SPECIAL RELEASE

DRAFT INCOME TAX AMENDMENTS:

ACQUISITIONS OF GAINS AND LOSSES

and

DEPARTMENT OF FINANCE TECHNICAL NOTES

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DEPARTMENT OF FINANCE RELEASE No 87-09

January 15, 1987

New Measures to Prevent Tax Avoidance from Offsets of Losses and Other Deductions

The Honourable Michael Wilson, Minister of Finance, today announced his intention to introduce legislation to limit transfers of losses and other deductions between unrelated corporate taxpayers.

The Minister said he has become aware of a variety of loss-trading or loss-offset transactions that are motivated largely or exclusively to avoid tax. For example, a vendor of property may use a loss corporation as an intermediary in a sale of business assets to a third party, avoiding the tax that would have been payable on a direct sale by offsetting his profit on the sale with the intermediary's losses. As another example, a loss corporation with unutilized capital cost allowances or other deductions may acquire a shell corporation with a tax liability and transfer its assets to that corporation, thereby eliminating that corporation's tax liability and, in certain circumstances, recovering its taxes paid in previous years.

The details of the changes are set out in the draft legislation and technical notes attached. The principal changes are described below:

(1) New rules will require a corporation to end its taxation year immediately before the time of a change in control occurring after January 15, 1987, and will restrict the use of losses realized or accrued up to the end of that year.

(2) New rules will treat depreciable and resource properties acquired by a corporation within the 12 months preceding a change in its control as having been acquired after control changes.

(3) An anti-avoidance rule will prevent the transfer of accrued gains to loss corporations and other arm's length taxpayers with available deductions and tax credits. Similarly, a new anti-avoidance rule will prevent the transfer of accrued losses to arm's length parties. These rules apply to transfers after January 15, 1987.

(4) New rules will limit the utilization of a corporation's unused research and development expenses following a change in control after January 15, 1987.

(5) New rules will limit so-called "seeding" and other tax avoidance transactions designed to circumvent the successor corporation rules for resource companies. These rules will be effective for acquisitions of property and changes of control after January 15, 1987.

Mr. Wilson noted: "As a matter of tax fairness, it is necessary to introduce legislation to make it clear that such transactions will not be accepted as a means of avoiding payment of taxes that are properly owing." In announcing the proposed changes the Minister confirmed his commitment to prevent the inappropriate transfer of unusable tax deductions and credits to unrelated taxpayers. The Minister also noted that as part of the consultation process respecting the draft legislation, the government will determine whether the provisions announced today should be extended to similar arrangements involving the use of partnerships and trusts established to circumvent the new rules.

For information: Harold White, Tax Policy—Legislation Division, (613) 995-2980

Draft Amendments to the Income Tax Act Relating to Acquisitions of Gains and Losses

1. (1) Paragraph 12(1)(v) of the *Income Tax Act* is repealed and the following substituted therefor:

"(v) the amount, if any, by which the aggregate of amounts determined at the end of the year in respect of the taxpayer under paragraphs 37(1)(d) to (h) exceeds the aggregate of amounts determined at the end of the year in respect of the taxpayer under paragraphs 37(1)(a) to (c.1);"

(2) Subsection (1) is applicable to taxation years ending after January 15, 1987.

2. (1) Section 13 of the said Act is amended by adding thereto the following subsection:

"(24) Notwithstanding any other provisions of this Act, where, at any time, control of a corporation has been acquired by a person or persons and within the 12-month period ending immediately before that time the corporation acquired depreciable property that was not used in a business carried on by the corporation immediately before that period, for the purpose of subparagraph (21)(f)(i) the property shall be deemed not to have been acquired by the corporation before that time and shall be deemed to have been acquired by it at that time, except that where the property was disposed of before that time for the purpose of subparagraph (21)(f)(i) the property shall be deemed to have been acquired by the corporation immediately before the property was disposed of."

(2) Subsection (1) is applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

3. (1) All that portion of subsection 33(1) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

"33. (1) In computing the income for a taxation year of a taxpayer whose business includes the lending of money on the security of a mortgage, hypothec or agreement of sale of real property, there may be deducted as a reserve, in lieu of any deduction under paragraph 20(1)(l) (*other than a deduction required by subsection 111(5.3)*), such amount as the taxpayer may claim not exceeding the *amount, if any, by which the* lesser of"

(2) All that portion of subsection 33(1) of the said Act following paragraph (b) thereof is repealed and the following substituted therefor:

"*exceeds the amount, if any, required by subsection 111(5.3) to be deducted in computing the corporation's income for the year,* but no deduction may be made under this subsection as a reserve in respect of loans made on the security of a mortgage or hypothec under the *National Housing Act* or any of the Housing Acts as defined in section 2 of the *Canada Mortgage and Housing Corporation Act*."

(3) Subsections (1) and (2) are applicable to taxation years ending after January 15, 1987.

4. (1) Subsection 37(1) of the said Act is amended by striking out the word "and" at the end of paragraph (f) thereof, by adding the word "and" at

the end of paragraph (g) thereof and by adding thereto, immediately after paragraph (g) thereof, the following paragraph:

"(h) where the taxpayer is a corporation control of which has been acquired by a person or persons before the end of the year, the amount determined for the year under subsection (6.1) with respect to the corporation in respect of the business."

(2) Section 37 of the said Act is further amended by adding thereto, immediately after subsection (6) thereof, the following subsection:

"(6.1) Where a taxpayer is a corporation control of which was last acquired by a person or persons at any time (in this paragraph referred to as "that time") before the end of a taxation year of the corporation, the amount determined for the purposes of paragraph (1)(h) for the year with respect to the corporation in respect of a business is the amount, if any, by which

(a) the amount, if any, by which

(i) the aggregate of all amounts determined in respect of the business each of which is

(A) an expenditure described in paragraph (1)(a) or (c) that was made by the corporation before that time,

(B) the lesser of the amounts determined in respect of the corporation under subparagraphs (1)(b)(i) and (ii) immediately before that time, or

(C) an amount determined in respect of the corporation under paragraph (1)(c.1) for its taxation year ending immediately before that time

exceeds the aggregate of all amounts determined in respect of the business each of which is

(ii) the aggregate of all amounts determined in respect of the corporation under paragraphs (1)(d) to (g) for its taxation year ending immediately before that time, or

(iii) the amount deducted by virtue of subsection (1) in computing the corporation's income for its taxation year ending immediately before that time

exceeds

(b) the aggregate of

(i) where the business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the year, the aggregate of

(A) the corporation's income for the year from the business before making any deduction under subsection (1), and

(B) where properties were sold, leased, rented, or developed or services rendered in the course of carrying on the business before that time, the corporation's income for the year, before making any deduction under subsection (1), from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services, and

(ii) the aggregate of all amounts each of which is an amount determined in respect of a preceding taxation year of the corporation that ended after that time equal to the lesser of

(A) the amount determined under subparagraph (i) with respect to the corporation in respect of the business for that preceding year, and

(B) the amount in respect of the business deducted by virtue of subsection (1) in computing the corporation's income for that preceding year."

(3) Subsections (1) and (2) are applicable to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

5. (1) Subsection 53(2) of the said Act is amended by adding thereto, immediately after paragraph (b.1) thereof, the following paragraph:

"(b.2) where the property is property of a corporation control of which was acquired by a person or persons at or before that time, any amount required by paragraph 111(4)(c) to be deducted in computing the adjusted cost base of the property;"

(2) Subsection (1) is applicable to taxation years ending after January 15, 1987.

6. (1) Subparagraph 66(6)(b)(ii) of the said Act is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor had, immediately before the acquisition by the successor corporation of the property so acquired, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right,* and"

(2) Subparagraph 66(7)(b)(ii) of the said Act is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor of the first successor corporation, within the meaning of subsection (6), had, immediately before the acquisition by the first successor corporation of the property so acquired by the second successor corporation, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right,* and"

(3) Subparagraph 66(11.1)(f)(iii) of the said Act is repealed and the following substituted therefor:

"(iii) the production referred to in subparagraphs (6)(b)(ii), 66.1(4)(b)(ii), 66.2(3)(b)(i) and 66.4(3)(b)(i) shall be deemed to

include the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, and the production of minerals from mines, situated on property in respect of which the corporation had, in the year and before that time, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*; and"

(4) Subparagraph 66(11.1)(g)(i) of the said Act is repealed and the following substituted therefor:

"(i) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in respect of which the subsidiary had, immediately before that time, an interest or right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(5) Section 66 of the said Act is further amended by adding thereto the following subsections:

"(11.4) Where, at any time,

(a) control of a taxpayer that is a corporation has been acquired by a person or persons, or

(b) a taxpayer has disposed of all or substantially all of his Canadian resource properties or foreign resource properties,

and, before that time, the taxpayer acquired a Canadian resource property or a foreign resource property and it may reasonably be considered that one of the main purposes of such acquisition was to avoid any limitation provided in subsections 29(25) or (29) of the *Income Tax Application Rules, 1971* or subsections (6) to (9), 66.1(4) or (5), 66.2(3) or (4) or 66.4(3) or (4) on the deductibility of any expense, the taxpayer shall be deemed for the purposes of those subsections not to have acquired the property.

(11.5) Where, at any time, control of a corporation has been acquired by a person or persons, the corporation acquired a Canadian resource property or a foreign resource property within the 12-month period ending immediately before that time and, immediately before that period, the corporation was not a principal-business corporation, for the purposes of subsection (4) and paragraphs 66.2(5)(b) and 66.4(5)(b), the property shall be deemed not to have been acquired by the corporation before that time and shall be deemed to have been acquired by it at that time except that where the property has been disposed of by it before that time, for the purposes of subsection (4) and paragraphs 66.2(5)(b) and 66.4(5)(b), the property shall be deemed to have been acquired by the corporation immediately before the property was disposed of."

(6) Subsections (1), (2) and (5) are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

(7) Subsections (3) and (4) are applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

7. (1) Subparagraph 66.1(4)(b)(ii) of the said Act is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor had, immediately before the acquisition by the successor corporation of the property so acquired, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(2) Subparagraph 66.1(5)(b)(ii) of the said Act is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor of the first successor corporation, within the meaning of subsection (4), had, immediately before the acquisition by the first successor corporation of the property so acquired by the second successor corporation, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(3) Subsections (1) and (2) are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

8. (1) Subparagraph 66.2(3)(b)(i) of the said Act is repealed and the following substituted therefor:

"(i) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor had, immediately before the acquisition by the successor corporation of the property so acquired, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(2) Subparagraph 66.2(4)(b)(i) of the said Act is repealed and the following substituted therefor:

"(i) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor of the first successor corpora-

tion had, immediately before the acquisition by the first successor corporation of the property so acquired by the second successor corporation, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(3) Subsections (1) and (2) are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

9. (1) Subparagraph 66.4(3)(b)(i) of the said Act is repealed and the following substituted therefor:

"(i) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor had, immediately before the acquisition by the successor corporation of the property so acquired, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(2) Subparagraph 66.4(4)(b)(i) of the said Act is repealed and the following substituted therefor:

"(i) the production of petroleum or natural gas from natural accumulations thereof or from oil or gas wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor of the first successor corporation had, immediately before the acquisition by the first successor corporation of the property so acquired by the second successor corporation, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals, *to the extent that the production may reasonably be regarded as attributable to that interest or right*, and"

(3) Subsections (1) and (2) are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

10. (1) Section 69 of the said Act is amended by adding thereto, immediately after subsection (10) thereof, the following subsections:

"(11) Notwithstanding any other provision of this Act, where a person or partnership (in this subsection referred to as the vendor) has disposed of property and would, but for this subsection, have had a loss from the disposition, the vendor's loss otherwise determined in respect of the disposition shall be reduced by such portion thereof as may reasonably be considered to have accrued while the property or property for which it was substituted was owned either by

(a) another person (other than a trust) or partnership that was not related to the vendor, or

(b) a trust of which neither the vendor nor any person or partnership that was related to the vendor was a beneficiary.

(12) Notwithstanding any other provision of this Act, where, at any time as part of a series of transactions, a person or partnership (in this subsection referred to as the "vendor") has disposed of property for proceeds of disposition that are less than its fair market value and it may reasonably be considered that one of the main purposes of the series was to obtain the benefit of

(a) any deduction in computing income, taxable income or tax payable under this Act (other than a deduction under section 125 or 125.1) or

(b) any balance of undeducted outlays, expenses or other amounts available to another person or partnership that was not (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) related to the vendor, the vendor shall be deemed to have disposed of the property at that time for proceeds of disposition equal to its fair market value at that time."

(2) Subsection (1) is applicable with respect to property disposed of after January 15, 1987 except where the taxpayer disposed of the property after that date pursuant to an obligation on that date under an agreement in writing entered into on or before that date.

11. (1) Paragraph 87(2)(j.6) of the said Act is repealed and the following substituted therefor:

"(j.6) for the purposes of paragraph 12(1)(x), subsection 13(7.4), subparagraph 13(21)(f)(ii.2), *subsection 13(24)*, paragraphs 20(1)(hh) and 53(2)(s) and *subsections* 53(2.1) *and 66(11.4) and (11.5)*, the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation;"

(2) Subsection (1) is applicable with respect to amalgamations occurring after January 15, 1987 and windings-up commencing after that date.

12. (1) Paragraph 88(1.1)(e) of the said Act 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 persons (each of whom is in this *paragraph* referred to as the "purchaser") 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 from carrying on a business is deductible

(i) only if that business is carried on by the subsidiary or the parent for profit or with a reasonable expectation of profit throughout the particular year, and

(ii) only to the extent of the aggregate of the parent's income for the particular year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all of the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services."

(2) Subsection (1) is applicable to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

13. (1) Section 100 of the said Act is amended by adding thereto, immediately after subsection (2) thereof, the following subsection:

"(2.1) Where as a result of an amalgamation (within the meaning assigned by section 87) an interest in a partnership owned by a predecessor corporation has become property of the new corporation, the predecessor corporation shall be deemed to have disposed of the interest in the partnership to the new corporation immediately before the amalgamation for proceeds of disposition equal to the adjusted cost base to the predecessor corporation of the interest in the partnership at the time of the disposition and the new corporation shall be deemed to have acquired the interest in the partnership from the predecessor corporation immediately after that time at a cost equal to the proceeds of disposition."

(2) Subsection (1) is applicable with respect to amalgamations occurring after January 15, 1987.

14. (1) Subsection 111(4) of the said Act is repealed and the following substituted therefor:

"(4) Notwithstanding subsection (1), where, at any time, control of a corporation has been acquired by a person or persons (each of whom is in this subsection referred to as the "purchaser")

(a) no amount in respect of a net capital loss for a taxation year ending before that time is deductible in computing the corporation's taxable income for a taxation year ending after that time,

(b) no amount in respect of a net capital loss for a taxation year ending after that time is deductible in computing the corporation's taxable income for a taxation year ending before that time,

(c) in computing the adjusted cost base at and after that time of each capital property, other than a depreciable property, owned by the corporation immediately before that time there shall be deducted the amount, if any, by which the adjusted cost base to the corporation of the property immediately before that time exceeds its fair market value immediately before that time,

(d) each amount required by paragraph (c) to be deducted in computing the adjusted cost base to the corporation of a property shall be deemed to be a capital loss of the corporation for the taxation year that ended immediately before that time from the disposition of the property, and

(e) where the corporation was immediately before that time not exempt from tax under this Part on its taxable income, each capital property owned by the corporation immediately before that time as is designated by it in its return of income under this Part for the year shall be deemed to have been disposed of by the corporation immediately before that time for proceeds of disposition equal to the greater of

(i) the adjusted cost base to the corporation of the property immediately before that time, and

(ii) the lesser of the fair market value of the property immediately before that time and such amount as is designated by the corporation in respect of the property in the return

and shall be deemed to have been reacquired by it immediately after that time at a cost equal to the proceeds of disposition thereof."

(2) All that portion of subsection 111(5) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

"(5) Where, at any time, control of a corporation has been acquired by a person or persons (each of whom is in this subsection referred to as the "purchaser") no amount in respect of its non-capital loss or farm loss for a taxation year ending before that time is deductible by the corporation for a taxation year ending after that time and no amount in respect of its non-capital loss or farm loss for a taxation year ending after that time is deductible by the corporation for a taxation year ending before that time except that"

(3) Subparagraphs 111(5)(a)(i) and (ii) of the said Act are repealed and the following substituted therefor:

"(i) only if that business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year, and

(ii) only to the extent of the aggregate of the corporation's income for the particular year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services; and"

(4) 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 is deductible by the corporation for a particular taxation year *ending* before that time"

(5) Subsections 111(5.1) to (5.3) of the said Act are repealed and the following substituted therefor:

"(5.1) Where, at any time, control of a corporation (other than a corporation that was immediately before that time exempt from tax under this Part on its taxable income) has been acquired by a person or persons and immediately before that time the undepreciated capital cost to the corporation of depreciable property of a prescribed class exceeded the aggregate of

(a) the fair market value of all the property of that class, and

(b) the amount otherwise allowed in respect of property of that class under regulations made under paragraph 20(1)(a) or deductible under subsection 20(16) in computing the corporation's income for the taxation year ending immediately before that time,

the excess shall be deducted in computing the income of the corporation for the taxation year ending immediately before that time and the deduction shall be deemed to have been allowed in respect of property of that class under regulations made under paragraph 20(1)(a).

(5.2) Where, at any time, control of a corporation (other than a corporation that was immediately before that time exempt from tax under this Part on its taxable income) has been acquired by a person or persons and immediately before that time the corporation's cumulative eligible capital in respect of a business exceeded the aggregate of

(a) ½ of the fair market value of the eligible capital property in respect of the business, and

(b) the amount otherwise deducted under paragraph 20(1)(b) in computing the corporation's income from the business for the taxation year ending immediately before that time,

the excess shall be deducted under paragraph 20(1)(b) in computing the corporation's income from the business for the taxation year ending immediately before that time.

(5.3) Where, at any time, control of a corporation (other than a corporation that was immediately before that time exempt from tax under this Part on its taxable income) has been acquired by a person or persons, the amount, if any, by which

(a) the aggregate of all debts owing to the corporation immediately before that time each of which is a debt described in paragraph 20(1)(l)

exceeds

(b) the aggregate of all amounts each of which is the fair market value of a debt described in paragraph (a)

shall be deducted under paragraph 20(1)(l) as a reserve for doubtful debts in computing the corporation's income for its taxation year ending immediately before that time and no other amount may be deducted by the corporation under that paragraph for the year."

(6) Subsections (1) to (5) are applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

15. (1) Paragraph 149(10)(a) of the said Act is repealed and the following substituted therefor:

"(a) the taxation year of the corporation that would otherwise have included that time shall be deemed to have ended *immediately before* that time and a new taxation year of the corporation shall be deemed to have commenced *at* that time;"

(2) Subsection (1) is applicable where a corporation ceases after January 15, 1987 to be exempt from tax under Part I of the said Act on its taxable income.

16. (1) Section 249 of the said Act is amended by adding thereto, immediately after subsection (3) thereof, the following subsection:

"(4) Where, at any time, control of a corporation (other than a corporation that was immediately before that time exempt from tax under

Part I on its taxable income) has been acquired by a person or persons, the taxation year of the corporation that would, but for this subsection, have included that time shall, for the purposes of this Act, be deemed to have ended immediately before that time and a new taxation year shall be deemed to have commenced at that time."

(2) Subsection (1) is applicable to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

17. (1) All that portion of subsection 256(7) of the said Act preceding (a) thereof is repealed and the following substituted therefor:

"(7) For the purposes of *subsection 13(24), section 37*, subsections 66(11), (11.1), *(11.4) and (11.5)*, 87(2.1), 88(1.1) and (1.2), sections 111 and 127 *and subsection 249(4)*"

(2) All that portion of subsection 256(8) of the said Act following paragraph (a) thereof is repealed and the following substituted therefor:

"(b) the application of *subsection 13(24), paragraph 37(1)(h), subsection 66(11.4) or (11.5)*, 111(4), (5.1), (5.2) *or (5.3) or section 127.6*, or

(c) the application of paragraph (j) or (k) of the definition "investment tax credit" in subsection 127(9),

in determining whether control of the corporation has been acquired for the purposes of *subsection 13(24)*, section 37, subsections 66(11), (11.1), *(11.4) and (11.5)*, sections 111 and 127 *and subsection 249(4)*, he shall be deemed to have acquired the shares at that time."

(3) Subsection (1) is applicable after January 15, 1987.

(4) Subsection (2) is applicable with respect to acquisitions of rights occurring after January 15, 1987.

18. (1) Subparagraph 29(25)(d)(ii) of the *Income Tax Application Rules, 1971* is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor had, immediately before the acquisition by the successor corporation of the property so acquired, an interest or a right to take or remove petroleum or natural gas or a right to take or remove minerals *to the extent that the production may reasonably be regarded as attributable to that interest or right*;"

(2) Subparagraph 29(29)(b)(ii) of the said Rules is repealed and the following substituted therefor:

"(ii) the production of petroleum or natural gas from wells, or the production of minerals from mines, situated on property in Canada in respect of which the predecessor of the first successor corporation, within the meaning of subsection (25), had, immediately before the acquisition by the first successor corporation of the property so acquired by the second successor corporation, an interest or a right to take or remove petroleum or natural gas or a right to take or remove

minerals *to the extent that the production may reasonably be regarded as attributable to that interest or right*;"

(3) Subsections (1) and (2) are applicable to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to the terms of agreements in writing entered into on or before that date.

19. For the purposes of sections 2 to 18, a person shall be considered not to be obliged to acquire or dispose of property or to acquire control of a corporation, as the case may be, if the person may be excused from performing the obligation as a result of changes to the said Act affecting acquisitions or dispositions of property or of control of corporations.

Draft Regulation

1. Section 1801 of the *Income Tax Regulations* is repealed.

2. Section 1 is applicable in valuing the cost to a taxpayer of the property described in an inventory of a business of the taxpayer at any time after January 15, 1987.

TECHNICAL NOTES TO PROPOSED INCOME TAX AMENDMENTS RELATING TO ACQUISITIONS OF GAINS AND LOSSES

Clause 1 — Amounts Included in Income — ITA 12(1)(v)

The amendment to paragraph 12(1)(v) of the Act is consequential on the changes to section 37 relating to the deduction of scientific research and experimental development expenditures. Under subsection 37(1), such expenditures are accumulated in a pool and the balance in that pool at the end of any year may either be deducted in that year or carried forward for deduction in later years. Where the balance in the pool is negative, the negative balance is required by paragraph 12(1)(v) to be included in the taxpayer's income. The effect of this is to restore the research and development expenditure pool to a nil balance. This paragraph is amended, applicable to taxation years ending after January 15, 1987, as a consequence of the introduction of new paragraph 37(1)(h), to ensure that the research and development expenditures of a corporation that were made by it before a change of control of the corporation and that are subject to a restriction on deduction after the change of control are taken into account in determining the negative balance to be included in income.

Clause 2 — Rule Relating to Depreciable Property — ITA 13(24)

Section 13 of the Act provides a number of special rules relating to the tax treatment of depreciable property. New subsection 13(24) adds a special rule that applies where a corporation has acquired a depreciable property within the 12-month period ending immediately before a change of its control and the property was not used in a business carried on by the corporation before that period. In those circumstances, the rule provides that the capital cost of the property will not be included in computing undepreciated capital cost until after the change of control. Where the property was disposed of by the corporation before the change of control, the corporation is treated as having acquired the property immediately before disposing of it. The purpose of this rule is to prevent the transfer of depreciable property to a taxable corporation in contemplation of a change of control in order to reduce its taxable income where the persons acquiring control would not themselves be in a position to use the capital cost allowance on the property.

This amendment is applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property under agreements in writing entered into on or before that date.

Clause 3 — Reserve for Lender of Money on Security — ITA 33(1)

Subsection 33(1) of the Act allows a taxpayer whose business includes the lending of money on security (such as a mortgage) to deduct a special reserve in lieu of the normal reserve for doubtful debts that is allowed to most other taxpayers under paragraph 20(1)(l) of the Act. This subsection is amended, applicable to taxation years ending after January 15, 1987, as a consequence of the introduction of a new rule in subsection 111(5.3). This rule provides for the mandatory deduction of the maximum reserve for doubtful debts in a corporation's taxation year that is treated by new subsec-

tion 249(4) as having ended immediately before a change of control of the corporation. Where new subsection 111(5.3) applies, the reserve otherwise allowed under subsection 33(1) will be reduced by the amount required by subsection 111(5.3) to be deducted as a reserve under paragraph 20(1)(l).

Clause 4 — Scientific Research and Experimental Development — ITA 37(1)(h) and (6.1)

Subsection 37(1) of the Act allows a taxpayer carrying on business in Canada to deduct certain current and capital expenditures in respect of scientific research and experimental development. Such expenditures may be claimed in the year they are made or they may be carried forward to any future year as long as the business to which the expenditures relate continues to be carried on in that future year and the taxpayer makes expenditures in respect of scientific research and experimental development in that future year.

The amendments to section 37 introduce a restriction on the carry-forward of scientific research and experimental development expenditures of a corporation where there has been a change of its control. In general, this restriction is that such expenditures incurred before the time of the acquisition of control of a corporation may be carried forward to be deducted in computing the income of the corporation for a taxation year ending after that time only where the business to which the expenditures related is carried on by the corporation throughout the year for profit or with a reasonable expectation of profit and only to the extent of its income for the year (before making any deduction under subsection 37(1)) from that or a similar business. This rule corresponds with that provided in section 111 of the Act relating to the deduction of losses following a change of control of a corporation.

In technical terms, this restriction is implemented by introducing new paragraph 37(1)(h) and subsection 37(6.1) which together reduce a corporation's pool of undeducted scientific research and experimental development expenditures to nil at the time when control of the corporation is acquired. In a subsequent taxation year throughout which the business to which the expenditures related is carried on for profit or with a reasonable expectation of profit, the corporation's pre-acquisition pool of expenditures is reinstated to the extent of the corporation's income for the year (before making any deduction under subsection 37(1)) from the business and all similar businesses. The amount thus restored to the R&D pool in that subsequent year will be allowed as a deduction under subsection 37(1) in computing the corporation's income for that year.

The amendments to section 37 are applicable to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

Clause 5 — Adjustments to Cost Base — ITA 53(2)(b.2)

Section 53 of the Act sets out the rules for determining the adjusted cost base of property for the purpose of calculating any capital gain or loss on its disposition. New paragraph 53(2)(b.2), applicable to taxation years ending after January 15, 1987, requires a deduction in computing the ad-

justed cost base of non-depreciable capital property of a corporation that has undergone a change of control. The amount of the deduction is determined under new paragraph 111(4)(c) of the Act, as explained in the commentary on that provision.

Clause 6 — Resource Exploration and Development Expenses — ITA 66

Section 66 of the Act provides for the deduction of Canadian exploration and development expenses and foreign exploration and development expenses and contains a number of rules that apply with respect to those expenses, Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses.

Subclauses 6(1) and (2) — ITA 66(6)(b)(ii) and (7)(b)(ii)

Subsections 66(6) and (7) of the Act contain what are generally referred to as the successor and second successor rules for Canadian exploration and development expenses. These rules allow the unclaimed Canadian exploration and development expenses of a taxpayer (the "predecessor") to be deducted by a corporation (the "successor") that acquires all or substantially all of the Canadian resource properties of the predecessor or by another corporation (the "second successor") that acquires all or substantially all of the Canadian resource properties of the successor. These expenses may generally be deducted by the successor or second successor only against income from the disposition of Canadian resource properties owned by the predecessor and from petroleum, natural gas or mineral production from property in Canada in respect of which the predecessor had an interest or right.

These restrictions in the amounts deductible can be circumvented if the successor or second successor transfers a nominal interest in a productive resource property to the predecessor before the acquisition by the successor of all or substantially all of the predecessor's resource properties — a so-called "seeding" transaction. In that case, the predecessor's expenses may be deducted by the successor or second successor against all of its income from that resource property rather than just the portion of its income that is attributable to the interest in the property that was acquired from the predecessor. The amendments to subparagraphs 66(6)(b)(ii) and (7)(b)(ii) correct this defect by limiting the production income from the property against which the predecessor's expenses may be deducted by the successor or second successor to the production income that may reasonably be regarded as attributable to the property interest or right that was owned by the predecessor.

These amendments are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Subclauses 6(3) and (4) — ITA 66(11.1)(f)(iii) and (g)(i)

Subsection 66(11.1) of the Act provides for the application of the successor rules for resource exploration and development expenses where control of a corporation changes or where a corporation ceases to be tax-exempt. As a result of the application of the successor rules, a corporation's

resource exploration and development expenses that were incurred before a change of control of the corporation may be deducted by the corporation after the change of control only against its income from the disposition of resource properties it owned immediately before the time of the change of control and from production income from those resource properties in which the corporation had an interest or right immediately before that time. The amendments to subsection 66(11.1), which are consistent with changes being made to the resource successor rules, limit the deductibility of the corporation's resource expenses incurred before the change of control to the income from production from the particular interests in resource properties which the corporation had before the change of control.

These amendments are applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to agreements in writing entered into on or before that date.

Subclause 6(5) — ITA 66(11.4)

New subsection 66(11.4) is an anti-avoidance rule that applies at any time where a taxpayer has disposed of all or substantially all of his Canadian or foreign resource properties or there has been a change of control of a corporate taxpayer, the taxpayer had previously acquired a Canadian or foreign resource property and it may reasonably be considered that one of the main purposes of the acquisition was to avoid any limitation in the successor or second successor rules on the deductibility of any resource expenses. Where the anti-avoidance rule applies, the taxpayer is treated for the purposes of those successor and second successor rules as not having acquired the property. The effect of this will be to deny any deduction in respect of the property. This new subsection is applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Subclause 6(5) — ITA 66(11.5)

New subsection 66(11.5) of the Act provides special rules that apply where there is a change of control of a corporation that was not a principal business corporation immediately before the 12-month period ending immediately before the change of control. In these circumstances, any Canadian or foreign resource property acquired by the corporation in that 12-month period is considered to have been acquired at the time control changes for the purpose of calculating the corporation's:

- foreign exploration and development expenses,
- cumulative Canadian development expense, and
- cumulative Canadian oil and gas property expense.

Where the property has been disposed of before control changes, it is considered, for the purposes of those expense pools, to have been acquired by the corporation immediately before being disposed of.

The special rule introduced by this amendment for resource properties corresponds with the rule provided in new subsection 13(24) relating to de-

preciable property. The purpose of the rule is to prevent the transfer of resource properties to a taxable corporation in contemplation of a change of control in order to reduce its taxable income where the persons acquiring control would not be in a position to use the deductions in respect of those properties.

This new subsection applies with respect to acquisitions of property occurring after January 15, 1987 other than those made before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Subclauses 6(6) and (7)

These set out the effective dates for the amendments to section 66 of the Act.

Clause 7 — Canadian Exploration Expenses — ITA 66.1(4)(b)(ii) and (5)(b)(ii)

Subsections 66.1(4) and (5) of the Act contain what are generally referred to as the successor and second successor rules for Canadian exploration expenses (CEE). These rules allow the unclaimed Canadian exploration expenses of a taxpayer (the "predecessor") to be deducted by a corporation (the "successor") that acquires all or substantially all of the Canadian resource properties of the predecessor or by another corporation (the "second successor") that acquires all or substantially all of the Canadian resource properties of the successor. These expenses may generally be deducted by the successor or second successor only against income from the disposition of Canadian resource properties owned by the predecessor and from production income from those Canadian resource properties in which the predecessor had an interest or right.

These restrictions in the deduction of CEE can be circumvented if the successor or second successor transfers a nominal interest in a productive resource property to the predecessor before the acquisition by the successor of all or substantially all of the predecessor's resource properties — a so-called "seeding" transaction. In that case, the predecessor's expenses may be deducted by the successor or second successor against all of its income from that resource property rather than just the portion of its income from the property that is attributable to the interest in the property that was acquired from the predecessor. The amendments to subparagraphs 66.1(4)(b)(ii) and (5)(b)(ii) correct this defect by limiting the production income from the property against which the predecessor's CEE may be deducted by the successor or second successor to the production income that may reasonably be regarded as attributable to the property interest or right that was owned by the predecessor.

These amendments are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Clause 8 — Canadian Development Expenses — ITA 66.2(3)(b)(i) and (4)(b)(i)

Subsections 66.2(3) and (4) of the Act contain what are generally referred to as the successor and second successor rules for Canadian devel-

opment expenses (CDE). These rules allow the unclaimed Canadian development expenses of a taxpayer (the "predecessor") to be deducted by a corporation (the "successor") that acquires all or substantially all of the Canadian resource properties of the predecessor or by another corporation (the "second successor") that acquires all or substantially all of the Canadian resource properties of the successor. These expenses may generally be deducted by the successor or second successor only against income from the disposition of Canadian resource properties owned by the predecessor and from production income from those Canadian resource properties in which the predecessor had an interest or right.

These restrictions in the deduction in respect of CDE can be circumvented if the successor or second successor transfers a nominal interest in a productive resource property to the predecessor before the acquisition by the successor of all or substantially all of the predecessor's resource properties. In this "seeding" transaction, the predecessor's CDE may be deducted by the successor or second successor against all of its income from that resource property rather than just the portion of its income that is attributable to the interest in the property that was acquired from the predecessor. The amendments to subparagraphs 66.2(3)(b)(i) and (4)(b)(i) correct this defect by limiting the production income from the property against which the predecessor's CDE may be deducted by the successor or second successor to the production income that may reasonably be regarded as attributable to the property interest or right that was owned by the predecessor.

These amendments are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Clause 9 — Canadian Oil and Gas Property Expense — ITA 66.4(3)(b)(i) and (4)(b)(i)

Subsections 66.4(3) and (4) of the Act contain what are generally referred to as the successor and second successor rules for Canadian oil and gas property expenses (COGPE). These rules allow the unclaimed Canadian oil and gas property expenses of a taxpayer (the "predecessor") to be deducted by a corporation (the "successor") that acquires all or substantially all of the Canadian resource properties of the predecessor or by another corporation (the "second successor") that acquires all or substantially all of the Canadian resource properties of the successor. These expenses can generally be deducted by the successor or second successor only against income from the disposition of Canadian resource properties owned by the predecessor and from production income from those Canadian resource properties in which the predecessor had an interest or right.

These restrictions in the deduction in respect of COGPE can be circumvented if the successor or second successor transfers a nominal interest in a productive resource property to the predecessor before the acquisition by the successor of all or substantially all of the predecessor's resource properties — a so-called "seeding" transaction. In that case, the predecessor's COGPE may be deducted by the successor or second successor against all of its income from that resource property rather than just the portion of its income that is attributable to the interest in the property that was acquired from the predecessor. The amendments to subparagraphs 66.4(3)(b)(i) and

(4)(b)(i) correct this defect by limiting the production income from the property against which the predecessor's COGPE may be deducted by the successor or second successor to the production income that may reasonably be regarded as attributable to the property interest or right that was owned by the predecessor.

These amendments are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on January 15, 1987 to acquire the property pursuant to agreements in writing entered into on or before that date.

Clause 10 — Anti-Avoidance Rules — ITA 69(11) and (12)

New subsection 69(11) of the Act is an anti-avoidance rule designed to limit the loss of a person or partnership from the disposition of property to that which accrued while it was owned by the taxpayer or partnership or a person related thereto. Thus, if a taxpayer acquired a property from a person or trust to whom he was not related and subsequently realized a loss on its disposition, the loss would be reduced to the extent that it accrued while the property was owned by that unrelated person. For this purpose, a trust is not related to the taxpayer during the period in which neither the taxpayer nor a related person is a beneficiary of the trust. This rule will apply with respect to all property, although it will not affect inventories since the repeal of Regulation 1801 will require inventory to be valued at the lower of cost and fair market value in all circumstances. This new subsection applies to property that is disposed of after January 15, 1987, other than property disposed of thereafter pursuant to an obligation on that date under an agreement in writing entered into on or before that date.

New subsection 69(12) of the Act sets out another anti-avoidance rule which prevents a person or partnership from disposing of a property for less than fair market value proceeds so as to obtain the benefit of the tax deductions or entitlements of an unrelated person. Where the subsection applies, the vendor is considered to have disposed of the property for proceeds equal to its fair market value. Thus, the provision will apply where a taxpayer transfers property with an accrued profit to an unrelated corporation or partnership on a tax-free basis using a rollover provision in the Act so that upon a subsequent disposition of the property the corporation or partnership may shelter the accrued profit. For this purpose a gain is considered to be sheltered where it is offset with a tax deduction or credit or where the proceeds are absorbed by any balance of undeducted expenditures — such as undepreciated capital cost in the case of depreciable property, unused R&D costs in the case of research properties, or the cumulative balances in the various resource expenditure pools in the case of mining and oil and gas properties. For the purpose of this rule, whether a person or partnership is unrelated to another person or partnership is to be determined without reference to any right referred to in paragraph 251(5)(b). This new subsection applies to property that is disposed of after January 15, 1987, other than pursuant to an obligation on that date under an agreement in writing entered into on or before that date.

Clause 11 — Amalgamations — ITA 87(2)(j.6)

Paragraph 87(2)(j.6) of the Act ensures that the rules in certain provisions of the Act that applied to a corporation that has later amalgamated

continue to apply to the amalgamated corporation as they would if the amalgamated corporation were the same corporation as, and a continuation of, the predecessor corporation. The provisions of this paragraph also apply with appropriate modifications to a winding-up of a taxable Canadian corporation pursuant to subsection 88(1) of the Act.

The amendment to paragraph 87(2)(j.6) adds new subsections 13(24) and 66(11.4) and (11.5) to the list of provisions covered by the continuation rule. As a result of this amendment, the rules in new subsections 13(24) and 66(11.4) and (11.5) that apply where a depreciable or resource property has been acquired by a corporation before a change of control (or before the disposition of all or substantially all of the corporation's Canadian or foreign resources properties) cannot be circumvented by arranging for an amalgamation or winding-up of the corporation between the time of the property acquisition and the time of the change of control. This amendment is applicable with respect to amalgamations occurring after January 15, 1987 and windings-up commencing after that date.

Clause 12 — Winding-up of a Corporation — ITA 88(1.1)(e)

Existing paragraph 88(1.1)(e) of the Act provides that where control of a parent or subsidiary corporation has been acquired, any non-capital losses or farm losses incurred by the subsidiary from carrying on a business before the change of control may be deducted by the parent following the winding-up of the subsidiary only if that business is carried on throughout the year in which the loss is sought to be claimed. Where this condition is met, the losses may be deducted to the extent of the parent's income for the year from that business and any similar business and the parent's net taxable capital gains from dispositions of certain property owned by the subsidiary at the time of the change of control.

The amendments to paragraph 88(1.1)(e) parallel amendments made to subsection 111(5) of the Act. The opening words of paragraph 88(1.1)(e) are amended to provide that no amount in respect of a subsidiary's non-capital loss or farm loss for a taxation year ending before the time of an acquisition of control of the parent or subsidiary is deductible in computing the parent's taxable income for a particular taxation year ending after that time except to the extent that the conditions in subparagraphs (i) and (ii) are met. As a result of this amendment, the subsidiary's losses from property and allowable business investment losses incurred before the acquisition of control may no longer be carried forward to be deducted by the parent after the acquisition of control.

The amendment also applies to restrict the deduction in respect of a subsidiary's non-capital losses and farm losses for its taxation year that is treated by new subsection 249(4) as having ended immediately before the acquisition of control.

Subparagraph 88(1.1)(e)(ii) is also amended to deny the deductibility of a subsidiary's non-capital losses and farm losses incurred before an acquisition of control of the subsidiary or parent against the parent's net taxable gains from dispositions of property owned by the subsidiary at the time of the change of control.

The amendments to paragraph 88(1.1)(e) are applicable to acquisitions of control occurring after January 15, 1987 other than those occurring before 1988 where the persons acquiring the control were obliged on January

15, 1987, to acquire the control pursuant to agreements in writing entered into on or before that date.

Clause 13 — Disposition of an Interest in a Partnership — ITA 100(2.1)

New subsection 100(2.1) applies where an amalgamation occurs after January 15, 1987 and as a result of the amalgamation, the new corporation formed on the amalgamation acquires a predecessor corporation's interest in a partnership. The predecessor is treated as having disposed of its interest in the partnership to the new corporation immediately before the amalgamation for proceeds of disposition equal to its adjusted cost base, and the new corporation is treated as having acquired the interest immediately after that time at a cost equal to the amount of such proceeds. As a result, the predecessor corporation will be required under existing subsection 100(2) to recognize a gain on the disposition of any interest in the partnership which has a negative adjusted cost base. The gain is measured as the excess of amounts required by subsection 53(2) of the Act to be deducted in computing the adjusted cost base of the predecessor's partnership interest over the total of its cost of the interest and all amounts required by subsection 53(1) to be added in computing the adjusted cost base of its interest.

Clause 14 — Restrictions on Loss Carry-overs

Under subsection 111(1) of the Act, a taxpayer may carry over losses of one taxation year for deduction in computing its taxable income in other taxation years. This carry-over is denied or restricted under subsections 111(4) to (5.2) in the case of a corporation which has undergone a change of control. The amendments to section 111 extend these restrictions and introduce other rules that apply where there has been an acquisition of control of a corporation.

Subclause 14(1) — ITA 111(4)

Subsection 111(4) of the Act provides that where control of a corporation is acquired, the corporation's net capital losses for taxation years preceding the acquisition of control may not be carried forward to taxation years ending after the acquisition, and its net capital losses for taxation years following the acquisition may not be carried back to taxation years commencing before the acquisition. New paragraphs 111(4)(a) and (b) preserve the rules in existing paragraphs 111(4)(a) and (b). Paragraphs 111(4)(c) to (e) add new rules that apply where control of a corporation is acquired.

New paragraph 111(4)(c) requires the adjusted cost base of each capital property, other than depreciable property, owned by a corporation immediately before the time of an acquisition of control of the corporation, to be reduced at and after that time by the excess immediately before that time of the property's adjusted cost base over its fair market value. This excess is the amount referred to in new paragraph 53(2)(b.2). New paragraph 111(4)(d) treats this excess as a capital loss of the corporation from the disposition of the property for the taxation year that is treated by new subsection 249(4) of the Act as having ended immediately before the acquisition of control.

New paragraph 111(4)(e) provides that, where control of a corporation (other than a tax-exempt corporation) is acquired, the corporation may treat such of its capital properties as it chooses as having been disposed of by it

at the end of the taxation year ending immediately before the time of the acquisition of control. The proceeds of disposition for such properties may be any amount between their adjusted cost base and their fair market value. The corporation is treated as having reacquired the properties immediately after the acquisition of control at a cost equal to those proceeds of disposition. The choice of properties and their proceeds of disposition must be designated by the corporation in its return of income for the year ending immediately before the acquisition of control. A corporation would generally want to take advantage of the new rule in paragraph 111(4)(e) to realize capital gains that could be offset by capital losses of the corporation for pre-acquisition taxation years.

The amendments to subsection 111(4) apply with respect to acquisitions of control occurring after January 15, 1987 other than those occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to agreements in writing entered into before that date.

Subclauses 14(2), (3) and (4) — ITA 111(5)

Subsection 111(5) of the Act provides that where control of a corporation has been acquired, its non-capital losses and farm losses incurred in carrying on a business in a taxation year ending before the acquisition of control are deductible by it in later years only if certain conditions are met. Also, its non-capital losses and farm losses for a taxation year commencing after the date of the acquisition of control are only deductible in a taxation year commencing before that date if similar conditions are met.

The opening words of subsection 111(5) are amended to provide that, except as provided by paragraphs (5)(a) and (b), no amount in respect of a non-capital loss or farm loss of a corporation for a taxation year ending before the time of an acquisition of control is deductible for a taxation year ending after that time, and no amount in respect of any such loss for a taxation year ending after that time is deductible for a taxation year ending before that time. As a result of this amendment, a loss from property or allowable business investment loss incurred by a corporation before the time of an acquisition of its control may no longer be carried forward as a non-capital loss to be deducted after that time and a loss from property or allowable business investment loss incurred by the corporation after that time may no longer be carried back as a non-capital loss to be deducted in a taxation year ending before that time.

The amendments also apply to restrict the deduction in respect of a corporation's non-capital losses and farm losses for its taxation year that is treated by new subsection 249(4) as having ended immediately before the time of the acquisition of control. The restricted carry-back of capital losses and farm losses is also extended to apply to the carry-back of such losses for a corporation's taxation year that is treated as having commenced at the time when a corporation's control was acquired. These changes apply where control of a corporation is acquired part way through its fiscal period. Thus, a non-capital loss or farm loss incurred in carrying on a business in that part of a corporation's fiscal period that is before the acquisition of control is deductible for the taxation year that is the remainder of the fiscal period or for any subsequent year only where that business is carried on throughout that year and only to the extent of the corporation's income from that business and any similar business. The carry-back of a non-capital loss

or farm loss of the corporation incurred in carrying on a business in the remainder of the fiscal period is similarly restricted.

Paragraph 111(5)(a) is also amended to deny the deductibility of non-capital losses and farm losses incurred by a corporation before an acquisition of control of the corporation against any taxable capital gains for a taxation year ending after the acquisition.

The amendments to subsection 111(5) are applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to the terms of agreements in writing entered into on or before that date.

Subclause 14(5) — ITA 111(5.1)

Existing subsection 111(5.1) of the Act provides that where control of a corporation has been acquired in a taxation year, the excess of the undepreciated capital cost of all its depreciable property of a prescribed class over its fair market value is treated as having been claimed by the corporation as capital cost allowance in previous taxation years. This amount is treated as a non-capital loss or farm loss of the corporation for the taxation year immediately preceding the year in which control was acquired.

Amended subsection 111(5.1) applies where there is an acquisition of control of a corporation and the undepreciated capital cost of all its property of a prescribed class immediately before the acquisition of control exceeds the total of:

- its fair market value at that time,
- the capital cost allowance taken by the corporation in respect of that class in computing its income for the taxation year that is treated by new subsection 249(4) as having ended at that time, and
- any amount deducted in that year as a terminal loss in respect of property of that class.

That excess is required to be deducted in computing the corporation's income for the year immediately preceding the change of control and the deduction is treated as having been claimed as capital cost allowance. As a result, the excess either reduces the income or increases the non-capital loss or farm loss of the corporation for that year and is not available to be deducted in later years except under the loss carry-forward rules as set out in subsections 111(1) and (5).

This amendment is applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to agreements in writing entered into on or before that date.

Subclause 14(5) — ITA 111(5.2)

Existing subsection 111(5.2) provides that where control of a corporation has been acquired in a taxation year, the amount by which its cumulative eligible capital in respect of a business exceeds one-half of the fair market value of the eligible capital property in respect of the business is treated as having been deducted by the corporation in computing its income in previous taxation years. This amount is treated as a non-capital loss or

farm loss of the corporation for the taxation year immediately preceding the year in which control was acquired.

Amended subsection 111(5.2) applies where there is an acquisition of control of a corporation and its cumulative eligible capital in respect of a business immediately before the acquisition of control exceeds the total of:

- the amount deducted by the corporation under paragraph 20(1)(b) of the Act in computing its income for the taxation year that is treated by new subsection 249(4) as having ended at that time, and
- one-half of the fair market value at that time of its eligible capital property in respect of the business.

That excess is required to be deducted by the corporation under paragraph 20(1)(b) of the Act in computing its income for the year immediately preceding the change of control. As a result, the excess either reduces the income or increases the non-capital loss or farm loss of the corporation for that year and is not available to be deducted in later years except under the loss carry-forward rules as set out in subsections 111(1) and (5).

This amendment is applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on that date to acquire the control pursuant to agreements in writing entered into on or before that date.

Subclause 14(5) — ITA 111(5.3)

Existing subsection 111(5.3) of the Act provides a special rule for the purposes of existing subsections 111(5.1) and (5.2) to deal with the circumstances where control of a corporation is acquired in its first taxation year. As a consequence of the amendments to subsections 111(5.1) and (5.2), this rule is no longer necessary and is repealed.

New subsection 111(5.3) of the Act applies where there has been an acquisition of control of a corporation that had a debt owing to it that either was included in computing its income for a taxation year ending at or before that time or, where the lending of money was part of the corporation's ordinary business, arose from a loan made in the ordinary course of its business and the amount of the debt exceeded its fair market value at that time. The new subsection requires the excess to be deducted under paragraph 20(1)(l) of the Act as a reserve for doubtful debts in computing the corporation's income for its taxation year that is treated by new subsection 249(4) as having ended at that time. As a result, the excess either reduces the income or increases the loss of the corporation for that year and will be required by paragraph 12(1)(d) of the Act to be included in computing the corporation's income for the following taxation year.

The repeal of existing subsection 111(5.3) and the introduction of new subsection 111(5.3) are applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to agreements in writing entered into on or before that date.

Subclause 14(6)

This sets out the effective date for the amendments to section 111 of the Act.

Clause 15 — Exempt Corporations — ITA 149(10)(a)

Paragraph 149(10)(a) of the Act provides that where a corporation ceases at any time to be exempt from tax under Part I of the Act, its taxation year that would otherwise have included that time is treated as having ended at that time and a new taxation year is considered to have commenced immediately thereafter. The amendment to this paragraph treats the taxation year that would otherwise have included that time as having ended immediately before that time and the new taxation year is considered to start at that time. This amendment is applicable where a corporation ceases after January 15, 1987 to be exempt from tax under Part I of the Act.

Clause 16 — Taxation Year — ITA 249(4)

New subsection 249(4) of the Act treats a corporation's taxation year that would otherwise have included the time when control of the corporation is acquired as having ended immediately before that time. This will give rise to all the consequences which normally follow a taxation year-end, such as the filing of the corporate tax return and the payment of taxes due. A new taxation year of the corporation is treated as having commenced at the time when control is acquired. The purpose of this new subsection is to require a separate determination of the income or loss of the corporation for the period ending immediately before the acquisition of control in order that the loss carry-over restrictions set out in section 111 can be applied to that year and the following year. Subsection 249(4) is applicable with respect to acquisitions of control occurring after January 15, 1987 other than acquisitions of control occurring before 1988 where the persons acquiring the control were obliged on January 15, 1987 to acquire the control pursuant to agreements in writing entered into on or before that date.

Clause 17 — Control Treated as Not Having Been Acquired — ITA 256(7)

Subsection 256(7) of the Act describes those circumstances where control of a corporation is considered not to have been acquired for the purposes of the loss and other carry-over provisions of the Act. This subsection is amended effective after January 15, 1987 to provide that it also applies for the purposes of the new rules in section 37, concerning the tax treatment of scientific research and experimental development expenditures, for the purposes of the rules in new subsections 13(24) and 66(11.4) and (11.5) that apply in certain cases where a depreciable or resource property has been acquired by a corporation prior to a change of control, and for the purpose of the rule in new subsection 249(4) which requires a corporation to have a taxation year-end immediately before a change of control.

ITA 256(8)

Subsection 256(8) of the Act extends the circumstances where an acquisition of control is considered to have occurred for the purposes of the rules relating to the carry-over of losses and certain other amounts. This subsection is amended with respect to acquisitions of rights occurring after January 15, 1987 so that it also applies for the purposes of the rules in amended section 37, concerning the tax treatment of scientific research and experimental development expenditures, for the purposes of the rules in new subsections 13(24) and 66(11.4) and (11.5) that apply in certain cases where a depreciable or resource property has been acquired by a corporation prior to a change of control, and for the purpose of the new rule in subsection

249(4) which requires a corporation to have a taxation year-end immediately before a change of control.

Clause 18 — Resource Exploration and Development Expenses — ITAR 29(25)(d)(ii) and (29)(b)(ii)

Subsections 29(25) and (29) of the *Income Tax Application Rules, 1971* contain what are generally referred to as the successor and second successor rules for exploration and development expenses incurred before 1972. These rules allow the unclaimed exploration and development expenses of a taxpayer (the "predecessor") incurred before 1972 to be deducted by a principal-business corporation (the "successor") that acquires all or substantially all of the Canadian resource properties of the predecessor or by another principal-business corporation (the "second successor") that acquires all or substantially all of the Canadian resource properties of the successor. These expenses may generally be deducted by the successor or second successor only against income from the disposition of Canadian resource properties owned by the predecessor and from petroleum, natural gas or mineral production from property in Canada in respect of which the predecessor had an interest or right.

These restrictions in the deductions in respect of such expenses can be circumvented if the successor or second successor transfers a nominal interest in a productive resource property to the predecessor before the acquisition by the successor of all or substantially all of the predecessor's resource properties. In that case, the predecessor's expenses may be deducted by the successor or second successor against all of its income from that resource property rather than just the portion of its income that is attributable to the interest in the property that was acquired from the predecessor. The amendments to subparagraphs 29(25)(d)(ii) and (29)(b)(ii) of the Rules correct this defect by limiting the production income from the property against which the predecessor's expenses may be deducted by the successor or second successor to the production income that may reasonably be regarded as attributable to the property interest or right that was owned by the predecessor.

These amendments are applicable with respect to acquisitions of property occurring after January 15, 1987 other than acquisitions of property occurring before 1988 where the persons acquiring the property were obliged on that date to acquire the property pursuant to agreements in writing entered into on or before that date.

Clause 19 — Interpretation of Coming-into-force Provisions

Clause 19 provides a rule of interpretation for the coming-into-force provisions for the amendments contained in clauses 2 to 18. Those coming-into-force provisions provide grandfather treatment for acquisitions or dispositions by persons after January 15, 1987 and before 1988 where the persons were obliged on that date to make the acquisitions or dispositions pursuant to agreements in writing entered into on or before that date. The rule in clause 19 provides that for the purpose of those coming-into-force provisions, where a person may be excused from an obligation to make an acquisition or disposition as a result of changes to the Act affecting the acquisition or disposition, the person shall not be considered to have been obliged to make the acquisition or disposition. In that case, the acquisition or disposition will not be grandfathered.

Inventory Valuation — IT Reg. 1801

Section 1801 of the *Income Tax Regulations* allows a taxpayer in calculating income from a business to value all inventory either at cost or at fair market value. The repeal of this provision, effective after January 15, 1987, will require inventories to be valued at the lower of either their cost or their fair market value. This will prevent a corporation from maintaining at cost inventories which have declined in value and thereby postponing the write-down to fair market value after a change of control.