

SPECIAL RELEASE

INCOME ATTRIBUTION RULES: DRAFT AMENDMENTS TO THE INCOME TAX ACT

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**Draft Changes to Tax Rules
on Income Attribution Published**

October 27, 1986

The Honourable Michael Wilson, Minister of Finance, today released draft amendments designed to simplify and strengthen the income attribution rules in the *Income Tax Act*.

Changes to the attribution rules, which are intended to prevent a taxpayer from splitting his or her income among family members to reduce the total amount of tax payable, were announced in the May 23, 1986 budget.

The Minister said that extensive consultations on the new rules have shown the need for some modifications, in particular to section 74.4 which was intended to deal with situations where income splitting is attempted through transfers to corporations rather than directly to individual family members.

The main changes proposed in the draft amendments are as follows:

- The corporate attribution rules in section 74.4 will be repealed effective for transactions after November 21, 1985 and replaced with a general anti-avoidance rule, effective after October 26, 1986.
- The attribution rules for minors will be limited to non-arm's-length minors, including nephews and nieces.
- A number of technical changes will be made to the existing rules to correct anomalies.

The new section 74.4 will require that, in cases where a taxpayer makes a loan or transfer to a corporation, the purpose of the transaction be considered in determining if the attribution rules are to apply. Where the requisite income-splitting purpose is present, the new section will require an amount of interest to be included in the taxpayer's income based on either the amount of the loan outstanding or, in the case of a transfer, the outstanding balance of the purchase price, without reference to any share consideration received in respect of the transfer.

The Minister indicated that he intends to proceed with these draft amendments as part of the bill implementing the tax changes proposed in the February 26, 1986 budget.

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DRAFT LEGISLATION: ATTRIBUTION RULES

1. (1) Subsection 74.1(2) of the said Act is repealed and the following substituted therefor:

Transfers and loans to minors

"(2) Where an individual has transferred or loaned property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who was under 18 years of age and who

(a) does not deal with the individual at arm's length, or

(b) is the niece or nephew of the individual,

any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that relates to the period in the year throughout which the individual is resident in Canada, shall be deemed to be income or a loss, as the case may be, of the individual and not of that person unless that person has, before the end of the year, attained the age of 18 years."

(2) Subsection (1) is applicable with respect to transfers of property made after May 22, 1985 and with respect to loans that are outstanding on or after May 22, 1985, except that in the case of a loan outstanding on May 22, 1985

(a) it is not applicable if the loan is repaid before 1988; and

(b) if the loan is not repaid before 1988, it does not apply to any income or loss, as the case may be, relating to any period ending before 1988.

2. (1) Subsection 74.3(2) of the said Act is repealed.

(2) Subsection (1) is applicable with respect to transfers of property made after May 22, 1985 and with respect to loans that are outstanding on or after May 22, 1985.

3. (1) Section 74.4. of the said Act is repealed.

(2) The said Act is further amended by adding thereto, immediately after section 74.3 thereof, the following section

Definition of "excluded consideration"

"74.4 (1) In this section, "excluded consideration", at any time, means consideration received by an individual that is

(a) indebtedness,

(b) a share of the capital stock of a corporation, or

(c) a right to receive indebtedness or a share of the capital stock of a corporation.

Transfers and loans to corp

(2) Where an individual has transferred or loaned property either directly or indirectly by means of a trust or by any other means whatever to a corporation and one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit either directly or indirectly by means of a trust or by any other means whatever a person who is a designated person in respect of the individual, in computing the income of the individual for any taxation year that includes a period after the loan or transfer throughout which

(a) the person is a designated person in respect of the individual and would have been a specified shareholder of the corporation if the definition "specified shareholder" in subsection 248(1) were read without reference to paragraphs (a) and (d) thereof,

(b) the individual was resident in Canada, and

(c) the corporation was not a small business corporation,
the individual shall be deemed to have received as interest in the year the amount, if any, by which

(d) the amount that would be interest on the outstanding amount of the loan or transferred property for such periods in the year if the interest were computed thereon at the prescribed rate of interest for such periods,

exceeds the aggregate of

(e) any interest received in the year by the individual in respect of the transfer or loan (other than amounts deemed by this subsection to be interest), and

(f) 4/3 of all taxable dividends received (other than dividends deemed by section 84 to have been received) by the individual in the year on shares that were received from the corporation as consideration for the transfer or as repayment for the loan that were excluded consideration at the time the dividends were received or on shares substituted therefor that were excluded consideration at that time.

Outstanding amount

(3) For the purposes of subsection (2), the outstanding amount of a transferred property or loan at a particular time is

(a) in the case of a transfer of property to a corporation, the amount, if any, by which the fair market value of the property at the time of the transfer exceeds the aggregate of

(i) the fair market value, at the time of the transfer, of the consideration (other than consideration that is excluded consideration at the particular time) received by the transferor for the property, and

(ii) the fair market value, at the time of receipt, of any consideration (other than consideration that is excluded consideration at the particular time) received by the transferor at or before the particular time from the corporation or from a person with whom the transferor deals at arm's length, in exchange for excluded consideration previously received by the transferor as consideration for the property or for excluded consideration substituted for such consideration,

(b) in the case of a loan of money or property to a corporation, the amount if any, by which

(i) the principal amount of the loan of money at the time the loan was made, or

(ii) the fair market value of the property loaned at the time the loan was made,

as the case may be, exceeds the fair market value, at the time the repayment is received by the lender, of any repayment of the loan (other than a repayment that is excluded consideration at the particular time)."

(3) Subsection (1) is applicable with respect to loans and transfers of property made after November 21, 1985.

(4) Subsection (2) is applicable with respect to loans and transfers of property made after October 26, 1986.

4. (1) Paragraphs 74.5(3)(a) and (b) of the said Act are repealed and the following substituted therefor:

"(a) subsection 74.1(1) does not apply with respect to any income or loss from the property, or property substituted therefor, that relates to the period throughout which the individual is living separate and apart from that person by reason of a breakdown of their marriage; and

(b) section 74.2 does not apply with respect to a disposition of the property, or property substituted therefor, during the period throughout which the individual is living separate and apart from that person by reason of a breakdown of their marriage, if the individual files with his return

of income under this Part for the taxation year during which the individual commenced to so live separate and apart from that person an election completed jointly with that person not to have that section apply."

(2) Subsections 74.5(4) to (8) of the said Act are repealed and the following substituted therefor:

"Idem

(4) No amount shall be included in computing the income of an individual under subsection 74.4(2) in respect of a designated person in respect of the individual who is the spouse of the individual for any period throughout which the individual is living separate and apart from the designated person by reason of a breakdown of their marriage.

Definition of "designated person"

(5) For the purposes of sections 74.3 and 74.4 and this section, "designated person" in respect of an individual, means a person

- (a) who is the spouse of the individual, or
- (b) who is under 18 years of age and who
 - (i) does not deal with the individual at arm's length, or
 - (ii) is the niece or nephew of the individual.

Back-to-back loans and transfers

(6) Where an individual has loaned or transferred property

- (a) to another person and that property, or property substituted therefor, is loaned or transferred by any person (in this subsection referred to as a "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual, or
- (b) to another person on condition that property be loaned or transferred by any person (in this subsection referred to as a "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual,

the following rules apply:

- (c) for the purposes of sections 74.1, 74.2, 74.3 and 74.4, the property loaned or transferred by the third party shall be deemed to have been loaned or transferred, as the case may be, by the individual to or for the benefit of the specified person; and
- (d) for the purposes of subsection (1), the consideration received by the third party for the transfer of the property shall be deemed to have been received by the individual.

Guarantees

(7) Where an individual is obligated, either absolutely or contingently, to effect any undertaking including any guarantee, covenant or agreement given to ensure the repayment, in whole or in part, of a loan made by any person (in this subsection referred to as the "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual or the payment, in whole or in part, of any interest payable in respect of the loan, the following rules apply:

- (a) for the purposes of sections 74.1, 74.2, 74.3 and 74.4, the property loaned by the third party shall be deemed to have been loaned by the individual to or for the benefit of the specified person; and
- (b) for the purposes of paragraphs (2)(b) and (c), the amount of interest that is paid in respect of the loan shall be deemed not to include any amount paid by the individual to the third party as interest on the loan.

Definition of "specified person"

(8) For the purposes of subsections (6) and (7), "specified person", with respect to an individual, means

- (a) a designated person in respect of the individual, or

(b) a corporation, other than a small business corporation, of which a designated person in respect of the individual would have been a specified shareholder of the corporation if the definition "specified shareholder" in subsection 248(1) were read without reference to paragraphs (a) and (d) thereof."

(3) Subsections (1) and (2) are applicable with respect to transfers of property made after May 22, 1985 and loans outstanding on or after May 22, 1985.

