated to relieve firms from the obligation to pay the tax in a variety of circumstances.

There currently are rules designed to eliminate the benefits from after-tax financing which apply to a limited category of preferred shares -- term preferred shares, short-term preferred shares and collateralized preferred shares -- the dividends on which do not qualify for the intercorporate dividend deduction and are therefore taxed at full corporate rates. When applied to a wider category of preferred shares this approach is deficient in a number of ways. On one hand, it does not apply to individuals who continue to receive the dividend tax credit. On the other hand, the denial applies even when the payer corporation is taxable and no after-tax financing advantage exists. Thus a new approach is necessary to deal with the broader problem. The new approach will ensure that inappropriate tax penalties do not arise when preferred shares are issued by taxpaying corporations for non-tax reasons.

The advantage derived from the use of preferred shares as a form of after-tax financing arises because of the different tax treatment of dividends and interest. Where a corporation issues debt it may deduct the interest it pays and the recipient is subject to tax on this interest. Dividends on the other hand, are presumed to be paid out of earnings that have been subject to tax. Accordingly, to avoid double taxation the corporate recipient of dividends may receive them tax-free. (The mechanism used to achieve this is the intercorporate dividend deduction.) Dividends received by individuals are eligible for the dividend tax credit which reduces the taxes paid on dividends received. Where the issuing corporation is tax paying these two forms of financing have the same after-tax consequences and so the choice of one or the other has no impact on government revenues. However, a non-tax paying corporation can take advantage of the dividend relief by issuing preferred shares even though the income out of which the dividend has been paid has not borne tax and therefore reduce its after tax cost of capital as compared with debt. The consequence of substituting a dividend-paying instrument for an interest-bearing one in such circumstances is that government revenues are reduced. The new tax is designed to ensure that tax has been paid with respect to dividends on preferred shares when relief is given at the shareholder level. As such it will affect dividends paid by non-taxpaying corporations and will have no impact on a taxpaying corporation issuing preferred shares.

The size of the tax advantage associated with preferred shares depends upon whether the share is purchased by an individual or a corporation. The new system allows the issuing corporation to choose between two forms of the tax. One, where a lower level of tax is paid by the payer and a supplemental tax is paid by a corporate purchaser ensures that preferred shares can still be offered for sale in the individual market. The other with a higher level of tax applied only to the payer is more appropriate for intercorporate transactions.

The new tax is intended to prevent the erosion of corporate tax revenues through the use of after-tax financing. There remains a variety of situations where the tax will not be applied:

- the new tax will not be applied to dividends on common shares, as common shareholders participate fully in the risks facing the corporation;
- an exemption of up to \$500,000 of preferred share dividends for any group of corporations will allow small corporations and venture capital start-up companies to continue to use preferred shares as an integral part of financing arrangements;
- no tax will be payable on dividends to individual or corporate shareholders with a significant interest in the payer corporation to ensure a free flow of funds within commonly-owned entities;
- the previous two provisions will allow preferred shares to be used in private financing arrangements and joint ventures where the shares may be necessary to recognize different ownership interests among shareholders;
- no tax will be payable by intermediary type companies, such as mutual funds and certain private holding companies which are structured to hold portfolio investments to allow continued use of such flow-through vehicles.

In summary, the new tax will reduce the tax advantages of after tax financing and the consequent loss of government revenues, while at the same time preserving the use of preferred shares in situations where such tax advantages are not a primary reason for their use.

Treatment of Corporations with Different Tax Status

The denial of the dividend exemption for dividends received under the present rules applies whether or not the corporation paying the dividend has paid corporate tax on the income from which the dividend was paid. If dividends paid by non-taxpaying corporations are to be

taxed differently from dividends paid by taxpaying corporations, the tax must be imposed on the corporation paying the dividend. This is what is proposed. With a tax levied on the payer corporation, an offset for the tax on the dividend against corporate income taxes can be provided in those circumstances where the earnings from which the dividend is paid are taxed. This is achieved by allowing the corporation paying the dividend, to claim a deduction in computing its taxable income for 5/2 the tax payable. The deduction in computing taxable income was chosen as an alternative to providing a credit for the tax, as is discussed below. For taxpaying corporations, any tax payable on dividends on taxable preferred shares will be offset by the reduction in the corporate income taxes realized through the deduction in computing taxable income. For non-taxpaying corporations, the deduction for 5/2 of the dividend tax in a year will increase the available non-capital loss and thereby reduce corporate taxes when that loss is carried over and deducted in calculating taxable income in the preceding three or subsequent seven years.

Tax on dividends paid on taxable preferred shares

Under the proposal an issuing corporation will be able to choose between two forms of the tax, one that imposes a 25% tax on dividends paid with a subsequent additional 10% tax on some corporate recipients of the dividend and one that imposes a 40% tax on dividends paid with no additional tax at the recipient level.

The 25% rate of tax to be applied to dividends on taxable preferred shares (generally all preferred shares issued after 8 p.m., EDT, June 18, 1987) reflects the tax regime applicable to dividends received by individuals and therefore the pricing of shares targetted at the individual market. This tax can be used to reduce corporate income taxes payable as outlined above. The 25% tax represents the minimum level of corporate tax presumed to be paid at the corporate level in justifying the granting of the dividend tax credit (which also has a 25% rate). Therefore, no further special taxes are applicable on dividends on taxable preferred shares paid to individuals or corporations that act as flow-through vehicles for the investments of individuals. These would include private corporations other than specified financial institutions and a number of other financial intermediaries as is discussed later. As is discussed in more detail below, a 10% tax would be payable on dividends on taxable preferred shares received by specified financial institutions and public corporations if the dividends were subject to the 25% tax in the hands of the payer corporation.

TAXABLE PREFERRED SHARES
SYSTEM IN CONCEPT

Taxes Levied on
The Payer of a Dividend

Taxes Levied on
The Recipient of a Dividend

BASIC SYSTEM

25% of dividends paid on taxable preferred shares.

- tax is offsettable against corporate tax payable.
- venture capital and small corporation deduction -- First \$500,000 of dividends exempt.

10% tax on dividends received on taxable preferred shares by specified financial institution and public corporations.

OPTIONAL SYSTEM

40% of dividends paid on taxable preferred shares.

- enables combined tax to be paid by corporation where it is subject to offset against corporate tax or benefits from the \$500,000 threshold

No taxes.

A mechanism has been designed specifically for shares priced to be sold to corporations which will enable the full taxes levied on dividends on such shares to benefit from the offset against corporate taxes payable. A corporation may elect to pay a tax of 40% on dividends paid by it on a class of taxable preferred shares. Dividends on such shares will not be subject to the additional 10% tax in the hands of a corporate shareholder. The same mechanism as described above will allow the 40% tax to be offset against any corporate income taxes payable.

The 40% rate of tax substantially reduces the tax advantages available to a non-taxpaying corporation on after-tax financing when the shareholders are corporations benefitting from the intercorporate dividend deduction. A taxpaying corporation could be expected to choose this option to ensure that the 10% tax on dividends received was not payable on dividends received by corporate shareholders.

Tax on dividends received on "Taxable Preferred Shares"

A 10% tax will be levied on dividends on taxable preferred shares received by public corporations, specified financial institutions and certain other corporations in cases where the corporation paying the

dividend has opted for the 25% rate of tax. With a 25% tax on the payer corporation, and the absence of the 10% holder tax on dividends received, a tax advantage would be retained for intercorporate preferred share investments. For such dividends the 10% tax will bring the total tax burden up to a rate that approximates the 40% tax otherwise payable by the payer corporation. This assumes that the tax on the recipient would be added into the gross dividend required to achieve a particular after-tax return. Therefore the appropriate rate of holder tax is not the simple difference between 40 and 25 per cent. The net tax paid under the two regimes is compared in the following table.

Tax Payable on Preferred Shares to Achieve \$100 of After Tax Income

	<u>25/10% Regime</u>	<u>40% Regime</u>
Gross Dividend Required to Provide \$100 After Tax Return	\$111	\$100
Tax on Dividend Received - 10% of Dividend	<u>11</u>	-
After Tax Yield	<u>\$100</u>	<u>\$100</u>
Tax on Dividend Paid - 25% (40%) of Dividend Paid	<u>\$ 28</u>	<u>\$ 40</u>
Total Taxes	<u>\$39</u>	<u>\$40</u>

Small corporation and venture capital exemption

The proposed tax regime is designed to be consistent with the government's policy to provide incentives for entrepreneurial activity. The risks involved in new ventures during their start-up years make financing such operations difficult. Mechanisms have been designed to ensure that the new taxes on preferred share dividends will not affect the financial arrangements between smaller corporations and their shareholders and also will not inhibit the financing of new ventures by such corporations.

Taxes on dividends paid on taxable preferred shares will only be payable if annual dividends paid on such shares exceed \$500,000 for any associated group of corporations. The exemption may be allocated among those corporations. The exemption will be reduced dollar for dollar by dividends on taxable preferred shares in excess of \$1 million paid in the previous calendar year by that group of corporations. Thus, if the group paid dividends in total of \$1.2 million to outside shareholders, its exemption would be \$300,000. If the group dividends were \$1.5 million, its exemption would be reduced to zero. The \$500,000 exemption will be applied first to dividends subject to the 40% tax. As dividends of \$500,000 would reflect an issue of taxable preferred shares of \$4-5 million, most corporations in Canada will not be affected by the tax on dividends paid on taxable preferred shares.

Dividends paid to shareholders with a substantial interest in the payer corporation

Dividends paid on taxable preferred shares will not be subject to either the 25% tax on dividends paid or the 10% tax on dividends received if the dividends are paid to a shareholder with a substantial interest in the payer corporation. A shareholder which is related to the payer corporation or a shareholder which owns together with persons related to it at least 25% of the "votes and value" of the payer corporation will have a substantial interest in that corporation. For the purposes of this exemption the shareholder can be either an individual or a corporation.

Agreement to transfer tax to a controlled subsidiary

A corporation that has issued taxable preferred shares and would otherwise have a liability for the 25% or 40% tax payable on dividends, may agree with a controlled subsidiary to transfer all or a portion of that tax to the controlled subsidiary. The controlled subsidiary will then pay the tax and the special deduction for 5/2 of the tax will be available to it. This will enable a holding corporation that does not pay corporate tax to issue taxable preferred shares to finance the operations of controlled subsidiaries and achieve an offset of any tax payable on dividends paid on those shares against corporate taxes payable by such subsidiaries.

Intermediary corporations

The 25% (40%) tax on dividends paid on taxable preferred shares will not apply to dividends paid by the following corporations which serve as flow-through vehicles for investments and are defined in the Income Tax Act:

- an investment corporation
- a mortgage investment corporation
- a mutual fund corporation
- a prescribed investment contract corporation
- a prescribed venture capital corporation; and
- a prescribed labour-sponsored venture capital corporation.

A corporation that has issued taxable preferred shares to shareholders holding less than 25% of "votes and values" and has as its major purpose the holding of shares, would not be able to offset the tax on dividends paid on its taxable preferred shares against corporate taxes payable on the earnings, since in most circumstances, its only tax payable would be the refundable Part IV tax on dividends received. Exemption is provided to grant relief for this situation. The 25% (40%) tax will also not apply to dividends paid by a "private holding corporation" which is defined as a private corporation that does not have a substantial interest in another corporation and has as its only undertaking the investment of its funds. As a private

corporation (other than a specified financial institution) is not subject to the 10% tax on dividends received no special relief for this tax for a private holding corporation is required.

The 10% tax on dividends received will not apply to individuals or private corporations (other than specified financial institutions) and to the following intermediary corporations:

- an investment corporation
- a mutual fund corporation
- a prescribed investment contract corporation
- a prescribed venture capital corporation; and
- a prescribed labour-sponsored venture capital corporation.

However, this exemption will not apply if any of the corporations listed above is also a specified financial institution or a corporation controlled for the benefit of one or more corporations that themselves would not qualify for the exemption or in which such corporations held a substantial interest.

Taxable preferred shares

Taxable preferred shares will be defined in the Act and will include all shares that would conventionally be seen as preferred shares. The definition will also include certain other shares if, by way of outside agreement or guarantee, they have acquired the attributes of preferred shares. Shares issued before 8 p.m. EDT June 18, 1987 or grandfathered shares will not be taxable preferred shares. Grandfathered shares are shares issued after 8 p.m. EDT June 18, 1987 and before 1988 pursuant to a written agreement entered into or in accordance with a prospectus or other document filed on or before 8 p.m. EDT June 18, 1987.

The offset mechanism

In order to provide that taxpaying corporations will be able to recover the tax on dividends paid on taxable preferred shares against other corporate taxes payable, an offset mechanism is provided. A deduction against taxable income for 5/2 of the tax on the dividend was considered to be more appropriate than a direct tax credit for several reasons.

The deduction mechanism enables the sharing of the tax with provinces without involving the provinces in levying their own dividend tax. It is proposed that the 25% (40%) tax will be allocated for purposes of provincial corporate taxes on the same basis (wage/revenue formula) that is used to allocate taxable income. When 5/2 of the tax is deducted by a corporation it will reduce taxable income and thus be allocated to a province on the same basis.

The deduction mechanism also enables all of the provisions of the Act applying to the carryback and carryforward of non-capital losses to be utilized to achieve a similar carryover for the tax on dividends paid on taxable preferred shares.

An exact offset of the tax on dividends on taxable preferred shares would not be possible under any mechanism without unacceptable complexity. Rates of tax applicable to corporate income vary from province to province, and can vary with the character of the income. The 5/2 multiple provides an exact offset in situations where a combined federal-provincial corporate tax rate on income of 40% applies.

Transition

Neither the 25% (40%) tax on dividends paid on taxable preferred shares or the 10% tax on dividends received on such shares will apply to shares issued before June 18, 1987 or grandfathered shares. For shares issued after 8 p.m. EDT, June 18, 1987, the taxes will only be applied to dividends paid after 1987.

Additional Taxes on Specific Categories of Preferred Shares

Short-term preferred shares

To prevent after-tax financing in the short term money market, the inter-corporate dividend deduction is presently denied for dividends paid on short-term preferred shares. Short-term preferred shares presently include preferred shares that are retractable or required to be redeemed within eighteen months from the date of issue. The denial of the inter-corporate dividend deduction applies to all corporations holding such shares.

In recent years a growing tendency for corporations to raise shorter term (2 to 5 years) funds by way of preferred shares has developed. These financings are more in the nature of debt financings rather than equity issues. Holders of such shares view them as debt substitutes because of their ability to retract their investment in the short term. It is proposed that short-term preferred shares be redefined with respect to shares issued after 8 p.m. EDT, June 18, 1987 (other than grandfathered shares) to include all shares that are retractable or required to be redeemed at any time with five years from the date of issue. Dividends received by a corporation after June 18, 1987 on such shares other than dividends received from a related corporation, will be denied the inter-corporate dividend deduction. Short-term preferred shares will also be taxable preferred shares. Dividends on short-term preferred shares will be exempt from the 10% tax on dividends received on taxable preferred shares but are not exempted from the 25% (40%) tax payable by the payer corporation.

Taxes to be applied to dividends on certain preferred shares held by specified financial institutions

Specified financial institutions include banks, trust companies, insurance corporations, credit unions and loan companies. Corporations controlled by one or more such corporations and corporations associated with such corporations or the corporations controlled by them are also specified financial institutions.

Dividends received by a specified financial institution on a term preferred share are denied the intercorporate dividend deduction under rules introduced to inhibit after-tax financing by the conversion of operating loans to preferred share investments. Term preferred shares include all shares that are retractable or can be required to be redeemed. Shares that would otherwise be term preferred shares are excluded from the definition if they are listed on a prescribed stock exchange and the specified financial institution and defined non-arms length persons hold less than 10% of shares in the class.

These rules will continue to apply with respect to dividends received on shares issued before June 18, 1987 and on grandfathered taxable preferred shares that fall within the definition of term preferred shares. Exceptions for dividends on shares listed on a prescribed stock exchange will apply as follows.

- o Listed shares acquired before 1988 will continue to benefit from the exclusion referred to above with respect to holdings of not more than 10% of the shares in a class.
- o If shares are acquired in 1988, this exclusion will only apply if the holding is not more than 5% of the shares in a class.
- o If shares are acquired in 1989 and thereafter the exclusion will only apply if the holding is not more than 2% of the class.

New rules will apply to dividends received by specified financial institutions on "taxable SFI shares." These are generally defined to be preferred shares that are issued before 8 p.m. EDT, June 18, 1987, or are grandfathered taxable preferred shares, other than shares that fall within the definition of term preferred shares. Dividends received by a specified financial institution on taxable SFI shares acquired after 8 p.m. EDT, June 18, 1987 will be subject to a 10% tax unless the specified financial institution and persons in defined non-arms length relationships with the institution hold not more than prescribed percentages of the shares in the class. For shares acquired before 1988 the tax will apply to dividends unless not more than 10% of the shares in the class are held. This percentage

will drop to 5% if shares are acquired in 1988 and 2% if shares are acquired in 1989 and thereafter. The 10% tax will not apply to a dividend received by a specified financial institution from a corporation in which the institution holds a substantial interest.

Guaranteed shares

Under the present rules, a dividend received by a corporation on a share that is subject to certain guarantees by a specified financial institution is denied the intercorporate dividend deduction. This provision will continue to apply with modifications.

Conclusion

The proposed regime will prevent the continued erosion of corporate tax revenues through the shifting of the tax benefit of accumulated tax losses and other tax deductions from non-tax paying corporations to arm's-length taxpaying corporations and individuals through after-tax financing with preferred shares. The system chosen will enable the achievement of these objectives while not inhibiting the financing of start-up ventures. The proposed taxes will generally not apply to smaller corporations and not alter existing patterns of investment in smaller corporations. The proposals will not apply to dividends on common shares. The proposals will not affect dividends on preferred shares held in corporations by shareholders holding substantial interests in those corporations and therefore will not interfere with the movement of funds by way of dividends within related corporate groups.

DRAFT LEGISLATION
PREFERRED SHARES

1.(1) Subsection 82(2) of the Income Tax Act is repealed and the following substituted therefor:

Dividends received

"(2) Where, by reason of subsection 56(4) or sections 74 to 75, there is included in computing a taxpayer's income for a taxation year a dividend received by another person, for the purposes of this Act, the dividend shall be deemed to have been received by the taxpayer."

(2) Subsection (1) is applicable to dividends received after June 18, 1987.

2.(1) Subsection 87(2) of the said Act is amended by striking out the word "and" at the end of paragraph (pp) thereof, by adding the word "and" at the end of paragraph (qq) thereof and by adding thereto the following paragraph:

Tax on taxable preferred shares

"(rr) for the purposes of subsections 191.1(2) and (4) and section 191.3, the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation."

(2) Section 87 of the said Act is further amended by adding thereto, immediately after subsection (4.1) thereof, the following subsection:

Exchanged shares after November 27, 1986.

"(4.2) Where there has been an amalgamation or merger of two or more corporations after November 27, 1986 and a share of any class of the capital stock of the new corporation (in this subsection referred to as the "new share") was issued in consideration for the disposition of a share of any class of the capital stock of a predecessor corporation (in this subsection referred to as the "exchanged share") and the terms and conditions of the new share were the same as, or substantially the same as, the terms and conditions of the exchanged share, for the purposes of applying the provisions of this subsection, subsections 112(2.2) and (2.4), Parts IV.I and VI.I, section 258 and the definitions "grandfathered share", "short-term preferred share", "taxable preferred share" and "taxable SFI share" in subsection 248(1) to the new share,

(a) the new share shall be deemed to have been issued at the time the exchanged share was issued;

(b) if the exchanged share was issued under an agreement in writing or distributed to the public in accordance with the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum, the new share shall be deemed to have been issued under that agreement or distributed to the public in accordance with the terms of that prospectus, preliminary prospectus, registration statement or offering memorandum;

(c) the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation; and

(d) any election made under subsection 191.2(1) by a predecessor corporation with respect to the class of shares of its capital stock to which the exchanged share belonged shall be deemed to have also been made by the new corporation with respect to the class of shares of its capital stock to which the new share belongs."

(3) Subsection (1) is applicable to amalgamations occurring after June 18, 1987.

(4) Subsection (2) is applicable to amalgamations and mergers occurring after November 27, 1986.

Note: Bill C-64 introduced in the House of Commons on June 9, 1987 proposes to amend paragraphs 88(1)(e.2) and 88(1.1)(e) of the said Act. Those paragraphs would require amendment as follows:

3.(1) All that portion of paragraph 88(1)(e.2) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(e.2) paragraphs 87(2)(c), (d.1), (e.1), (g) to (l), (1.3) to (u), (x), (y.1), (z.1), (cc), (ll) to (nn), (pp) and (rr), subsection 87(6) and, subject to section 78, subsection 87(7) apply to the winding-up as if the references therein to"

(2) All that portion of paragraph 88(1.1)(e) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(e) where, at any time, control of the parent or subsidiary has been acquired by a person or group of persons, no amount in respect of the subsidiary's non-capital loss or farm loss for a taxation year ending

before that time is deductible in computing the taxable income of the parent for a particular taxation year ending after that time, except that such portion of the subsidiary's non-capital loss or farm loss as may reasonably be regarded as its loss from carrying on a business and, where a business was carried on by the subsidiary in that year, such portion of the non-capital loss as may reasonably be regarded as being in respect of an amount deductible under paragraph 110(1)(k) in computing its taxable income for the year is deductible"

(3) Subsection (1) is applicable to windings-up ending after June 18, 1987.

(4) Subsection (2) is applicable with respect to non-capital losses and farm losses for the 1988 and subsequent taxation years.

4.(1) Subsection 110(1) of the said Act is amended by striking out the word "and" at the end of paragraph (i) thereof, by adding the word "and" at the end of paragraph (j) thereof and by adding thereto the following paragraph:

Part VI.1 tax

"(k) 5/2 of the tax payable under subsection 191.1(1) by the taxpayer for the year."

(2) Subsection (1) is applicable to the 1988 and subsequent taxation years.

5.(1) All that portion of paragraph 111(5)(a) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(a) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending before that time as may reasonably be regarded as its loss from carrying on a business and, where a business was carried on by the corporation in that year, such portion of the non-capital loss as may reasonably be regarded as being in respect of an amount deductible under paragraph 110(1)(k) in computing its taxable income for the year is deductible by the corporation for a particular taxation year ending after that time"

(2) Clause 111(8)(b)(i)(A) of the said Act is repealed and the following substituted therefor:

"(A) the aggregate of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property, his

allowable business investment loss for the year or an amount deductible under paragraph 110(1)(d), (d.1), (d.2), (d.3), (f), (j) or (k), section 110.6 or 112 or subsection 113(1) or 138(6) in computing his taxable income for the year"

(3) Subsection (1) is applicable with respect to non-capital losses and farm losses for the 1988 and subsequent taxation years.

(4) Subsection (2) is applicable to the 1988 and subsequent taxation years.

Note: Bill C-64 introduced in the House of Commons on June 9, 1987 proposes to amend paragraph 111(5)(b) of the said Act. That paragraph would require further amendment as follows applicable with respect to non-capital losses and farm losses for the 1988 and subsequent taxation years:

All that portion of paragraph 111(5)(b) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(b) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending after that time as may reasonably be regarded as its loss from carrying on a business and, where a business was carried on by the corporation in that year, such portion of the non-capital loss as may reasonably be regarded as being in respect of an amount deductible under paragraph 110(1)(k) in computing its taxable income for the year is deductible by the corporation for a particular year ending before that time"

6.(1) Subsection 112(2.2) of the said Act is repealed and the following substituted therefor:

Idem

"(2.2) No deduction may be made under subsection (1) or (2) or 138(6) in computing the taxable income of a particular corporation in respect of a dividend received on a share of the capital stock of a corporation that was issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 where a person or partnership (other than the issuer of the share, a person related, otherwise than by reason of a right referred to in paragraph 251(5)(b), to the issuer or an individual other than a trust) that is a specified financial institution or a specified person in relation to any such institution was, at or immediately before the time the dividend was paid, obligated, either absolutely or contingently and either immediately or in the

future, to effect any undertaking (in this subsection referred to as a "guarantee agreement"), including any guarantee, covenant or agreement to purchase or repurchase the share and including the lending of funds to or the placing of amounts on deposit with, or on behalf of, the particular corporation or any specified person in relation to the particular corporation, given as part of a transaction or event or a series of transactions or events that included the issuance or acquisition of the share to ensure that

(a) any loss that the particular corporation or a specified person in relation to the particular corporation may sustain by reason of the ownership, holding or disposition of the share or any other property is limited in any respect, or

(b) the particular corporation or a specified person in relation to the particular corporation will derive earnings by reason of the ownership, holding or disposition of the share or any other property,

except that this subsection does not apply to a dividend received on

(c) a share described in paragraph (e) of the definition "term preferred share" in subsection 248(1), or

(d) a grandfathered share, a taxable preferred share or a prescribed share,

and for the purposes of this subsection

(e) where a guarantee agreement in respect of a share is given at any particular time after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, otherwise than pursuant to a written arrangement to do so made before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, the share shall be deemed to have been issued at the particular time and deemed to be part of a series of transactions that included the issuance of the share; and

(f) "specified person" in relation to an institution or a corporation has the meaning assigned by paragraph (i) of the definition "taxable preferred share" in subsection 248(1)."

(2) Subsection 112(2.3) of the said Act is repealed and the following substituted therefor:

Idem

"(2.3) No deduction may be made under subsection (1) or (2) or 138(6) in computing the taxable income of a particular corporation in respect of a dividend received by it on a share

that was, at the time the dividend was paid, a short-term preferred share of a corporation unless, at the time the dividend was paid, the corporation would be related to the particular corporation if this Act were read without reference to paragraph 251(5)(b)."

(3) Section 112 of the said Act is further amended by adding thereto the following subsection:

Dividend on shares acquired on reorganization

"(8) Where a corporation (referred to in paragraph 55(3)(b) and this subsection as a "particular corporation") has disposed of property to another corporation in exchange for shares of the capital stock of the other corporation in the course of a reorganization to which subsection 55(2) does not apply by reason of paragraph 55(3)(b) and within one year after the exchange all such shares are redeemed, acquired or cancelled for an amount that in total does not exceed the fair market value of the property so disposed of at the time of the disposition, the amount of any dividend deemed to have been paid under subsection 84(3) on the redemption, acquisition or cancellation of those shares of the other corporation and that, but for paragraph 55(3)(b), would have been deemed not to be a dividend received by the particular corporation, shall

(a) for the purposes of Part IV.1 and Part VI.1 be deemed to be an excepted dividend or excluded dividend, as the case may be, and

(b) be deemed not to be a dividend to which subsection (2.1), (2.2), (2.3) or (2.4) applies to deny a deduction with respect to the dividend in computing the taxable income of the particular corporation under subsection (1), (2) or 138(6)."

(4) Subsection (1) is applicable with respect to dividends received on shares

(a) issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 other than shares issued after that time pursuant to an agreement in writing entered into before that time and shares distributed to the public in accordance with the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum required by law to be filed before distribution of the shares could commence, filed before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 with a public authority pursuant to and in accordance with the securities legislation of the jurisdiction in which the shares are distributed; or

(b) deemed by subsection 112(2.2) of the said Act, as enacted by subsection (1), to have been issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987.

(5) Subsection (2) is applicable with respect to dividends received on short-term preferred shares issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987.

(6) Subsection (3) is applicable with respect to dividends received after June 18, 1987.

Note: Bill C-64 introduced in the House of Commons on June 9, 1987 proposes the enactment of a new subsection 112(2.9) of the said Act. That subsection would require an amendment as follows to make it applicable, after June 18, 1987 for the purposes of the proposed new subsection 112(2.2) and (2.3) of the Act:

Related corporations

"(2.9) For the purposes of subsections (2.2) and (2.3) and subparagraph (2.4)(b)(i); where it may reasonably be considered having regard to all the circumstances, that a corporation has become related to any other corporation for the purpose of avording any limitation upon the deduction of a dividend under subsection (1), (2) or 138(6), the corporation shall be deemed not to be related to the other corporation."

7.(1) Subparagraph 157(1)(a)(i) of the said Act is repealed and the following substituted therefor:

"(i) on or before the last day of each month in the year, the aggregate of an amount equal to 1/12 of the amount estimated by it to be the tax payable under this Part by it for the year computed without reference to sections 127.2 and 127.3 and an amount equal to 1/12 of the amount estimated by it to be the tax payable under Part VI.1 by it for the year,"

(2) All that portion of paragraph 157(1)(b) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(b) the remainder of the taxes payable by it under this Part and Part VI.1 for the year".

(3) All that portion of subsection 157(2) of the said Act following paragraph (b) thereof is repealed and the following substituted therefor:

"and for the year or the immediately preceding taxation year

(c) its taxable income was not more than \$10,000, and

(d) no tax was payable by it under Part VI.1,

it may, instead of paying the instalments required by subsection (1), pay to the Receiver General at the end of the third month following the end of the year the whole of the tax payable by it under this Part and Part VI.1 for the year."

(4) Subsection 157(2.1) of the said Act is repealed and the following substituted therefor:

Idem

"(2.1) Where

(a) the aggregate of the tax payable under this Part (computed without reference to sections 127.2 and 127.3) and the tax payable under Part VI.1 by a corporation for a taxation year, or

(b) the corporation's first instalment base for the year

is not more than \$1,000, the corporation may, instead of paying the instalments required by paragraph (1)(a) for the year, pay to the Receiver General, pursuant to paragraph (1)(b), the whole of the tax payable by it under this Part and Part VI.1 for the year."

(5) Subsections (1) to (4) are applicable to the 1988 and subsequent taxation years.

8.(1) Paragraph 161(4.1)(a) of the said Act is repealed and the following substituted therefor:

"(a) the aggregate of the tax payable under this Part by it for the year computed without reference to sections 127.2 and 127.3 and the tax payable under Part VI.1 by it for the year,"

(2) Subsection (1) is applicable to the 1988 and subsequent taxation years, except that for the purposes of computing interest on instalments payable for a corporation's 1988 taxation year that commenced in 1987,

(a) the tax for the year payable under Part VI.1 of the said Act by the corporation shall, for the purpose of paragraph 161(4.1)(a) of the said Act, as enacted by subsection (1), be deemed to be nil; and

(b) the tax for the year payable under Part I of the said Act by the corporation shall, for the purpose of paragraph 161(4.1)(a) of the said Act, as enacted by subsection (1), be determined as if the said Act were read without reference to paragraph 110(1)(k) thereof.

Note: Bill C-64 introduced in the House of Commons on June 9, 1987 proposes the enactment of a new subsection 161(2.2) of the said Act. That subsection would require an amendment as follows applicable to the 1988 and following taxation years:

Paragraph 161(2.2)(a) of the said Act is repealed and the following substituted therefor:

"(a) where the taxpayer is a corporation, on the day on or before which the corporation is, pursuant to paragraph 157(1)(b), required to pay the remainder of its tax payable under this Part and Part VI.1 for the year or would be so required if a remainder of such tax were payable, and"

9.(1) All that portion of paragraph 186(1)(b) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(b) all amounts, each of which is an amount in respect of a taxable dividend, in respect of which an amount is deductible under subsection 112(1) from its income for the year, received by the particular corporation in the year from a corporation (in this section referred to as the "payer corporation") connected with the particular corporation equal to that proportion of"

(2) Section 186 of the said Act is further amended by adding thereto, immediately after subsection (1) thereof, the following subsection:

Reduction in tax

"(1.1) Notwithstanding subsection (1), where a taxable dividend referred to in paragraph (1)(a) or (b) was received by a corporation in a taxation year and has been included in an amount in respect of which tax under Part IV.1 was payable by the corporation for the year, the tax otherwise payable under this Part by the corporation for the year shall be reduced

(a) in the case of a taxable dividend referred to in paragraph (1)(a), by 10% of the amount determined in respect of that dividend under that paragraph; and

(b) in the case of a taxable dividend referred to in paragraph (1)(b), by 10% of the amount determined in respect of that dividend for the purpose of the computation under that paragraph."

(3) Section 186 of the said Act is further amended by adding thereto, immediately after subsection (5) thereof, the following subsection:

Partnerships

"(6) For the purposes of this Part,

(a) all amounts received in a fiscal period by a partnership as, on account or in lieu of payment of, or in satisfaction of, taxable dividends, shall be deemed to have been received by each member of the partnership in the member's fiscal period or taxation year in which the partnership's fiscal period ends, to the extent of that member's share thereof, and

(b) each member of a partnership shall be deemed to own at any time that proportion of the number of the shares of each class of the capital stock of a corporation that are property of the partnership at that time that the member's share of all dividends received on such shares by the partnership in its fiscal period that includes that time is of the total of all such dividends."

(4) Subsections (1) and (2) are applicable to dividends received after June 18, 1987.

(5) Subsection (3) is applicable with respect to fiscal periods ending after June 18, 1987.

10.(1) The said act is amended by adding thereto, immediately after section 187 thereof, the following Part:

Part IV.1

TAXES ON DIVIDENDS ON TAXABLE PREFERRED SHARES RECEIVED BY CORPORATIONS.

Definitions

187.1 In this Part,

"excepted corporation" means a corporation that is

(a) a private corporation,

- (b) an investment corporation,
- (c) a mutual fund corporation,
- (d) a prescribed investment contract corporation,
- (e) a prescribed venture capital corporation, or
- (f) a prescribed labour-sponsored venture capital corporation,

but does not include

- (g) a prescribed corporation,
- (h) a specified financial institution, or
- (i) any corporation

(i) that is controlled directly or indirectly in any manner whatever, whether by virtue of a beneficial interest in one or more trusts or otherwise, by or for the benefit of one or more corporations other than excepted corporations, or

(ii) in which a corporation other than an excepted corporation has a substantial interest (as determined under section 191);

"excepted dividend" means

- (a) a dividend received by a corporation on a share of the capital stock of a foreign affiliate of the corporation and that was not acquired by the corporation in the ordinary course of the business carried on by the corporation,
- (b) a dividend received by a corporation from another corporation in which it has a substantial interest (as determined under section 191) at the time the dividend was paid,
- (c) a dividend received by a corporation that was, at the time the dividend was received, an excepted corporation, and
- (d) a dividend received by a corporation from another corporation that was, at the time the dividend was paid, an excluded corporation (within the meaning assigned by subsection 191(1)).

Tax on dividends on taxable preferred shares

187.2 Every corporation shall, on or before the last day of the second month after the end of each taxation year, pay a tax under this Part for the year equal to 10% of the aggregate of all amounts each of which is a dividend, other than an excepted dividend, received by the corporation in the year on a taxable preferred share (other than a share of a class in respect of which an election under subsection 191.2(1) has been made) to the extent that an amount in respect of the dividend was deductible under subsection 112(1), section 113 or subsection 138(6) in computing its taxable income for the year or under subsection 115(1) in computing its taxable income earned in Canada for the year.

Tax on dividends on taxable SFI shares

187.3(1) Every specified financial institution shall, on or before the last day of the second month after the end of each taxation year, pay a tax under this Part for the year equal to 10% of the aggregate of all amounts each of which is a dividend, other than an excepted dividend, received by the institution at any time in the year on a share acquired by any person or partnership before that time and after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 that was, at the time the dividend was paid, a taxable SFI share to the extent that an amount in respect of the dividend was deductible under subsection 112(1), section 113 or subsection 138(6) in computing its taxable income for the year or under subsection 115(1) in computing its taxable income earned in Canada for the year.

Time of acquisition of share

(2) For the purposes of subsection (1),

(a) a share acquired by a person or partnership after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 pursuant to an agreement in writing entered into before that time shall be deemed to have been acquired by that person or partnership before that time; and

(b) where a share that was owned by a particular person at 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 has, by one or more transactions between related persons, been transferred to another person that is a specified financial institution or a specified person in relation to the institution (within the meaning assigned by paragraph (i) of the definition "taxable preferred share" in subsection 248(1)), the share shall be deemed to have been acquired by the other person before that time unless at any particular time after 8:00 p.m. Eastern Daylight Saving

Time, June 18, 1987 and before the share was transferred to the other person the share was owned by shareholder who, at that particular time, was not related to the particular person or a specified person in relation to the particular person (within the meaning assigned by paragraph (i) of the definition "taxable preferred share" in subsection 248(1)).

Partnerships

187.4 For the purpose of this Part,

(a) all amounts received in a fiscal period by a partnership as, on account or in lieu of payment of, or in satisfaction of, taxable dividends shall be deemed to have been received by each member of the partnership in the member's fiscal period or taxation year in which the partnership's fiscal period ends, to the extent of that member's share thereof; and

(b) each member of a partnership shall be deemed to own at any time that proportion of the number of the shares of each class of the capital stock of a corporation that are property of the partnership at that time that the member's share of all dividends received on such shares for the fiscal period of the partnership that includes that time is of the total of all such dividends.

Information return

187.5 Every corporation liable to pay tax under this Part for a taxation year shall file with the Minister, not later than the day on or before which it is required by section 150 to file its return of income for the year under Part I, a return for the year under this Part in prescribed form containing an estimate of the tax payable by it under sections 187.2 and 187.3 for the year.

Provisions applicable to Part

187.6 Sections 152, 158 and 159, subsections 161(1), (2) and (11), sections 162 to 167 and Division J of Part I are applicable to this Part with such modifications as the circumstances require."

(2) Subsection (1) is applicable with respect to dividends received after 1987.

11.(1) The said Act is further amended by adding thereto, immediately after section 190.24 thereof, the following Part:

"PART VI.I

TAX ON CORPORATION PAYING DIVIDENDS ON TAXABLE PREFERRED SHARES

Definitions

191.(1) In this Part,

"excluded corporation"

"excluded corporation" means a corporation that is

- (a) an investment corporation,
- (b) a mortgage investment corporation,
- (c) a mutual fund corporation,
- (d) a prescribed investment contract corporation,
- (e) a prescribed venture capital corporation,
- (f) a prescribed labour-sponsored venture capital corporation, or
- (g) a private holding corporation,

but does not include

- (h) a prescribed corporation,
- (i) a specified financial institution, or
- (j) any corporation

(i) that is controlled directly or indirectly in any manner whatever, whether by virtue of a beneficial interest in one or more trusts or otherwise, by or for the benefit of one or more corporations other than excluded corporations, or

(ii) in which a corporation other than an excluded corporation has a substantial interest;

"excluded dividends"

"excluded dividends" means

- (a) dividends paid by a corporation to a shareholder that, at the time the dividend was paid, had a substantial interest in the corporation, and
- (b) dividends paid by a corporation that was an excluded corporation at the time the dividend was paid;

"private holding corporation"

"private holding corporation" means a private corporation

- (a) that does not have a substantial interest in another corporation, and
- (b) the only undertaking of which is the investing of its funds.

Substantial interest

(2) For the purposes of this Part, a shareholder has a substantial interest in a corporation at any time if the corporation is a taxable Canadian corporation and

- (a) the shareholder is related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the corporation at that time; or
- (b) the shareholder owned, at that time,
 - (i) shares of the capital stock of the corporation that would give the shareholder 25% or more of the votes that could be cast under all circumstances at an annual meeting of shareholders of the corporation, and
 - (ii) shares of the capital stock of the corporation having a fair market value of 25% or more of the fair market value of all of the issued shares of the capital stock of the corporation,

and for the purposes of this paragraph, a shareholder shall be deemed to own at any time each share of the capital stock of a corporation that is owned, otherwise than by reason of this paragraph, at that time by a person to whom the shareholder is related (otherwise than by reason of a right referred to in paragraph 251(5)(b)).

Idem

(3) Notwithstanding subsection (2), where it may reasonably be considered, having regard to all the circumstances, that the principal purpose for a shareholder acquiring an interest that would, but for this subsection, be a substantial interest in a corporation is to avoid or limit the application of Part IV.1 or this Part, the shareholder shall be deemed not to have a substantial interest in the corporation.

Partnerships and trusts

(4) Notwithstanding subsection (2), any partnership or trust shall be deemed not to have a substantial interest in a corporation.

Tax Payable

191.1(1) Every taxable Canadian corporation shall pay a tax under this Part for each taxation year on taxable dividends, other than excluded dividends, paid by it in the year on taxable preferred shares equal to the amount, if any, by which the aggregate of

(a) 40% of the amount, if any, by which the aggregate of all such dividends paid on a class of shares in respect of which an election under subsection 191.2(1) has been made exceeds the corporation's dividend allowance for the year,

(b) .25% of the amount, if any, by which the aggregate of all such dividends paid on a class of shares in respect of which an election under subsection 191.2(1) has not been made exceeds the amount, if any, by which the corporation's dividend allowance for the year exceeds the aggregate of dividends referred to in paragraph (a), and

(c) any tax payable by it for the year by reason of paragraph 191.3(1)(d)

exceeds

(d) the aggregate of all amounts each of which is an amount determined for the year in respect of the corporation under paragraph 191.3(1)(c).

"Dividend allowance"

(2) For the purposes of this section, a corporation's "dividend allowance" for a taxation year is the amount, if any, by which

(a) \$500,000

exceeds

(b) the amount, if any, by which the aggregate of taxable dividends, other than excluded dividends, paid by it on taxable preferred shares in the calendar year immediately preceding the calendar year in which the taxation year ended exceeds \$1,000,000,

unless the corporation is associated in the taxation year with one or more other taxable Canadian corporations, in which case, except as otherwise provided in this section, its dividend allowance for the year is nil.

Associated corporations

(3) If all of the taxable Canadian corporations that are associated with each other in a taxation year and that have paid taxable dividends on taxable preferred shares in the year have filed with the Minister in prescribed form an agreement whereby, for the purposes of this section, they allocate an amount to one or more of them for the taxation year, and the amount so allocated or the aggregate of the amounts so allocated, as the case may be, is equal to the total dividend allowance for the year for those corporations and all other taxable Canadian corporations with which each such corporation is associated in the year, the dividend allowance for the year for each of the corporations is the amount so allocated to it.

"Total dividend allowance"

(4) For the purposes of this section, the "total dividend allowance" for a group of taxable Canadian corporations that are associated with each other in a taxation year is the amount, if any, by which

(a) \$500,000

exceeds

(b) the amount, if any, by which the aggregate of taxable dividends, other than excluded dividends, paid by those corporations on taxable preferred shares in the calendar year immediately preceding the calendar year in which the taxation year ended exceeds \$1,000,000.

Failure to file agreement

(5) If any of the taxable Canadian corporations that are associated with each other in a taxation year and that have paid taxable dividends on taxable preferred shares in the year has failed to file with the Minister an agreement as contemplated by subsection (3) within 30 days after notice in writing by the Minister has been forwarded to any of them that such an agreement is required for the purpose of any assessment of tax under this Part, the Minister shall, for the purpose of this section, allocate an amount to one or more of them for the taxation year, which amount or the aggregate of which amounts, as the case may be, shall equal the total dividend allowance for the year for those corporations and all other taxable Canadian corporations with which each such corporation is associated in the year, and the dividend allowance for the year of each of the corporations is the amount so allocated to it.

Dividend allowance in short years

(6) Notwithstanding any other provision of this section,

(a) where a corporation has a taxation year that is less than 51 weeks, its dividend allowance for the year is that proportion of its dividend allowance for the year determined without reference to this paragraph that the number of days in the year is of 365; and

(b) where a taxable Canadian corporation (in this paragraph referred to as the "first corporation") has more than one taxation year ending in a calendar year and is associated in two or more of those taxation years with another taxable Canadian corporation that has a taxation year ending in that calendar year, the dividend allowance of the first corporation for each taxation year in which it is associated with the other corporation ending in that calendar year is, subject to the application of paragraph (a), an amount equal to the amount that would be its dividend allowance for the first such taxation year if such allowance were determined without reference to paragraph (a).

Election

191.2(1) With respect to a class of its taxable preferred shares the terms and conditions of which require an election to be made under this subsection and for the purposes of determining the tax payable by it under paragraph 191.1(1)(a), a corporation may make an election by filing a prescribed form with the

Minister not later than the day on or before which its return of income under Part I is required by section 150 to be filed for the taxation year in which shares of that class are first issued.

Time of election

(2) An election with respect to a class of taxable preferred shares filed under and in accordance with subsection (1) shall be deemed to have been filed before any dividend on a share of that class is paid.

Agreement respecting liability for tax

191.3(1) Where a corporation (in this section referred to as the "parent corporation") and a corporation (in this section referred to as the "controlled corporation") controlled by the parent corporation

(a) throughout a taxation year of the parent corporation, and

(b) where that taxation year of the parent corporation is less than 365 days, throughout the part, if any, of the calendar year in which that taxation year ends that precedes the beginning of that taxation year,

file as provided in subsection (2) an agreement with the Minister not later than the day on or before which the parent corporation's return for the year under this Part is required to be filed, under which the controlled corporation agrees to pay all or any portion, as is specified in the agreement, of the tax for the year that would, but for the agreement, be payable under this Part by the parent corporation (other than any tax payable by the parent corporation by reason of another agreement made under this section), the following rules apply:

(c) the amount of tax specified in the agreement is an amount determined for the year in respect of the parent corporation for the purpose of paragraph 191.1(1)(d);

(d) the controlled corporation shall pay, for its taxation year ending in the calendar year in which that taxation year of the parent corporation ends, in addition to any tax otherwise payable by it under this Part for the year, a tax under this Part equal to the amount of tax specified in the agreement; and

(e) the parent corporation and the controlled corporation are jointly and severally liable to pay the tax payable by the controlled corporation by reason of paragraph (d).

Manner of filing agreement

(2) An agreement referred to in subsection (1) between a parent corporation and a controlled corporation shall be deemed not to have been filed with the Minister unless the agreement is in prescribed form and it is accompanied by,

(a) where the directors of the parent corporation are legally entitled to administer its affairs, a certified copy of their resolution authorizing the agreement to be made;

(b) where the directors of the parent corporation are not legally entitled to administer its affairs, a certified copy of the document by which the person legally entitled to administer the corporation's affairs authorized the agreement to be made;

(c) where the directors of the controlled corporation are legally entitled to administer its affairs, a certified copy of their resolution authorizing the agreement to be made; and

(d) where the directors of the controlled corporations are not legally entitled to administer its affairs, a certified copy of the document by which the person legally entitled to administer the corporation's affairs authorized the agreement to be made.

Assessment of parent corporation

(3) The Minister may at any time assess a parent corporation in respect of any amount for which it is jointly and severally liable by reason of paragraph (1)(e) and the provisions of Division I of Part I are applicable in respect of the assessment as though it had been made under section 152.

Payment by parent corporation

(4) Where a parent corporation and a controlled corporation are by reason of paragraph (1)(e) jointly and severally liable in respect of tax payable by the controlled corporation by reason of paragraph (1)(d), the following rules apply:

(a) a payment by the parent corporation on account of the liability shall, to the extent thereof, discharge the joint liability; but

(b) a payment by the controlled corporation on account of its liability only discharges the parent corporation's liability to the extent that the payment operates to reduce

the controlled corporation's liability under this Act to an amount less than the amount in respect of which the parent corporation was, by paragraph (1)(e), made jointly and severally liable.

Information Return

191.4(1) Every corporation that is or would, but for section 191.3, be liable to pay tax under this Part for a taxation year shall, not later than the day on or before which it is required by section 150 to file its return of income for the year under Part I, file with the Minister a return for the year under this Part in prescribed form containing an estimate of the tax payable by it under this Part for the year.

Provisions applicable to Part

(2) Sections 152, 157, 158 and 159, subsections 161(1),(2) and (11), sections 162 to 167 and Division J of Part I are applicable to this Part with such modifications as the circumstances require".

(2) Subsection (1) is applicable to the 1988 and subsequent taxation years with respect to dividends paid after 1987.

12.(1) Subsection 227(14) of the said Act is repealed and the following substituted therefor:

Application of Parts III, IV, IV.1 and VI.1

"(14) Parts III, IV, IV.1 and VI.1 are not applicable to any corporation that was, at any time or for any period that is relevant for the purposes of any of those Parts, a corporation exempt from tax under section 149."

(2) Subsection (1) is applicable to the 1988 and subsequent taxation years.

13.(1) The definition "short-term preferred share" in subsection 248(1) of the said Act is repealed and the following substituted therefor:

"short-term preferred share"

""short-term preferred share" of a corporation at any particular time means a share, other than a grandfathered share, of the capital stock of the corporation issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 that is at that particular time

(a) a taxable preferred share where, under the terms and conditions of the share, any agreement relating to the share or any modifications of such terms, conditions or agreement, the corporation or a specified person in relation to the corporation is or may be required to redeem, acquire or cancel, in whole or in part, the share or to reduce the paid-up capital of the share at any time within 5 years from the date of its issue, or

(b) a share that is convertible or exchangeable at any time within 5 years from the date of its issue unless

(i) it is convertible or exchangeable only into

(A) another share that, if issued, would not be short-term preferred share,

(B) a right or warrant that, if exercised, would allow the person exercising it to acquire a share that, if issued, would not be a short-term preferred share, or

(C) both a share described in clause (A) and a right or warrant described in clause (B), and

(ii) all or substantially all the consideration receivable for the exchange of the share on the conversion or exchange is the share described in clause (i)(A) or the right or warrant described in clause (i)(B) or both, as the case may be,

but does not include a share that is

(c) a share described in paragraph (e) of the definition "term preferred share" in this subsection,

(d) a share of the capital stock of a mutual fund corporation, or

(e) a prescribed share,

and for the purposes of this definition,

(f) where at any particular time after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 the terms or conditions of a share of the capital stock of a corporation relating to the redemption, acquisition, cancellation or conversion of the share or to the reduction of the paid-up capital of the share by the corporation or a specified person in relation to the corporation have been changed, otherwise than pursuant to a written arrangement to do so made before

8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, or any agreement in respect of the share relating to any such event, or any guarantee agreement (within the meaning assigned by paragraph (k)) in respect of the share, has been changed or entered into by the corporation or a specified person in relation to the corporation, the share shall be deemed to have been issued at that particular time,

(g) where at any time after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, a particular share of the capital stock of a corporation has been issued or its terms or conditions have been modified, otherwise than pursuant to a written arrangement to do so made before that time, and it may reasonably be considered, having regard to all the circumstances (including the rate of interest on any debt or the dividend provided on any short-term preferred share), that

(i) but for the existence at any time of the debt or the short-term preferred share, the particular share would not have been issued or its terms or conditions modified, and

(ii) one of the main purposes for the issue of the particular share or the modification of its terms or conditions was to avoid or limit the application of subsection 112(2.3),

the particular share shall be deemed to be a short-term preferred share of the corporation,

(h) where the terms or conditions of a share of the capital stock of a corporation are modified or established after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, or any agreement in respect of the share has been changed or entered into after that time, otherwise than pursuant to a written arrangement to do so made before that time, and as a consequence thereof the corporation or a specified person in relation to the corporation may reasonably be expected to redeem, acquire or cancel, in whole or in part, the share, or to reduce its paid-up capital, within 5 years from the date of its issue, the share shall be deemed after the date of the modification or establishment, as the case may be, to be a short-term preferred share of the corporation,

(i) where a share of the capital stock of a corporation was issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 and at the time the share was issued the existence of the corporation was, or there was an

arrangement under which it could be, limited to a period that was within 5 years from the date of its issue, the share shall be deemed to be a short-term preferred share of the corporation,

(j) where a share of the capital stock of a corporation is issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 by the corporation to a specified person in relation to the corporation and the share is subsequently sold by the corporation or a specified person in relation to the corporation to a person with whom the corporation or such specified person was, but for paragraph 251(5)(b), dealing at arm's length, the share shall be deemed to have been issued at the time the share was subsequently sold,

(k) where at any time any person (other than the issuer or an individual other than a trust) was obligated, either absolutely or contingently and either immediately or in the future, to effect any undertaking (in this paragraph referred to as a "guarantee agreement") in respect of a share of the capital stock of a corporation, including any guarantee, covenant or agreement to purchase or repurchase the share, and including the lending of funds or the placing of amounts on deposit with, or on behalf of the holder of the share or a specified person in relation to the holder of the share, given as part of a transaction or event or a series of transactions or events that included the issuance or acquisition of the share to ensure that any loss that the holder of the share or a specified person in relation to the holder of the share may sustain within 5 years after the date that the share was issued, by reason of the ownership, holding or disposition of the share or any other property is limited in any respect, the share shall be deemed to be at and immediately after that time a short-term preferred share,

(l) where a taxable preferred share of the capital stock of a corporation would, but for this paragraph, be a short-term preferred share by reason of the existence of an exchange agreement under which the corporation or a specified person in relation to the corporation agrees to acquire the share at any time within 5 years from the date of its issue solely in consideration for a share other a short-term preferred share of the acquiring corporation, the existence of the agreement shall be ignored for the purposes of applying paragraph (a) of this definition, and

(m) "specified person" in relation to a holder of a share has the meaning assigned by paragraph (i) of the definition "taxable preferred share" in this subsection;"

(2) Subsection 248(1) of the said Act is amended by adding thereto, in alphabetical order within the subsection the following definitions:

"grandfathered share"

"grandfathered share" means a share of the capital stock of a corporation issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 and before 1988

(a) pursuant to an agreement in writing entered into before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, or

(b) as part of a distribution to the public made in accordance with the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum required by law to be filed before distribution of the shares could commence filed before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 with a public authority pursuant to and in accordance with the securities legislation of the jurisdiction in which the shares are distributed,

other than a share that is deemed under paragraph 112(2.2)(e) or the definition "short-term preferred share", "taxable preferred share" or "taxable SFI share" in this subsection or to have been issued after that time;

"specified financial institution"

"specified financial institution" has the meaning assigned by subsection 112(2.1);

"taxable preferred share"

"taxable preferred share" at any particular time means a share (other than a grandfathered share) of the capital stock of a corporation issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 where, at that particular time under the terms or conditions of the share or any agreement in respect of the share or its issue to which the corporation, or a person related to it, is a party,

(a) the amount of the dividends (in this definition referred to as the "dividend entitlement") that may be declared or paid on the share is, by way of a formula or otherwise, fixed, limited or established to be not less than a minimum amount,

(b) the amount (in this definition referred to as the "liquidation entitlement") that the holder of the share is entitled to receive in respect of the share on the dissolution, liquidation or winding-up of the corporation or on the redemption, acquisition or cancellation of the share by the corporation or by a specified person in relation to the corporation is, by way of a formula or otherwise, fixed, limited or established to be not less than a minimum amount,

(c) the share is convertible at any time unless

(i) it is convertible only into

(A) another share of that, if issued, would not be a taxable preferred share,

(B) a right or warrant that, if exercised, would allow the person exercising it to acquire a share that, when issued, would not be a taxable preferred share, or

(C) both a share described in clause (A) and a right or warrant described in clause (B), and

(ii) all or substantially all the consideration receivable for the exchange of the share on the conversion is the share described in clause (i)(A) or the right or warrant described in clause (i)(B) or both, as the case may be,

(d) any person (other than the corporation) was, at or immediately before that particular time, obligated either absolutely or contingently, and either immediately or in the future, to effect any undertaking with respect to the share (including any guarantee, covenant or agreement to purchase or repurchase the share, and including the lending of funds to or the placing of amounts on deposit with, or on behalf of, the holder of the share or any specified person in relation to the holder) given as part of a transaction or event or a series of transactions or events that included the issuance or acquisition of the share to ensure that

(i) any loss that the holder of the share or a specified person in relation to the holder may sustain by reason of the holding, ownership or disposition of the share or any other property is limited in any respect, or

(ii) the holder of the share or a specified person in relation to the holder will derive earnings by reason of the holding, ownership or disposition of the share or any other property,

but does not include a share that is a prescribed share or a share described in paragraph (e) of the definition "term preferred share" in this subsection and, for the purposes of this definition,

(e) the dividend entitlement of a share of the capital stock of a corporation shall be deemed not to be fixed, limited or established to be not less than a minimum amount where it may reasonably be considered that all or substantially all of the dividend entitlement is determinable by reference to the dividend entitlement of another share of the capital stock of the corporation that would not be a taxable preferred share if this definition were read without reference to paragraph (h) and the share were issued after June 18, 1987,

(f) the liquidation entitlement of a share of the capital stock of a corporation shall be deemed not to be fixed, limited or established to be not less than a minimum amount where it may reasonably be considered that all or substantially all of the liquidation entitlement is determinable by reference to the liquidation entitlement of another share of the capital stock of the corporation that would not be a taxable preferred share if this definition were read without reference to paragraph (h) and the share were issued after June 18, 1987,

(g) where at any particular time after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, the terms or conditions of a share of the capital stock of a corporation that are relevant to any matters referred to in paragraphs (a) to (d) are changed or any existing agreement in respect thereof, to which the corporation or a corporation controlled by it is a party, is changed or a new agreement in respect of the share, to which the corporation or a corporation controlled by it is a party, is entered into, the share shall, for the purpose of determining whether it is a taxable preferred share, be deemed to have been issued at that particular time,

(h) a reference to an agreement in respect of a share does not include an agreement in respect of a share of the capital stock of a corporation under which the purchaser agrees to acquire the share for an amount that approximates its fair market value at the time of the acquisition, determined without regard to the agreement, and

(i) "specified person", in relation to a corporation, a specified financial institution or a holder of a share, as the case may be (in this definition referred to as the "taxpayer"), means any person with whom the taxpayer does

not deal at arm's length or any partnership or trust of which the taxpayer (or a person with whom the taxpayer does not deal at arm's length) is a member or beneficiary, respectively;

"taxable SFI share"

"taxable SFI share" means a share of a class of shares of the capital stock of a corporation issued before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 or a grandfathered share where, under the terms or conditions of the share of that class or any agreement in respect of that class or the issue of a share of that class,

(a) the amount of the dividends (in this definition referred to as the "dividend entitlement") that may be declared or paid on a share of that class is, by way of a formula or otherwise, fixed, limited or established to be not less than a minimum amount, or

(b) the amount (in this definition referred to as the "liquidation entitlement") that the holder of a share of that class is entitled to receive in respect of the share on dissolution, liquidation or winding-up of the corporation is, by way of formula or otherwise, fixed, limited or established to be not less than a minimum amount,

but does not include a share that is a prescribed share, a term preferred share, a share described in paragraph (e) of the definition "term preferred share" in this subsection or a short-term preferred share (within the meaning of the definition of that expression in this subsection as that definition applies to shares issued before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987) and for the purposes of this definition

(c) the dividend entitlement of a share of a class of shares of the capital stock of a corporation shall be deemed not be fixed, limited or established to be not less than a minimum amount where it may reasonably be considered that all or substantially all of the dividend entitlement is determinable by reference to the dividend entitlement of a share of another class of shares of the capital stock of the corporation that would not be a taxable preferred share if the definition "taxable preferred share" in this subsection were read without reference to paragraph (h) thereof and the share were issued after June 18, 1987,

(d) the liquidation entitlement of a share of a class of shares of the capital stock of a corporation shall be deemed not to be fixed, limited or established to be not less than a minimum amount where it may reasonably be considered that

all or substantially all of the liquidation entitlement is determinable by reference to the liquidation entitlement of a share of another class of shares of the capital stock of the corporation that would not be a taxable preferred share if the definition "taxable preferred share" in this subsection were read without reference to paragraph (h) thereof and the share were issued after June 18, 1987, and

(e) where at any particular time after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987, the terms or conditions of a class of shares that are relevant to any matters referred to in paragraphs (a) and (b) are changed or any existing agreement in respect thereof is changed or a new agreement in respect thereof is entered into, the shares of that class shall, for the purpose of determining whether it is a taxable SFI share, be deemed to have been issued at that particular time;"

(3) All that portion of paragraph (a) of the definition "amount" in subsection 248(1) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(a) in the case of a dividend described in any of subsections 112(2.1), (2.2), (2.3) and (2.4), Part VI.I and subsections 258(3) and (5) the greater of"

(4) Subparagraph (e)(iii) of the definition "term preferred share" in subsection 248(1) of the said Act is repealed and the following substituted therefor:

"(iii) at a time when, by reason of financial difficulty, the issuing corporation or another corporation resident in Canada with which it does not deal at arm's length was in default, or could reasonably be expected to default, on a debt obligation held by a person with whom the issuing corporation or the other corporation was dealing at arm's length and the share was issued either wholly or in substantial part and either directly or indirectly in exchange or substitution for that obligation,"

(5) The definition "term preferred share" in subsection 248(1) of the said Act is further amended by striking out the word "or" at the end of paragraph (e) thereof, by adding the word "or" at the end of paragraph (f) thereof and by adding thereto, immediately after paragraph (f) thereof, the following paragraph:

"(f.1) that is a taxable preferred share, other than a share that, but for this paragraph, would be a term preferred share by reason of paragraph (b) of this definition,"

(6) The definition "term preferred share" in subsection 248(1) of the Act is further amended by striking out the word "and" at the end of paragraph (i) thereof and by adding thereto, immediately after paragraph (i) thereof, the following paragraph:

"(i.1) where a share of the capital stock of a corporation would, but for this paragraph, be a term preferred share by reason of the existence of an exchange agreement under which the corporation or a specified person in relation to the corporation (within the meaning assigned by paragraph (i) of the definition "taxable preferred share" in this subsection) agrees to acquire the share at any time solely in consideration for a share other than a term preferred share of the acquiring corporation, the existence of the agreement shall be ignored for the purpose of applying subparagraphs (a)(i) and (ii) of this definition, and"

(7) All that portion of the definition "term preferred share" in subsection 248(1) of the said Act following paragraph (j) thereof is repealed.

(8) Section 248 of the said Act is amended by adding thereto the following subsection:

Interests in trusts

"(12) Where after November 12, 1981 a person has an interest in a trust, whether directly or indirectly through an interest in any other trust or in any manner whatever, the person shall, for the purposes of the definitions "income bond", "income debenture" "short-term preferred share" and "term preferred share" in subsection (1), the definition "specified person" in paragraph (i) of the definition "taxable preferred share" in subsection (1), subsections 112(2.2) and (2.4) and section 258, be deemed to be a beneficiary of the trust."

(9) Subsections (1), (4), (5), (7) and (8) and the definitions "grandfathered share" and "taxable preferred share" in subsection 248(1) of the said Act, as enacted by subsection (2), are applicable with respect to shares issued after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 or shares deemed by the said Act to have been issued after that time.

(10) The definitions "specified financial institution" and "taxable SFI share" in subsection 248(1) of the said Act, as enacted by subsection (2), and subsection (6) are applicable after June 18, 1987,

(11) Subsection (3) is applicable with respect to dividends paid or received after June 18, 1987.

14.(1) Section 258 of the said Act is amended by adding thereto, immediately after subsection (1), the following subsection:

Deemed dividend on taxable preferred shares

"(1.1) Where at any time after 1987 the paid-up capital of a taxable preferred share, a taxable SFI share or a short-term preferred share of a corporation was reduced otherwise than by way of redemption, acquisition or cancellation of the share or of a transaction described in subsection 84(2) or (4.1), a dividend shall be deemed,

(a) for the purposes of this Act, to have been received on the share by the shareholder; and

(b) for the purposes of Part VI.1, to have been paid on the share by the corporation,

at that time, in an amount equal to the amount received on the reduction of the paid-up capital of the share."

(2) Subsection 258(3) of the said Act is repealed and the following substituted therefor:

Deemed interest on preferred shares

"(3) For the purposes of paragraphs 12(1)(c) and (k) and sections 113 and 126 and subject to subsection (4), each amount that is a dividend received on

(a) a term preferred share by a specified financial institution from a corporation not resident in Canada, or

(b) any other share by any corporation from a corporation not resident in Canada, if the dividend would have been a dividend in respect of which no deduction could have been made under subsection 112(1) or 112(2) by virtue of subsection 112(2.2), as it read on June 17, 1987, or subsection 112(2.4) had the payer corporation been a taxable Canadian corporation at the time the dividend was paid

shall be deemed to be interest received in the year and not a dividend received on a share of the capital stock of the payer corporation."

(3) Section 258 is further amended by adding thereto the following subsection:

Deemed interest on certain shares

"(5) For the purposes of paragraphs 12(1)(c) and (k) and sections 113 and 126, each amount that is a dividend received after June 18, 1987 in a taxation year from a corporation not resident in Canada, other than a corporation in which the recipient has a substantial interest (within the meaning assigned by section 191), on

(a) a short-term preferred share, or

(b) any other share, if the dividend would have been a dividend in respect of which no deduction could have been made under subsection 112(1) or 112(2) by reason of subsection 112(2.2) or (2.4) had the payer corporation been a taxable Canadian corporation at the time the dividend was paid,

shall be deemed to be interest received in the year and not a dividend received on a share of the capital stock of the payer corporation."

(4) Subsection (1) is applicable with respect to amounts received after 1987.

(5) Subsection (2) is applicable with respect to dividends received or deemed by the said Act to be received on shares acquired after 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987.

(6) Subsection (3) is applicable after June 18, 1987.

DRAFT REGULATIONS

1.(1) Subsection 5301(1) of the Income Tax Regulations is revoked and the following substituted therefor:

"5301.(1) Subject to subsections (6) and (8), for the purposes of subsection 157(4) and 161(9) of the Act, the "first instalment base" of a corporation for a particular taxation year means the product obtained when the aggregate of

(a) the tax payable by the corporation under Part I of the Act for its taxation year immediately proceeding the particular year computed without reference to sections 123.1, 127.2 and 127.3 thereof and before taking into consideration any amount referred to in any of subparagraphs 161(7)(a)(i) to (vii) thereof that was excluded or deducted, as the case may be, and

(b) the tax payable by the corporation under Part VI.1 of the Act for its taxation year immediately preceding the particular year,

is multiplied by the ratio that 365 is of the number of days in that preceding year."

(2) Subparagraph 5301(4)(a)(i) of the said Regulations is revoked and the following substituted therefor:

"(i) its "first instalment base" for the particular year means the aggregate of all amounts, each of which is equal to the product obtained when the aggregate of

(A) the tax payable under Part I of the Act, computed without reference to sections 123.1, 127.2 and 127.3 thereof and before taking into consideration any amount referred to in any of subparagraphs 161(7)(a)(i) to (vii) thereof that was excluded or deducted, as the case may be, and

(B) the tax payable under Part VI.1 of the Act

for the year by a predecessor corporation (within the meaning assigned by section 87 of the Act) for its last taxation year is multiplied by the ratio that 365 is of the number of days in that year, and"

2. Subsection 6201(2) of the said Regulations is revoked and the following substituted therefor:

"(2) For the purposes of paragraph (f) of the definition "term preferred share" in subsection 248(1) of the Act, a share that

(a) was issued before 8:00 p.m. Eastern Daylight Saving Time, June 18, 1987 (whether or not it is deemed to have been issued after that time) or is a grandfathered share,

(b) was acquired after June 28, 1982, and

(c) is a share of a class of the capital stock of a corporation (in this subsection referred to as the "issuer") that is listed on a stock exchange referred to in section 3200

is a prescribed share with respect to another corporation (in this subsection referred to as the "recipient") that receives a dividend at any time in respect of the share unless dividends are received at that time by the recipient or by the recipient and specified persons in relation to the recipient from the issuer in respect of more than the least of

(d) 10% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired before 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length,

(e) 5% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired in 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length, or

(f) 2% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired after 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length,

and, for the purpose of this subsection,

(g) where a taxpayer is a beneficiary of a trust and an amount in respect of the beneficiary has been designated by the trust in a taxation year pursuant to subsection 104(19) of the Act, the taxpayer shall be deemed to have received the amount so designated at the time it was received by the trust; and

(h) where a taxpayer is a member of a partnership and a dividend has been received by the partnership, the taxpayer's share of the dividend shall be deemed to have been received by the taxpayer at the time the dividend was received by the partnership."

3. Subsection 6201(4) of the said Regulation is revoked and the following substituted therefor:

"(4) For the purposes of the definition "taxable SFI share" in subsection 248(1) of the Act, a share of a class of the capital stock of a corporation (in this subsection referred to as the "issuer") is a prescribed share with respect to another corporation (in this subsection referred to as the "recipient") that receives a dividend at any time in respect of the share unless dividends are received at that time by the recipient or by the recipient and specified persons in relation to the recipient from the issuer in respect of more than the least of

(a) 10% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired before 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length,

(b) 5% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired in 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length, or

(c) 2% of the issued and outstanding shares of that class where a dividend is received at that time by the recipient or a specified person in relation to the recipient in respect of a share of that class acquired after 1988 by the recipient or a specified person in relation to the recipient from a person with whom the recipient or the specified person would, but for a right referred to in paragraph 251(5)(b) of the Act, be dealing at arm's length,

and, for the purpose of this subsection,

(d) where a taxpayer is a beneficiary of a trust and an amount in respect of the beneficiary has been designated by the trust in a taxation year pursuant to subsection 104(19) of the Act, the taxpayer shall be deemed to have received the amount so designated at the time it was received by the trust; and

(e) where a taxpayer is a member of a partnership and a dividend has been received by the partnership, the taxpayer's share of the dividend shall be deemed to have been received by the taxpayer at the time the dividend was received by the partnership.

(5) For the purpose of determining under subsection (2) or (4) the year in which a share of a class of the capital stock of a corporation was acquired by any person, shares of that class acquired by the person at any time before a disposition by him of shares of that class shall be deemed to have been disposed of before shares of that class acquired by him before that time.

(6) For the purposes of subsections (2) and (4), "specified person" in relation to a recipient has the meaning assigned by paragraph (i) of the definition "taxable preferred share" in subsection 248(1) of the Act."

4. All that portion of section 6700 of the said Regulations preceding paragraph (a) thereof is repealed and the following substituted therefor:

"6700. For the purposes of paragraph 40(2)(i), clause 53(2)(k)(i)(C), paragraph 125(7)(b), sections 186.1, 186.2 and 187.1 and subsection 191(1) of the Act and in this Part and Part LI, "prescribed venture capital corporation" means at any particular time"

5. Section 6701 of the said Regulations is repealed and the following substituted therefor:

"6701. For the purposes of paragraph 40(2)(i), clause 53(2)(k)(i)(C), the definition "approval share" in subsection 127.4(1), sections 186.1 and 187.1 and subsection 191(1) of the Act, the corporation established by an Act to Establish the Fonds de Solidarité des Travailleurs du Québec (F.T.Q.), Statutes of Quebec 1983, chapter 58, as amended, is a prescribed labour-sponsored venture capital corporation."

6. Section 6703 of the said Regulations is repealed and the following substituted therefor:

"6703. For the purposes of sections 186.1 and 187.1 and subsection 191(1) of the Act, a "prescribed investment contract corporation" means a corporation described in clause 146(1)(j)(ii)(B) of the Act."

7. Sections 1 and 2 are applicable to the 1988 and subsequent taxation years.

8. Sections 3 to 6 are applicable after June 18, 1987.

Introduction

The proposed system provides for a special tax on dividends paid on preferred shares issued after 8:00 p.m. EDT, June 18, 1987. There is also a tax on corporate recipients of dividends on certain types of preferred shares. The system contains a number of mechanisms designed to avoid the application of this system to smaller corporations, dividends paid to related shareholders, venture capital investments, corporations that serve as flow-through vehicles such as mutual funds and generally to transactions where the use of preferred shares does not provide a tax advantage.

The basic system

A tax will be payable by any corporation paying dividends after 1987 on "taxable preferred shares" -- generally all preferred shares issued after 8:00 p.m. EDT, June 18, 1987 -- other than dividends paid to shareholders related to the corporation or shareholders having a substantial interest (25 per cent) in the corporation. The tax on the issuer corporation is 25 per cent of such dividends paid in a taxation year in excess of a threshold amount. The annual threshold is \$500,000 for each corporation or associated group of corporations and is reduced to the extent of dividends on taxable preferred shares paid in the preceding calendar year in excess of \$1,000,000. A special mechanism will allow the issuer tax to be offset against corporate income taxes otherwise payable. In addition to the special tax on the dividend paying corporation, there will also be a further 10 per cent tax on dividends received by public corporations, specified financial institutions and certain other corporations on taxable preferred shares. A corporation that issues a class of taxable preferred shares may elect to be subject to a 40 per cent tax on dividends paid on shares of that class, in lieu of the 25 per cent tax, in which case the 10 per cent tax payable by corporate shareholders on dividends received will not be exigible. Taxable corporations, or corporations whose dividends on taxable preferred shares are fully covered by the \$500,000 exemption threshold, are likely to make this election where the shares are held by a specified financial institution or other corporation that would otherwise be subject to the 10% tax on the receipt of the dividend.

The 25 per cent tax on a corporation paying dividends on taxable preferred shares is imposed under new Part VI.1 of the Act. The tax payable is determined under new subsection 191.1. The \$500,000 exemption threshold or "dividend allowance" is determined in new subsections 191.1(2) to (6). The amount of the exemption is subject to a clawback, on a dollar-for-dollar basis with respect to dividends on taxable preferred shares in excess of \$1,000,000 paid by the corporation and any other members of its corporate group (subsection 191.1(2)) in the previous year. Dividends paid by a corporation to shareholders with a substantial interest in the corporation (defined in new subsection 191(2)) and dividends paid to

excluded corporations (new subsection 191(1)) are exempt from the Part VI.1 tax. The tax is payable by monthly instalments (proposed amendments to sections 157 and 161). The election to pay the 40 per cent tax is provided in section 191.2.

The 10 per cent tax on taxable preferred share dividends received by public corporations and specified financial institutions is dealt with in Part IV.1, specifically new section 187.2. Dividends received from "excluded corporations" (as defined in subsection 191(1)) and from corporations in which the shareholder holds a substantial interest are not subject to this tax. In addition, dividends received by excepted corporations, which include most private corporations and investment intermediaries, are exempt from the tax. Dividends received on shares of a class in respect of which the dividend-paying corporation has made the special election to pay the 40 per cent higher rate of Part VI.1 tax are also exempt from the Part IV.1 tax.

The offset mechanism for the Part VI.1 tax on dividend paying corporations is provided by way of a deduction in computing taxable income equal to $5/2$ of the Part VI.1 tax payable in the year (new paragraph 110(1)(k)). The unused portion of this deduction will form part of the corporation's non-capital loss, (proposed amendment to paragraph 111(8)(b)) and therefore be eligible for a 3-year carry-back and 7-year carry-forward.

Where a parent corporation has a Part VI.1 tax payable on its taxable preferred share dividends, it may, by agreement with its subsidiary, transfer the liability for all or a portion of the tax to the subsidiary. This permits the parent to transfer its entitlement to the paragraph 110(1)(k) deduction for $5/2$ of the tax to its subsidiary. Thus, for example, a holding company which has no corporate income tax payable may issue and pay dividends on taxable preferred shares and its subsidiaries will be able to claim the offset for the resulting Part VI.1 tax against the Part I corporate income taxes payable on their earnings.

The definition "taxable preferred share" is in subsection 248(1) of the Income Tax Act. The definition includes all shares that would conventionally be considered preferred shares including convertible preferred shares. Shares that are common shares or fully-participating equity shares are excluded in the definition unless, through outside guarantee agreements to which the issuing corporation or a non-arm's length person is a party, they have the attributes of preferred shares. Shares issued before 8:00 p.m. EDT, June 18, 1987 will not be taxable preferred shares unless their terms or conditions are changed after that date. Shares issued after that time pursuant to a written agreement entered into or prospectus filed before that time are also grandfathered.

Taxes under Part VI.1 and IV.1 are effective with respect to dividends paid on taxable preferred shares after 1987.

Short-term preferred shares

The inter-corporate dividend deduction will be denied for dividends received on short-term preferred shares issued after June 18, 1987 with a term of five years or less (amended subsection 112(2.3)). A dividend received from a related corporation is not subject to this restriction. The new definition of "short-term preferred share" is in subsection 248(1) of the Act.

Special provisions applicable to dividends received by specified financial institutions

(a) Term preferred shares

Subsection 112(2.1) of the Act is not amended, but its application to deny the inter-corporate dividend deduction on dividends received by specified financial institutions on term preferred shares will generally apply only to dividends on such shares issued before 8:00 p.m. EDT, June 18, 1987. This results from a change to the definition of term preferred share in subsection 248(1) to exclude taxable preferred shares.

The application of subsection 112(2.1) with respect to shares issued after 8:00 p.m. EDT, June 18, 1987 will arise only if a share included in the definition of term preferred share falls outside the definition of taxable preferred share. Shares to which paragraph (b) of the definition "term preferred share" applies will continue to be term preferred shares.

The exclusion from term preferred shares for a publicly-listed class of shares, which applies where no more than 10 per cent of the class is held by a specified financial institution and specified persons in relation to it, is being phased down to 5 per cent where shares of a class are acquired in 1988 and to 2 per cent where the shares are acquired after 1988 (proposed amendment to subsection 6201(2) of the Income Tax Regulations). However, the reduced limits will not affect existing holdings. Thus, for example, the limit will be reduced to 5 per cent for shares of a listed class in 1988 only where the institution acquires additional shares of that class in 1988.

(b) Preferred shares issued before 8:00 p.m. EDT, June 18, 1987 and acquired after 8:00 p.m. EDT, June 18, 1987 that are not term preferred shares

Dividends received after June 18, 1987 by specified financial institutions on preferred shares issued before 8:00 p.m. EDT, June 18, 1987 -- referred to as "taxable SFI shares" -- may be

subject to a special 10% tax under Part IV.1 (new section 187.3). The tax will apply only with respect to such shares acquired after June 18, 1987 by a specified financial institution and then only if the size of the holding exceeds specified limits for the specified financial institution and related persons (proposed amendments to subsection 6201(4) of the Income Tax Regulations). These limits are 10 per cent of an issue if all of the shares are acquired before 1988, 5 per cent if any shares are acquired in 1988 and 2 per cent if any shares are acquired in 1989 and thereafter. Taxable SFI shares are defined in subsection 248(1) of the Act.

Guaranteed Shares

If a shareholder's investment in or return on a share is guaranteed by the issuing corporation or a party related thereto, it will generally be a taxable preferred share and, as such, will be subject to the Part VI.1 and Part IV.1 tax regime. A guarantee by parties unrelated to the issuing corporation will not transform a share into a taxable preferred share. However, dividends on shares guaranteed by a specified financial institution will be denied the inter-corporate dividend deduction (amended subsection 112(2.2)).

Clause 1
Dividends received

ITA
82(2)

Section 82 of the Act deals with dividends. Subsection 82(2) provides that dividends received by one taxpayer but included under certain attribution rules in computing the income of another taxpayer are treated as having been received by the other taxpayer for the purposes of section 112 (relating to the inter-corporate dividend deduction) and section 121 (relating to the dividend tax credit). This amendment makes this rule applicable for all purposes of the Act. It will thus apply for the purposes of section 113 (relating to dividends from foreign affiliates) and section 258 (the special rules relating to term preferred shares, income bonds and debentures and certain dividends from corporations not resident in Canada). The amendment to this subsection will also extend its application for the purposes of the Part IV tax and the special tax imposed under Part IV.1 on certain dividends received on "taxable preferred shares" and "taxable SFI shares".

The amendment to subsection 82(2) is effective for dividends received after June 18, 1987.

Clause 2
Amalgamations

ITA
87

Section 87 of the Act deals with the tax treatment of an amalgamation of two or more corporations.

Subclause 2(1)
ITA
87(2)(rr)

New paragraph 87(2)(rr) of the Act is consequential on the introduction of the Part VI.1 tax relating to the special tax on certain dividends paid on taxable preferred shares in excess of an annual \$500,000 threshold amount -- referred to in the Act as a "dividend allowance". This allowance is determined for any taxation year by reference to dividends paid in the preceding calendar year. The references to new subsections 191.1(2) and (4) ensure that, in computing the dividend allowance of an amalgamated corporation, the dividends paid by its predecessor corporations in the previous calendar year are taken into account.

New section 191.3 allows a special election to be made for the purposes of the new Part VI.1 tax to permit a parent corporation to assign to a corporation that it controls its liability for the tax on dividends paid by the parent on taxable preferred shares. The reference to this section in paragraph 87(2)(rr) ensures that any such election remains valid where either corporation is amalgamated. For this purpose the amalgamated corporation is treated as being the same corporation as its predecessor corporations.

New paragraph 87(2)(rr) applies with respect to amalgamations after November 27, 1986.

Subclause 2(2)
ITA
87(4.2)

New subsection 87(4.2) of the Act is consequential on the introduction of new rules relating to the tax treatment of preferred shares. The status of certain preferred shares depends on their date of issue. The purpose of this new subsection is to treat preferred shares issued on an amalgamation in exchange for substantially similar shares issued by a predecessor as having been issued when they were issued by the predecessor and under the same circumstances. Thus, for example, where a grandfathered share of a predecessor would have been a taxable preferred share if it had been issued after June 18, 1987, a new share issued on an amalgamation in exchange for that share will also be a grandfathered share where it has substantially similar terms and conditions.

This subsection also applies to preserve the special election provided for in section 191.2 made by a predecessor corporation before an amalgamation where the newly amalgamated corporation issues shares the terms and conditions of which are substantially the same as those of an elected class of shares of the predecessor.

Subclauses 2(3) and (4)

These set out the effective dates for the amendments to section 87 of the Act.

Clause 3
Windings-Up
ITA
88

Section 88 of the Act sets out the rules that apply on the winding-up of a corporation.

Subclause 3(1)
ITA
88(1)(e.2)

Subsection 88(1) of the Act sets out rules that apply on the winding-up of a subsidiary into a parent corporation that owns at least 90 per cent of its shares. Under paragraph 88(1)(e.2), many of the detailed rules to be applied on a winding-up of a subsidiary into its parent are adopted by way of cross-reference to the corresponding provisions in section 87 relating to amalgamations. The amendment to paragraph 88(1)(e.2) is consequential on the new rules relating to the tax treatment of preferred shares. This amendment treats the parent corporation as the same corporation as the subsidiary corporation for the purposes of the provisions mentioned in new paragraph 87(2)(rr) which are discussed above. This amendment is applicable to windings-up ending after June 18, 1987.

Subclause 3(2)
ITA
88(1.1)(e)

This subclause proposes an amendment to paragraph 88(1.1)(e) of the Act as that paragraph would read after the enactment of the amendment proposed to that paragraph in Bill C-64 introduced in the House of Commons on June 9, 1987.

Existing paragraph 88(1.1)(e) of the Act provides that where control of a parent or subsidiary corporation has been acquired, special rules apply to restrict the ability of the parent, following the winding-up of the subsidiary, to deduct any non-capital losses or farm losses incurred by the subsidiary before the acquisition of control. The amendment proposed in the June 5, 1987 Notice of Ways and Means Motion

would alter these special rules so that the only losses of the subsidiary that will be available to the parent corporation in these circumstances will be the subsidiary's non-capital losses or farm losses that may reasonably be regarded as its losses from carrying on a business.

As discussed in the commentary on new paragraph 110(1)(k), the deduction provided by this paragraph effectively allows a corporation to offset the new part VI.1 tax against its liability for Part I tax. Under the amendment proposed to clause 111(8)(b)(i)(A), the unused portion of the deduction allowed by paragraph 110(1)(k) in a taxation year becomes part of the corporation's non-capital loss for the year. The amendment ensures that, where there has been an acquisition of control of the parent or subsidiary before the subsidiary's winding-up, the parent will be allowed, in a subsequent taxation year, to deduct that portion of the subsidiary's non-capital loss that may reasonably be regarded as being in respect of a deduction under new paragraph 110(1)(k), but only if the subsidiary carried on a business in the year in which the deduction arose and only to the extent of the parent's income from that business or from a similar business in the subsequent year. This amendment, which parallels similar amendments to subsection 111(5), is applicable for the 1988 and subsequent taxation years.

Subclauses 3(3) and (4)

These set out the effective dates for the amendments to section 87.

Clause 4
ITA
110(1)(k)

New paragraph 110(1)(k) of the Act provides a deduction in computing a corporation's taxable income equal to 5/2 of any tax payable by it for the year under Part VI.1 on dividends paid on taxable preferred shares. The purpose of this deduction is to permit an approximate offset of any Part VI.1 tax payable for a year against the corporate income tax payable either for the year, or for another year through the non-capital loss carry-back and carry-forward mechanism. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 5
ITA
111

Section 111 of the Act sets out the rules relating to the carryover of non-capital losses and certain other categories of loss.

Subclause 5(1) and Note
ITA
111(5)(a) and (b)

The amendment to paragraph 111(5)(a) is consequential on the inclusion in non-capital losses of amounts deductible under new paragraph 110(1)(k). Without this change and the changes to the proposed amendments to paragraphs 88(1.1)(e) and 111(5)(b) in Bill C-64 introduced in the House of Commons on June 9, 1987, the amounts included in a corporation's non-capital loss resulting from a deduction under new paragraph 110(1)(k) would cease to qualify for carry-forward or carry-back after a change in control of the corporation. The amendments to these paragraphs are applicable with respect to non-capital losses and farm losses for the 1988 and subsequent taxation years.

Subclause 5(2)
ITA
111(8)(b)(i)(A)

The amendment to clause 111(8)(b)(i)(A) of the Act ensures that the amount deductible under paragraph 110(1)(k) by a corporation of 5/2 of Part VI.1 taxes payable will be included in the computation of its non-capital loss that is available for carryover to the preceding three and subsequent seven taxation years. The amount by which the non-capital loss will be increased is the unused portion of the paragraph 110(1)(k) deduction -- that is, the portion that did not reduce the corporation's taxable income for the year in which it was deductible. This amendment is applicable to the 1988 and subsequent taxation years.

Subclauses 5(3) and (4)

These set out the effective dates for the amendments to section 111.

Clause 6

Taxable Dividends

ITA

112

Section 112 of the Act is one of the principal provision dealing with the treatment of dividends received by a corporation resident in Canada from another corporation.

Subclause 6(1)

ITA

112(2.2)

Subsection 112(1) of the Act permits a corporation to deduct taxable dividends in computing its taxable income. New subsection 112(2.2) denies the intercorporate dividend deduction for dividends on certain shares issued after 8 p.m. EDT, June 18, 1987 which are guaranteed by a bank or other specified financial institution. This applies where a "specified financial institution" (other than the issuer, a person related to the issuer or an individual other than a trust) has undertaken to protect a shareholder or a specified person (as defined) in relation to the shareholder from sustaining a loss on the share. The amendments to paragraphs 112(2.2)(a) and (b) ensure that the intercompany dividend deduction will not apply where a specified financial institution has provided a guarantee to the shareholder or a specified person in relation to the shareholder with respect to the share or dividend. Subsection 112(2.2) is also amended to remove the existing paragraph 112(2.2)(d) and (e) exceptions for publicly listed shares issued by a specified financial institution.

Subsection 112(2.2) as amended will also apply to a dividend on a particular share where a specified financial institution has guaranteed or insured the investment in, or return on, any share or debt that was issued or acquired as part of a transaction or event or a series of transactions or events that included the issuance or acquisition of the particular share. This ensures that this subsection will apply to dividends on shares that would not otherwise be subject to subsection 112(2.2) but are issued in conjunction with guaranteed shares or debt.

The changes to subsection 112(2.2) will generally apply only to dividends paid on shares issued after 8:00 p.m. EDT, June 18, 1987. However, amended subsection 112(2.2) will also apply to a share issued before that time where a guarantee in respect of the share has been provided after that time. New paragraph 112(2.2)(e) treats the share as having been issued at the time that the guarantee was provided.

The expression "specified person" in relation to a specified financial institution and to a corporate shareholder is defined in the definition of taxable preferred share in subsection 248(1) of the Act.

The amendments to subsection 112(2.2) apply to dividends received on shares issued after 8:00 p.m. EDT, June 18, 1987 other than a dividend received on a prescribed share, a taxable preferred share, a grandfathered share or a preferred share issued by a corporation in financial difficulty.

Subclause 6(2)

ITA

112(2.3)

Subsection 112(2.3) denies a deduction under subsection 112(1) or (2) or 138(6) to a corporation in respect of a dividend received by it on a "short-term preferred share" unless the payer corporation was not at arm's length with the recipient corporation at the time the dividend was paid. Subsection 112(2.3) has been amended to change the exception from its application from a non-arm's-length test to a related-person test. Thus the subsection denies a deduction for all short-term preferred share dividends except where the recipient corporation was related (otherwise than by reason of paragraph 251(5)(b)) to the payor corporation at the time the dividend was paid. See also the amendment to the expression "short-term preferred share" in subsection 248(1) of the Act. This amendment applies for dividends received on short-term preferred shares issued after 8 p.m. EDT, June 18, 1987.

Subclause 6(3)

ITA

112(8)

Subsection 84(3) of the Act provides that where a corporation resident in Canada has paid an amount on the redemption, acquisition or cancellation of a share of its capital stock, a dividend equal to the excess of the amount paid over the paid-up capital of the share is deemed to have been paid by the corporation and received by the shareholder. Paragraph 55(3)(b) of the Act permits, as part of what is generally referred to as a "butterfly" reorganization, the distribution of assets by a corporation to its shareholders on a tax-deferred basis.

In order to permit such a reorganization to occur without any other immediate tax consequences, new subsection 112(8) provides that, where an amount that is deemed by subsection 84(3) of the Act to be a dividend in those circumstances where, but for paragraph 55(3)(b) the amount would not be treated as a dividend, the amount will not fall within the scope of new Part IV.1 and VI.1. As a consequence, in these circumstances the intercorporate dividend deduction will not be denied by subsections 112(2.1), (2.2), (2.3) and (2.4) of the Act.

New subsection 112(8) is applicable with respect to dividends received after June 18, 1987.

Subclause 6(4), (5) and (6)

These set out the effective dates for the amendments to section 112.

Clause 6 Note
Related Corporations

ITA
112(2.9)

Effective after June 18, 1987, this change to subsection 112(2.9) extends to subsections 112(2.2) and (2.3), the application of the special anti-avoidance rule provided in new subsection 112(2.9). Thus, where two corporations become related in order to qualify for the related company exception to the application of subsection 112(2.3) or to qualify for the exception for related company guarantees provided in subsection 112(2.2), the corporations will be deemed not to be related for the purposes of these subsections.

Clause 7
Instalments

Subclauses 7(1) and (2)
ITA
157(1)

Subparagraph 157(1)(a)(i) of the Act contains a formula by which a corporation may calculate its Part I income tax instalments, based upon its estimate of such tax payable for the year.

Subparagraph 157(1)(a)(i) is amended to integrate the instalment requirements for tax payable under Part I and new Part VI.1. This change is necessary because new Part VI.1 tax payable on dividends for a year may offset Part I tax payable on income for the year. The amendment will ensure that a corporation's Part I tax instalments for a year are not inappropriately reduced where Part VI.1 tax is payable for the year. Absent this change, in the first year Part VI.1 tax was payable by a corporation it could estimate its Part I tax payable for the year after claiming a deduction under paragraph 110(1)(k) in computing its taxable income of 5/2 of its Part VI.1 tax payable for the year. The result is that its Part I tax instalments for the year might be reduced yet its Part VI.1 tax instalments would be nil since it had no Part VI.1 payable for the preceding year.

An amendment to paragraph 157(1)(b) combines Part I and Part VI.1 tax for purposes of determining the remainder of tax payable by a corporation at the final tax payment date for a year. Consequential

changes to Income Tax Regulation 5301 combine Part I tax and the new Part VI.1 tax for the purposes of determining the first and second instalment bases referred to in subparagraphs 157(1)(a)(ii) and (iii).

The amendments to paragraphs 157(1)(a) and (b) apply to the 1988 and subsequent taxation years.

Subclause 7(3)
ITA
157(2)

Subsection 157(2) of the Act is amended to provide that the relief from the instalment provisions for a credit union with taxable income not exceeding \$10,000 will apply only where it has no Part VI.1 tax for the year or the preceding year.

Subclause 7(4)
ITA
157(2.1)

Subsection 157(2.1) of the Act is amended to provide that the relief from the instalment provisions for a corporation with Part I tax payable or a first instalment base not exceeding \$1,000 for a year be amended to add a reference to the corporation's Part VI.1 tax for the year.

Subclause 7(5)

This sets out the effective dates for the amendments to section 157, all of which are applicable to the 1988 and subsequent taxation years.

Clause 8
Interest on Unpaid Taxes

Subclauses 8(1) and (2)
ITA
161(4.1)(a)

Subsection 161(4.1) of the Act charges interest on the late or deficient instalments of a corporation based on its actual Part I tax payable for the year. Paragraph 161(4.1)(a) is amended to add a reference to the Part VI.1 tax payable by the corporation for the year. This change is consequential on the amendments to section 157 that integrate the instalment requirements for tax payable under Part I and new Part VI.1.

The amendment to paragraph 161(4.1)(a) is effective for the 1988 and subsequent taxation years. However, where the 1988 taxation year commences in 1987, interest on late or deficient instalments will be determined as if Part VI.1 tax were not payable by the corporation for the year. Therefore, no interest will be charged for this year if the

payment of Part VI.1 tax is made on the final tax payment date for the year. In addition, for such year the effect of the deduction under paragraph 110(1)(k) on the computation of a corporation's Part I tax instalments is ignored.

Clause 9
Part IV

The purpose of Part IV of the Act is to prevent the deferral of tax on portfolio dividend income through the use of a private or closely-held corporation. While dividends received by individuals are subject to tax in their hands, corporations are generally permitted, under sections 112 and 113, to deduct such amounts in computing their taxable income. To counter the incentive for individuals to defer tax on their dividend income by transferring their portfolio shareholdings to a corporation, Part IV imposes a refundable tax (presently at the rate of 33-1/3 per cent) on portfolio dividends received by private and other closely-held corporations. This tax is refunded to the corporation when dividends are distributed to its shareholders since individual shareholders will then be subject to tax at their marginal rates on the distribution.

Subclause 9(1)
ITA
186(1)(b)

Where a corporation that has paid tax under Part IV or has paid refundable taxes on other investment income subsequently pays dividends, it is entitled to a refund of such taxes. Where such dividends are received by a connected corporation, paragraph 186(1)(b) imposes Part IV tax on the receipt of the dividend of an amount calculated by reference to the dividend refund in respect thereof obtained by the corporation that paid the dividend.

New subsections 112(2.2) and (2.3) of the Act apply in certain circumstances to deny the intercorporate dividend deduction in respect of dividends received by a corporation. Where this occurs, Part IV tax should not apply since the corporation is fully taxed on these dividends under Part I of the Act. The amendment to paragraph 186(1)(b) excludes taxable dividends received from a connected corporation from the base on which Part IV tax is calculated in those circumstances where the dividend is not deductible under section 112(1) of the Act. A similar exclusion is provided in paragraph 186(1)(a) for non-deductible dividends received from a non-connected corporation. This amendment to paragraph 186(1)(b) is applicable to dividends received after June 18, 1987.

Subclause 9(2)

ITA

186(1.1)

New subsection 186(1.1) of the Act is consequential on the addition of new Part IV.1 which imposes a 10% tax on certain dividends received by a corporation. The tax under both Part IV and Part IV.1 can apply with respect to the same dividend received by a corporation. New subsection 186(1.1) provides that where a dividend is subject to tax under both Parts, the Part IV.1 tax payable on the dividend will be deducted from the Part IV tax otherwise payable on the same dividend. This amendment is applicable to dividends received after June 18, 1987.

Subclause 9(3)

ITA

186(6)

New subsection 186(6) of the Act sets out rules that clarify, for purposes of Part IV, the tax treatment of dividends received by partnerships for fiscal periods ending after June 18, 1987. These rules provide for the flow-through of dividends received by a partnership and they consider each partner to own the same proportion of a corporation's shares owned by a partnership in a fiscal period as the partner's share of dividends received by the partnership on such shares in the period.

Subclauses 9(4) and (5)

These set out the effective dates for the amendments to section 186.

Clause 10

Part IV.1

New Part IV.1 of the Act provides for two special taxes to be paid by certain corporations on dividends received by them after 1987 on a "taxable preferred share" or a "taxable SFI share" as defined in subsection 248(1) of the Act.

Subclause 10(1)

Tax on dividends on taxable preferred shares

ITA

187.1 and 187.2

New subsection 187.2 of the Act imposes a 10% tax on dividends other than "excepted dividends", received after 1987 by a corporation, on a "taxable preferred share" other than a share of a class subject to the special election provided in subsection 191.2(1). The tax payable for a taxation year must be paid by it on or before the last day of the

second month following the end of its year. A "taxable preferred share" is defined in subsection 248(1) to include most preferred shares, including convertible preferred shares, issued after 8:00 p.m. EDT June 18, 1987.

Excepted dividends, as defined in new section 187.1, include dividends received by a corporation that was an "excepted corporation". This expression is defined in new section 187.1 as

- a private corporation
- an investment corporation
- a mutual fund corporation
- a prescribed investment contract corporation
- a prescribed venture capital corporation, or
- a prescribed labour-sponsored venture capital corporation.

Such a corporation will not be an excepted corporation, however, if it is a prescribed corporation, a specified financial institution (as defined in subsection 112(2.1) of the Act) or a corporation

- that is controlled in any manner whatever by one or more corporations that are not excepted corporations, or
- in which a specified financial institution or any other corporation that is not an excepted corporation has a "substantial interest"

For this purpose new subsection 191(2) applies to determine whether a corporation has a substantial interest in another corporation. Generally, a corporation is considered to have a substantial interest in another corporation if it is related to the other corporation or if it owns 25% or more, in terms of votes and value, of the shares of the other corporation.

The 10% tax is payable on dividends on "taxable preferred shares" in respect of which the recipient corporation may claim an intercorporate dividend deduction under subsections 112(1) and 138(6) or section 113 in computing its taxable income for the year. The tax is not payable on dividends on such shares where the corporation paying the dividends has made a special election in respect of the relevant class of shares under new subsection 191.2(1). Reference may be made to the commentary under that provision.

An "excepted dividend" will also include

- a dividend received by a corporation on a share of its foreign affiliate that was not acquired in the ordinary course of its business,
- a dividend received by a corporation on a share of another corporation in which it has a substantial interest at the time the dividend was paid, and

- a dividend received by a corporation at a time when it was an "excepted corporation", and
- a dividend received by a corporation on a share of the capital stock of an "excluded corporation" (as defined in subsection 191(1)) at the time the dividend was paid.

Tax on dividends on taxable SFI shares

ITA

187.3

New Section 187.3 of the Act levies a 10% tax on dividends, other than "excepted dividends", received after 1987 by a specified financial institution on a "taxable SFI share" that is acquired after 8:00 p.m. EDT, June 18, 1987. This tax applies to dividends received after 1987 and must be paid on or before the last day of the second month following the end of the institution's taxation year. A taxable SFI share is defined in subsection 248(1) to include most preferred shares that were issued before 8:00 p.m. EDT, June 18, 1987 and are not term preferred shares.

New subsection 187.3(2) treats a share that is acquired by a person or partnership after 8:00 p.m. EDT, June 18, 1987 as having been acquired before that time and thus not subject to the new tax under section 187.3, if it was acquired pursuant to an agreement in writing entered into before that time or if it was acquired in the circumstances outlined in paragraph (b) from a related person.

However, an important exception in the taxable SFI share definition will permit a specified financial institution to avoid the 10% tax on dividends received on shares that would otherwise be taxable SFI shares as long as it acquires no more than certain threshold amounts. Reference should be made to the commentary under the definitions of such shares and to proposed Regulation 6201(4).

The 10% tax is not payable by a specified financial institution on an "excepted dividend" as that expression is defined in paragraph 187.1(b).

Partnerships

ITA

187.4

New section 187.4 of the Act sets out rules that clarify, for purposes of new Part IV.1, the tax treatment of dividends received by partnerships after June 17, 1987. These rules provide for the flow-through of dividends received by a partnership and they consider each partner to own a proportion of the shares owned by the partnership in a fiscal period based on the partner's share of the dividends received by the partnership on such shares in the period.

Information return

ITA

187.5

New section 187.5 of the Act requires a corporation liable to pay tax under new Part IV.1 for a taxation year to file a return containing an estimate of its tax payable under section 187.2 and 187.3 for the year.

Provisions applicable to Part

ITA

187.6

New section 187.6 of the Act provides that certain provisions of Part I relating to assessments, penalties, objections and appeals are applicable for the purposes of the taxes payable levied under Part IV.1.

Subclause 10(2)

Subclause 10(2) provides that the new Part IV.1 tax is applicable with respect to dividends received after 1987.

Clause 11

Part VI.1

New Part VI.1 of the Act has been added to provide for a special tax to be paid with respect to dividends, other than excluded dividends, paid by corporations after 1987 on taxable preferred shares. The purpose of this tax is to make the tax system more neutral as between debt and preferred share financing. The Part VI.1 tax may be offset against Part I tax by way of a deduction provided by new paragraph 110(1)(k) so that the overall tax liability for those corporations with Part I tax payable will remain largely unaffected by the special Part VI.1 tax. As explained below, a \$500,000 annual dividend allowance will exempt from the tax dividends on preferred shares paid by most small corporations. The tax does not apply with respect to dividends paid by excluded corporations.

Definitions

ITA

191(1)

New subsection 191(1) defines certain expressions used in new Part VI.1. The term "excluded corporation" is defined to be a corporation that is either an investment corporation, a mortgage investment corporation, a mutual fund corporation, a prescribed investment contract corporation, a prescribed venture capital corporation, a prescribed labour-sponsored venture capital corporation

or a "private holding corporation" as defined in subsection 191(1). A corporation will not be an excluded corporation, however, if it is either a prescribed corporation, a specified financial institution or a corporation

- that is controlled in any manner whatever by one or more specified financial institutions or corporations which are not excluded corporations, or
- in which a specified financial institution or a corporation that is not an excluded corporation has a substantial interest. New subsection 191(2) defines substantial interest for this purpose.

The term "private holding corporation" is defined as a private corporation that does not have a substantial interest in another corporation and has as its only undertaking the investment of funds. A private holding company will not be taxable under Part VI.1.

Excluded dividends on taxable preferred shares are not subject to the Part VI.1 tax. The term "excluded dividends" means dividends paid by a corporation at a time when that corporation was an excluded corporation and dividends paid to a shareholder that, at the time the dividend was paid, had a "substantial interest" (as defined in new subsection 191(2)) in the paying corporation.

Substantial interest
ITA
191(2), (3) and (4)

New subsection 191(2) of the Act describes the circumstances in which a shareholder has a substantial interest in a corporation. A shareholder has a substantial interest in a corporation where the shareholder is related to the corporation (otherwise than by reason of a right referred to in paragraph 251(5)(b)) or where the shareholder owns shares of that corporation representing, in terms of votes and value, 25% or more of its issued shares. For this purpose, shares owned by persons related to a shareholder are considered to be owned by the shareholder. In addition, under new subsection 191(4), partnerships and trusts will be considered not to have a substantial interest in any corporation.

New subsection 191(3) is an anti-avoidance rule that treats a shareholder of a corporation as not having a substantial interest in another corporation where it is reasonable to consider that the principal purpose for acquiring the interest in the other corporation was to avoid or limit the application of Part IV.1 or VI.1.

Tax payable
ITA
191.1(1)

New subsection 191.1(1) of the Act provides for a tax to be paid by a corporation that has paid taxable dividends on taxable preferred shares. This tax applies to dividends, other than excluded dividends, paid after 1987 and is to be paid by way of monthly instalments, as provided by amended subparagraph 157(1)(a)(i).

Where no election has been made under section 191.2, the tax to be paid is equal to 25% of the amount by which the taxable dividends (other than excluded dividends) paid by the corporation in the year on its taxable preferred shares exceeds the corporation's dividend allowance for the year. As discussed in the commentary on the definition of "taxable preferred share" in subsection 248(1), these are preferred shares issued after 8:00 p.m. EDT, June 18, 1987.

Where the corporation has made an election under subsection 191.1(2) in respect of a class of its taxable preferred shares, the rate of this tax will be 40%. Reference should be made to the commentary on subsection 191.2(1) relating to this election.

A parent corporation and its subsidiary may also agree under subsection 191.3(1) that the subsidiary will pay any Part VI.1 tax otherwise payable by the parent corporation. The purpose of this provision is described in the commentary on subsection 191.3(1).

New Part VI.1 tax is not payable in respect of "excluded dividends" as defined in subsection 191(1). These are dividends paid by a corporation that is an "excluded corporation" and dividends paid by a corporation to a shareholder that, at the time the dividend was paid, had a substantial interest in the paying corporation.

The Part VI.1 tax is payable only in respect of dividends paid on taxable preferred shares (other than excluded dividends) by the corporation in excess of its dividend allowance for the year. As explained in the commentary under subsection 191.1(2), the dividend allowance for a taxation year of a corporation or corporate group is \$500,000 less the amount of non-excluded dividends paid on taxable preferred shares in the preceding calendar year in excess of \$1,000,000.

Dividend allowance
ITA
191.1(2), (3), (4), (5) and (6)

A corporation will generally pay tax under Part VI.1 only on dividends on taxable preferred shares (other than excluded dividends) paid by it in excess of its dividend allowance. New subsections 191.1(2) to (6) of the Act set out the rules applicable for the computation of a

corporation's dividend allowance. These rules parallel the rules used in determining a corporation's business limit for the purposes of the small business deduction under section 125.

New subsection 191.1(2) deems a corporation's dividend allowance for a taxation year to be \$500,000 where the corporation is not associated with another corporation in the year. This amount, however, is subject to a clawback that reduces it on a dollar-for-dollar basis by the amount of non-excluded dividends in excess of \$1,000,000 paid by the corporation on its taxable preferred shares in the preceding calendar year.

New subsections 191.1(3), (4) and (5) of the Act apply for the purpose of determining the dividend allowance of associated corporations. A total dividend allowance is first determined for a group of associated taxable Canadian corporations. Under subsection 191.1(4), this total dividend allowance is \$500,000 less the excess over \$1,000,000 of non-excluded dividends paid on taxable preferred shares in the preceding calendar year by the corporations in that group. These corporations may then allocate the total dividend allowance among the group by filing a prescribed agreement under new subsection 191.1(3) of the Act. If such agreement is not filed by any corporation of the group that has paid dividends on taxable preferred shares in the year, the Minister of National Revenue may make the allocation under new subsection 191.1(5).

New paragraph 191.1(6)(a) of the Act applies to all corporations, whether or not associated, and requires a proration of the dividend allowance for any taxation year of less than 51 weeks duration. It provides that a corporation's dividend allowance for a short taxation year is its dividend allowance otherwise determined multiplied by the number of days in the year and divided by 365.

New paragraph 191.1(6)(b) of the Act is applicable where a corporation has two or more taxation years ending in the same calendar year in which it is associated with another corporation. This rule provides that the corporation's dividend allowance (before proration for the short year) for each such taxation year is the amount allocated to it for its first such taxation year under subsection 191.1(3). The corporation's dividend allowance for each such year is then determined after the required proration pursuant to new paragraph 191.1(6)(a).

Election

ITA

191.2

The rate of Part VI.1 tax on dividends paid on taxable preferred shares of a class in respect of which a corporation has made an election under new section 191.2 is 40% instead of 25%. The effect of the election to pay the 40% is to enable shareholder corporations to receive dividends without being subject to the 10% tax under Part IV.1.

An election may be made by a corporation in respect of a class of its taxable preferred shares only if the terms and conditions applicable to the shares require that this election be made. According to new section 191.2, the election is to be made by filing a prescribed form with the Minister not later than the day on or before which a return of income must be filed by the corporation under Part I for the taxation year in which shares of that particular class of shares are first issued.

Agreement respecting liability for tax
ITA
191.3

New section 191.3 allows a corporation that is liable to pay tax under Part VI.1 in a taxation year and a corporation controlled by it to file an agreement whereby all or a portion of the Part VI.1 tax liability is transferred to the controlled corporation. This will prove advantageous to holding corporations that do not pay Part I tax against which they can offset any Part VI.1 tax through the special deduction provided by paragraph 110(1)(k).

This agreement may only be made where a corporation (the parent corporation) controls another corporation throughout its taxation year. Where the taxation year of the parent corporation is less than 365 days, the parent corporation must also control the other corporation throughout that part of the calendar year in which the parent's taxation year ends that precedes the beginning of that taxation year.

Under new subsection 191.3(1), the agreement must be filed by the parent corporation and the controlled corporation with the Minister of National Revenue in prescribed form no later than the day on which the parent corporation's tax return under Part I is required to be filed for its taxation year in which Part VI.1 tax would otherwise be payable by it. Subsection 191.3(2) requires that the agreement be accompanied by a certified copy of a resolution of the directors (or the persons legally entitled to administer the affairs of the corporation) of both the parent and controlled corporation authorizing such an election.

As a result of this agreement, the amount of tax specified in the agreement will be included in the Part VI.1 tax payable by the controlled corporation and will be deducted from the amount of Part VI.1 tax otherwise payable by the parent corporation. Both corporations remain jointly and severally liable to pay the tax. Thus, new subsection 191.3(3) permits the Minister to assess the parent corporation in respect of the agreed amount of tax and provides that certain provisions of Part I relating to assessments, penalties, objections and appeals are then applicable.

New subsection 191.3(4) provides that where payment is made by the parent corporation on account of this joint liability, the joint liability is reduced accordingly. However, any payment by the controlled corporation will reduce the parent corporation's liability only to the extent of the excess, if any, of the joint liability over what is the controlled corporation's remaining liability under the Act after the payment. In effect, this treats a tax payment by the controlled corporation as applying first against its other tax liabilities under the Act.

Information return

ITA

191.4

New subsection 191.4(1) of the Act requires a corporation liable for any tax under new Part VI.1 for a taxation year to file a return containing an estimate of its tax payable for the year. The return is to be filed on or before the date on which its Part I corporate tax return is required to be filed.

New subsection 191.4(2) of the Act provides that certain provisions of Part I relating to assessments, penalties, objections and appeals are applicable to the tax under Part VI.1.

Subclause 11(2)

The Part VI.1 tax is applicable to the 1988 and subsequent taxation years but only with respect to dividends paid after 1987.

Clause 12

Application to other Parts

Subclause 12(1)

ITA

227(14)

Subsection 227(14) of the Act provides that a corporation is not liable to tax under Part III, IV or VI of the Act for any period of time during which it was exempt from Part I tax by reason of section 149 of the Act. This provision is amended effective for the 1988 and subsequent taxation years as a consequence of the introduction of new Parts IV.1 and VI.1 to provide that those new Parts do not apply to any corporation while it is tax-exempt under section 149.

Clause 13

Definitions

Subsection 248(1) of the Act defines many of the terms used in the Act.

Subclause 13(1)

"Short-term preferred share"

The definition "short-term preferred share" is to be amended for shares issued after 8:00 p.m. EDT, June 18, 1987. Under existing subsection 112(2.3) of the Act dividends received by a corporation on a short-term preferred share are not deductible in computing its taxable income unless the corporation does not deal at arm's length with the dividend-paying corporation. In general, a share which was issued in lieu of commercial paper or short-term debt and that may be retracted within 18 months of its issue falls within the existing definition short-term preferred share.

The amended definition of short-term preferred share generally applies to shares that are taxable preferred shares (as defined) and are issued after 8:00 p.m. EDT, June 18, 1987. The requirement that the share be issued in lieu of commercial paper or short-term debt is no longer included in the definition. In addition, under paragraph (a), the 18-month retraction period is extended so that a share will be a short-term preferred share if the issuing corporation or a "specified person" in relation to the issuer may under the terms of the share or an agreement in respect of the share be required to redeem, acquire or cancel, in whole or in part, the share or to reduce its paid-up capital within 5 years of the date of issue. The expression "specified person" is defined in paragraph (i) of the definition of taxable preferred share and means any other person with whom the corporation does not deal at arm's length or any partnership or trust of which the corporation or the other person is a member or beneficiary.

A short-term preferred share also includes a share that is convertible or exchangeable within 5 years from the date of its issue, except in those circumstances where the share is only convertible or exchangeable into a share that if issued would not be a short-term preferred share, or into a right or warrant to acquire a share that is not a short-term preferred share, or both and all or substantially all of the consideration receivable upon the conversion or exchange is the share, right, warrant or combination thereof.

Paragraphs (c) to (e) of the definition exclude shares of a mutual fund corporation, shares issued by a corporation in a financial difficulty as described in paragraph (e) of the definition "term preferred share", and a prescribed share.

Paragraphs (f) to (m) of the definition provide a number of supplementary rules.

A share is a short-term preferred share only where it was issued after 8:00 p.m. EDT, June 18, 1987. When, after that time, the terms or conditions of a share issued before that time are changed, or any

agreement in respect of that share is changed or entered into relating to the share's redemption, acquisition, cancellation, conversion or reduction of its paid-up capital, paragraph (f) will treat the share as having been issued at that later time. This rule is necessary to prevent the use of a share that was issued before 8:00 p.m. EDT, June 18, 1987 to circumvent the rule.

Paragraph (g), which is similar to existing paragraph (h) of the definition, anticipates the possibility that a share with unusual characteristics (for example, one with a very low paid-up capital in relation to a relatively high stipulated dividend rate) might be issued jointly with a debt obligation or a short-term preferred share (with a very low or nil interest or dividend rate) in order to circumvent the provisions of subsection 112(2.3). Where one of the main purposes of the issue of such a share is to avoid or limit the application of subsection 112(2.3), this paragraph treats it as a short-term preferred share.

Paragraph (h) treats a share as a short-term preferred share if, after 8:00 p.m. EDT, June 18, 1987, the terms of the share are established or modified or any agreement in respect of the share has been changed or entered into so that it is reasonable to expect that the share will be redeemed within 5 years of its date of issue. This might apply, for example, in the case of a redeemable share issued for an indefinite term but on which the rate of dividends or redemption premium is scheduled to increase sharply at sometime within 5 years from its date of issue. In this case the share could reasonably be expected to be redeemed before any such increase would take effect.

Paragraph (i) also treats a share as a short-term preferred share in circumstances where the issuing corporation will dissolve or wind up within 5 years from the date the share was issued.

Paragraph (j) applies to a share issued by a corporation to a specified person in relation to the corporation in circumstances where the share is subsequently sold in an arm's length sale. In this situation, for the purposes of the 5-year test, the share is treated as having been issued at the time of the subsequent sale.

Paragraph (k) of the definition will treat a share as a short-term preferred share where any person (other than the issuing corporation or an individual) has undertaken to guarantee all or part of the shareholder's investment against any loss that he may suffer within 5 years of the issue or deemed issue of the share.

Paragraph (l) confirms that a taxable preferred share will not fall within the definition of short-term preferred share by virtue of an exchange agreement under which the corporation or a specified person in relation to the corporation has agreed to acquire the share solely in consideration for a share other than a short-term preferred share.

The new definition of short-term preferred share applies with respect to shares issued or treated as having been issued after 8:00 p.m. EDT, June 18, 1987.

Subclause 13(2)

"grandfathered share"

This amendment adds the definition "grandfathered share" to subsection 248(1) of the Act. Grandfathered shares are expressly excluded from the definitions in subsection 248(1) of "short-term preferred share" and "taxable preferred share". Under the definition a share is a grandfathered share if it is issued after 8 p.m. EDT, June 18, 1987 and before 1988 pursuant to an agreement made or a public distribution made in accordance with a prospectus or similar document filed before 8:00 p.m. EDT, June 18, 1987.

"specified financial institution"

This amendment adds the definition "specified financial institution" to subsection 248(1) of the Act. The status of a taxpayer as a specified financial institution is relevant in determining the tax consequences of subsections 112(2.1) and (2.2), new Parts IV.1 and VI.1, the definitions "short-term preferred share" and "taxable SFI share" and other provisions of the Act. A specified financial institution is defined to have the meaning assigned by subsection 112(2.1), namely, a corporation described in any of paragraphs 39(5)(b) to (f) or a corporation controlled by or associated with such a corporation. These corporations include banks, trust companies, credit unions, insurance corporations and loan and mortgage companies.

"taxable preferred share"

This amendment adds the definition "taxable preferred share" to subsection 248(1).

This definition is used for the purpose of determining which dividends will be subject to the new taxes levied under Part IV.1 or VI.1 of the Act.

Under this definition, a share is a taxable preferred share if it is issued after 8:00 p.m. EDT, June 18, 1987 and:

- (a) the amount of any dividend on the share is fixed or limited to a maximum or minimum amount,
- (b) the amount that a shareholder is entitled to receive for the share upon the dissolution, liquidation or winding-up of the issuing corporation, or on the redemption, acquisition or cancellation of the share is fixed or limited to a maximum or minimum amount,

- (c) the share is convertible, except in those circumstances where the share is only convertible into a share that if issued would not be a taxable preferred share or a right or warrant to acquire such a share, or both and all or substantially all the consideration receivable upon the conversion is the share, right, warrant or combination thereof.
- (d) any person, other than the issuing corporation, has undertaken (in an agreement with the issuing corporation or a person related to it) to guarantee or insure the shareholder's investment in or return on the share.

Excepted from this definition is a share issued in a financial difficulty situation described in paragraph (e) of the definition "term preferred share".

Paragraphs (e) to (j) of the definition provide a number of supplementary rules.

Paragraphs (e) and (f) of the definition treat a shareholder's entitlement to dividends or an amount on liquidation of the issuing corporation as not being fixed or limited where such entitlement is determined by reference to the entitlement of another share that would not be a taxable preferred share if this definition were read without reference to paragraph (h).

As noted above, the definition of taxable preferred share applies only where the share was issued after 8:00 p.m. EDT, June 18, 1987. Where the terms or conditions of a share issued before that time, or an agreement in respect of that share, are changed to affect any of the matters referred to paragraphs (a) to (d), paragraph (g) will treat the share as having been issued at the time of the change for the purposes of determining whether the share is a taxable preferred share.

Paragraph (h) will prevent a share from falling within the definition of taxable preferred share solely by virtue of a purchase and sale agreement under which a purchaser has agreed to buy the share at its fair market value.

The amended definition of taxable preferred share applies with respect to shares issued, or deemed to be issued, after 8:00 p.m. EDT, June 18, 1987.

"taxable SFI share"

This amendment adds the definition "taxable SFI share" to subsection 248(1) of the Act.

New section 187.3 of the Act imposes a tax of 10% on dividends received by specified financial institutions on taxable SFI shares acquired after 8:00 p.m. EDT, June 18, 1987.

A "taxable SFI share" is a share issued before 8:00 p.m. EDT, June 18, 1987 which is not a term preferred share, a short-term preferred share or a share issued by a corporation in financial difficulty as described in paragraph (e) of the definition "term preferred share and if:

- (a) the amount of any dividend on the share is fixed or limited to a maximum or minimum amount, or
- (b) the amount that a shareholder is entitled to receive for the share upon the dissolution, liquidation or winding-up of the issuing corporation is fixed or limited to a maximum or minimum amount.

Paragraphs (c) and (d) of the definition treat a shareholder's entitlement to dividends or an amount on liquidation of the issuing corporation as not being fixed or limited where such entitlement is determined by reference to the entitlement of a share that is not a taxable preferred share.

The definition of "taxable SFI share" applies only where the share was issued before 8:00 p.m. EDT, June 18, 1987. Where the terms or conditions of a share issued before that time are changed or an agreement in respect of that share is changed or entered into which affects any of the matters referred to paragraph (a) or (b), paragraph (e) will treat the share as having been issued at the time of the change for the purposes of determining whether the share is a taxable SFI share.

Since taxable SFI shares cannot by definition be term preferred shares, specified financial institutions holding such shares are generally entitled to the intercorporate dividend deduction under subsection 112(1) for dividends received on such shares. Subsection 187.3 imposes a 10% tax on dividends received after 1987 on taxable SFI shares acquired after 8 p.m. EDT, June 18, 1987 other than shares acquired pursuant to a written agreement entered into before that time or shares deemed to be acquired before that date under paragraph 187.3(b) (essentially acquisitions from a related person who held the shares before 8 p.m., EDT, June 18, 1987).

The definition of taxable SFI shares permits an exclusion for prescribed shares. For this purpose, Regulation 6201(4) prescribes certain shares acquired after June 18, 1987 not to be taxable SFI shares. Under that paragraph a share of a class of the capital stock of a corporation will be a prescribed share at the time a dividend is received with respect to a corporation holding the share if, the

aggregate holdings of the corporation and persons with which the corporation does not deal at arm's length (referred to herein as the group) in shares of that class at that time does not exceed certain limits.

These rules are designed to preserve the prescribed status of a share so long as additional shares are not acquired that would increase the group's holdings to a level above the size limits for group holdings at the time of the receipt of a dividend.

If, at the time a dividend is received by a corporation with respect to shares of a class, none of the shares of the class owned by any member of the group (other than those acquired from another member of the group) were acquired after 1987, those shares will be prescribed shares only if the total group holding at the time does not exceed 10% of the shares of that class.

If, at the time a dividend is received by a corporation with respect to shares of a class, all of the shares of the class owned by any member of the group (other than those acquired from another member of the group) were acquired before 1989 and that holding of the group included shares acquired in 1988, those shares will be prescribed shares only if the total group holding does not exceed 5% of the shares of the class at that time.

If, at the time a dividend is received by a corporation with respect to shares of a class, any of the shares of the class owned by the corporation and any other member of the group (other than those acquired from another member of the group) were acquired after 1989, those shares will be prescribed shares only if the total group holding does not exceed 2% of the shares of the class at that time.

The rule in Regulation 6201(5) provides that shares disposed of will be considered to be disposed of on a last-in, first-out basis. The effect of this rule is illustrated in the following example. Assume that a financial institution holding 10% of the shares of a class in 1987 acquired additional shares of that class in 1988, because of the acquisition, the 5% holding threshold for 1988 applies and all shares will therefore no longer qualify as prescribed shares. Thus, all such shares would qualify as taxable SFI shares and any dividends received by the financial institution on such shares would be subject to the 10% tax under section 187.3. On a subsequent sale of the number of shares acquired in 1988, the last-in first-out rule will treat the institution as not owning any shares that it acquired after 1987. As a result, after the sale, the remaining shares will again qualify as prescribed shares and will continue to qualify as such until such time as the institution acquires additional shares of that class.

Subclause 13(3)

ITA

248(1)

"amount"

The amendment to the definition of "amount" in subsection 248(1) of the Act is consequential on the addition of new Part VI.1 to the Act relating to taxable preferred shares. The amendment adds a reference to Part VI.1 and subsections 258(3) and (5) for the purpose of determining the amount of a stock dividend. Thus, for the purposes of the new Part VI.1 tax and the special rules that deny the intercorporate dividend deduction in respect of certain shares, the amount of a stock dividend paid by a corporation will be the greater of the amount of the resultant increase in the corporation's paid-up capital and the fair market value of the stock dividend at the time of its payment. This amendment is applicable with respect to dividends paid or received after June 18, 1987.

Subclauses 13(4), (5), (6) and (7)

"term preferred share"

ITA

248 (1)

Paragraph (e) of the definition "term preferred share" in subsection 248(1) of the Act excludes shares issued by a corporation in financial difficulty. The amendment to subparagraph (e)(iii) of the definition clarifies that if a corporation is, or is expected to be, in default on a debt obligation and a share is issued in exchange for the obligation, the share will be excluded from the definition only if all or substantially all of the share issue proceeds are used to retire the debt. New paragraph (f.1) will exclude a taxable preferred share from this definition other than a share that is a term preferred share by reason of paragraph (b) of that definition. New paragraph (i.1) confirms that a share will not fall within the definition of term preferred share solely by virtue of an exchange agreement under which the corporation or a specified person in relation to the corporation has agreed to acquire the share solely in consideration for a share other than a term-preferred share. The further amendment to the definition "term preferred share" is strictly consequential on the addition of new subsection 248(12).

Subclause 13(8)

Interests in trusts

New subsection 248(12) of the Act treats a person having a direct or indirect interest in a trust as being a beneficiary of that trust for the purposes of a number of definitions and rules in the Act.

Subclauses 13(9), (10), (11) and (12)

These subclauses set out the effective dates for the amendments to section 248.

Clause 14

Dividends on certain shares

ITA

258

Special rules are provided under the Act to disallow the intercorporate dividend deduction in respect of dividends paid on certain shares and income bonds or debentures. Section 258 complements these rules.

Subclause 14(1)

ITA

258(1.1)

New subsection 258(1.1) of the Act is an anti-avoidance provision relating to Part IV.1 and VI.1 taxes. Generally, where the paid-up capital of a share of the capital stock of a corporation that is not a public corporation is reduced otherwise than by transactions that result in a disposition of the share, a dividend is deemed to have been received by the shareholder only to the extent that the amount received exceeds the reduction of the paid-up capital of that share. This effectively allows a tax-free distribution to shareholders of an amount up to the paid-up capital of their shares. In the context of the new Part IV.1 and VI.1 taxes, such a tax-free distribution would permit a shareholder to obtain a tax-free return of capital in lieu of dividends on a taxable preferred share, a taxable SFI share or a short-term preferred share in order to defer taxation until the share is sold. New subsection 258(1.1) provides that the total amount received by a shareholder on a reduction of the paid-up capital of such a share shall be deemed to be a dividend paid and received on the share rather than only that part of the amount that exceeds the paid-up capital. This subsection is applicable to amounts received after 1987 and parallels the tax treatment under subsection 84(4.1) of an amount received on the reduction of the paid-up capital of a share of a public corporation.

Subclause 14(2)

ITA

258(3)

The amendment to subsection 258(3) of the Act clarifies the type of shares to which paragraph 258(3)(b) is intended to apply. This amendment is applicable to dividends received on shares acquired, or deemed under the said Act to be acquired, after June 18, 1987.

Subclause 14(3)
ITA
258(5)

Subsections 112(2.2), (2.3) and (2.4) of the Act disallow the intercorporate dividend deduction under subsections 112(1), (2) and 138(6) in respect of dividends paid on short-term preferred shares and on certain shares the value or yield of which is guaranteed. In the case of such dividends received by a corporation from a foreign affiliate, the disallowance of the intercorporate deduction provided by section 113 would deprive that corporation from the relief for foreign tax paid which is built into the computation of the deduction provided by section 113. In order to prevent the corporation from claiming the deduction provided by section 113, but, at the same time, to allow it to benefit from the foreign tax credit with respect to any foreign withholding tax on these dividends, new subsection 258(5) treats these dividends as interest for the purposes of their inclusion in the corporation's income and the computation of the foreign tax credit. This amendment is applicable to dividends received after June 18, 1987.

Subclauses 14(4), (5) and (6)

This sets out the effective dates for the amendments to section 258 of the Act.