Explanatory Notes to Draft Legislation and Regulations Relating to Income Tax Reform

The Honourable Michael H. Wilson
Minister of Finance

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Canada

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Department of Finance Canada
Ministère des Finances Canada

These explanatory notes are provided to assist in an understanding of the amendments proposed to be made to the Income Tax Act, the Income Tax Application Rules, 1971, the Canada Pension Plan, the Unemployment Insurance Act, 1971 and chapters 6 and 55 of the Statutes of Canada, 1986 to implement the tax reform proposals as announced by the Minister of Finance on December 16, 1987. With the exception of material contained herein which relates to proposed section 245 of the Income Tax Act, these notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Cette publication est également offerte en français.

PREFACE

The draft legislation contains proposed amendments to the Income Tax Act, the Income Tax Application Rules, 1971, the Canada Pension Plan, the Unemployment Insurance Act, 1971 and chapters 6 and 55 of the Statutes of Canada, 1986 to implement the tax reform proposals announced on December 18, 1987.

These explanatory notes describe the proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisers. In addition, explanatory notes to draft regulations relating to financial institutions, insurers and motor vehicles are attached as appendices.

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TABLE OF CONTENTS

APPENDICES

Clause 1

Income from an Office or Employment

ITA
6

Section 6 of the Act provides for the inclusion of various amounts in computing income from an office or employment.

Subclauses 1(1) and (2)

ITA
6(1)(b)

Paragraph 6(1)(b) of the Act requires the inclusion in computing income of employees of employer-provided allowances subject to certain specified exceptions such as reasonable travel allowances, including allowances in respect of travelling expenses, received by an employee as described in subparagraphs 6(1)(b)(v), (vi) and (vii). New subparagraph (x) provides that an allowance in respect of motor vehicle expenses shall be deemed not to be reasonable and, accordingly, will be included in income, unless the allowance is based on the number of kilometres for which the motor vehicle is used for employment purposes. This change requires a consequential change to subparagraph (vii) deleting the requirement therein that a travelling allowance, in order to be considered reasonable, has to be computed by reference to time spent travelling. New subparagraph (xi) provides that where an employee receives both an allowance and a reimbursement in whole or in part for motor vehicle expenses in respect of the same kilometres, the whole amount of the allowance will be deemed not to be reasonable and must, accordingly, be included in income. Where such allowances are included in the income of an employee, paragraphs 8(1)(f) and (h) may allow a deduction in respect of any travelling expenses. This deduction is available to salesmen and to other employees who regularly travel in the course of their employment and who are required by their employment to pay for their travelling expenses.

These amendments to paragraph 6(1)(b) are applicable to the 1988 and subsequent taxation years.

Subclause 1(3)

ITA
6(2) to (2.2)

Subsection 6(2) of the Act provides rules concerning the reasonable standby charge which must be included in computing an employee's income where an employer-provided automobile is made available to the employee. This subsection is amended by restructuring the calculation of the standby charge in the format of a formula. In addition, the reduction in the standby charge that is available for an employee whose personal use of the automobile is very little is restricted to those situations where the automobile is used all or substantially all in the course of the employment.

Subsection 6(2.1) of the Act provides for an optional reduced standby charge for employees employed principally in selling automobiles. This subsection is amended to be applicable as well to employees employed principally in leasing automobiles. In addition, the subsection is amended so as to permit the calculation of the reduced standby charge in the case where an employer is engaged solely in the business of selling used automobiles and accordingly had not acquired any new automobiles for sale in the course of his business. This is accomplished by computing the amount of the standby charge by reference to the greater of the average cost of new automobiles and the average cost of all automobiles acquired by the employer for sale.

Subsection 6(2.2) of the Act provides a special election for an employee in computing the benefit he receives by way of employer-paid operating expenses for personal use of an employer-provided automobile. This benefit is one-half of the amount of the automobile standby charge as determined under subsection 6(2). Subsection 6(2.2) is amended so that the special election for operating expenses will be available only where the automobile is used primarily in the course of the taxpayer's office or employment.

These amendments are applicable to the 1988 and subsequent taxation years.

Clause 2

Deductions from Income
from an Office or
Employment

ITA
8

Section 8 of the Act provides for the deduction of various amounts in computing income from an office or employment.

Subclause 2(1)

ITA
8(1)(a), (k) and (l)

Paragraph 8(1)(a) of the Act, which provides for the employment expense deduction of 20% of employment income up to $2,500, is repealed.

Paragraphs 8(1)(k) and (l) of the Act, which provide for the deductions for unemployment insurance premiums and Canada Pension Plan contributions, are repealed. These deductions have been converted into tax credits, and are now contained in new section 118.7.

These amendments are applicable to the 1988 and subsequent taxation years.

Subclause 2(2)

ITA
8(1)(p)

Subsection 8(1) of the Act is amended by adding new paragraph (p) which deals with musical instrument costs of an employed musician, where, as a condition of employment, he is required to provide a musical instrument. This paragraph permits the deduction (not exceeding the taxpayer's income for the year from his employment as a musician) of amounts paid in the year for the maintenance, insurance and rental of the instrument. In addition, capital cost allowance, as allowed by regulation (20% on a declining balance basis), may be claimed. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 2(3)

ITA
8(3)

Subsection 8(3) of the Act, which placed limitations on the entitlement to the employment expense deduction, is repealed as a consequence of the elimination of the deduction itself. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 2(4)

ITA
8(5)(b)

Paragraph 8(5)(b) of the Act is amended so as to not disallow the deductibility of dues paid in respect of professional or malpractice insurance that is necessary to maintain a professional status recognized by statute. This amendment is applicable to the 1984 and subsequent taxation years.

Subclause 2(5)

ITA
8(10) and (11)

Section 8 of the Act is also amended by adding thereto two new subsections. New subsection 8(10) provides that expenses will only be deductible by an employee under paragraph 8(1)(f) or (h) or subparagraph 8(1)(i)(ii) or (iii) where the employee files with his return of income a prescribed form signed by his employer to the effect that the employee met the requirements of the relevant provisions for the deductibility of such expenses.

New subsection 8(11) of the Act provides that, where an employee is entitled to deduct an amount under paragraph 8(1)(f) or (h) in respect of the use of his automobile for employment purposes, he may instead deduct an amount determined in accordance with prescribed rules. Regulations will prescribe the amount that may be so deducted as 27 cents for each of the first 5,000 kilometres driven by the individual in a year and 21 cents for each subsequent kilometre. An additional 4 cents for each kilometre travelled in the Yukon and the Northwest Territories will be allowed. These amendments are applicable to the 1988 and subsequent taxation years.

Clause 3

Valuation of Inventory

ITA
10(1.1)

Section 10 of the Act provides rules concerning the valuation of inventory held in a business. New subsection 10(1.1) is consequential on the amendments to subsection 18(2) concerning carrying charges in respect of vacant land.

This amendment permits a taxpayer to include in the cost of land that is held as inventory, amounts that are denied a deduction under subsection 18(2) to him or to a person with whom he does not deal at arm's length, a corporation of which he is a specified shareholder, or a partnership of which his share of any income or loss is 10% or more.

Subsection 10(1.1) is applicable to the 1988 and subsequent taxation years.

Clause 4

Amounts to be Included as Income
from Business or Property

ITA
12

Section 12 of the Act provides for the inclusion of various amounts in computing the income of a taxpayer for a taxation year from a business or property.

Subclause 4(1)

ITA
12(1)(d) and (d.1)

Paragraph 12(1)(d) of the Act provides for an inclusion in computing a taxpayer's income for a year of any amount deducted as a reserve for doubtful debts under paragraph 20(1)(l) in the immediately preceding year. The amendment to paragraph 12(1)(d), applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987, is strictly consequential on the amendments to paragraph 20(1)(l) which provides for the deduction of both a doubtful debt reserve and a reserve for doubtful loans or lending assets of a financial institution.

New paragraph 12(1)(d.1) of the Act, which is consequential on the introduction of new paragraph 20(1)(l.1), provides for an inclusion in computing a taxpayer's income for a taxation year or fiscal period commencing after June 17, 1987 that ends after 1987 of any amount deducted as a reserve under new paragraph 20(1)(l.1) in the immediately preceding year. New paragraph 20(1)(l.1) allows an insurer or a taxpayer whose ordinary business includes the lending of money to deduct a reserve in respect of credit risk losses expected to arise under or in respect of certain instruments or commitments such as loan guarantees and letters of credit.

Subclause 4(2)

ITA
12(1)(i),(i.1)

Paragraph 12(1)(i) of the Act requires a taxpayer to include in his income for a taxation year an amount received in the year on account of a debt in respect of which a deduction for bad debts was taken in a previous year. New paragraph 12(1)(i.1) provides for a similar income inclusion in respect of amounts received in a year in respect of which a deduction was previously taken under new subsection 20(4.2), which applies in respect of debts arising from dispositions of eligible capital property. As only 3/4 of bad debts arising in this situation may be deducted under new subsection 20(4.2), only 3/4 of amounts which are subsequently recovered will be required to be included in income under new paragraph 12(1)(i.1). However, where the bad debt relates to a disposition of eligible capital property in respect of which the inclusion rate in calculating the taxpayer's eligible capital amount was restricted to 1/2, the portion of the debt which may be deducted under new subsection 20(4.2) is 1/2 and, accordingly, only 1/2 of any amounts recovered in respect of such a debt is required to be included in the taxpayer's income under new paragraph 12(1)(i.1). This amendment is applicable after June 17, 1987.

Subclause 4(3)

ITA
12(1)(y)

Subsection 12(1) of the Act is amended by adding new paragraph (y) which imposes a standby charge on a member of a partnership or an employee of a member of a partnership who is entitled to make personal use of an automobile provided by the partnership. Where a partnership makes an automobile available to a partner or an employee of a partner, or a person related to such a person, new paragraph (y) includes in the income of the partner or the employee an amount equal to the standby charge that would be included in that person's income if the person were employed by the partnership. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 5

Cash Bonus on Canada
Savings Bonds

ITA
12.1

Section 12.1 of the Act provides rules for the tax treatment of cash bonuses paid on Canada Savings Bonds. Currently, such bonuses are taxed at capital gains rates by including one-half of the bonus in income as interest income under section 12.1.

The amendment to this section, which is consequential on the changes to the inclusion rate for capital gains of individuals, increases the portion of the cash bonus to be included in income. The portion required to be included in income will be increased from one-half to two-thirds for cash bonuses received in taxation years and fiscal periods of individuals and partnerships ending after 1987 and to three-quarters for cash bonuses received in taxation years and fiscal periods of individuals and partnerships ending after 1989.

Clause 6

Net Reserve Inclusion and Bad Debt Inclusion

ITA
12.3 and 12.4

New section 12.3 of the Act is a special transitional provision that arises out of the changes to the tax treatment of the reserves of financial institutions. This section applies to a taxpayer who has deducted an amount in respect of the prescribed amount of his net reserve adjustment under new subsection 20(26) in his first taxation year or fiscal period that commences after June 17, 1987 and ends after 1987. Such taxpayers are required to include the prescribed amount of the net reserve adjustment inclusion in computing his income for taxation years or fiscal periods ending after 1988 that commence before 1993. The prescribed amount of a taxpayer's net reserve inclusion, as calculated under new section 8100 of the Regulations, equals, in most cases, a portion of the amount deducted in respect of the prescribed amount of his net reserve adjustment. Section 8100 of the Regulations provides that the prescribed amount of a taxpayer's net reserve inclusion for a year is 15% for 1989, 25% for 1990, 25% for 1991 and 35% for 1992 of the amount deducted by the taxpayer under subsection 20(26) of the Act in respect of his prescribed amount of net reserve adjustment where his taxation year or fiscal period coincides with the calendar year. In other cases, the percentage of the amount of net reserve adjustment to be included in computing his income for a taxation year will be determined by prorating the percentages based on the number of days of his taxation year or fiscal period within such calendar years. Special rules are provided under section 8100 of the Regulations that apply on certain reorganizations of corporations and partnerships to allow the prescribed amount of net reserve deduction to flow-through to another corporation or partnership for the purposes of determining the inclusion under section 12.3 of the Act.

New section 12.4 of the Act requires a taxpayer who disposes of a property described in his inventory in respect of which he has previously deducted an amount as a bad debt under paragraph 20(1)(p) of the Act to include in computing his income the amount by which the previous bad debt deductions in respect of the property exceed previous bad debt recoveries in respect of the property under paragraph 12(1)(i) of the Act. This section, which is applicable for taxation years and fiscal periods commencing after June 17, 1987 that end after 1987, is intended to prevent a taxpayer from claiming both a bad debt deduction and a loss on the sale of a property that is part of his inventory.

Clause 7

Recaptured Depreciation

ITA
13

Section 13 provides a number of special rules relating to the tax treatment of depreciable property. These rules apply only for the purposes of sections 13 and 20 of the Act and the capital cost allowance regulations.

Subclause 7(1)

ITA
13(1)

Subsection 13(1) of the Act provides for the inclusion in income of depreciation recapture where the proceeds of disposition of depreciable property of a prescribed class exceed the undepreciated capital cost of such property. This subsection is amended to include a reference to subparagraph 13(21)(f)(ii.2), a new subparagraph relating to repayment of assistance received relating to the acquisition of depreciable property which was added to the Act for the 1985 and subsequent years. This is a technical amendment, applicable to the 1985 and subsequent taxation years, which will include amounts determined under subparagraph 21(f)(ii.2) in the calculation of recaptured depreciation.

Subclause 7(2)

ITA
13(2)

New subsection 13(2) of the Act provides that, where an excess amount is determined under subsection (1), that excess depreciation shall not be included in a taxpayer's income where the amount is in respect of a any motor vehicle owned by an individual (except where all or substantially all of the use of the motor vehicle throughout the period that he owned it was for the purpose of earning income from business or property) or a passenger vehicle owned by any taxpayer. It is in respect of such vehicles that capital cost allowance is restricted by the rules set out in new section 67.2 of the Act. The definitions of "motor vehicle" and "passenger vehicle" are contained in the amendments to subsection 248(1) of the Act. This new subsection is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 7(3)

ITA
13(6.1)

New subsection 13(6.1) of the Act governs the amounts in respect of undepreciated capital cost of motor vehicles that are transferred from Class 10 to new Class 10.1 which will be a separate class for each motor vehicle owned by an individual and each passenger vehicle owned by any person. The amount to be included in each new separate class is the amount by which the cost of the vehicle exceeds the portion of the capital cost allowance that may reasonably be considered to have been previously claimed in respect of that vehicle. However, where the motor vehicle is a passenger vehicle, the amount to be transferred will be the lesser of the amount described above and the excess of $20,000 over the portion of capital cost allowance that may reasonably be considered to have been claimed in respect of the passenger vehicle. This new subsection is applicable to the 1988 and subsequent taxation years.

Subclauses 7(4) and (5)

ITA
13(7)(a) and (b)

Paragraphs 13(7)(a) and (b) of the Act provide special rules where there is a change of use of depreciable property from an income earning purpose to some other purpose or vice-versa. However, the present provisions are applicable only where the income earning purpose is with respect to income from property or a business. Since it will also be possible to use a motor vehicle or a musical instrument to earn income from an office or employment, these paragraphs are amended so as to be applicable to changes of use to or from any income earning purpose. The amendment is applicable to changes in use occurring after April, 1988.

Subclause 7(6)

ITA
13(7)(b)(ii)(B)

Paragraph 13(7)(b) determines the capital cost of depreciable property acquired for a purpose other than to produce income where a taxpayer commences to use the property for the purpose of producing income. Two amendments are being made to this paragraph as a consequence of the changes to the inclusion rates for capital gains.

The first amendment to paragraph 13(7)(b) increases the portion of the excess of the property's fair market value at the time of the change in use over its cost immediately before the change in use that is added in determining the capital cost of the property to the taxpayer. The portion is increased from one-half to two-thirds for changes in use in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. For changes in use in taxation years or fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989, the portion of the excess to be added to the taxpayer's capital cost will be further increased from two-thirds to three-quarters. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

The second amendment to paragraph 13(7)(b) provides that the amount by which the excess referred to above is reduced under subclause 13(7)(b)(ii)(B)(III) in respect of capital gains exemptions claimed by an individual will be two times the exemption claimed prior to 1988, three-halves of the exemption claimed after 1987 and before 1990 and four-thirds of the exemption claimed after 1989.

Subclause 7(7)

ITA
13(7)(c)

Paragraph 13(7)(c) of the Act currently provides that where a taxpayer acquires property and uses it regularly for the purposes of earning income from that property or from a business and in part for some other purpose, the cost of the property for capital cost allowance purposes is deemed to be that proportion of the cost of the property represented by the proportion that the use made of the property for earning income from the property or from a business is of the whole use of the property. Likewise, when such a property is disposed of, the proceeds of disposition of the property shall be deemed to be the proportion of the total proceeds represented by the proportion that the use of the property for earning income from the property or a business is of the whole use of the property. Since it is possible for certain property to be used for earning income from an office or employment, this paragraph is amended so as to refer solely to property used in part for earning income and for some other purpose. This paragraph does not apply to a motor vehicle which is subject to the restrictions on the deductibility of certain expenses contained in new section 67.3. This amendment is applicable with respect to changes in use occurring after April, 1988.

Subclause 7(8)

ITA
13(7)(d)(i)(B)

Paragraph 13(7)(d) determines the capital cost of depreciable property where the use of the property for the purposes of gaining or producing income changes relative to other uses made of the property. Subparagraph 13(7)(d)(i) applies where the income producing use has increased relative to the other uses made of the property. Two amendments are being made to this subparagraph as a consequence of the changes to the inclusion rates for capital gains.

The first amendment to subparagraph 13(7)(d)(i) increases the portion of the excess of the amount deemed to be his proceeds of disposition of the property under subparagraph 45(1)(c)(ii) in respect of the change over its cost immediately before the change in use that is added in determining the capital cost of the property. The portion is increased from one-half to two-thirds for changes in use in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. For changes in use in taxation years or fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989, the portion of the excess to be added to the taxpayer's capital cost will be further increased from two-thirds to three-quarters. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

The second amendment to subparagraph 13(7)(d)(i) provides that the amount by which the excess determined above is reduced under subclause 13(7)(d)(i)(B)(III) in respect of capital gains exemptions claimed by an individual will be two times the exemption claimed prior to 1988, three-halves of the exemption claimed after 1987 and before 1990 and four-thirds of the exemption claimed after 1989.

Subclause 7(9)

ITA
13(7)(e)(i)(B)

Paragraph 13(7)(e) of the Act sets out a number of special rules that apply where depreciable property is transferred between persons or partnerships not dealing at arm's length.

Subparagraph 13(7)(e)(i) determines a taxpayer's capital cost of property acquired by him from an individual resident in Canada or a partnership, any member of which is either an individual resident in Canada or another partnership. Two amendments are being made to clause 13(7)(e)(i)(B) as a consequence of the changes to the inclusion rate for capital gains of individuals and partnerships.

The first amendment to clause 13(7)(e)(i)(B) increases the portion of the excess of the purchase price over the vendor's cost of the property that is added in determining the purchaser's capital cost of the property. This amendment increases the portion of the excess from one-half to two-thirds for non-arm's length transfers in taxation years and fiscal periods ending after 1987 and before 1990 and further increases the portion of the excess from two-thirds to three-quarters for such transfers in taxation years and fiscal periods ending after 1989.

The second amendment to clause 13(7)(e)(i)(B) provides that the excess determined above will be reduced by two times the exemption claimed before 1988, three-halves of the exemption claimed after 1987 and before 1990 and four-thirds of the exemption claimed after 1989.

Subclause 7(10)

ITA
13(7)(e)(ii)(B)

Subparagraph 13(7)(e)(ii) determines a taxpayer's capital cost of property acquired by him in a non-arm's length transaction from a person or partnership other than one to which the rules in subparagraph 13(7)(e)(i) apply. Clause 13(7)(e)(ii)(B) is amended as a consequence of the increased inclusion rates for capital gains.

The amendment to clause 13(7)(e)(ii)(B) increases the portion of the excess of the sale price over the vendor's cost that is added in determining the purchaser's cost of the property. The amount of the excess is increased from one-half to two-thirds of that excess for property acquired in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years commencing after 1987 for Canadian-controlled private corporations and in taxation years commencing after June, 1988 for other corporations. The portion of the excess to be added to the purchaser's capital cost of the property will be further increased from two-thirds to three-quarters for property acquired in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 7(11)

ITA
13(7)(f)(ii)

Paragraph 13(7)(f) of the Act applies where a corporation is treated as having disposed of and reacquired depreciable property either as a result of a change of control where an election has been made under paragraph 111(4)(e) or as a result of becoming exempt or ceasing to be exempt from tax under Part I of the Act on its taxable income under paragraph 149(10)(b). Paragraph 13(7)(f) is being amended as a consequence of the increased inclusion rates for capital gains.

The amendment to paragraph 13(7)(f) increases the portion of the excess of the proceeds over the cost to the corporation that is added in determining the corporation's capital cost of the property from one-half to two-thirds of the excess for property deemed to have been acquired in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion of the excess to be added to the corporation's capital cost of the property will be further increased from two-thirds to three-quarters of the excess for property deemed to have been acquired in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 7(12)

ITA
13(7)(g) and (h)

Subsection 13(7) of the Act is amended by the addition of two new paragraphs. New paragraph 13(7)(g) imposes a $20,000 limit on the depreciable capital cost of a passenger vehicle by deeming the capital cost of a passenger vehicle whose actual cost exceeds $20,000 to be $20,000. The reference to such other amount as may be prescribed will permit the adjustment of the $20,000 limit on a periodic basis.

New paragraph 13(7)(h) of the Act is a rule designed to prevent the $20,000 limit on the depreciable capital cost of a passenger vehicle from being circumvented by a transfer of the vehicle between parties not dealing at arm's length. Where a passenger vehicle is acquired by a taxpayer from a person with whom the taxpayer was not dealing at arm's length, the capital cost to the taxpayer of the vehicle shall be deemed to be the least of $20,000, its fair market value and its undepreciated capital cost to the transferer immediately before the transfer.

The definition of "passenger vehicle" is contained in the amendments to subsection 248(1) of the Act but is restricted to vehicles acquired after June 17, 1987. New paragraphs 13(7)(g) and (h) of the Act are applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 7(13)

ITA
13(7.1)(a)

Subsection 13(7.1) of the Act requires a taxpayer to reduce the capital cost of depreciable property to the extent that he has deducted a federal investment tax credit or received other governmental assistance in respect of that property. Paragraph 13(7.1)(a) excludes from the operation of this subsection governmental assistance received under an Appropriation Act in respect of scientific research and experimental development (R&D) expenditures. These amounts are excluded from the operation of subsection 13(7.1) because they, instead, reduce the taxpayer's pool of R&D expenditures under subsection 37(1) of the Act.

Paragraph 13(7.1)(a) is amended as a consequence of the changes to paragraphs 37(1)(c) and (d) of the Act which will require any governmental or non-governmental assistance which the taxpayer has received or is entitled to receive in respect of R&D expenditures to be accounted for directly in the calculation of his pool of R&D expenditures. This amendment is applicable in respect of expenditures made after April, 1988.

Subclause 7(14)

ITA
13(7.1)

As noted in the commentary to subclause 7(13), subsection 13(7.1) of the Act reduces the capital cost of a depreciable property where an investment tax credit has been deducted by the taxpayer in respect of the property. However, because a claim of the credit affects capital cost allowance, which in turn affects tax otherwise payable and the amount of the investment tax credit which may be claimed in a year, the calculations very often become circular where the credit reduces the capital cost of the property in the same year as that in which the credit is claimed. Accordingly, subsection 13(7.1) is amended to require a reduction of the capital cost of a depreciable property only for taxation years following that in which a related credit is claimed. This amendment is applicable for taxation years ending after 1987.

Subclause 7(15)

ITA
13(21)(e)

Paragraph 13(21)(e) of the Act defines "total depreciation" for the purposes of the provisions of the Act and the Regulations governing recapture of depreciation and capital cost allowance as the aggregate of amounts allowed in respect of capital cost allowance and terminal losses. This paragraph is amended as a consequence of the restrictions on certain motor vehicle expenses contained in new section 67.3 and the restriction on terminal losses in respect of motor vehicles in new subsection 20(16.1). "Total depreciation" now is defined as the aggregate of amounts deducted in respect of capital cost allowance or that would be allowed but for new section 67.3 and amounts deducted under subsection 20(16) in respect of a terminal loss or that would have been so deducted but for new subsection 20(16.1). The effect of this amendment is to reduce the undepreciated capital cost of property to which new section 67.3 or subsection 20(16.1) applies by the amount of capital cost allowance and terminal loss that would have been available if those new provisions had not applied. New section 67.3 and subsection 20(16.1) apply in some circumstance to restrict the capital cost allowance and deny any terminal loss in respect of motor vehicles owned by an individual and passenger vehicles owned by a taxpayer.

Subclause 7(16)

ITA
13(21.1)(b)(ii)

Subsection 13(21.1) of the Act provides special rules where land is sold and the building thereon is also disposed of for less than both its cost amount and its capital cost to the taxpayer immediately before the disposition.

Paragraph 13(21.1)(b) applies to determine the proceeds of disposition of a building where the land is not sold at the same time as the building and, at any time prior to the disposition, the taxpayer or a non-arm's length person owned the land. This rule is changed strictly as a consequence of the increase in the inclusion rate for capital gains and losses to two-thirds after 1987 and to three-quarters after 1989.

Clause 8

Eligible Capital Property

ITA
14

Section 14 of the Act sets out the provisions in respect of the treatment of eligible capital property.

Subclause 8(1)

ITA
14(1)

Subsection 14(1) of the Act provides that where, at the end of a taxation year, the amounts required to be deducted from a taxpayer's pool of expenditures in respect of eligible capital property, known as his cumulative eligible capital, exceed the amounts required to be added to the pool, that excess, for the purposes of this commentary referred to as the "negative balance", must be included in the taxpayer's income for the year. Two amendments are made in this regard. The first is strictly consequential on the change in the inclusion rate for eligible capital property from 1/2 to 3/4. The second treats a portion of the negative balance in the cumulative eligible capital to be a taxable capital gain eligible for the lifetime capital gains exemption.

Subsection 14(1) is amended to refer to the appropriate provisions in paragraph 14(5)(a) which were amended consequential to the increase in the inclusion rate for eligible capital property from 1/2 to 3/4.

Subsection 14(1) is further amended to provide that, in the case of a taxpayer who is an individual other than a trust, where the taxpayer's cumulative eligible capital has a negative balance at the end of a taxation year, the amount that must be included in the taxpayer's income is only the portion of that negative balance that represents the recapture of previous deductions taken under paragraph 20(1)(b) of the Act in respect of eligible capital property. The remainder of the negative balance is deemed to be a taxable capital gain of the taxpayer from a disposition of capital property by him in the year and is, therefore, eligible for the lifetime capital gains exemption.

The following example illustrates the operation of these provisions:

Assume that an individual, with a calendar fiscal period for his business, makes an eligible capital expenditure of $80 in 1988. This is his first such expenditure. For his 1988 through 1990 taxation years the individual deducts, in each year, the maximum allowance in respect of his cumulative eligible capital (7% on a declining balance basis) for a total of $11.74. In 1991 the individual disposes of the eligible capital property for proceeds of $200. Subsection 14(1) would apply as follows:

- the individual's cumulative eligible capital at the end of 1991

  = (3/4 of eligible capital expenditures) less (deductions taken + 3/4 of proceeds of disposition)

  = 3/4 ($80) - ($11.74 + 3/4 ($200))

  = $60 - $161.74

  = ($101.74)

- the amount included in the individual's income for 1991 from the business

  = lesser of (A) the negative balance in his cumulative eligible capital, and

    (B) his unrecaptured prior deductions

  = lesser of (A) $101.74

    (B) $11.74

  = $11.74

- the amount deemed to be a taxable capital gain of the individual and eligible for the capital gains exemption

  = the amount by which the negative balance in his cumulative eligible capital exceeds the amount included in his income

  = $101.74 - $11.74

  = $90.

These amendments are applicable for taxation years of corporations commencing after June 30, 1988 and, in any other case, for fiscal periods commencing after 1987.

Subclause 8(2)

ITA
14(5)(a)

Paragraph 14(5)(a) of the Act defines a taxpayer's cumulative eligible capital. This account operates on a pooled basis requiring, in general, that a portion of expenditures made by a taxpayer in respect of eligible capital property be added to the pool, and that a portion of amounts received by the taxpayer in respect of dispositions of such property be subtracted from the pool. The existing provisions require that one-half of amounts so expended or received be added to or subtracted from the pool. Effective for taxation years commencing after June 30, 1988 for corporations and, in any other case, for fiscal periods commencing after 1987, paragraph 14(5)(a) is amended to increase this inclusion rate from 1/2 to 3/4. As well, at the time that the three-quarters inclusion rate becomes effective for a taxpayer, referred to as the taxpayer's "adjustment time", the existing cumulative eligible capital is increased by one-half to reflect the new inclusion rate.

Paragraph 14(5)(a) is further amended as a result of the changes to subsection 14(1) which treat a portion of the amount in respect of eligible capital property that would otherwise be included in an individual's income from a business to be a taxable capital gain. Accordingly, in the case of an individual, only that portion of the amount which is deemed to be a taxable capital gain is included in subparagraph 14(5)(a)(ii). The portion of the amount which represents a recapture of previous deductions taken under paragraph 20(1)(b) in respect of eligible capital property is taken into account in clause 14(5)(a)(v)(C) and reduces the aggregate of such deductions in subparagraph 14(5)(a)(v).

In order to ensure that paragraph 20(1)(b) deductions taken before the taxpayer's "adjustment time" are recapturable, the aggregate of such deductions is included in clause 14(5)(a)(v)(B). Because these deductions are also taken into account in increasing the balance of the taxpayer's cumulative eligible capital at his adjustment time, a balancing amount is included in subparagraph 14(5)(a)(iii.1). These amendments are applicable for taxation years of corporations commencing after June, 1988 and, in any other case, for fiscal periods commencing after 1987.

Paragraph 14(5)(a) is also amended to require that a taxpayer deduct, in calculating the balance of his cumulative eligible capital, the applicable percentage of the proceeds of disposition of eligible capital property at the time of disposition, rather than at some future time at which the purchase price is required to be paid by the purchaser. This provision ensures that no "reserve" is available for such dispositions in keeping with the policy affecting other properties for which deductions are recaptured. This amendment is applicable for dispositions after June 17, 1987.

Subclause 8(3)

ITA
14(5)(c)

New paragraph 14(5)(c) defines a taxpayer's "adjustment time". This concept applies for the purposes of determining the time at which the new three-quarters inclusion rate in respect of expenditures and receipts relating to eligible capital property applies in respect of a taxpayer in calculating his cumulative eligible capital. It is at this point in time that the taxpayer's existing cumulative eligible capital is increased by one-half, and the calculation of the account is started at the new, higher inclusion rate. The adjustment time in respect of a corporation formed as a result of an amalgamation occurring after June 30, 1988 is the time immediately before the amalgamation, the adjustment time in respect of any other corporation is the time immediately after the commencement of its first taxation year commencing after June 30, 1988 and, in any other case, the adjustment time is the time immediately after the commencement of the taxpayer's first fiscal period commencing after 1987.

Subclause 8(4)

ITA
14(6)

Subsection 14(6) of the Act is a replacement property rule for eligible capital property. It allows the recognition of a negative balance, arising as a consequence of a disposal, in the cumulative eligible capital account of a taxpayer at the end of a taxation year to be deferred where he acquires a replacement eligible capital property before the end of the taxation year following the year of disposition. This amendment is strictly consequential to the increase in the inclusion rate from 1/2 to 3/4 for eligible capital property.

This amendment is applicable with respect to dispositions occurring, in the case of a corporation, in taxation years commencing after June 30, 1988 and, in any other case, in fiscal periods commencing after 1987. However, where a disposition occurred in the last taxation year of a corporation commencing before July 1, 1988 or, in any other case, in the last fiscal period of the taxpayer commencing before 1988, the rate at which the amount received in respect of that disposition is subtracted from the taxpayer's cumulative eligible capital will be 3/4.

Clause 9

Benefits Conferred on Shareholder

ITA
15(1)

Subsection 15(1) of the Act requires a shareholder to include in his income the amount or value of certain benefits, described in paragraphs (a) to (c), which are obtained from a corporation unless these benefits result from some specific transactions or events described in paragraphs (d) to (g).

Paragraph 15(1)(a) applies to payments received from the corporation otherwise than pursuant to a bona fide business transaction. Paragraph 15(1)(b) applies to funds or property of the corporation which are appropriated in any manner to or for the benefit of a shareholder. Finally, paragraph 15(1)(c) applies to a benefit or advantage which has been conferred on a shareholder by the corporation. The words "benefit or advantage" in paragraph (c) are broad enough to include the payments, funds or property specifically referred to in paragraphs (a) and (b). Subsection 15(1) is therefore amended by deleting paragraphs (a) and (b) in order to eliminate this overlap. In addition, subsection 15(1) is extended to apply to a benefit that is conferred on a person in contemplation of his becoming a shareholder.

Subsection 15(1) is further amended by deleting from paragraph (e) (redesignated paragraph (b)) the reference to a stock dividend. Since the definition of dividend in subsection 248(1) already includes a stock dividend, this reference in paragraph 15(1)(e) is redundant.

Paragraph (f) (redesignated paragraph (d)) provides that subsection 15(1) does not apply where a corporation confers on the owners of its common shares a right to buy additional common shares. This paragraph is amended to extend this exception where the right conferred on the common shareholders is the right to buy any additional shares, and not only common shares, of the corporation.

These amendments are applicable to benefits conferred after June, 1988.

Clause 10

Income and Capital Combined

ITA
16(1)

Subsection 16(1) of the Act deals with blended payments which are partly of capital nature and partly of the nature of interest or other income. It provides that such part of a blended payment as can reasonably be regarded as being a payment of interest or other payment of an income nature must be included in computing the recipient's income from property for the taxation year in which it has been received.

Subsection 16(1) is amended to provide that the part of a blended payment that can reasonably be regarded as interest will be treated as interest on a debt obligation rather than simply included as income from property. This amendment clarifies that other rules -- such as those contained in subsection 12(3) of the Act which require corporations, partnerships and certain trusts to include interest in their income on an accrual basis -- will be applicable to the interest portion of a blended payment.

Subsection 16(1) is further amended to provide that the part of a blended payment that can reasonably be regarded as an amount of an income nature other than interest shall be included in the recipient's income for the taxation year in which that amount was received or became receivable, except to the extent it is otherwise included in the taxpayer's income.

This amendment is applicable to amounts paid or payable after June, 1988.

Clause 11

Deductions Prohibited - Business and Property Income

ITA
18

Section 18 of the Act prohibits the deduction of certain outlays or expenses in computing a taxpayer's income from a business or property.

Subclause 11(1)

ITA
18(1)(e)

Paragraph 18(1)(e) of the Act denies a deduction for amounts transferred or credited to a reserve, contingent account or sinking fund except as expressly permitted by Part I of the Act. The amendment to paragraph 18(1)(e) clarifies the application of this provision in two respects. First, the words "transferred or credited" have been deleted because they may be technically inappropriate with respect to contingent liabilities and some reserves. Second, contingent liabilities have been expressly included in the items mentioned in paragraph 18(1)(e). This amendment is applicable to taxation years commencing after June, 1988.

Subclause 11(2)

ITA
18(1)(e.1)

New paragraph 18(1)(e.1) of the Act, applicable to taxation years commencing after June 17, 1987 that end after 1987, denies an insurer a reserve in respect of claims under insurance policies that were received by the insurer before the end of a particular year and are unpaid at the end of that year, except as expressly permitted under other provisions of the Act.

The deduction of a prescribed amount of a reserve is permitted under new subparagraph 138(3)(a)(ii) of the Act and new subsection 1401(4) of the Income Tax Regulations for such unpaid claims arising in the course of a life insurance business and under paragraph 20(7)(c) of the Act and new paragraph 1400(e) of the Regulations for unpaid claims arising in the course of an other than life insurance business. In both cases, the prescribed amount provides for the discounting of unpaid claims.

Subclause 11(3)

ITA
18(1)(h)

Paragraph 18(1)(h) of the Act contains a general prohibition against the deduction of any personal or living expenses of a taxpayer, except travelling expenses, including the entire amount spent on meals and lodging, incurred while the taxpayer is away from home in the course of his business. This paragraph is amended to delete the reference to "the entire amount expended for meals and lodging" as a consequence of the general restriction provided in section 67.1 on the deductibility of meal expenses to 80% of their cost. The amendment is applicable to costs incurred after 1987.

Subclause 11(4)

ITA
18(1)(r) and (s)

New paragraph 18(1)(r) of the Act restricts the amount that may be deducted by a taxpayer in respect of amounts paid as an allowance for the use by an individual of an automobile to an amount determined in accordance with prescribed rules, unless the individual is an employee who is entitled to a deduction under paragraph 8(1)(f) or (h) in respect of automobile expenses. Regulations will determine the maximum amount which may be deducted in this respect as 27 cents for each of the first 5,000 kilometres driven by the individual in a year and 21 cents for each subsequent kilometre. An additional 4 cents for each kilometre travelled in the Yukon and the Northwest Territories will be allowed. This amendment is applicable to amounts paid after 1987.

New paragraph 18(1)(s) of the Act provides that, except as expressly permitted under Part I of the Act, no amount shall be deducted in a year in respect of any loss, depreciation or reduction in the value or amortized cost of a loan or lending asset described in subparagraph 20(1)(l)(ii). The rule in paragraph 18(1)(s) applies where the loan or lending asset, as defined in subsection 248(1) of the Act, was not disposed of in the year and was acquired in the ordinary course of business by a taxpayer who was an insurer or whose ordinary business included the lending of money. As a result, a taxpayer will not be able to claim an inventory write-down on assets that are eligible for a reserve under subparagraph 20(1)(l)(ii).

Subclause 11(5)

ITA
18(2)

Interest and Property Taxes on Land

Subsection 18(2) prohibits the deduction of certain carrying charges (interest and property taxes) in respect of vacant land to the extent that these expenses exceed any income from the land. This rule does not apply to land used or held in the course of a business or to taxpayers whose business is the sale or development of land. The amendments to subsection 18(2) remove the exemption for taxpayers whose business is the sale or development of land as well as the exemption for land held, but not used, in a business.

For corporations whose principal business is the leasing, rental or sale, or the development for lease, rental or sale, of real property, such carrying charges incurred in a year on vacant land will remain deductible to the extent of the income from the land (net of other deductions) and the base level deduction of the corporation for the year. The base level deduction of such a corporation for a taxation year is the amount that would be the amount computed at the prescribed rate of interest for the year in respect of $1,000,000 of debt outstanding for the year. This additional deductible amount must be shared by associated corporations in a manner similar to the existing rules applicable to the annual small business deduction and must be adjusted for short taxation years.

These amendments are applicable to taxation years ending after 1987. However, special transitional relief is provided such that the new rules will apply on a pro-rata basis to carrying charges incurred in taxation years which include January 1, 1988 and will be phased-in over five years. The five-year phase-in is prorated for any taxation year that does not coincide with a calendar year in the transitional period based upon the number of days in each calendar year.

Subclause 11(6)

ITA
18(2.2), (2.3), (2.4) and (2.5)

New subsections 18(2.2), (2.3), (2.4) and (2.5) of the Act provide the rules for determining the base level deduction of a corporation for the purposes of subsection 18(2). Under subsection 18(2.2), the base level deduction of a corporation, other than a corporation that is a member of an associated group of corporations, is the amount that would be the amount of interest, computed at the prescribed rate, for the year in respect of a debt of $1,000,000 outstanding throughout the year.

The base level deduction of a corporation that is a member of an associated group of corporations is calculated by reference to a prescribed agreement which may be filed pursuant to new subsection 18(2.3) under which the $1,000,000 to which the prescribed rate is applied under subsection 18(2.2) is allocated amongst the associated corporations. If such an agreement is not filed by any corporation in the group in the year, the Minister is permitted to make the allocation under new subsection 18(2.4).

New paragraph 18(2.5)(a) of the Act is applicable where a corporation has two or more taxation years ending in the same calendar year in which it is associated with another corporation. This rule provides that the corporation's base level deduction (before proration for the short year) for each taxation year is the amount allocated to it for its first such taxation year under subsection 18(2.2). The corporation's base level deduction for each such year is then determined after the required proration pursuant to new paragraph 18(2.5)(b).

New paragraph 18(2.5)(b) of the Act, requires a proration of the base level deduction for any taxation year of less than 51 weeks duration. It provides that a corporation's base level deduction for a short taxation year is its base level deduction otherwise determined multiplied by the number of days in the year and divided by 365.

Subclause 11(7)

ITA
18(3)(b)

Paragraph 18(3)(b) of the Act currently provides a definition of "interest on borrowed money used to acquire land" for the purposes of the rules provided in subsection 18(2). The preamble to paragraph 18(3)(b) is amended as a consequence of the amendments to subsection 18(2) to refer to "interest on debt relating to the acquisition of land" to ensure that the terminology used in the two provisions is consistent. This amendment to paragraph 18(3)(b) is applicable for expenses incurred in taxation years ending after 1987.

Subclause 11(8)

ITA
18(3)(b)(ii)

Subparagraph 18(3)(b)(ii) of the Act includes in the definition of "interest on borrowed money used to acquire land" (amended to "interest on debt relating to the acquisition of land") for the purposes of the rules in subsection 18(2), certain interest expenses incurred by a taxpayer in respect of borrowed money used to finance the acquisition of land by another person with whom the taxpayer does not deal at arm's length. This provision is expanded as a consequence of the amendments to subsection 18(2) to apply also to interest on borrowed money used to finance the acquisition of land by a corporation of which the taxpayer is a specified shareholder or a partnership in which the taxpayer has a 10 per cent or greater interest. This amendment is applicable to taxation years commencing after April, 1988.

Subclauses 11(9) and (10)

ITA
18(3.1)(a) and (b)

Construction Period Costs

Subsection 18(3.1) of the Act denies the deduction of certain costs relating to the construction, renovation or alteration of a building and requires the addition of such outlays to the land and building to which they relate. Paragraph 18(3.1)(a) is amended to delete the references therein to section 37 and 37.1 as a consequence of the amendments excluding the cost of buildings from the research and experimental development incentives. Paragraph 18(3.1)(b) is also amended to provide that all costs the deduction of which is denied by paragraph 18(3.1)(a) may be added to the cost of the associated building. The amendment to paragraph 18(3.1)(a) is applicable in respect of buildings acquired by a taxpayer after 1989. The amendment to paragraph 18(3.1)(b) is applicable in respect of expenses incurred after 1987.

Subclause 11(11)

ITA
18(3.2)(b)

Subsection 18(3.2) includes in the definition of costs relating to the construction, renovation or alteration of a building, for the purposes of the rules in subsection 18(3.1) which require the capitalization of such costs, interest in respect of borrowed money used by a taxpayer to finance the construction of a building by a partnership with whom the taxpayer does not deal at arm's length. This subsection is amended so as to apply in respect of partnerships in which the taxpayer has a 10 per cent or greater interest. This amendment is applicable to taxation years commencing after April, 1988.

Subclause 11(12)

ITA
18(3.4)

Subsection 18(3.4) provides an exemption for principal business corporations from the rules in subsection 18(3.1) which require that taxpayers include construction period "soft costs" in the capital cost of buildings under construction, renovation or alteration and the related land. In general, a principal business corporation is a corporation the principal business of which is the leasing, rental, or sale or the development for lease, rental or sale, of real property owned by it. The amendment to subsection 18(3.4), which removes this exemption over a transitional period, is applicable in respect of expenses incurred after 1987 subject to a five-year phase-in such that 20 per cent of the relevant costs incurred in 1988 will be required to be capitalized, 40 per cent for calendar year 1989, 60 per cent for calendar year 1990, 80 per cent for calendar year 1991 and 100 per cent after 1991.

Subclause 11(13)

ITA
18(5)(a)(ii)

Subsections 18(4) to (6) of the Act contain rules which are referred to as the "thin capitalization" rules. These rules limit the deduction allowed to a corporation for interest on debts owing to certain non-residents and persons related thereto known as specified non-residents. These rules apply where the corporation's debt-equity ratio in relation to specified non-residents exceeds 3 to 1.

Subparagraph 18(5)(a)(ii) of the existing Act provides that a debt owing to a non-resident insurer by a corporation that it controls will not be included in the corporation's "outstanding debt to specified "non-residents" for the purpose of the thin capitalization rules if, by reason of an election under former subsection 138(9) of the Act, the non-resident insurer treats the debt as property held by it in the year in the course of carrying on an insurance business in Canada. This subparagraph is amended to provide that such a debt will not be considered to be an outstanding debt to a specified non-resident where under paragraph 138(12)(l) of the Act the debt is property used or held by the non-resident insurer in the course of carrying on an insurance business in Canada.

The amendments to subparagraph 18(5)(a)(ii) are applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 11(14)

ITA
18(9)(d)

Paragraph 18(9) of the Act prohibits the deduction of prepaid expenses in computing income for a taxation year preceding the taxation year to which the expenses relate. Paragraph 18(9)(b) allows an amount prohibited as a deduction by paragraph (a) in one year to be deducted in the subsequent year to which the amount relates. Paragraph 18(9)(d) provides that amounts paid to an approved organization that in turn pays the amounts to another organization to undertake scientific research will not be treated as a prepaid expense. This paragraph is amended strictly as a consequence of the modifications to subsection 37(1) of the Act to change the reference to subparagraph 37(1)(a)(vi) to a reference to clause 37(1)(a)(ii)(E). This amendment is applicable in respect of payments to which paragraph 37(1)(a) of the Act, as enacted by subclause 15(1), is applicable.

Subclause 11(15)

ITA
18(12) and (13)

New subsection 18(12) of the Act restricts the deduction of expenses incurred by an individual in respect of a home office. No amount may be deducted in respect of a "work space" in a self-contained domestic establishment in which the individual resides unless certain conditions are met. The work place must be either the principal place of business of the individual or used by him exclusively on a regular and continuous basis for meeting his clients, customers or patients. Where these conditions are met, the individual may deduct otherwise allowable amounts, but only to the extent of his income from the business for the year. To the extent that this latter requirement restricts the deduction of a portion of home office expenses for a particular year, such expenses are treated as home office expenses incurred in the immediately following year, thus permitting an indefinite carryforward of this type of expense. This amendment is applicable to fiscal periods commencing after 1987.

New subsection 18(13) of the Act introduces a superficial loss rule that denies such losses sustained by a taxpayer whose ordinary business includes the lending of money. This rule is similar to the superficial loss rule in paragraph 54(i) relating to capital properties. A superficial loss under subsection 18(13) is a loss realized by the taxpayer on the sale or transfer of a property that is a share or a loan, bond, debenture, mortgage, note, hypothec, agreement of sale or any other indebtedness that was not a capital property of the taxpayer where the same or identical property (referred to as the "substituted property") is acquired by the taxpayer or a non-arm's length person or partnership during the period commencing 30 days before and ending 30 days after the sale or transfer and that substituted property is held by the taxpayer or the person or partnership at the end of that period. Any loss that is a superficial loss is added in computing the cost of the substituted property to the taxpayer or the person or partnership who owns the property 30 days after the sale or transfer. New subsection 18(13) is applicable to sales or transfers in taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Clause 12

Deductions Permitted
- Business and Property Income

ITA
20

Section 20 of the Act sets out rules providing for the deduction of certain outlays, expenses and other amounts in computing a taxpayer's income from a business or property for a year.

Subclause 12(1)

ITA
20(1)(b)

Paragraph 20(1)(b) of the Act provides for a deduction in calculating a taxpayer's income from a business in respect of his cumulative eligible capital in respect of that business. This paragraph is amended to reduce the annual deduction allowed from 10% to 7% of the cumulative eligible capital of the business at the end of its fiscal period. This amendment is applicable, in the case of corporations, for taxation years commencing after June 30, 1988 and, in any other case, for fiscal periods commencing after 1987. Other amendments relating to eligible capital property are described in the explanatory notes describing the changes to section 14 of the Act.

Subclause 12(2)

ITA
20(1)(e), (e.1)

Paragraph 20(1)(e) of the Act currently provides for the deduction of expenses of issuing securities or borrowing money in the year they are incurred. The amendment to this paragraph provides that such expenses incurred after 1987 are only deductible in equal portions over five years subject to a pro-rata reduction for short taxation years. If the borrowings for which the expenses were incurred are repaid in a year (otherwise than as part of a refinancing) the undeducted balance of the expenses will be deductible in that year. In cases where a partnership is dissolved, the undeducted expenses will be deductible over the remainder of the five-year period in the hands of the partners, with a cost base reduction to the partners of their partnership interests immediately before the dissolution (see subparagraph 53(2)(c)(x)). Where a corporation which has an undeducted balance of such expenses is wound-up into, or amalgamated with, another corporation, the other corporation will continue to deduct the expenses over the balance of the five-year period (see paragraph 87(2)(j.6)).

New paragraph 20(1)(e.1) overrides the provisions of new paragraph 20(1)(e) and provides that guarantee and standby fees incurred after 1987 that relate only to a particular taxation year may be deducted in computing income for that year.

These amendments are applicable to expenses incurred after 1987 in respect of issuances or sales of shares, units of trusts or interests in partnerships and borrowings occurring after 1987.

Subclause 12(3)

ITA
20(1)(f)(ii)

Paragraph 20(1)(f) sets out rules concerning the deductibility of discounts paid by a taxpayer in satisfaction of the principal amount of any bond, debenture, bill, note, mortgage, hypothec or similar obligation issued by the taxpayer on which interest was stipulated to be payable. Subparagraph 20(1)(f)(ii) limits the deductibility of discounts on obligations where the discount is greater than 3% of the principal amount of the obligation or where the annual rate of return exceeds four-thirds of the interest stipulated to be payable on the obligation. Discounts such as these are commonly called deep discounts. Subparagraph 20(1)(f)(ii) is being amended as a consequence of the changes to the inclusion rates for capital gains.

The portion of the discount deductible under subparagraph 20(1)(f)(ii) in computing a taxpayer's income is increased from one-half to two-thirds for payments made in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion of the discount that is deductible from income will be further increased to three-quarters for payments made in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 12(4)

ITA
20(1)(k)

Paragraph 20(1)(k) of the Act provides that the portion of a blended payment that is included in the recipient's income from property pursuant to subsection 16(1) of the Act may be deducted in computing the payor's income from business or property where the payment is for borrowed money used for the purpose of earning such income or for property acquired for the same purpose.

Paragraph 20(1)(k) is repealed as a consequence of the amendment to subsection 16(1). By reason of this amendment, subsection 16(1) deems the interest portion of a blended payment to be interest on a debt obligation. Therefore, the general rules applicable to the deduction of interest will apply to that part of the payment and paragraph 20(1)(k) is no longer necessary.

This amendment is applicable to amounts paid or payable after June, 1988.

Subclause 12(5)

ITA
20(1)(l) and (l.1)

Paragraph 20(1)(l) allows a taxpayer to deduct a reasonable amount as a reserve for doubtful debts. Subparagraph 20(1)(l)(i) provides a reserve in respect of debts that have been included in computing the income of a taxpayer. In the case of a loan, this subparagraph would provide a reserve in respect of interest that has been included in a taxpayer's income but the collection of which is doubtful.
Subparagraph 20(1)(l)(ii) provides a reserve in respect of certain debts of taxpayers whose ordinary business included the lending of money.

Several amendments are being made to paragraph 20(1)(l) as a result of the repeal of the provisions of the Act that provided special reserves for financial institutions.

Subparagraph 20(1)(l)(ii) of the Act allows a taxpayer whose ordinary business included the lending of money to deduct a reasonable amount as a reserve for doubtful debts arising from loans made in the ordinary course of business by the taxpayer. This subparagraph is being amended to include insurers in the class of taxpayers eligible to claim this reserve. In addition the list of assets eligible for this reserve is expanded to include loans or lending assets made or acquired by the taxpayer in the ordinary course of his business. A lending asset is defined in subsection 248(1) of the Act as a bond, debenture, mortgage, note, hypothec, agreement of sale or any other indebtedness and includes a preferred share owned by a bank that is an alternative or a substitute for a loan but does not include any of the above assets that are part of the trading account of a bank or the inventory of any other taxpayer. Subparagraph 20(1)(l)(ii) is further amended to provide that the amount of the reserve that may be claimed is the total of two amounts. The first amount, which is set out in clause 20(1)(l)(ii)(A), is the prescribed reserve amount for the taxpayer for the year. The prescribed reserve amount, unlike the amount determined under clause 20(1)(l)(ii)(B), is not reduced by a prescribed recovery rate. The prescribed reserve amount of a taxpayer is an amount determined under new section 8000 of the Regulations as including amounts in respect of two types of reserves. The first type of reserve is applicable to a bank and includes the special provision for losses on transborder claims for the year and the general provisions in respect of exposures to designated countries. The prescribed reserve amount for this type of reserve is the amount reported to and accepted by the Superintendent of Financial Institutions for the year in respect of those provisions, not exceeding 40% of the amortized cost of the loans or lending assets included in calculating those provisions that were made or acquired by the bank in the ordinary course of its business. The second type of reserve is a reserve of a taxpayer calculated by pooling particular types of doubtful loans and lending assets based on the length of time that interest or principal payable to the taxpayer has been in arrears. The amortized cost at the end of the year to the taxpayer of indebtedness in each of these pools is then reduced by an historical loss experience, as defined in new section 8002 of the Regulations, that is a representation of the prior years' losses net of recoveries for each of those classes.

The second amount -- that is the reserve under clause 20(1)(l)(ii)(B) -- is the lesser of two amounts. The first amount is a reasonable amount as a reserve for doubtful loans or lending assets in respect of their amortized cost to the taxpayer at the end of the year. The second amount is determined as the reserve for doubtful loans or lending assets reported in the financial statements of the taxpayer for the year that is in respect of the amortized cost to the taxpayer at the end of the year of such loans or lending assets. The reserve in respect of doubtful loans or lending assets reported in the financial statements of the taxpayer is increased to the extent it was reduced by interest that has been included in the taxpayer's income under subsection 12(3) of the Act. This addition recognizes the fact that some taxpayers such as banks are required in certain circumstances for financial statement purposes to apply interest payments received on a doubtful loan or lending asset towards reducing the amount of the reserve taken against that loan or lending asset. This adjusted financial statement reserve is then reduced by the prescribed recovery rate for the year. The prescribed recovery rate as set out in new section 8001 of the Regulations is 10% and is intended to reflect the prudential element included in reserves of financial institutions.

The postamble to paragraph 20(1)(l) is also amended to clarify that the deduction of a reserve can be for such amount as the taxpayer may claim of the permissible maximum amount determined under that paragraph. The amendments to paragraph 20(1)(l) are applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

New paragraph 20(1)(l.1) of the Act allows a taxpayer who is an insurer or whose ordinary business includes the lending of money to deduct a reserve in respect of credit risks under guarantees, indemnities, letters of credit or other credit facilities, bankers' acceptances, interest rate or currency swaps, foreign exchange or other future or option contracts, interest rate protection agreements, risk participations and other similar instruments or commitments issued, made or assumed in the ordinary course of that business. Only instruments and commitments issued to or made or assumed in favour of persons with whom the taxpayer deals at arm's length qualify for this new reserve. The amount of the reserve under paragraph 20(1)(l.1) is the lesser of two amounts. The first amount is a reasonable amount as a reserve for credit risk losses of the taxpayer expected to arise under or in respect of such instruments or commitments. The second amount is calculated by reducing the reserve in respect of credit risk losses expected to arise under or in respect of such instruments or commitments as reported in the financial statements of the taxpayer for the year by a prescribed recovery rate. The prescribed recovery rate as set out in new section 8001 of the Regulations is 10%. New paragraph 20(1)(l.1) is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 12(6)

ITA
20(1)(p)

Paragraph 20(1)(p) of the Act allows a taxpayer to deduct an amount in respect of debts owing to him that are established by him to have become bad debts in the year. In order for a taxpayer to obtain a bad debt deduction, subparagraph 20(1)(p)(ii) provides that, except in the case of debts arising from loans made in the ordinary course of business by a taxpayer whose ordinary business included the lending of money, the debts must have been included in computing his income. The exception in subparagraph 20(1)(p)(ii) for taxpayers whose ordinary business included the lending of money is amended to include taxpayers who were insurers and the eligible assets are expanded to include loans or lending assets that were made or acquired in the ordinary course of business by such a taxpayer. With the amendments to paragraph 20(1)(p) such a taxpayer will be able to claim a deduction in respect of that part of the amortized cost to him at the end of the year of loans or lending assets, as defined in subsection 248(1), that are established to have become uncollectable in the year. The amendments to paragraph 20(1)(p) are applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 12(7)

ITA
20(1)(t)

Paragraph 20(1)(t) of the Act permits a taxpayer to deduct in computing his income for a taxation year such amounts in respect of scientific research and experimental development as are permitted by sections 37 or 37.1. This paragraph is redundant and could cause confusion with respect to the changes being made to section 37 and subsection 96(1) of the Act. As a consequence, paragraph 20(1)(t) is repealed effective after December 15, 1987.

Subclause 12(8)

ITA
20(1)(z.1)

Paragraph 20(1)(z.1) provides a deduction for a year to a taxpayer in respect of amounts paid by him to a lessee for the cancellation of a lease of a property where the property was not owned at the end of the year by the taxpayer or a non-arm's length person. Where the property is sold to an arm's length party, the deduction under paragraph 20(1)(z.1) is, in the case of capital property, equal to one-half of the amount of the lease cancellation payment that was not deductible under paragraph 20(1)(z).

As a result of the changes to the capital gains inclusion rates, the deductible portion under paragraph 20(1)(z.1) of a lease cancellation payment made in respect of capital property will be increased from one-half to two-thirds for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion of the payment that is deductible to the taxpayer will be further increased to three-quarters for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 12(9)

ITA
20(1)(ll)

Paragraph 20(1)(ll) permits the deduction from income of a taxpayer of certain amounts paid by him as may reasonably be considered repayment of interest which was included in computing his income for the year or the preceding year. Where the taxpayer is an individual, the deductible amount under this paragraph could not exceed the excess of the amount of interest included in his income for the year, over $1,000. This amendment deletes the reference to $1,000 as a result of the repeal of section 110.1, the $1,000 interest and dividend income deduction.

Subclause 12(10)

ITA
20(1)(nn)

Paragraph 20(1)(nn) of the Act allows a deduction in computing a financial institution's income for a taxation year of any capital tax paid by it for that year under Part VI (sections 190 to 190.24) of the Act. This paragraph is repealed for the 1988 and subsequent taxation years and is replaced by new section 125.2 of the Act which provides a tax credit -- that is, a deduction in computing tax payable -- in respect of the Part VI capital tax.

Subclause 12(11)

ITA
20(4.2)

Where a taxpayer has a negative balance in his cumulative eligible capital at the end of a taxation year, subsection 14(1) of the Act requires the taxpayer to include that negative balance in his income for the year. This inclusion applies whether or not payment has been received. Currently, the Act contains no explicit provision which would allow a taxpayer a deduction if, at some time in the future, the debt received in respect of the disposition of an eligible capital property proves to be uncollectable. New subsection 20(4.2) is intended to provide that, to the extent that an amount received upon the disposition of an eligible capital property did not generate a taxable capital gain and proves to be uncollectable, the taxpayer shall deduct 3/4 of that amount.

This amendment is applicable with respect to dispositions of eligible capital property after June 17, 1987, other than such dispositions made pursuant to the terms of an obligation entered into in writing before June 18, 1987. However, in the case of a corporation, amounts in respect of dispositions occurring in taxation years commencing before July 1, 1988 and, in any other case, amounts in respect of dispositions occurring in fiscal periods commencing before 1988, one-half of such amounts may be deducted from the taxpayer's income in the year in which they are established to have become bad.

Subclause 12(12)

ITA
20(16)(a)

Subsection 20(16) of the Act provides for the deduction in computing income of a terminal loss arising in respect of depreciable property. Paragraph 20(16)(a) is amended to include a reference to subparagraph 13(21)(f)(ii.2), a new subparagraph which was added in 1986 applicable to the 1985 and subsequent taxation years, relating to the repayment of any assistance which reduced the capital cost of depreciable property. This is a technical amendment, applicable to the 1985 and subsequent years which will include amounts determined under subparagraph 13(21)(f)(ii.2) in the calculation of a terminal loss.

Subclause 12(13)

ITA
20(16.1)

Subsection 20(16) provides that where a taxpayer has a terminal loss (excess amount) at the end of a taxation year with respect to depreciable property, the loss may be deducted in computing income for the year.

New subsection 20(16.1) provides that where the terminal loss is determined under subsection 20(16), that loss shall not be deducted in computing a taxpayer's income where it relates to a motor vehicle owned by an individual (except where all or substantially all of the use of the motor vehicle throughout the period that he owned it was for the purpose of earning income from business or property) or a passenger vehicle owned by any taxpayer. A related amendment to section 13 excludes from income any depreciation recapture with respect to such vehicles. It is in respect of such vehicles that capital cost allowance is restricted by new subsection 67.2 of the Act. The definitions of "motor vehicle" and "passenger vehicle" are contained in the amendments to subsection 248(1) of the Act. This new subsection is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 12(14)

ITA
20(26)

New subsection 20(26) of the Act deals with the transition for the changes to the tax treatment of the reserves of financial institutions. This subsection allows a taxpayer who is an insurer or whose ordinary business includes the lending of money to deduct an amount not exceeding the prescribed amount of his net reserve adjustment in his first taxation year that commences after June 17, 1987 and ends after 1987. A taxpayer's prescribed amount of net reserve adjustment is defined in new section 8101 of the Regulations and is basically the difference between the reserves he claimed in the taxation year immediately preceding that first taxation year and the amount of reserves he could have claimed if the June 18, 1987 tax reform proposals with respect to reserves had applied to that immediately preceding taxation year. This difference, called the preliminary reserve adjustment, which is also defined in new section 8101 of the Regulations, is then reduced by unused deductions, such as non-capital loss carryovers and unused section 26 deductions of banks at the end of that immediately preceding taxation year or fiscal period and unclaimed capital cost allowance for that immediately preceding taxation year or fiscal period, to arrive at the taxpayer's prescribed amount of net reserve adjustment. Any amount deducted under subsection 20(26) is then included in income in the four calendar years 1989 to 1992 under new section 12.3 as the taxpayer's prescribed amount of net reserve inclusion.

Clause 13

Banks

ITA
26

Section 26 of the Act currently provides that a bank may deduct an amount for contingencies such as bad or doubtful debts or other losses on loans as is, in the opinion of the Minister of Finance, not in excess of the reasonable requirements of the bank. The Minister of Finance sets out his opinion in the Minister's rules issued annually by the Office of the Superintendent of Financial Institutions. Section 26 of the Act also prohibits banks from deducting the normal reserve for doubtful accounts allowed to most taxpayers under paragraph 20(1)(l) of the Act, the normal bad debt expense deduction allowed under paragraph 20(1)(p) and the special reserve allowed under subsection 33(1) to other taxpayers whose business includes the lending of money on security. The June 18, 1987 tax reform proposals proposed that a bank's tax reserves no longer be computed by reference to the Minister's rules and, as a consequence, the existing section 26 is being repealed and replaced with a new section 26.

New subsection 26(1) of the Act requires a bank to include certain amounts in computing its income for its first taxation year that commences after June 17, 1987 and ends after 1987. The bank is required to include in income the amount of its specific provisions, general provisions, special provision for losses on transborder claims net of the amount of that special provision that is comprised of realized losses and any positive balance in its tax allowable appropriations account at the end of its immediately preceding taxation year. This inclusion is required in order to place the banks under the new regime of deducting reserves under paragraphs 20(1)(l) and (l.1) for a year and including the prior year's reserves taken under those provisions in income for the year.

New subsection 26(2) of the Act allows a bank to carry forward certain unused deductions it was entitled to deduct at the end of its taxation year immediately preceding its first taxation year that commences after June 17, 1987 and ends after 1987. These deductions are comprised of its undeducted five-year average loan loss experience, its undeducted transfers to its tax allowable-appropriations account (also referred to as PAR transfers), the undeducted portion of its special provision for losses on transborder claims net of that portion of its undeducted special provision that is comprised of realized losses of the bank and any negative balance in its tax allowable appropriations account. In addition, any undeducted amounts calculated under Procedure 8 of the Procedures for the Determination of the Provision for Loan Losses for the purposes of the Minister's rules can be carried forward. This latter amount represents certain losses that were viewed by a bank as seriously impairing its capital and were not required to be included in the calculation of its five-year average loan loss experience.

New subsection 26(3) of the Act provides special transitional rules for a bank in order to integrate its previous bad debt deductions and recoveries of bad debts recorded by the bank under the Minister's rules. These rules will operate in conjunction with paragraph 12(1)(i) dealing with recoveries of previous bad debt deductions and new section 12.4 which requires the excess of bad debts deducted over recoveries of bad debts in respect of a property disposed of from an inventory of the taxpayer to be included in his income. Paragraph 26(3)(a) treats, for the purposes of paragraph 12(1)(i) and section 12.4, any amount recorded by a bank as a realized loss or as a write-off of an asset under the Minister's rules prior to its first taxation year that commences after June 17, 1987 and ends after 1987, as having been deducted by the bank under paragraph 20(1)(p) in computing its income in the year it was so recorded. Therefore, any amount recovered in respect of that loss or write-off will be included in computing the income of the bank under paragraph 12(1)(i) for taxation years commencing after June 17, 1987 that end after 1987. New paragraph 26(3)(b) of the Act treats, for the purposes of section 12.4, any amount recorded by the bank as a recovery of a realized loss or a write-off of an asset of the bank in the calculation of an amount deductible under the Minister's rules prior to its first taxation year that commences after June 17, 1987 and ends after 1987 as having been included under paragraph 12(1)(i) in computing its income for the year for which it was so recorded.

New subsection 26(4) defines the Minister's rules for the purposes of section 26 as the Rules for the Determination of the Appropriations for Contingencies of a Bank issued under the authority of the Minister of Finance pursuant to section 308 of the Bank Act for the purposes of subsections 26(1) and (2) of the Income Tax Act.

New section 26 is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Clause 14

Lending of Money on Security

ITA
33

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). Subsection 33(1) and (3) are repealed, effective for taxation years commencing after June 17, 1987 that end after 1987, with the result that a reserve for doubtful debts will thereafter only be available to such taxpayers under paragraph 20(1)(l) of the Act. Subsection 33(2) of the Act, which requires the inclusion in income of the previous year's reserve deducted under subsection 33(1), is repealed applicable to taxation years after the first taxation year that commences after June 17, 1987 and ends after 1987.

Clause 15

Scientific Research and
Experimental Development

ITA
37

Section 37 of the Act sets out rules relating to the deductibility of scientific research and experimental development (R&D) expenditures.

Subclause 15(1)

ITA
37(1)

Under subsection 37(1) of the Act, expenditures made by a taxpayer for R&D carried on in Canada are accumulated in a pool. The balance of the pool at the end of any year may either be deducted in that year or carried forward to be deducted in subsequent years. However, such expenditures are only deductible in a year if the taxpayer carries on business in Canada in the year.

The amendments to paragraphs 37(1)(a) and (b) of the Act ensure that, in order to qualify for a deduction under section 37, an R&D expenditure must be related to a business of the taxpayer in which he was actively engaged at the time the expenditure was made. In addition, the amendments extend the related-to-the-business requirement for payments made to research institutes, universities and other entities described in new subparagraph 37(1)(a)(ii). The changes to subsection 37(1) also provide that a taxpayer who has made R&D expenditures in a year in respect of a particular business, but not claimed a deduction in the year, may deduct those expenditures in any subsequent year in computing his income from that or any other business carried on by him in the subsequent year. Paragraph 37(1)(b) has been clarified to ensure that it applies only in respect of property that would otherwise be depreciable property and to exclude a leasehold interest in land.

These amendments are applicable with respect to expenditures made after December 15, 1987 other than such expenditures made before 1989 pursuant to

(a) an obligation in writing entered into before December 16, 1987,

(b) the terms of a prospectus, preliminary prospectus, registration statement, or offering memorandum filed with a public authority before December 16, 1987, or

(c) the terms of an offering memorandum distributed as part of an offering of securities which contained a substantially complete description of the securities, was distributed before December 16, 1987 and in respect of which solicitations were made before December 16, 1987.

However, if an expenditure is made by way of a payment to a third party listed in new subparagraph 37(1)(a)(ii) and pursuant to a written obligation or prospectus, preliminary prospectus, registration statement or offering memorandum, the R&D to be performed as a result of such payment must be performed before 1989 in order for the expenditure to be eligible for this transitional relief.

These amendments are not applicable to payments made before 1989 to an approved association, university, college, research institute or non-profit R&D corporation as part of a public fund raising campaign commenced on or before December 15, 1987, or after that date pursuant to a settled plan evidenced in writing on or before that date, which was for the purpose of funding the construction and equipping of an R&D building which was under construction on December 16, 1987.

Subclauses 15(2) and (3)

ITA
37(1)(c) and (d)

Paragraph 37(1)(d) of the Act reduces a taxpayer's pool of R&D expenditures by the amount of any governmental assistance paid to the taxpayer under an Appropriation Act. Paragraph 37(1)(c) increases this pool by the amount of any such assistance repayed by the taxpayer. The equivalent treatment is achieved in respect of assistance paid to the taxpayer otherwise than under an Appropriation Act, but through a more circuitous manner by way of the provisions in paragraphs 12(1)(x) and 13(7.1)(a) of the Act. Paragraphs 37(1)(c) and (d) are amended to apply generally to any governmental assistance or non-governmental assistance in respect of R&D expenditures which the taxpayer has received or is entitled to receive. These amendments are applicable in respect of expenditures made after April 1988.

Subclause 15(4)

ITA
37(1)(e) and (f)

Paragraph 37(1)(e) of the Act requires that, where a taxpayer claims an investment tax credit (ITC) earned in respect of qualifying R&D expenditures, the taxpayer's pool of R&D expenditures must be reduced by the amount of the ITC claimed. However, the calculation of a taxpayer's deduction in respect of his R&D pool in a taxation year, and hence his tax otherwise payable and the calculation of his ITC claimed in the year, becomes circular where the ITC claim will reduce his R&D pool in the same year as that in which the ITC is claimed. Accordingly, paragraph 37(1)(e) of the Act is amended to require a reduction of the R&D pool only for taxation years following that in which a related ITC claim is made. This amendment is applicable for taxation years ending after 1987.

Paragraph 37(1)(f) is amended as a consequence of the repeal of paragraph 20(1)(t) and to the changes to the wording of the other paragraphs of subsection 37(1) to ensure that the wording used throughout this subsection is consistent. This amendment is applicable with respect to deductions claimed for taxation years ending after December 16, 1987.

Subclause 15(5)

ITA
37(1)(h)

Paragraph 37(1)(h) and subsection 37(6.1) of the Act restrict a corporation's ability to carry forward its pool of unused R&D deductions where there has been a change of its control. In general terms, the undeducted portion of R&D expenditures made before control of a corporation is acquired may be carried forward to be deducted in computing its income for a subsequent taxation year only where the business to which the expenditure related is carried on by the corporation 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. The amendment to paragraph 37(1)(h) is strictly consequential on the change to subsection 37(1) which allows a taxpayer a deduction in computing income for a taxation year in respect of a particular business for any R&D expenditures related to any business of the taxpayer. The amendment is applicable after December 15, 1987.

Subclause 15(6)

ITA
37(1.1)

New subsection 37(1.1) of the Act provides that, for the purposes of subsection 37(1), where a taxpayer is a corporation, R&D performed by the taxpayer, which is related to a business actively carried on by a related corporation at the time at which the R&D is performed, shall be considered to be an eligible R&D expenditure. This will allow R&D

conducted by a specialized R&D corporation on behalf of other members of a corporate group to qualify under subsection 37(1). This amendment is applicable after December 15, 1987.

Subclause 15(7)

ITA
37(2)

Subsection 37(2) of the Act allows a taxpayer to deduct expenditures of a current nature made in respect of R&D carried on outside Canada. The amendment to this subsection is consequential to the changes to subsection 37(1) to incorporate the refinements made therein to the "related-to-the-business" test and to include the requirement that payments to third parties who conduct R&D on behalf of the taxpayer will qualify for deduction under that section only if the taxpayer is entitled to exploit the results of the R&D.

These changes are applicable with respect to expenditures made after December 15, 1987, other than such expenditures made before 1989 pursuant to

> (a) an obligation in writing entered into before December 16, 1987,
>
> (b) the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum filed with a public authority before December 16, 1987, or
>
> (c) the terms of an offering memorandum distributed as part of an offering of securities which contained a substantially complete description of the securities, was distributed before December 16, 1987, and in respect of which solicitations were made before December 16, 1987.

Subclause 15(8)

ITA
37(5)

Subsection 37(5) of the Act currently provides that, where an expenditure in respect of scientific research and experimental development could be deductible under either section 37 relating to scientific research expenditures or under section 110 relating to charitable donations, the amount must be deducted under section 37 and not as a donation under section 110. Subsection 37(5) is amended to incorporate a reference to new sections 110.1 and 118.1 which deal with the deductibility of donations in computing taxable income of corporations and the deductibility of donations in computing tax payable by individuals, respectively. Accordingly, where an amount in respect of scientific research and experimental development could be deductible either under section 37 or new section 110.1 or 118.1, that amount must be deducted under section 37. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 15(9)

ITA
37(6)

Subsection 37(6) of the Act treats amounts claimed under subsection 37(1) in respect of expenditures of a capital nature as capital cost allowance allowed to the taxpayer in respect of the property. This subsection is amended as a consequence of the restructuring of subsection 37(1) which amends the opening words of the preamble to subsection 37(1) and of each of paragraphs 37(1)(a), (b) and (c) to ensure that subsection 37(1) operates as one pool of all expenditures described in each of those paragraphs. This amendment is applicable after December 15, 1987.

Subclauses 15(10) and (11)

ITA
37(6.1)

Paragraph 37(1)(h) and subsection 37(6.1), taken together, restrict a corporation's ability to carry forward its pool of unused R&D deductions where there has been a change of control. In general terms, the undeducted portion of R&D expenditures made before control of a corporation is acquired may be carried forward to be deducted in computing its income for a subsequent taxation year only where the business to which the expenditures related is carried on by the corporation 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. The amendments to subsection 37(6.1) are strictly consequential to the change to subsection 37(1) which allows a taxpayer a deduction in computing income for a taxation year in respect of a particular business for any R&D expenditures related to any business of the taxpayer. These amendments are applicable after December 15, 1987.

Subclause 15(12)

ITA
37(7)(d)

Paragraph 37(7)(d) of the Act provides that, for the purposes of section 37, R&D which may lead to or facilitate an extension of a business will be considered to be related to that business. This paragraph is amended to parallel the terminology used in new subsection 37(1). This amendment is applicable after December 15, 1987.

Subclause 15(13)

ITA
37(7)(e)

New paragraph 37(7)(e) of the Act clarifies that, for the purposes of the "related-to-the-business" test that is a precondition for the deduction of R&D expenditures, unless a taxpayer derives all or substantially all of his revenue from the prosecution of R&D, the prosecution of R&D will not itself be considered to be a business to which R&D is related.

New paragraph 37(7)(e) is applicable in respect of expenditures made after December 15, 1987 other than expenditures made after that date, and before 1989, pursuant to

(a) an agreement in writing entered into before December 16, 1987,

(b) the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum, filed with a public authority before December 16, 1987, or

(c) the terms of an offering memorandum distributed as part of an offering of securities which contained a substantially complete description of the securities, was distributed before December 16, 1987, and in respect of which solicitations were made before December 16, 1987.

Subclause 15(14)

ITA
37(7)(f)

New paragraph 37(7)(f) of the Act provides that expenditures in respect of the acquisition of a building or a leasehold interest in a building, or rental or lease expenses in respect of a building, other than a prescribed special purpose building, shall not be deductible as R&D expenditures. The exclusion from this restriction for "prescribed special purpose buildings" was introduced because, with the exclusion of expenditures in respect of buildings but not other structures from qualification as R&D expenditures, the distinction between buildings and other structures becomes more important for these purposes. Accordingly, if at some time in the future it should be determined that a particular property is considered to be a building but, within the policy behind this amendment, the property should continue to qualify for the R&D incentives, it will be possible to prescribe that property as a special purpose building. No such properties have been identified at this time. This amendment is applicable to buildings and leasehold interests acquired after 1987, other than such property acquired before 1990 pursuant to an obligation in writing entered into before June 18, 1987, or the construction of which was commenced before June 18, 1987 by or on behalf of the taxpayer.

This amendment is also applicable in respect of rental expenses relating to a building incurred after 1987 other than such rental expenses incurred pursuant to a written lease agreement renewed, extended or entered into before June 18, 1987 by the taxpayer or by a person with whom the taxpayer did not deal at arm's length at the time the lease was renewed, extended or entered into.

New paragraph 37(7)(f) also denies R&D treatment to payments made to

(a) a non-profit R&D corporation, an approved research institute, or an approved association, with which the taxpayer does not deal at arm's length, or

(b) a corporation,

to the extent that they are used to acquire a building or leasehold interest in a building or to pay a rental expense in respect of a building, and to payments to an approved university, college or organization to the extent they are used to acquire a building or leasehold interest in a building in which the payor has, or may reasonably be expected to acquire, an interest. This amendment is applicable to payments made after December 15, 1987 other than such payments made pursuant to an agreement in writing entered into before December 16, 1987 with a person with whom the taxpayer deal's at arm's length.

Clause 16

Taxable Capital Gain and
Allowable Capital Loss

ITA
38

Section 38 of the Act defines a taxpayer's taxable capital gain, allowable capital loss and allowable business investment loss from the disposition of property as one-half of his capital gain, capital loss or business investment loss from that disposition. This section is amended as a consequence of the changes to the inclusion rates for capital gains and losses.

The portion of a capital gain, capital loss or business investment loss to be included in computing a taxpayer's taxable capital gain, allowable capital loss or allowable business investment loss will be increased from one-half to two-thirds for gains or losses realized in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The inclusion rate will be further increased from two-thirds to three-quarters for gains or losses realized in taxation years and fiscal periods of individuals and partnerships ending after 1989 and for taxation years of corporations commencing after 1989. For taxation years of Canadian-controlled private corporations that straddle January 1, 1988 or for taxation years of other corporations that straddle July 1, 1988, the inclusion rate for the gain or loss will be determined by prorating the one-half and two-thirds rates based on the number of days in the corporation's year that fall on either side of that date. A similar proration of the two-thirds and three-quarters rates will be made for taxation years of corporations that straddle January 1, 1990.

Clause 17

Definitions - Capital Gains and Losses

ITA
39

Section 39 of the Act sets out the definitions of a taxpayer's capital gain, capital loss and business investment loss for a taxation year.

Subclause 17(1)

ITA
39(1)(a)(i.1)(A)

Clause 39(1)(a)(i.1)(A) of the Act excludes from the definition of capital gain, any gain on the disposition of property which meets certain criteria set out in the Cultural Property Export and Import Act and which has been donated by will to certain donees. This technical amendment adds a reference in clause 39(1)(a)(i.1)(A) to new subsection 118.1(5) which replaces subsection 110(2.1) as a consequence of the conversion of donations made by individuals from a deduction to a credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 17(2)

ITA
39(9)(b)

Subsection 39(9) of the Act provides for a reduction of a business investment loss of an individual (other than a trust) in a taxation year where he has claimed a capital gains exemption in a previous taxation year. The reduction is equal to the lesser of the individual's business investment loss for the year otherwise determined and twice the total of capital gains exemptions deducted in previous years, except to the extent that any other business investment loss was reduced under this provision.

As a result of the increases in the taxable capital gains inclusion rate for individuals, from one-half to two-thirds in 1988 and to three-quarters in 1990, the reference in paragraph 39(9)(b) to "twice the amount deducted" will no longer be appropriate in all circumstances. Paragraph 39(9)(b) is therefore amended, applicable to the 1988 and subsequent taxation years, to provide for a reduction in an individual's business investment loss of twice the amounts deducted by the taxpayer under section 110.6 for taxation years prior to 1988, three-halves of such amounts deducted for 1988 or 1989, and four-thirds of such amounts deducted for taxation years after 1989.

Subclause 17(3)

ITA
39(10)(b)

Subsection 39(10) of the Act provides for a reduction in the business investment loss of a trust for a taxation year where the trust has, in a prior taxation year, designated a capital gain to a beneficiary of the trust pursuant to subsection 104(21.2). Paragraph 39(10)(b) is amended, applicable to the 1988 and subsequent taxation years, in the same manner as paragraph 39(9)(b), to reflect the higher inclusion rates for individuals in determining taxable capital gains after 1987.

Clause 18

Capital Gains - Special Rules

ITA
40

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

Subclause 18(1)

ITA
40(1)(a)(iii)

Paragraph 40(1)(a) governs the computation of a taxpayer's capital gain upon the disposition of any property. Subparagraph 40(1)(a)(iii) is amended to include a reference to a prescribed form. This is a technical amendment which will facilitate an administrative requirement of Revenue Canada, Taxation as a result of the removal of the capital gains schedule from the T1 form, to a separate form.

Subclause 40(2)

ITA
40(3)

Subsection 40(3) provides rules governing capital properties whose adjusted cost base in a year has been reduced below nil as a result of the adjustments required under subsection 53(2) of the Act. In this case the negative balance is generally treated as a capital gain of the taxpayer.

The amendment to subsection 40(3), effective for the 1988 and subsequent taxation years, treats such gain as arising from a disposition in that year by the taxpayer of property for the purposes of section 110.6. This ensures that such gains will be eligible for the capital gains exemption provided under that section.

Clause 19

Listed Personal Property

ITA
41

Subsection 41(1) defines a taxpayer's taxable net gain for a taxation year from dispositions of listed personal property as one-half of his net gain determined under subsection (2) from dispositions of such property. This subsection is amended as a consequence of the changes to the inclusion rates for capital gains.

The portion of a taxpayer's net gain to be included in computing his taxable net gain from dispositions of listed personal property will be increased from one-half to two-thirds for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion of the net gain to be included in computing his taxable net gain will be further increased from two-thirds to three-quarters for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Clause 20

Dispositions Subject to Warranty

ITA
42

Section 42 of the Act provides rules governing warranties and other conditional obligations given by a taxpayer in respect of a disposition of capital properties.

Amounts received or receivable by a taxpayer as consideration for a warranty or other contingent obligation with respect to a capital property are, under section 42, included in computing the taxpayer's proceeds of disposition of the property. Any expenditure subsequently made pursuant to the warranty or other obligation is treated by section 42 as a loss of the taxpayer, for the taxation year in which it was made, from the disposition of the property. The amendment to this section, effective for the 1988 and subsequent taxation years ensures that such losses are taken into account in determining a taxpayer's entitlement to the capital gains exemption.

Clause 21

Property With More Than One Use

ITA
45

Section 45 of the Act contains rules which apply in determining a capital gain or allowable capital loss of property which has been used for more than one purpose.

Subclause 21(1)

ITA
45(1)(a)

Paragraph 45(1)(a) provides that where there is a change of use of property the taxpayer shall be deemed to have disposed of it for proceeds equal to its fair market value and immediately thereafter, reacquired it at a cost equal to that fair market value. Subparagraphs 45(a)(i) and (ii) currently refer to the acquisition of property for the purpose of gaining or producing income therefrom or from a business. Since it is possible for certain property to be used to earn income from an office or employment, these subparagraphs are amended so as to be applicable to changes of use after April, 1988 to or from any income producing purpose.

Subclause 21(2)

ITA
45(1)(b)

Paragraph 45(1)(b) provides that, where property is used in part for gaining or producing income therefrom or from a business and in part for some other purpose, the taxpayer is deemed to have acquired, for that other purpose, the proportion of the property that the use made of the property for that other purpose is of the whole use of the property, at a cost equal to the same proportion of the cost of the whole property. A similar treatment applies to proceeds of disposition of such a property.

This amendment, effective for changes in use after April, 1988, is similar to that in subclause (1) and ensures that, since certain property may be used in part for gaining or producing income from an office or employment and in part for some other purpose, paragraph 45(1)(b) will apply where the property is used in part for gaining or producing income from any source and in part for some other purpose.

Subclause 21(3)

ITA
45(1)(c)

Paragraph 45(1)(c) governs situations where the proportion of use of the property for gaining or producing income therefrom or from a business changes. This amendment is similar to the amendments in subclauses (1) and (2) and ensures that since certain property may be used in part for gaining or producing income from an office or employment and in part for some other purpose, paragraph 45(1)(c) will apply where a change in the proportion of use of property for gaining or producing income from any source and the use for some other purpose occurs. This amendment is effective for changes in use occurring after April, 1988.

Subclause 21(4)

ITA
45(3)

Subsection 45(3) provides an exception to the deemed disposition rule on change of use where the property becomes the taxpayer's principal residence and the taxpayer so elects. This amendment ensures that the exception is available where the property was used for gaining or producing income from any source.

All the amendments to section 45 of the Act are applicable with respect to changes in use occurring after April, 1988.

Clause 22

Identical Properties

ITA
47

Section 47 of the Act sets out rules that apply to identical properties for the purposes of subdivision c of the Act which deals with capital gains and capital losses on such properties.

Subclause 22(1)

ITA
47(2)

The amendment to subsection 47(2) of the Act, applicable to taxation years commencing after June 17, 1987 that end after 1987, is strictly consequential on the repeal of subsection 47(3) as discussed below.

Subclause 22(2)

ITA
47(3)

Subsection 47(3) of the Act is repealed and enacted as new subsection 248(12) applicable to taxation years commencing after June 17, 1987 that end after 1987. This change ensures that the rule determining whether a bond, debenture, bill, note or other similar obligation issued by a debtor is identical to another such obligation issued by the debtor will also apply for the purposes of the special superficial loss rule in new subsection 18(13) for the securities of financial institutions and in new subsection 138(5.2) for the securities of insurance corporations.

Clause 23

Options

ITA
49

Section 49 of the Act provides rules dealing with the granting, expiry, exercise and renewal of options.

Subclause 23(1)

ITA
49(3)

Where an option to acquire property is exercised, subsection 49(3) of the Act applies to treat the previous granting of the option as not being a disposition of property. Instead, the consideration received by the vendor for the option is added to the vendor's proceeds of disposition of the property and the purchaser's adjusted cost base of the option is added to the purchaser's cost of the property. Options granted by individuals were excluded from the operation of subsection 49(3) in order to prevent the use of options as a means of postponing sales of property in order to take advantage of increased capital gains exemption limits during the period over which the exemption was to be phased in.

As a result of amendments to section 110.6 of the Act which limit the lifetime capital gains exemption to $100,000 of capital gains after 1987 in most circumstances, the special treatment of options granted by vendors who are individuals is no longer required. The result of the amendment to subsection 49(3) is to extend to individuals the same rules in relation to options that apply to corporations and other taxpayers. This amendment is effective for dispositions of property under options exercised after 1987.

Subclause 23(2)

ITA
49(4)(a)

Subclause (2)

Subsection 49(4) of the Act provides rules for reassessing a taxpayer's return of income for a year in which an option is granted when the option is exercised in a subsequent year. As a result of the amendment to subsection 49(3) which extends the application of that subsection to individuals, paragraph 49(4)(a) is similarly amended, applicable to options exercised after 1987, to apply also to options granted by individuals.

Clause 24

Adjustments to Cost Base

ITA
53

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

Subclause 24(1)

ITA
53(1)(c)

Paragraph 53(1)(c) of the Act provides that where a contribution of capital has been made by a shareholder to a corporation, the resulting increase in the fair market value of any share owned by that shareholder shall be added to the adjusted cost base of that share. However, the amount to be added shall only include that part of the contribution that cannot reasonably be considered as a gift made to or for the benefit of any person related to the shareholder. Paragraph 53(1)(c) is amended to replace the words "gift made to or for the benefit of", the meaning of which is imprecise, by the words "benefit conferred on". This change conforms with other provisions of the Act, such as subsections 51(2), 86(2) and 87(4), that deal with benefits conferred by a shareholder on related persons. This amendment is applicable to contributions of capital made after June, 1988 in computing the adjusted cost base of property after that date.

Subclauses 24(2) and (6)

ITA
53(1)(e)(i)(A) and 53(2)(c)(i)(A)

Paragraph 53(1)(e) of the Act provides additions to the taxpayer's cost of a partnership interest for the purposes of determining its adjusted cost base. Clause (i)(A) thereof provides an addition to the cost base for each fiscal period of the partnership equal to the amount that would be the taxpayer's share of the income of the partnership for that fiscal period if any amounts included in income in respect of eligible capital property, taxable capital gains and taxable net gains on listed personal property for that fiscal period were computed without the references to "1/2" in those provisions.

Paragraph 53(2)(c) of the Act provides deductions from the taxpayer's cost of a partnership interest for the purposes of determining its adjusted cost base. Clause (i)(A) thereof provides for a deduction from the cost base for each fiscal period of the partnership equal to the amount that would be the taxpayer's share of any loss of the partnership for that fiscal period if any amounts deducted in respect of eligible capital property and allowable capital losses of the partnership were computed without the references to "1/2" in those provisions.

Clauses 53(1)(e)(i)(A) and 53(2)(c)(i)(A) are being amended applicable to taxation years and fiscal periods ending after 1987 to require that the provisions of the Act referred to therein be read without reference to the fractions contained in those provisions. These changes are consequential on the changes to the inclusion rates for capital gains and capital losses and the changes to the rates of inclusion and reduction of the cumulative eligible capital of a taxpayer in respect of expenditures made or amounts received for eligible capital expenditures.

Subclause 24(3)

ITA
53(1)(e)(iv)

Subparagraph 53(1)(e)(iv) of the Act provides that, in computing the adjusted cost base of a taxpayer's interest in a partnership, there shall be added such part of the amount of a contribution of capital made to the partnership as cannot reasonably be regarded as a gift to any other member of the partnership who is related to the taxpayer. Paragraph 53(1)(e)(iv) is amended to replace the words "gift made to or for the benefit of", the meaning of which is imprecise, by the words "benefit conferred on". This change conforms with other provisions of the Act that deal with benefits conferred on related persons. This amendment is applicable with respect to contributions of capital made after June, 1988 in computing the adjusted cost base of property after that date.

Subclause 24(4) and (5)

ITA
53(1)(h)

Subparagraph 53(1)(h)(i), which provides for an addition to the adjusted cost base of land in respect of carrying charges the deduction of which was denied by reason of subsection 18(2), is amended as a consequence of the amendments to that subsection to ensure that the terminology used in the two provisions is consistent.

In addition, the postamble to paragraph 53(1)(h) is amended as a consequence of the amendments to paragraph 18(3)(b) concerning interest expenses incurred by a taxpayer to finance the acquisition of land by certain third parties. Paragraph 53(1)(h), as amended, requires an addition to the adjusted cost base to a taxpayer of land of amounts the deduction of which is denied by subsection 18(2) to the taxpayer or to a person with whom he does not deal at arm's length, a corporation of which he is a specified shareholder, or a partnership of which his share of any income or loss is 10 per cent or more. This amendment is applicable for taxation years ending after 1987.

Subclause 24(7)

ITA
53(2)(c)(iii)

Subparagraph 53(2)(c)(iii) of the Act provides for a deduction, in computing the adjusted cost base to a taxpayer of a partnership interest, of amounts deemed by subsections 110(5) and 127(4.2) to have been a charitable donation made or an amount contributed to a registered political party by virtue of the taxpayer's membership in the partnership. Subparagraph 53(2)(c)(iii) is amended to refer to new subsections 110.1(4) and 118.1(8) which are now the relevant subsections for purposes of the allocation of the charitable donations in the case of such donations made by a partnership. This amendment applies to gifts made and amounts contributed by partnerships in their fiscal periods ending after 1987.

Subclause 24(8)

ITA
53(2)(c)(x)

Section 53 of the Act sets out rules for determining the adjusted cost base of property for the purposes of the Act relating to capital gains and losses. Paragraph 53(2)(c) provides for certain amounts that must be deducted in computing the adjusted cost base to a taxpayer of a partnership interest.

New subparagraph 53(2)(c)(x) provides that the adjusted cost base to a taxpayer of an interest in a partnership which has ceased to exist must be reduced by the amount of his share of certain undeducted issue expenses and borrowing costs that the partnership would have been able to deduct had the partnership continued to exist and which, as a consequence of the dissolution of the partnership, will be deductible by the partner. This subparagraph has been added, applicable after 1987, as a consequence of the introduction in paragraph 20(1)(e) of the requirement to spread the deduction of such financing expenses over a five-year period.

Subclause 24(9)

ITA
53(2)(k)(i)(A)

Paragraph 53(2)(k) of the Act provides that the adjusted cost base of a property is reduced by the amount of governmental assistance received in respect thereof. Clause 53(2)(k)(i)(A) excludes from the operation of this paragraph governmental assistance received by the taxpayer under an Appropriation Act in respect of scientific research and experimental development (R&D) expenditures. These amounts are excluded from the operation of paragraph 53(2)(k) because they instead reduce the taxpayer's pool of R&D expenditures under subsection 37(1) of the Act.

Clause 53(2)(k)(i)(A) is amended as a result of the changes to paragraphs 37(1)(c) and (d) of the Act which will require any governmental or non-governmental assistance which the taxpayer has received or is entitled to receive in respect of R&D expenditures to be accounted for directly in the calculation of his pool of R&D expenditures. This amendment is applicable in respect of expenditures made after April, 1988.

Clause 25

Definitions - Capital Gains and Losses

ITA
54

Section 54 of the Act contains various definitions for purposes of subdivision c - Taxable Capital Gains and Allowable Capital Losses.

Subclause 25(1)

ITA
54(d)

Paragraph 54(d) of the Act defines "eligible capital property". This definition is amended to replace the reference to "1/2" strictly as a consequence of the change in the cumulative eligible capital inclusion rate from 1/2 to 3/4. The amendment is applicable after June 17, 1987.

Subclause 25(2)

ITA
54(g)(i)

Subparagraph 54(g)(i) of the Act provides criteria for the classification of a dwelling as the "principal residence" of a taxpayer for the purposes of the exemption of such property from capital gains taxation. In order to qualify as the principal residence of a taxpayer, the housing unit must be ordinarily inhabited by the taxpayer, his spouse or his dependent child. Subparagraph 54(g)(i) is amended to remove the requirement that the child be dependent upon the taxpayer for the purposes of the capital gains exemption allowed on the disposition of a principal residence. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 26

Transfer of a Business for Shares

ITA
54.2

New section 54.2 of the Act provides that where a person disposes of all or substantially all the assets used in an active business to a corporation, the shares received in consideration shall be capital property of that person. The purpose of this new rule, which applies to dispositions occurring after 1987, is to ensure that the sale of a business through a sale of the shares of a corporation to which the business was recently transferred is not treated as a sale on income account. Thus, a parent corporation that would transfer a separate business to a subsidiary and subsequently sell the shares of that subsidiary would get capital gains treatment on the sale of the shares. A further example would be where an individual sells his business to a newly formed corporation in contemplation of a subsequent sale of all the shares of that corporation. In that case, the new rule will apply to ensure that the shares received as consideration for the business will get capital gains treatment and will thus be eligible, provided other conditions are met, for the lifetime capital gains exemption for shares of a small business corporation.

A prerequisite to the application of the new rule is that the shares be issued as consideration for all or substantially all the assets used in an active business. Section 54.2 is not intended to apply where a taxpayer sells indirectly, through the sale of the shares of a corporation, non-business assets or only some of the assets used in a business.

An amendment to the definition of "business" in subsection 248(1) of the Act ensures that the disposition of the assets used in an adventure or concern in the nature of a trade will not qualify for the application of new section 54.2.

Clause 27

Artificial Reduction of Capital Gains

ITA
55

Section 55 of the Act deals with certain avoidance transactions involving capital gains and losses.

Subclause 27(1)

ITA
55(1)

Subsection 55(1) of the Act is an anti-avoidance provision aimed at transactions designed to artificially or unduly reduce a capital gain or increase or create a capital loss on a disposition of property.

Subsection 55(1) is repealed as a consequence of the introduction of new section 245 of the Act, which constitutes a general anti-avoidance rule. Because the scope of that general anti-avoidance rule is broad enough to cover the transactions to which subsection 55(1) was intended to apply, that subsection is no longer necessary. Subsection 55(1) is repealed with respect to transactions entered into on or after the date on which the implementing legislation receives Royal Assent, other than transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that date and completed before 1989. This parallels the coming-into-force of new section 245.

Subclause 27(2)

ITA
55(5)(b)(ii)

Subsection 55(2) deals with certain inter-corporate dividends that are ordinarily tax-free.

In order to prevent the conversion of capital gains on arm's length dispositions of property into tax-free inter-corporate dividends, subsection 55(2) of the Act treats, in certain circumstances, all or a portion of such a dividend to be proceeds of disposition of shares and not a dividend.

Subsection 55(2) does not apply where the dividend can reasonably be considered to be attributable to income earned or realized by any corporation after 1971 and before the transaction or event or the commencement of the series of transactions or events referred to in paragraph (3)(a). Paragraph 55(5)(b) defines the income earned or realized by a corporation for a period throughout which it was resident in Canada and not a private corporation for the purpose of the rule in subsection 55(2). One of the components of this income, as set out in subparagraph 55(5)(b)(ii), is one-half of the amount by which the corporation's capital gains for the period exceeds its capital losses for the period. This subparagraph is being amended as a result of the changes to the inclusion rates for capital gains and capital losses. The amount under subparagraph 55(5)(b)(ii) will be determined by subtracting the allowable capital losses of the corporation for the period from its taxable capital gains for that period. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 27(3)

ITA
55(5)(b)(iii)

As noted in the commentary to subclause 27(2), paragraph 55(5)(b) of the Act provides certain rules for determining the income of a corporation during a period throughout which it was resident in Canada and was not a private corporation. Subparagraph 55(5)(b)(iii) provides, in general, that included in this income is the amount by which the aggregate of 1/2 of all amounts received by a corporation in respect of the disposition of eligible capital property in the period (the "untaxed" portion) exceeds the corporation's cumulative eligible capital at the commencement of the period and 1/2 of the aggregate of all eligible capital expenditures made by the corporation in the period.

This subparagraph is amended as a consequence of the increase in the inclusion rate in respect of eligible capital property from 1/2 to 3/4. New subparagraph 55(5)(b)(iii) will operate in essentially the same manner as the existing provision except that the un-taxed portion will now be 1/4 of the amounts outlined above, rather than 1/2. Where the period commences before the new inclusion rate is applicable in respect of the corporation (i.e. before its "adjustment time"), the amount calculated under existing subparagraph 55(5)(b)(iii) at the corporation's adjustment time is included in new clause 55(5)(b)(iii)(A). Pursuant to new subclause 55(5)(b)(iii)(A)(IV), this amount will be reduced by 1/2 of eligible capital expenditures made after the corporation's adjustment time. Where the corporation is in a "deficit" position under existing subparagraph 55(5)(b)(iii) at its adjustment time, 1/2 of that deficit will be included in clause 55(5)(b)(iii)(D). Reducing this deficit by 1/2 equates this deficit, which was generated when the inclusion rate for eligible capital property was 1/2, with the new 1/4 rate for the non-taxable portion of receipts in respect of dispositions of eligible capital property. This will allow the corporation to "earn back" this deficit with receipts in respect of dispositions of eligible capital property after its adjustment time when the non-taxable portion is 1/4. Where the corporation has deducted an amount under new subsection 20(4.2) in respect of a bad debt relating to a disposition of eligible capital property, 1/3 of this amount is deducted under clause 55(5)(b)(iii)(G) (1/3 of 3/4 being equal to 1/4 or, in other words, the un-taxed portion) and, where such a bad debt is later recovered and an amount is included in the corporation's income by reason of new paragraph 12(1)(i.1), 1/3 of this amount is added under clause 55(5)(b)(iii)(C).

This amendment is applicable after June 17, 1987 except that, where an amount added under clause 55(5)(b)(iii)(C) or subtracted under clause (G) thereof relates to a bad debt in respect of a disposition of eligible capital property for which the inclusion rate in calculating the taxpayer's eligible capital amount was 1/2, these clauses shall be read without reference to the words "1/3 of".

Clause 28

Other Income

ITA
56

Section 56 of the Act lists certain types of income that are required to be included in computing the income of a taxpayer for a taxation year from a source other than property, business or employment and other than from the disposition of capital properties.

Subclause 28(1)

ITA
56(3)

Subsection 56(3) of the Act provides that where, in a taxation year, a payment or transfer of property is made to or for the benefit of the taxpayer jointly with other persons or a profit is made by the taxpayer jointly with other persons, the taxpayer shall be deemed to have received such payment, transfer or profit in that year to the extent of his interest. This is the case whether or not there was any division or distribution of the profit, payment or property in the year.

The proper interpretation of subsection 56(3) is uncertain. It has rarely been applied and it has never been considered by the courts. Given its uncertain application and the introduction of new section 245 of the Act, which constitutes a general anti-avoidance rule, this provision is repealed.

Subsection 56(3) is repealed with respect to transactions entered into on or after the date on which the implementing legislation receives Royal Assent other than transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that date and completed before 1989. This parallels the coming-into-force of new section 245.

Subclause 28(2)

ITA
56(4.1), (4.2) and (4.3)

New subsections 56(4.1) to (4.3) of the Act are intended to prevent individuals from avoiding tax through loans to other non-arm's length individuals. Under these new subsections, income from property that is diverted by an individual to another non-arm's length individual through a low interest or an interest-free loan will be taxed in the first individual's hands.

New subsection 56(4.1) provides that where an individual loans property to another individual with whom he does not deal at arm's length and one of the main reasons for the loan is to reduce or avoid tax on income from the property or substituted property, such income is considered to be income of the individual that made the loan and not of the other individual. However, this rule does not apply where the attribution rules in section 74.1 apply. The rule also does not apply to attribute income from property that is transferred outright.

New subsection 56(4.2) provides an exemption from the attribution rule contained in subsection 56(4.1) for loans that bear a commercial rate of interest. This exemption is applicable where interest is charged on the loan at a rate not less than either the prescribed rate of interest or the rate that would have been agreed upon between arm's length parties under similar circumstances at the time the indebtedness was incurred. However, the exemption applies only if the interest that is payable on the loan in respect of that year and each preceding year has in fact been paid not later than 30 days after the end of each such year.

New subsection 56(4.3) provides rules which ensure that subsection (4.1) will apply to a loan which is used either to repay borrowed money that was used to acquire property or to reduce an amount payable in respect of that property in the same manner as it would apply if that property had been acquired directly with the proceeds of the loan. This subsection also ensures that if a loan that is exempt from the application of subsection (4.1) because of subsection (4.2) (i.e. a loan made on an arm's length, commercial basis) is used to repay a prior loan to the same non-arm's length person, the rule of subsection 56(4.1) will nevertheless continue to apply to the income from the previously loaned property or from property substituted therefor.

These amendments are applicable to the 1989 and subsequent taxation years.

Subclause 28(3)

ITA
56(5) to (8)

Subsections 56(5) to (8) of the Act deal with the treatment of family allowances for tax purposes. New subsection 56(5) requires an individual to include in computing his income family allowances received in respect of a child where the individual is deemed by new subsection 56(6) or (7) to have supported that child in the taxation year. For this purpose, new subsection 56(6) deems an individual to have supported a child in a taxation year if all of the following conditions are met:

- the child is the child of the individual or of the individual's spouse, or is dependent for support on the individual or the individual's spouse,

- the individual's income for the year, computed without reference to the family allowances and the child care expense deduction, exceeds that of the spouse, and

- the spouse was not living separate and apart from the individual at the end of the year and for a period of 90 days commencing in the year as a result of a breakdown of the marriage.

New subsection 56(7) provides that, where no individual is deemed to have supported a child under new subsection 56(6) (for example where the supporting person is the child's aunt or uncle) the person to whom the family allowance in respect of the child has been paid shall be deemed to have supported the child in the year.

Subsection 56(8) of the Act required family allowances in respect of a child to be apportioned as between those persons who claimed the exemption for that child. This provision is repealed as a consequence of the amendments to subsections 56(5) to (7).

These amendments are applicable to the 1988 and subsequent taxation years.

Clause 29

Resource Property Dispositions

ITA
59

Section 59 of the Act provides rules relating to the recovery of resource expenditures.

Subclauses 29(1) to (6)

ITA
59(3.3)

Subsection 59(3.3) of the Act provides for inclusions in computing income with respect to the recovery or recapture of resource expenditures that earned depletion, supplementary depletion, frontier exploration allowance or mining exploration depletion. The amendments to this subsection are consequential on the phase-out of earned depletion and mining exploration depletion. Currently, the earned depletion and mining exploration depletion rate is 33 1/3 per-cent; on July 1, 1988, it is reduced to 16 2/3 per-cent and on January 1, 1990, it is eliminated altogether. These amendments generally ensure that the inclusion in computing the income of the recipient as a recapture of earned depletion or mining exploration depletion previously claimed by him will correspond to the earned depletion or mining exploration depletion deduction of the payor. Subject to new subsection 59(3.5) of the Act, there will be no recapture of earned depletion, supplementary depletion, frontier exploration allowance or mining exploration depletion after 1989.

Subclause 29(7)

ITA
59(3.4)

Subsection 59(3.4) of the Act provides definitions for expressions used in subsection 59(3.3) of the Act.

New paragraph 59(3.4)(b) defines "stated percentage" for the purposes of the recapture of earned depletion and mining exploration depletion in paragraphs 59(3.3)(a), (b) and (f). Paragraphs 59(3.4)(b) and 59(3.3)(a), (b) and (f) generally ensure that, during the phase-out of depletion, the inclusion in the income of the recipient as a recapture of earned depletion or mining exploration depletion claimed by him will correspond to the earned or mining exploration depletion deduction available to the payor.

Subclause 29(8)

ITA
59(3.5)

New subsection 59(3.5) of the Act provides for an extended meaning of the term "stated percentage" in clauses 59(3.4)(b)(i)(B) and (C) of the Act. The effect of this extension is to provide for the recapture, in certain circumstances, of earned depletion and mining exploration depletion after 1989.

After 1989, a taxpayer will be required to recapture depletion where an amount becomes receivable by the taxpayer after 1989 in respect of the disposition of a property, the cost of which was taken into account in computing his earned depletion or mining exploration depletion base, and where the disposition was made to a corporation that renounces, effective December 31, 1989, an amount under subsection 66(12.66) of the Act which amount includes an expenditure in respect of the amount that became receivable by the taxpayer. In these circumstances, new subsection 59(3.5) of the Act provides that the "stated percentage" for the purposes of paragraphs 59(3.3)(a) and (f) will be 50 per-cent for amounts that became receivable within 60 days after the end of December 1989.

Clause 30

Other Deductions

ITA
60(e), (f), (g) and (h)

This clause repeals paragraphs 60(e), (f), (g) and (h) of the Act. These paragraphs formerly provided deductions in respect of tuition fees and Canada or Quebec Pension Plan contributions. Their repeal is consequential on the conversion of these deductions to tax credits effective for the 1988 and subsequent taxation years.

Clause 31

Child Care Expenses

ITA
63

Section 63 of the Act, which provides rules concerning the deductibility of child care expenses, is amended as a result of the conversion of personal exemptions into tax credits, thus rendering obsolete certain references to the former sections dealing with exemptions. All of these amendments are applicable to the 1988 and subsequent taxation years.

Subclauses 31(1) and (2)

ITA
63(2)(b)(iii) and (vi)

Subparagraph 63(2)(b)(iii) of the Act is amended to provide a reference to new subsection 118.6(1) which defines "designated educational institution" for the purposes of the education tax credit. Subparagraph 63(2)(b)(vi) is amended to refer to a person living separate and apart from the taxpayer, by reason of marriage breakdown, at the end of the year.

Subclause 31(3)

ITA
63(3)(a)(ii)(C)

Paragraph 63(3)(a) of the Act provides a definition of child care expenses for the purposes of the deduction of such expenses and currently refers to a person who has claimed a deduction in respect of a dependent child. Clause 63(3)(a)(ii)(C) of the Act is amended to refer to an amount deducted as a tax credit in respect of a dependent child under new section 118, which section provides for the new personal tax credits.

Subclause 31(4)

ITA
63(3)(a)(iv)

New subparagraph 63(3)(a)(iv) of the Act is amended to exclude from the definition of child care expenses, expenses permitted for purposes of the medical expense tax credit. Currently, expenses eligible for the medical expense deduction are excluded from eligible child care expenses.

Subclause 31(5)

ITA
63(3)(c)(ii)

Paragraph 63(3)(c) of the Act defines an eligible child for the purposes of the child care expenses and currently contains a reference to amounts deducted in respect of dependent children. Subparagraph 63(3)(c)(ii) of the Act is amended to refer to an amount deducted in respect of a dependent child under the new personal tax credit provisions.

Subclause 31(6)

ITA
63(3)(d)(iii)

Paragraph 63(3)(d) of the Act defines a supporting person for the purposes of the child care expense deduction and currently refers to a person who has claimed a deduction in respect of a dependent child. New subparagraph 63(3)(d)(iii) of the Act is amended to refer to an individual who deducted an amount in respect of a dependent child under the new personal tax credits section.

Clause 32

Application to Deemed Residents

ITA
63.1

Section 63.1 of the Act provides rules governing the deductibility of certain amounts by persons who are deemed to be resident in Canada for income tax purposes. Section 63.1 of the Act is amended to delete the references therein to section 60 and paragraph 60(f) relating to tuition fees as a result of the conversion of the tuition fees deduction to a tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 33

Flow-Through Shares

ITA
66

Section 66 of the Act provides various rules with respect to Canadian and foreign resource properties.

Subclause 33(1)

ITA
66(12.66)(b)

Under the existing law, subsections 66(12.6), (12.62) and (12.64) of the Act permit a principal-business corporation to renounce certain resources expenses to a person who acquires flow-through shares of the corporation. As a general rule, the corporation may only renounce resource expenses incurred by it on or before the effective date of the renunciation. Subsection 66(12.66), as an exception to the general rule, allows certain exploration expenses incurred by the corporation within 60 days after the end of a calendar year to be treated as having been incurred on the last day of the year. Paragraph 66(12.66)(b) restricts the exploration expenses qualifying for the 60 day treatment to "grass-roots" mining exploration expenses incurred in respect of a mineral resource other than a bituminous sands deposit, an oil sands deposit or an oil shale deposit.

New paragraph 66(12.66)(b) extends the exploration expenses qualifying for the 60 day treatment to include oil and gas exploration expenses. Under this extension, oil and gas expenses described in subparagraph 66.1(6)(a)(i), (ii.1) or (iii) will qualify.

Paragraph 66(12.66)(b) is applicable with respect to expenses incurred after 1987 except that an amount in respect of oil or gas expenses renounced under subsection 66(12.66) of the said Act by a corporation on or before the day that is 30 days after the implementing legislation receives Royal Assent will be treated as having been renounced within 90 days after the end of 1987.

Subclause 33(2)

ITA
66(12.74) and (12.75)

Under the existing law, subsections 66(12.68) and (12.7) require a corporation to file with the Minister of National Revenue certain documents with respect to a flow-through share issue and its resource flow-through share expenditures. Subsection 66(12.69) requires a partnership, which has resource flow-through share expenditures renounced to it, to file with the Minister of National Revenue certain documents indicating the amount of such expenditures attributed to each of its members. The documents must be filed within the period specified in the particular subsection. Currently, there is no provision in the Act for the late filing of any of these documents.

New subsection 66(12.74) empowers the Minister of National Revenue to accept the late filing of documents referred to in subsections 66(12.68), (12.69) and (12.7) if, in the opinion of the Minister, it would be just and equitable to do so. In these circumstances, documents filed late will be treated as having been filed on time provided they are filed within 90 days of the day they were required to be filed under the relevant subsection and provided the corporation or partnership making the late filing pays, at the time of filing, a penalty in respect thereof.

New subsection 66(12.75) of the Act provides for the determination of the amount of the penalty which must be paid under new subsection 66(12.74) in respect of the late filing of documents referred to in subsection 66(12.68), (12.69) or (12.7). The penalty is the lesser of $15,000 and 1/4 of 1 per cent of the total of resource expenditures set out in the documents required to be filed under the relevant subsection.

These subsections are applicable after March 19, 1987, except that documents filed with the permission of the Minister of National Revenue on or before May 15, 1988, shall be treated as having been filed on or before the day on or before which they were required to be filed.

Subclause 33(3)

ITA
66(15)(e)(iv)

Paragraph 66(15)(e) of the Act defines oil, gas and mining expenses that qualify as foreign exploration and development expenses. Paragraph (iv) thereof provides that a taxpayer's foreign exploration and development expenses include his share of such expenses incurred by a partnership in a fiscal period of the partnership, if at the end of the fiscal period the taxpayer is a member of the partnership. The amendment to this subparagraph is consequential on the introduction of new "at-risk" rules for resource expenses incurred by a partnership in section 66.8 and is applicable after June 17, 1987.

Clause 34

Canadian Exploration Expense

ITA
66.1

Section 66.1 of the Act provides rules relating to the deduction of "Canadian exploration expense".

Subclause 34(1)

ITA
66.1(6)(a)(ii.1)(D)

Paragraph 66.1(6)(a) of the Act defines oil, gas and mining expenses that qualify for treatment as Canadian exploration expense ("CEE") eligible for a 100-per-cent write-off rate. Subparagraph (ii.1) thereof describes certain oil and gas expenses which if incurred after March, 1985 qualify as CEE. Clause (ii.1)(D) provides that an expense incurred in respect of an oil or gas well is a CEE if a prescribed certificate in respect of the well has been filed with the Minister of National Revenue on or before the day that is 60 days after the end of the calendar year in which the drilling of the well commenced.

New clause 66.1(6)(a)(ii.1)(D) of the Act replaces, and clarifies the intent of, old clause (D). As a result of new clause (D), certain expenses incurred in respect of an oil or gas well qualify as CEE in the year in which they are incurred provided that a certificate in respect of the well has been issued by the Minister of Energy, Mines and Resources and has been filed with the Minister of National Revenue on or before the day that is 6 months after the end of the month in which the drilling of the well commenced. The Minister of Energy, Mines and Resources will issue the certificate in respect of the well provided he is satisfied, based on the facts submitted to him, that

> (a) the aggregate of expenses to be incurred in drilling or completing the well, in building a temporary access road to the well or in preparing the site in respect of the well will exceed $5,000,000, and
>
> (b) the well will not produce, otherwise than for a specified purpose as defined in paragraph 66.1(6)(d) of the Act, within the period of 24 months commencing on the day of completion of the drilling of the well.

Clause 66.1(6)(a)(ii.1)(D) is applicable after March 1987, except that a certificate filed within 120 days after the implementing legislation receives Royal Assent will be treated as having been filed on or before the day that is six months after the end of the month in which the drilling of the well to which the certificate relates was commenced.

Subclause 34(2)

ITA
66.1(6)(a)(iv)

Paragraph 66.1(6)(a) of the Act defines oil, gas and mining expenses that qualify as Canadian exploration expenses. Paragraph (iv) thereof provides that a taxpayer's Canadian exploration expenses include his share of such expenses incurred by a partnership in a fiscal period of the partnership, if at the end of the fiscal period the taxpayer is a member of the partnership. The amendment to this subparagraph is consequential on the introduction of new "at-risk" rules for resource expenses incurred by a partnership in section 66.8 and is applicable after June 17, 1987.

Subclause 34(3)

ITA
66.1(10)

New subsection 66.1(10) of the Act provides for the conditions under which a certificate, issued by the Minister of Energy, Mines and Resources for the purposes of clause 66.1(6)(a)(ii.1)(D) of the Act, will be treated as never having been issued or filed. A certificate will be rendered invalid if the well produces, otherwise than for a specified purpose as defined in paragraph 66.1(6)(d) of the Act, within the relevant 24 month period or if the applicant in applying for the certificate provided incorrect information or failed to provide information, which information is material to the matter certified. Where a certificate is rendered invalid, expenses initially treated as CEE may be reclassified as Canadian development expenses within the meaning of paragraph 66.2(5)(a) of the Act.

New subsection 66.1(10) of the Act is applicable after March 1987, except that a certificate filed within 120 days after the implementing legislation receives Royal Assent will be treated as having been filed on or before the day that is six months after the end of the month in which the drilling of the well to which the certificate relates was commenced.

Clause 35

Canadian Development Expenses

ITA
66.2

Section 66.2 of the Act provides rules relating to the deduction of "Canadian development expense".

Subclause 35(1)

ITA
66.2(5)(a)(ii.1)

Paragraph 66.2(5)(a) of the Act defines oil, gas and mining expenses that qualify for treatment as Canadian development expenses ("CDE") eligible for a 30 per-cent write-off rate. New subparagraph 66.2(5)(a)(ii.1) provides that expenses incurred, after 1987, in sinking or excavating a mine shaft or main haulage way for a mine after it came into production will qualify as CDE. Such costs incurred before 1988 are treated as a class 12 depreciable property eligible for a 100 per-cent capital cost allowance.

Subclause 35(2)

ITA
66.2(5)(a)(iv)

Paragraph 66.2(5)(a) of the Act defines oil, gas and mining expenses that qualify as Canadian development expenses. Paragraph (iv) thereof provides that a taxpayer's Canadian development expenses include his share of such expenses incurred by a partnership in a fiscal period of the partnership, if at the end of the fiscal period the taxpayer is a member of the partnership. The amendment to this subparagraph is consequential on the introduction of new "at-risk" rules for resource expenses incurred by a partnership in section 66.8 and is applicable after June 17, 1987.

Clause 36

Canadian Oil and Gas
Property Expense

ITA
66.4(5)(a)(ii)

Section 66.4 of the Act provides rules relating to the deduction of "Canadian oil and gas property expense". Paragraph 66.4(5)(a) provides the definition of "Canadian oil and gas property expense". Paragraph 66.4(5)(a)(ii) provides that a taxpayer's Canadian oil and gas property expenses include his share of such expenses incurred by a partnership in a fiscal period of the partnership, if at the end of the fiscal period the taxpayer is a member of the partnership. The amendment to this subparagraph is consequential on the introduction of new "at-risk" rules for resource expenses incurred by a partnership in section 66.8 and is applicable after June 17, 1987.

Clause 37

At-Risk Resource Rules

ITA
66.8

Sections 64 to 66.7 of the Act set out rules relating to the deduction by a taxpayer of Canadian and foreign resource expenditures. A taxpayer's resource expenditures include his share of such expenditures incurred by a partnership in a fiscal period of the partnership, if at the end of the fiscal period the taxpayer is a member of the partnership. Thus, resource expenditures incurred by a partnership are not accumulated in the partnership, but rather are allocated to its partners, who in turn treat such expenditures as their own. On June 18, 1987, it was proposed that the existing "at-risk" rules applicable to limited partnerships and certain other partnerships be extended to apply to resource expenditures incurred by such partnerships. New section 66.8 of the Act implements the proposal and thereby restricts the deductibility of resource expenditures allocated to a limited partner of a partnership to the amount of investment the partner has at-risk.

New section 66.8 of the Act provides an ordering of deductions for a limited partner of resource expenditures incurred by a partnership and of reductions to the partner's "at-risk" amount in respect of the partnership. It provides that where a taxpayer is a member of a partnership at the end of a fiscal period of the partnership, the taxpayer's share of resource expenditures incurred by the partnership in the fiscal period cannot exceed the amount by which his "at-risk" amount for the period exceeds his share of investment tax credits and farm losses for the period. Investment tax credits and farm losses allocated by the partnership to the taxpayer will reduce the taxpayer's "at-risk" amount and consequently, will reduce his share of resource expenditures. Thus, the taxpayer may deduct his share of partnership resource expenditures to the extent he is at-risk for them. Where his share of such expenditures, as otherwise determined, is greater than his at-risk amount, the excess may be carried forward indefinitely and deducted in future years when the taxpayer is at-risk for the excess.

New subsection 66.8(3) of the Act provides that, subject to certain date references, the meaning of "at-risk amount" of a taxpayer in respect of a partnership, "limited partner" of a partnership and "exempt interest" have the meanings assigned by subsections 96(2.2), (2.4) and (2.5) of the Act. The date references in the definition of "exempt interest" in subsection 96(2.5) of the Act reflect the June 18, 1987 proposal extending the partnership "at-risk" concept to resource expenditures. Also, the reference in "exempt interest" to prospectus, preliminary prospectus or registration statement includes an offering memorandum or notice that is required to be filed before any distribution of securities may commence.

While new section 66.8 is applicable to taxation years ending after June 17, 1987, a taxpayer will not be subject to the new rules if his interest in a partnership is an "exempt interest."

Clause 38

Restrictions on Expenses

ITA
67.1, 67.2, 67.3 and 67.4

New section 67.1 of the Act provides a general limitation on the amount that may be deducted in respect of food, beverage or entertainment expenses to 80% of the expense.

Subsection 67.1(1) of the Act provides that expenses in respect of food, beverages and entertainment shall be deemed to be 80% of the lesser of the amount paid or payable in respect thereof and an amount that would be reasonable in the circumstances to pay for the food, beverages and entertainment. This general prohibition applies for all purposes of the Act, other than sections 62 (moving expenses) 63 (child care expenses) and 118.2 (medical expenses).

Subsection 67.1(2) of the Act provides several exceptions to the 80% restriction. The restriction will not apply in the following circumstances.

- Where the amount is paid or payable by a taxpayer for food, beverages or entertainment in the ordinary course of his business of providing food, beverages or entertainment to customers. This will exempt restaurants, hotels and airlines from these rules where the costs are incurred in the provision of food, beverages or entertainment for compensation.

- Where the expense relates to a fund-raising event, the primary purpose of which is to benefit a registered charity. This paragraph will exempt those meal and entertainment expenses relating to a specific fund-raising event for a charity, but not any meal or entertainment expenses incurred, for example, at a meeting to organize the event.

- Where the expense is an amount for which the taxpayer is compensated and the amount of compensation is reasonable and is specifically identified in writing to the person paying the compensation. Accordingly, where a taxpayer expends an amount in respect of food, beverages or entertainment for which he will ultimately bill his client or customer, the amount must be identified in the account submitted to the client or customer as an expense relating to food, beverages or entertainment in order for the taxpayer to be entitled to fully deduct the expense. The 80% restriction would apply to the person to whom the account was rendered.

- Where the amount is included in computing the income of an employee or would be so included but for the provisions of subparagraph 6(6)(a)(ii) relating to employment at a remote location. Amounts paid for food or beverages in respect of employees at a location where, due to its remoteness from any established community, the employee could not reasonably be expected to establish and maintain a self-contained domestic establishment, will not be restricted.

- Where the amount is incurred to provide food, beverages or entertainment to all employees at a particular location. This provision will exempt costs incurred for a Christmas party or similar event to which all employees at a particular location have access.

The effect of treating the amount expended in respect of food, beverages or entertainment as 80% of the amount otherwise determined means that the restriction will apply equally to amounts that are capitalized and to amounts that are deducted as operating expenses. Subsections 67.1(1) and (2) are applicable with respect to amounts incurred after June 17, 1987 in respect of food and beverages consumed and entertainment enjoyed after 1987.

New subsection 67.1(3) of the Act provides a rule for the treatment of meal or entertainment expenses which are included in conference and convention fees. Where a fee is paid or payable for attendance at a conference, convention, seminar or similar event which entitles the participant to food, beverages or entertainment (other than incidental beverages and refreshments made available during the course of meetings or receptions such as coffee and muffins) and a reasonable portion of the fee has not been allocated or identified by the organizer of the event as pertaining to the food, beverages or entertainment, $50 for each day of the event shall be deemed to be paid or payable in respect of food beverages and entertainment. The fee for the event itself is treated as being reduced by the same amount. Subsection 67.1(3) is applicable with respect to amounts incurred after June 1988.

New section 67.2 of the Act contains restrictions on the amount that may be deducted in respect of interest expense and capital cost allowance relating to a passenger vehicle. A passenger vehicle is defined in subsection 248(1) of the Act applicable to vehicles acquired after June 17, 1987.

Subsection 67.2(1) provides that, where an amount may be deducted in respect of interest payable on debt relating to the acquisition of a passenger vehicle, the amount deductible shall not exceed $250 (or such other amount as may be provided in the Regulations) multiplied by the number of 30 day periods in the year in respect of which the interest was payable.

New subsection 67.2(2) of the Act provides that, where capital cost allowance is deductible in respect of a passenger vehicle, new paragraphs 13(7)(g) and (h) (the $20,000 capital cost restriction and the special rules for determining capital cost in non-arm's length transfers), shall apply in determining the capital cost to the taxpayer of the vehicle.

Section 67.2 is applicable with respect to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

New section 67.3 of the Act contains a restriction on the total amount of motor vehicle expenses that may be deducted by an individual in respect of a motor vehicle which is used for both business or employment use and personal use where the total number of kilometers travelled in the vehicle for business or employment purposes is less than 24,000. The maximum deduction in this respect is determined by way of a formula. Where the individual uses the vehicle for business or employment purposes for 24,000 kilometres or more in a year, the individual may deduct a fully prorated share of the operating expenses (fuel, maintenance and repair costs) and the fixed expenses (insurance, registration or licensing fee, interest and capital cost allowance or leasing expenses) that relates to business or employment use. The proration is based on the proportion of the number of business or employment kilometres to the total number of kilometres travelled by the vehicle. Where business or employment use of the vehicle is less than 24,000 kilometres (on an annual basis), the individual is entitled to a fully prorated share of the operating expenses of the vehicle. However, for the purposes of calculating the maximum amount deductible in respect of the fixed costs (as described above), these costs will be reduced by that proportion represented by the ratio of business or employment kilometres to total kilometres, to a maximum of 24,000. This reduced amount of fixed costs is then subject to proration based on the ratio of business or employment kilometres to total kilometres. This "double proration" reduces the amount of allowable fixed costs to less than a fully prorated share. However, the allowable amount increases as business or employment use increases and is fully prorated where such use exceeds 24,000 km in a year.

New subsection 67.3(2) of the Act restricts the amount that may be deducted in respect of leasing costs of a passenger vehicle worth more than $20,000. The deductible amount shall not exceed the lesser of the amounts produced by the two following formulas. The first amount is determined by multiplying $600 by the number of 30 day periods in the year during which the vehicle is leased, and deducting from that amount two further sums, where applicable: the total of all amounts deducted in a preceding taxation year in respect of the lease of the vehicle and an amount in respect of interest that would be earned on that part of any refundable amount paid in respect of the lease that exceeds $1,000.

The interest is computed as the amount that would be payable on the refundable amount at the prescribed rate if that amount were an amount payable under the Act, for the period in the year during which the refundable amount is outstanding. The second amount is determined by multiplying the total of the lease charges paid by the taxpayer during the year by the quotient obtained when $20,000 is divided by the greater of $23,529 and the aggregate of the manufacturer's list price for the vehicle and the provincial sales tax that would have applied if the vehicle had been purchased, at the time the first lease was entered into, in the province in which the vehicle was primarily used, and deducting from that amount, an amount in respect of imputed interest on any refundable amount paid in respect of the lease, as outlined above. The effect of this second formula is to place a similar restriction on the deductible cost of leased passenger vehicles as is placed on the depreciable capital cost of purchased passenger vehicles.

Section 67.3 is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

New section 67.4 contains a special rule which governs the maximum deductible amount where two or more persons jointly own or lease a motor vehicle. In order that the restrictions contained in new sections 67.2 and 67.3 apply on a vehicle basis rather than an individual basis this new section provides that where a vehicle is jointly owned or leased by two or more persons. The aggregate of all amounts that may be deducted by those persons in respect of the vehicle shall not exceed the maximum amount that would be deductible in computing income where the vehicle was owned or leased by only one person.

Clause 39

Allocation of Consideration

ITA
68

Section 68 of the Act applies where an amount can reasonably be regarded as being in part consideration for the disposition of any property of a taxpayer and in part consideration for something else. In such a case, the part of the amount that can reasonably be regarded as consideration for the property is deemed to be the proceeds of disposition of that property and, reciprocally, the cost of the property for the acquiror.

The amendment to section 68 clarifies the application of that rule and extends it to the situation where an amount can reasonably be regarded as being in part consideration for the provision of services by a taxpayer. In such case, that part of the amount that can be so considered shall be deemed to be an amount received or receivable by the taxpayer in respect of those services and, reciprocally, an amount paid or payable by the payor in respect of those services.

This amendment is applicable with respect to amounts received or receivable after June, 1988 otherwise than pursuant to a written agreement entered into before May, 1988.

Clause 40

Amalgamations or Mergers - Transfers
of Eligible Capital Property

ITA
69(13)(b)

Subsection 69(13) of the Act provides a special rule for the purpose of determining whether subsection 69(11) of the Act is applicable in respect of an amalgamation or merger. Subsection 69(11) sets out an anti-avoidance rule which prevents a person or partnership from disposing of a property as part of a series of transactions for proceeds less than fair market value so as to obtain the benefit of the tax deductions or entitlements of certain persons or partnerships on a subsequent disposition of the property. In the case of an amalgamation of two corporations, there may not technically be a disposition of property from a predecessor corporation to the new corporation formed as a result of the amalgamation. Accordingly, paragraph 69(13)(b) treats the property of a predecessor corporation as having been disposed of immediately before the amalgamation or merger for proceeds of disposition that reflect the rollover of the property to the new corporation. This paragraph is amended as a consequence of the increase in the inclusion rate in respect of eligible capital property from 1/2 to 3/4, and is applicable with respect to an amalgamation or merger of a corporation after the beginning of its first taxation year commencing after June, 1988.

Clause 41

Death of a Taxpayer

ITA
70

Section 70 of the Act provides for certain rules that are applicable when a taxpayer dies.

Subclause 41(1)

ITA
70(2)(c)

Subsection 70(2) of the Act provides for an election by the legal representative of a deceased taxpayer to file a separate return in respect of rights or things receivable at the date of death. Paragraph 70(2)(c) is amended to remove the reference to the personal tax exemptions and certain other deductions and to include references to the new personal tax credit provisions, as a consequence of the conversion of such exemptions and deductions to tax credits. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 41(2)

ITA
70(5.1)(a) and (b)
73(3)(b.1) and (d.1)

Subsection 70(5.1) of the Act treats a taxpayer as having disposed of an eligible capital property immediately before his death where, as a consequence of his death, any person, other than his spouse or a corporation that was controlled by him, has acquired that property. Subsection 73(3) of the Act provides rules for the inter vivos transfer by a taxpayer to his children of family farm properties on a rollover basis. These provisions are amended as a consequence of the increase in the inclusion rate for eligible capital property from 1/2 to 3/4. Accordingly, the deemed proceeds of the taxpayer and, consequently, the deemed cost to the recipient of the eligible capital property in such situations will be 4/3 of the taxpayer's cumulative eligible capital.

These provisions are also amended as a consequence of the changes to subsection 14(1) and paragraph 14(5)(a) of the Act which treat a portion of an individual's negative balance in his cumulative eligible capital at the end of a taxation year as a taxable capital gain. These further amendments will apply where an eligible capital property is rolled-over pursuant to subsection 70(5.1) or 73(3) from a taxpayer to a person who carries on the business previously carried on by the taxpayer. In such a situation, the person will be deemed to have made an expenditure in respect of that eligible capital property equal to the aggregate of the taxpayer's cumulative eligible capital and the deductions under paragraph 20(1)(b) previously taken by the taxpayer in respect of that eligible capital property which have not been recaptured. The person will also be deemed to have taken deductions under paragraph 20(1)(b) equal to those unrecaptured deductions of the taxpayer. This will ensure that the recapture of such deductions is not avoided following a subsection 70(5.1) or 73(3) transfer.

The amendments to subsection 70(5.1) are applicable with respect to acquisitions as a consequence of the death of a taxpayer occurring after the commencement of the first fiscal period of the taxpayer commencing after 1987. The amendments to subsection 73(3) are applicable to transfers occurring after the commencement of the first fiscal period commencing after 1987 of a taxpayer's business.

Subclause 41(3)

ITA
70(10)(a)(iii)

Subsection 70(10) contains the definition of "child" for the purposes of sections 40,44,70,73 and 146 of the Act. Paragraph 70(10)(a)(iii) is amended to change the reference from 21 years to 19 years, as a consequence of the recognition of 18 years as the age of majority for income tax purposes. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 42

Reserves for Year of Death

ITA
72(2)(b)(ii)

Section 72 of the Act provides rules applicable to certain reserves in the year of a taxpayer's death. Subsection 72(2) provides special rules to allow a rollover of a deceased taxpayer's tax reserves to a spouse or spouse trust if certain conditions are met. If the rollover applies, the capital gains reserve claimed by the deceased taxpayer in his final return is treated as a capital gain of the spouse or spouse trust, as the case may be, from a disposition of capital property in the first taxation year ending after the death of the taxpayer. Existing subparagraph 72(2)(b)(ii) provides that any such capital gain of the spouse or spouse trust will not qualify for the purposes of the capital gains exemption. This treatment of reserves conforms to the existing rule that the exemption is not available with respect to capital gains reserves of prior years included in income in a subsequent year.

The amendments to section 110.6 will permit reserves brought into income after 1987 and arising from dispositions of property occurring after 1984 to qualify for the capital gains exemption.
Subparagraph 72(2)(b)(ii) is amended, applicable to the 1988 and subsequent taxation years, to permit capital gains of the spouse or spouse trust, arising from dispositions of property occurring after 1984 and rolled-over pursuant to subsection 72(2), to qualify for the exemption.

Clause 43

Inter Vivos Transfer of
Eligible Capital Property

ITA
73(3)

These amendments are described in the notes explanations describing the amendments to section 70 of the Act.

Clause 44

Attribution - Capital Gains

ITA
74.2(2)

Section 74.2 of the Act attributes to an individual any taxable capital gains or allowable capital losses realized by his or her spouse on the disposition of property that was loaned or transferred by the individual to or for the benefit of his or her spouse, or someone who has since become his or her spouse.

Subsection 74.2(2) of the Act treats the gain or loss attributed to an individual by virtue of subsections 74(2), 74.2(1) or section 75.1 to be a gain or loss of that individual. In order to ensure that such gains and losses are taken into account in determining that individual's entitlement to the capital gains exemption, subsection 74.2(2) is amended, applicable to the 1988 and subsequent taxation years, to also treat the gain or loss as having arisen in respect of property disposed of by that individual in the year.

Clause 45

Taxable Dividends

ITA
82

Section 82 of the Act provides rules regarding the inclusion in income of taxpayers of taxable dividends.

Subclause 45(1)

ITA
82(1)(b)

Where an individual receives taxable dividends from a taxable Canadian corporation, subsection 82(1) of the Act requires him to include in his income, in addition to the actual dividends received, a "gross-up" of 1/3 of such dividends. The individual is then subject to tax on this grossed-up amount and is entitled to claim a dividend tax credit under section 121. This amendment provides that the amount by which an individual is required to gross-up the actual amount of taxable dividends received is 1/4. The amendment is applicable to dividends received in the 1988 and subsequent taxation years.

Subclause 45(2)

ITA
82(2)

Subsection 82(2) of the Act provides that dividends received by one taxpayer but included under certain attribution rules in computing the income of another taxpayer are treated as having been received by the other taxpayer for certain purposes of the Act. The amendment to this subsection, which is applicable to the 1989 and subsequent taxation years, is strictly consequential on the introduction of new subsection 56(4.1) of the Act. It adds the reference to that subsection to the list of the attribution rules with respect to which subsection 82(2) applies.

Subclause 45(3)

ITA
82(3)

Subsection 82(3) of the Act provides for an election permitting taxable dividends from taxable Canadian corporations received by a taxpayer's spouse to be included in the income of the taxpayer (rather than in the income of the taxpayer's spouse) where such an inclusion has the effect of increasing the taxpayer's married exemption in respect of his spouse. Subsection 82(3) of the Act is amended strictly as a consequence of the conversion of personal exemptions to tax credits to delete the reference to the former married exemption and include instead a reference to the married tax credit for the purposes of that election. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 46

Capital Dividends

ITA
83(2.1) to (2.4)

Subsection 83(2) of the Act provides for an election to treat a dividend as having been paid out of the capital dividend account of a private corporation. The capital dividend account is part of the system for integrating the corporate and shareholder tax of private corporations, and seeks to preserve the character of the non-taxable portion of capital gains and certain other non-taxable receipts of a corporation in the hands of its shareholders. A dividend elected to be paid out of a corporation's capital dividend account is not subject to tax in the hands of shareholders resident in Canada.

New subsection 83(2.1) of the Act provides an anti-avoidance rule which applies where one of the main purposes of an acquisition of shares is to acquire a right to a capital dividend. For example, a private corporation controlled by non-residents who would be taxable on capital dividends may be willing to sell shares to another corporation and thereby transfer its capital dividend account in order to permit that other corporation to reduce the taxes payable on distributions to its domestic shareholders. In addition, a corporation not in a position to pay dividends itself may be willing to sell shares and thereby transfer its capital dividend account to another corporation the shareholders of which would not be taxable on the distribution. New subsection 83(2.1) is intended to apply to dividends paid in these circumstances. It will also apply to dividends paid to individuals in circumstances that are limited by the application of new subsection 83(2.2) discussed below.

New subsection 83(2.1) provides that where:

- a capital dividend is paid on a share of a corporation after 4 p.m. Eastern Daylight Saving Time on September 25, 1987,

- the share (or a substituted share) was acquired by the holder in a transaction or as part of a series of transactions, and

- one of the main purposes of the transaction or the series of transactions was to receive the capital dividend,

the capital dividend will be treated as a taxable dividend received by the shareholder and paid by the corporation. As such, the dividend will be required to be included in computing the shareholder's income. However, the capital dividend will retain its character as a capital dividend in determining any liability of the corporation for Part III tax in respect of excessive elections made under subsection 83(2) and in computing the capital dividend account of the corporation.

New subsections 83(2.2) to (2.4) of the Act provide certain exceptions to the rule described above applicable to dividends paid after 4 p.m. Eastern Daylight Saving Time on September 25, 1987.

Subsection 83(2.2) provides that subsection 83(2.1) will not apply to a capital dividend paid to an individual where, before the dividend became payable, all or substantially all of the capital dividend account (CDA) of the corporation out of which the dividend was paid consisted of amounts other than those specified in paragraphs (a) to (d). The specified amounts are those added:

- in respect of a capital dividend received on a share of another corporation which share was acquired by the particular corporation as part of a series of transactions one of the main purposes of which was to receive the dividend -- paragraph (a); in this case there is an exception so that the anti-avoidance rule in subsection 83(2.1) will not apply where the capital dividend was paid by the other corporation as a distribution of life insurance proceeds included in its CDA as a consequence of the death of any person;

- as a result of an addition on an amalgamation or winding-up where the addition would not have so arisen had the amalgamation or winding-up occurred, or a series of transactions including the amalgamation or winding-up commenced, after 4 p.m. Eastern Daylight Saving Time on September 25, 1987 -- paragraph (b);

- at a time when the corporation was controlled by non-residents -- paragraph (c); or

- in respect of a capital gain from a disposition of a property that accrued while the property (or a property for which it was substituted) was a property of a corporation controlled by non-residents -- paragraph (d).

New subsection 83(2.3) provides that the anti-avoidance rule in new subsection 83(2.1) will not apply to a capital dividend paid by a corporation in order to distribute life insurance proceeds which were received by it and included in its capital dividend account as a consequence of the death of a person. New subsection 83(2.1) will not apply where a capital dividend funded by life insurance proceeds is paid to an individual either directly or through a holding corporation by reason of new subsection 83(2.2).

New subsection 83(2.4) provides the circumstances in which the anti-avoidance rule in new subsection 83(2.1) will not apply to a capital dividend paid on a share of a corporation to a related corporation. Subsection 83(2.1) will not apply in related company circumstances where, before the dividend became payable, all or substantially all of the capital dividend account of the corporation out of which the dividend was elected to be paid consisted of amounts other than those specified in paragraphs (a) to (e). The specified amounts are those:

- added in respect of a capital dividend paid on a share of another corporation if any portion of the capital dividend account of that other corporation consisted of amounts added thereto as a result of an event that is an intercorporate capital dividend, amalgamation or winding-up where the addition would not have so arisen had the event occurred, or a series of transactions including the event commenced, after 4 p.m. Eastern Daylight Saving Time on September 25, 1987 -- paragraph (a);

- added in respect of the capital dividend account of another corporation which arose before it became related -- paragraph (b);

- added at a time when the corporation was controlled by non-residents -- paragraph (c);

- added in respect of a capital gain from a disposition of property that accrued while the property (or a property for which it was substituted) was a property of a corporation controlled by non-residents -- paragraph (d); or

- added in respect of a capital gain from a disposition of a property (or a property for which it was substituted) that accrued while the property was a property of a person that was not related to the corporation -- paragraph (e).

Clause 47

Deemed Dividends

ITA
84

Section 84 of the Act provides that certain transactions involving the shares of a corporation, such as share redemptions, winding-up distributions or certain increases or reductions of paid-up capital, give rise to dividend treatment.

Subclause 47(1)

ITA
84(1)(c.3)

Subsection 84(1) deems a dividend to have been paid by a corporation on the shares of a class of its capital stock where the paid-up capital of that class has been increased by the corporation, otherwise than in the circumstances set out in that subsection. The paid-up capital of a share represents the amount that can be received by the shareholder from the corporation as a return of capital.

New paragraph 84(1)(c.3) allows a corporation, other than an insurance corporation or a bank, to convert into the paid-up capital of a class of shares any contributed surplus of the corporation that arose on an issuance of shares of that class after March 31, 1977, other than an issuance to which certain special provisions of the Act applied. These special provisions, which allow a rollover of property to the corporation or reduce the paid-up capital of a class of shares of the corporation, are sections 51, 66.3, 84.1, 85, 85.1, 86 and 87, subsections 192(4.1) and 194(4.1) and section 212.1. Contributed surplus will arise on the issuance of shares when the paid-up capital of the shares issued is less than the consideration received by the corporation on the issue of its shares. New paragraph 84(1)(c.3), which is applicable to actions taken to convert contributed surplus into paid-up capital after 1987, will allow a corporation to increase the paid-up capital of a class of shares to reflect the amount received from shareholders of that class on the issuance of their shares.

Subclause 47(2)

ITA
84(6)(a)

In order to eliminate the possibility of double taxation, existing subsection 84(6) of the Act provides that the deemed dividend provisions of subsections 84(2) or (3) are not applicable on a winding-up or share redemption if subsection 84(1) applies in respect of the same transaction or event. In some circumstances, however, it is argued that the wording of subsection 84(6) may lead to unintended results -- for example, if a transaction which would normally lead to a deemed dividend pursuant to subsection 84(3) were structured so as to give rise to a nominal dividend under subsection 84(1), it could thereby avoid having an amount paid on a share redemption treated as a deemed dividend under subsection 84(3). The amendment to paragraph 84(6)(a), which is applicable to transactions or events occurring after April, 1988, clarifies that the exemption from subsections 84(2) and (3) is available for any transaction or event only to the extent that subsection 84(1) applies in respect of that transaction or event.

Clause 48

Non-Arm's Length Sale of Shares

ITA
84.1

Subsection 84.1(1) of the Act provides an anti-avoidance rule to prevent the removal of taxable corporate surpluses as a tax-free return of capital where there is a non-arm's length transfer of shares by an individual resident in Canada to a corporation.

Subclause 48(1)

ITA
84.1(2)(a)

Paragraphs 84.1(2)(a) and (a.1) of the Act provide rules for determining a taxpayer's adjusted cost base of shares for the purposes of that rule. The former paragraph applies to shares acquired by the taxpayer before 1972 while the latter paragraph applies to shares acquired by the taxpayer after 1971 from a person with whom he was not dealing at arm's length.

Paragraph 84.1(2)(a) provides that where a share was acquired before 1972, the taxpayer's adjusted cost base of the share is the amount that would be determined under the provisions of the Act if the Income Tax Application Rules were read without reference to subsections 26(3) and (7) thereof. In effect, the share's adjusted cost base is reduced by the excess of the share's fair market value on Valuation Day over its cost as at January 1, 1972. The rule also applies to a share substituted for such a share.

Prior to 1979, subsection 83(1) of the Act permitted a corporation to distribute certain amounts as a tax-free dividend and such distributions reduced the adjusted cost base of the share in the hands of the recipient. The amendment adds such dividends into the computation of the adjusted cost base of a share for the purposes of the anti-avoidance rule effective for share dispositions after May 22, 1985 -- the date on which section 84.1 in its present form became effective.

A technical amendment has also been made to paragraph 84.1(2)(a) by striking out the reference therein to a substituted share. Substituted shares will now be governed by the provisions of amended paragraph 84.1(2)(a.1) in order to reduce conflicts between paragraphs (2)(a) and (2)(a.1).

Subclause 48(2)

ITA
84.1(2)(a.1)

Where a share which is disposed of by a taxpayer was acquired by him after 1971 from a person with whom he was not dealing at arm's length, or was a share substituted for such a share, subparagraph 84.1(2)(a.1)(i) applies to reduce the adjusted cost base to the taxpayer otherwise determined by an amount equal to the excess, if any, of the share's fair market value on Valuation Day over the cost of the share to the taxpayer on January 1, 1972. The amendment parallels that above to increase the adjusted cost base of a share to reflect pre-1979 dividends received on the share in respect of which a valid subsection 83(1) election was made. As a technical matter, paragraph 84.1(2)(a.1) has also been expanded to include shares substituted for shares owned by the taxpayer at the end of 1971. This ensures that the provisions of subparagraph 84.1(2)(a.1)(ii) dealing with post-1984 share gains eligible for the capital gains exemption are equally applicable to these substituted shares. The amendments to paragraph 84.1(2)(a.1) are applicable in respect of dispositions made after May 22, 1985.

Clause 49

Transfers to a Corporation

ITA
85

Section 85 of the Act provides rules which allow a taxpayer or a partnership to transfer certain property on a rollover basis to a taxable Canadian corporation in exchange for consideration that includes shares of the corporation.

Subclause 49(1)

ITA
85(1)

Subsection 85(1) of the Act allows a transfer on a tax-deferred basis of certain properties by a taxpayer to a taxable Canadian corporation in exchange for shares. The amendment to this subsection deletes the references to particular types of properties and, instead, provides for the tax-deferred transfer of "eligible property" as that term is defined under new subsection 85(1.1) of the Act. This amendment is applicable to dispositions of property occurring after 1986.

Subclause 49(2)

ITA
85(1)(c.1)

Paragraph 85(1)(c.1) of the Act provides that the amount elected by a taxpayer and a taxable Canadian corporation on a section 85 rollover in respect of inventory or non-depreciable capital property cannot be below the lesser of its fair market value and its cost amount. The amendment to this paragraph extends this rule to the amount elected in respect of a property that is a security or debt obligation used or held by the taxpayer in the business of insurance or lending money. This amendment is applicable to dispositions of property occurring after 1986. A related amendment to the definition of the term "cost amount" in subsection 248(1) of the Act provides the meaning of cost amount in respect of property that is a debt.

Subclause 49(3)

ITA
85(1)(d)(i)

Subparagraph 85(1)(d)(i) of the Act is amended to reflect the increase in the inclusion rate in respect of eligible capital property in the calculation of cumulative eligible capital from 1/2 to 3/4. This amendment is applicable, in the case of a corporation, with respect to dispositions of property occurring after the commencement of its first taxation year commencing after June 30, 1988 and, in any other case, with respect to dispositions of property in respect of a business after the commencement of the first fiscal period of the business commencing after 1987.

Subclause 49(4)

ITA
85(1)(e.2)

Paragraph 85(1)(e.2) applies where a taxpayer transfers property to a corporation under subsection 85(1) but the fair market value of the transferred property exceeds the fair market value of the consideration received. In that case, where it is reasonable to regard any portion of the excess as a gift to another shareholder, special rules apply.

Paragraph 85(1)(e.2) is amended to provide that such an excess is to be determined on the basis of the fair market value of the transferred property immediately before the disposition rather than at the time of the disposition. Similarly, the fair market value of the consideration received is to be determined immediately after the disposition rather than at the time of the disposition.

As a further amendment to this paragraph, the words "gift made to or for the benefit of", are replaced by the words "benefit conferred on" to parallel other provisions of the Act.

These changes are applicable to dispositions occurring after June, 1988.

Subclause 49(5)

ITA
85(1)(e.4)

Subsection 85(1) of the Act is amended by the addition of new paragraph (e.4) which places a restriction on the amount that may be elected by the shareholder and the corporation in respect of the transfer to the corporation of a passenger vehicle of the shareholder.

This is an anti-avoidance provision which prevents the $20,000 depreciable cost ceiling for passenger vehicles acquired after June 17, 1987 from being circumvented. New paragraph 85(1)(e.4) will apply where a passenger vehicle is transferred to a corporation which does not deal at arm's length with the shareholder and deems the elected amount to be the undepreciated capital cost to the shareholder of the vehicle immediately before the disposition. New paragraphs 13(7)(g) and (h) are to be applied in determining that undepreciated capital cost. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 and ending after 1987.

Subclause 49(6)

ITA
85(1.1)

New subsection 85(1.1) of the Act provides the definition of the term "eligible property" for the purposes of the rules under subsection 85(1) which allow a transfer on a tax-deferred basis of eligible property by a taxpayer to a taxable Canadian corporation. The meaning of eligible property covers the particular types of properties that are referred to in existing subsection 85(1). As well, eligible property includes a property that is neither capital property nor inventory of the taxpayer that is a security or debt obligation used or held by the taxpayer in the year in the business of insurance or lending money. Eligible property also includes a capital property that is real property owned by a non-resident insurer that is used or held by it in the year in an insurance business in Canada. In this case, the consideration received by the insurer in respect of the transferred real property must be property used or held by it in an insurance business in Canada. New subsection 85(1.1) is applicable to dispositions of property occurring after 1986.

Subclause 49(7)

ITA
85(2)

Subsection 85(2) of the Act provides that the rules in subsection 85(1) will apply and allow a transfer on a tax-deferred basis of certain properties by a partnership to a taxable Canadian corporation in exchange for shares. The amendment to this subsection provides for the tax-deferred transfer of a property that is a security or debt obligation used or held by the taxpayer in the year in the business of insurance or lending money. This amendment parallels the change to subsection 85(1.1) described above. This amendment is applicable to dispositions of property occurring after 1986.

Subclause 49(8)

ITA
85(4)(b)

Subsection 85(4) of the Act applies to prevent a taxpayer from realizing a capital loss or a deduction in respect of his cumulative eligible capital where an eligible capital property is disposed of to a corporation which is controlled directly or indirectly, immediately after the disposition, by the taxpayer, the taxpayer's spouse, or a person or group of person's by whom the taxpayer was controlled.
Paragraph 85(4)(b) is amended to reflect the increase in the inclusion rate in respect of eligible capital property in the calculation of cumulative eligible capital from 1/2 to 3/4. This amendment is applicable, in the case of a corporation, with respect to dispositions of property occurring after the commencement of its first taxation year commencing after June 30, 1988 and, in any other case, with respect to dispositions of property in respect of a business after the commencement of the first fiscal period of the business commencing after 1987.

Clause 50

Amalgamations

ITA
87

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

Subclause 50(1)

ITA
87(2)(e.2)

Subsection 87(2) of the Act sets out rules which apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation. New paragraph 87(2)(e.2) provides that the new corporation's cost of a property that is a security or debt obligation of a predecessor corporation which was used or held by the predecessor corporation in the business of insurance or lending money is equal to the cost amount of that property to the predecessor corporation immediately before the amalgamation. This rule ensures that all adjustments required to be made by the predecessor corporation in calculating the cost amount of such property will be taken into account in computing any income or loss from a subsequent disposition of that property by the new corporation. New paragraph 87(2)(e.2) is applicable to amalgamations occurring after December 15, 1987.

A related amendment to the definition of the term "cost amount" in subsection 248(1) of the Act, applicable after 1986, provides the meaning of cost amount in respect of property that is a debt.

Subclause 50(2)

ITA
87(2)(f.1)

Paragraph 87(2)(f) treats the cumulative eligible capital of a predecessor corporation in respect of a business as forming part of the cumulative eligible capital of the new corporation where the new corporation carries on the business. New paragraph 14(5)(c) of the Act defines the "adjustment time" of a corporation which is the point in time at which the increased inclusion rate in respect of eligible capital property applies to the corporation, and the corporation's cumulative eligible capital is increased by 50% to reflect this increase. This time is defined as the time immediately after the commencement of the first taxation year of the corporation commencing after June 30, 1988. However, where the corporation is a new corporation formed as a result of the amalgamation occurring after June 30, 1988, the corporation's adjustment time is the time immediately before the amalgamation. Accordingly, where the last taxation year of a predecessor corporation commenced before July 1, 1988 and the predecessor is amalgamated with another corporation after June 30, 1988, the predecessor will not have reached its adjustment time, and therefor its cumulative eligible capital will not have been increased as outlined above, while the new higher inclusion rate in respect of eligible capital property will apply to the new corporation. Accordingly, in such situations, new paragraph 87(2)(f.1) increases the cumulative eligible capital of the predecessor corporation on the transfer of the predecessor's cumulative eligible capital to the new corporation. This amendment is applicable with respect to amalgamations occurring after June 30, 1988.

Subclause 50(3)

ITA
87(2)(g.1)

Paragraph 87(2)(g.1) provides that, for the purposes of the rules relating to the special reserves for banks under section 26 of the Act, a new corporation formed as a result of an amalgamation shall be treated as a continuation of each predecessor corporation. This paragraph is amended applicable to taxation years commencing after June 17, 1987 that end after 1987 to add a reference to new sections 12.3 and 12.4 and new subsection 20(26). New section 12.3 requires a taxpayer, who is an insurer or whose ordinary business includes the lending of money and who has deducted an amount in respect of his prescribed amount of net reserve adjustment under new subsection 20(26) in his first taxation year that commences after June 17, 1987 and ends after 1987, to include the amount so deducted in computing his income for taxation years ending after 1988 that commence before 1993. The amendment to paragraph 87(2)(g.1), along with the rule in new subsection 8100(2) of the Regulations which deems the new corporation to have an amount of net reserve adjustment equal to the amount of net reserve adjustment of a predecessor corporation, is being made to ensure that amounts deducted under new subsection 20(26) by a predecessor corporation are included in the new corporation's income under new section 12.3. New section 12.4 requires a taxpayer who disposes of a property that is part of his inventory to include the excess of bad debts previously deducted over bad debts recovered in respect of the property in his income in the year of disposition. The amendment to paragraph 87(2)(g.1), adding a reference to new section 12.4, ensures that bad debts deducted or recovered by a predecessor corporation are treated, for the purposes of new section 12.4, as having been deducted or recovered by the new corporation. By reason of paragraph 88(1)(e.2) of the Act, these rules will apply to a parent in respect of a wholly-owned subsidiary that has been wound-up pursuant to subsection 88(1) of the Act.

Subclause 50(4)

ITA
87(2)(h)

Paragraph 87(2)(h) of the Act provides that for the purposes of computing a deduction under paragraph 20(1)(1)(p) or section 33 from the income of a new corporation formed as result of an amalgamation, any debt acquired by the new corporation which was owing to a predecessor corporation and which was included in computing its income or that arose from a loan made in the ordinary course of its business where its ordinary business included the lending of money shall be deemed to have been included in the new corporation's income or as having arisen from a loan so made by it. Two amendments are proposed to this paragraph applicable to taxation years commencing after June 17, 1987 that end after 1987. The first amendment removes the reference to section 33 as a result of the repeal of that section. The second amendment expands the list of assets which are deemed to have arisen in the ordinary course of a new corporation's business. The list of assets will include loans and lending assets, as defined in subsection 248(1), made or acquired and instruments and commitments described in new paragraph 20(1)(1.1) that were issued, made or assumed in the ordinary course of business of a predecessor corporation who was an insurer or whose ordinary business included the lending of money. By reason of paragraph 88(1)(e.2) of the Act, these rules will apply to a parent in respect of a wholly-owned subsidiary that has been wound-up pursuant to subsection 88(1) of the Act.

Subclause 50(5)

ITA
87(2)(j.6)

The amendment to paragraph 87(2)(j.6) of the Act is consequential on the amendments to subsection 13(7.1), which will require that the capital cost of a depreciable property be reduced by investment tax credits in respect of that property claimed in previous taxation years only, rather than such credits claimed in previous and the current taxation year, and the introduction in paragraph 20(1)(e) of the requirement to spread the deduction of issue expenses over five years. The amendment treats an amalgamated corporation as a continuation of its predecessors for the purposes of these provisions. This amendment is applicable to amalgamations occurring after 1987.

Subclause 50(6)

ITA
87(2)(j.9)

New paragraph 87(2)(j.9) of the Act is consequential on the introduction of the Part VI tax credit in new section 125.2. Section 125.2 provides that a financial institution may deduct in computing its tax payable under Part I of the Act for a taxation year any capital tax payable under Part VI by it for the year. Under that section a financial institution may also deduct any Part VI taxes payable by it for the seven preceding and three following years that have not already been credited against Part I tax in those other years. This amendment is intended to permit an amalgamated corporation to carry forward "unused Part VI tax credits" of its predecessor corporations for the purposes of this carryover. Accordingly, new paragraph 87(2)(j.9) provides that for this purpose an amalgamated company will be considered to be a continuation of its predecessors. In addition, pursuant to paragraph 88(1)(e.2) of the Act, new paragraph 87(2)(j.9) will apply to allow a parent corporation to claim any unused Part VI tax credits of its subsidiary financial institution following its winding-up.

Subclause 50(7)

ITA
87(2)(v)

Paragraph 87(2)(v) of the Act is amended to delete the reference to paragraphs 110(1)(a), (b) and (b.1) dealing with deductions from income in respect of charitable gifts and include a reference to new section 110.1 which governs the deductibility of charitable gifts made by corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 50(8)

ITA
87(2)(z.1)

Paragraph 87(2)(z.1) of the Act provides for the transfer of the capital dividend account (CDA) of a predecessor corporation to the new amalgamated corporation on an amalgamation. The transfer of the CDA of a subsidiary corporation to its parent on a winding-up will follow automatically by reason of paragraph 88(1)(e.2) of the Act.

The amendment to paragraph 87(2)(z.1), applicable to amalgamations or windings-up occurring after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, provides the circumstances in which the CDA of a predecessor or subsidiary corporation will not be transferred on an amalgamation or winding-up. The CDA of a corporation will not be transferred in any case where, if immediately before the amalgamation or winding-up, a capital dividend were paid by it, the dividend would have been deemed to be a taxable dividend by reason of the rule in new subsection 83(2.1). For example, if a corporation acquires all of the shares of another corporation that has a balance in its CDA, the CDA of the other corporation will not be transferred to the corporation as a result of new paragraph 87(2)(z.1) if one of the main purposes of the share acquisition and wind-up was to obtain the capital dividend account.

Subclause 50(9)

ITA
87(2)(z.2)

New paragraph 87(2)(z.2) treats a new corporation formed on an amalgamation as being the same corporation as and a continuation of the predecessor corporation for the purposes of Part III of the Act. Part III of the Act imposes a tax on excessive elections by a corporation in respect of capital dividends paid out of its capital dividend account or in respect of capital gains dividends paid by a mortgage investment corporation or a mutual fund corporation. As a result of the addition of paragraph 87(2)(z.2), the new corporation will be entitled to elect, for the purposes of determining the amount of Part III tax payable, to treat as a separate dividend or a loan under subsection 184(3), (3.1) or (3.2) of the Act an amount that is an excessive dividend in respect of the predecessor's capital dividend account. In addition, the new corporation will be liable for any unpaid Part III tax of a predecessor. An amendment to paragraph 88(1)(e.2) provides that this rule will also apply to a corporation that was a parent of a subsidiary wholly-owned corporation that was wound up pursuant to subsection 88(1) of the Act.

New Paragraph 87(2)(z.2) is applicable to amalgamations occurring after April, 1988.

Subclause 50(10)

ITA
87(2.2)

Subsection 87(2.2) of the existing Act deals with the amalgamation of two or more life insurance corporations to form a new corporation and treats the new corporation as a continuation of its predecessor corporations for the purposes of the rules in section 138 of the Act which apply to insurance corporations. New subsection 87(2.2) deals with the amalgamation of two or more corporations that include any insurance corporation and ensures a proper measurement of the income of the new corporation formed as a result of the amalgamation. This is effected by treating the new corporation as a continuation of each predecessor insurance corporation for the purposes of certain provisions relating to insurance corporations listed in subsection 87(2.2). This subsection is applicable to amalgamations occurring after December 15, 1987.

Clause 51

Winding-up of a Corporation

ITA
88

Section 88 of the Act deals with the tax treatment of the winding-up of a taxable Canadian corporation into its parent corporation.

Subclause 51(1)

ITA
88(1)(d)(i.1)

Paragraph 88(1)(d) contains the rules applicable to the computation of the additional amount that, pursuant to paragraph 88(1)(c), can be added to the cost to a parent corporation of capital property distributed to it on the winding-up of its subsidiary corporation. Subparagraph 88(1)(d)(i.1) provides that in computing that additional amount, there must be deducted the amount of certain dividends received by the parent corporation, prior to the winding-up, on any share of the capital stock of the subsidiary disposed of by it on the winding-up.

The amendment to this subparagraph extends that rule to the dividends received on the shares of the subsidiary that the parent has disposed of in contemplation of the winding-up. This amendment prevents the parent corporation from avoiding a reduction of the additional amount by having a large number of shares on which dividends were paid cancelled prior to the winding-up.

This amendment is applicable to windings-up commencing after June, 1988.

Subclause 51(2)

ITA
88(1)(e.1)

Paragraph 88(1)(e.1) of the Act provides for the flow-through of reserves from a subsidiary corporation to its parent corporation where the subsidiary's assets are transferred to the parent on a winding-up. Under this paragraph, the subsidiary corporation is entitled to claim a reserve for the taxation year in which its assets are transferred to its parent and is not required to include any amount in respect of the reserve in computing its income for the following year. The parent corporation is treated as having taken the reserve claimed by the subsidiary and will include the amount in respect of that reserve in computing its income for that following year. The amendment to paragraph 88(1)(e.1) ensures that this rule applies where the subsidiary's obligations are assumed by the parent, as well as where the subsidiary's assets are transferred to the parent, on a winding-up. The reference to obligations of the subsidiary corporation clarifies the treatment of reserves in respect of liabilities of the subsidiary. This amendment is applicable to windings-up commencing after December 15, 1987.

Subclause 51(3)

ITA
88(1)(e.2)

Under paragraph 88(1)(e.2) of the Act, many of the detailed rules to be applied on the winding-up of a subsidiary into its parent are established by reference to the specific provisions in section 87 relating to amalgamations. This paragraph is amended to include a reference to new paragraphs 87(2)(e.2) and 87(2)(z.2) so that the rules in those new paragraphs will apply on a winding-up of a subsidiary to which subsection 88(1) applied. By reason of the reference to new paragraph 87(2)(e.2), the parent's cost of a property acquired from the subsidiary that was wound-up that was a security or debt obligation of the subsidiary that was used or held by the subsidiary in the business of insurance or lending money and was neither a capital property nor inventory is the cost amount of that property to the subsidiary immediately before the winding-up. The reference to new paragraph 87(2)(e.2) in paragraph 88(1)(e.2) is applicable to windings-up commencing after December 15, 1987. The reference to new paragraph 87(2)(z.2) will result in the parent corporation being deemed to be a continuation of its subsidiary for the purposes of determining its liability for Part III tax on excessive elections and for the purposes of making the elections under subsections 184(3), (3.1) or (3.2) of the Act. The addition of the reference to new paragraph 87(2)(z.2) in paragraph 88(1)(e.2) is applicable to windings-up commencing after April, 1988.

Subclause 51(4)

ITA
88(1)(e.6)

Paragraph 88(1)(e.6) of the Act is amended to delete the references therein to paragraphs 110(1)(a), (b) and (b.1) dealing with deductions from income in respect of charitable gifts and substitutes a reference to new section 110.1 which governs the deductibility of donations made by corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 51(5)

ITA
88(1)(g)

New paragraph 88(1)(g) of the Act deals with the winding-up of a subsidiary insurance corporation into its parent corporation and ensures a proper measurement of the income of the subsidiary and the parent both before and after the winding-up.

Subparagraph 88(1)(g)(i) treats the parent corporation as a continuation of the subsidiary insurance corporation for the purposes of certain tax provisions relating to insurance corporations listed therein.

Subparagraph 88(1)(g)(ii) provides special rules for use in determining the gross investment revenue and the gains and losses from property of the subsidiary insurance corporation and the parent corporation. Clause 88(1)(g)(ii)(A) treats the subsidiary and the parent as having had a taxation year ending immediately before the time when the subsidiary's assets are transferred to, and its obligations are assumed by, the parent. This special taxation year rule is necessary in order to measure the gross investment income and the gains and losses from property of the subsidiary and the parent, determined under section 2400 of the Income Tax Regulations to be property used or held in an insurance business in Canada, both for their taxation years in which the transfer took place and for their subsequent taxation years. Further, clause 88(1)(g)(ii)(B) provides that, for those subsequent taxation years, the property and the obligations are considered to have been transferred to the parent on the last day of its taxation year preceding the transfer and the parent is treated as a continuation of the subsidiary with respect to such property and obligations and the insurance businesses carried on by the subsidiary.

New paragraph 88(1)(g) is applicable to windings-up commencing after December 15, 1987.

Subclause 51(6)

ITA
88(1.3)

Subsection 88(1.3), which provides special rules where the parent corporation is incorporated after a particular year of the subsidiary corporation, is amended to delete the references therein to paragraphs 110(1)(a), (b) and (b.1) dealing with deductions from income in respect of charitable gifts and substitutes a reference to new section 110.1 which governs the deductibility of donations made by corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 52

Definitions Relating to Corporations

ITA
89

Section 89 of the Act sets out the definitions that apply for the purposes of Subdivision h of the Act which deals with certain transactions relating to corporations resident in Canada and their shareholders.

Subclause 52(1)

ITA
89(1)(b)

Paragraph 89(1)(b) of the Act defines the "capital dividend account" of a corporation. A dividend elected to be paid out of a corporation's capital dividend account is not subject to tax in the hands of shareholders resident in Canada. Subparagraph 89(1)(b)(i) includes in the computation of a private corporation's capital dividend account, at any particular time, the non-taxable portion of its capital gains for the period commencing on the first day of the first taxation year commencing after the time it last became a private corporation and ending after 1971 and ending immediately before the particular time to the extent that such amounts exceed the portion of its capital losses for that period not included in the computation of its allowable capital losses. The portion of a capital gain or loss that accrued while the property disposed of was held by a corporation that was not a private corporation, an investment corporation, a mortgage investment corporation or a mutual fund corporation is excluded from the capital dividend account. Two amendments are being made to subparagraph 89(1)(b)(i).

The first amendment is made as a result of the changes to the portion of the gain or loss included in the calculation of the taxable capital gain or allowable capital loss of corporations. This amendment, applicable after November 26, 1987, increases the capital dividend account by each capital gain realized in that period to the extent it exceeds the portion of the gain that is a taxable capital gain and reduces the account by each capital loss realized in that period to the extent it exceeds the portion of the loss that is an allowable capital loss.

The second amendment is consequential on the introduction of the new anti-avoidance rule in section 83 relating to capital dividends. Subclauses 89(1)(b)(i)(A)(II) and (B)(II) are amended, applicable to dispositions occurring after November 26, 1987, to exclude from the capital dividend account that part of any such gain or loss that accrued while the property disposed of:

- was a property of a corporation controlled by non-residents and after November 26, 1987 the property became a property of a Canadian-controlled private corporation; or
- was a property of a tax-exempt corporation and after November 26, 1987 the property became a property of a taxable corporation.

Subclause 52(2)

ITA
89(1)(b)(iii)

As noted in the commentary to subclause 52(1), paragraph 89(1)(b) of the Act defines the "capital dividend account" of a corporation. Where an appropriate election has been made by a private corporation, dividends paid out of the capital dividend account are received tax-free by its shareholders resident in Canada. Subparagraph 89(1)(b)(iii) includes in a corporation's capital dividend account the amount by which 1/2 of amounts received in respect of dispositions of eligible capital property (the "untaxed portion") that accrued during the period since the corporation last became a private corporation, exceeds the aggregate of 1/2 of expenditures in respect of eligible capital property made by the corporation in the period and the corporation's cumulative eligible capital at the commencement of the period. This subparagraph is amended as a consequence of the increase in the inclusion rate in respect of eligible capital property from 1/2 to 3/4. The new subparagraph 89(1)(b)(iii) will operate in essentially the same manner as the existing provision except that the untaxed portion will now be 1/4 of the amounts outlined above, rather than 1/2. Where the period commences before the new inclusion rate is applicable in respect of the corporation -- that is before its "adjustment time" -- the amount calculated under existing subparagraph 89(1)(b)(iii) is included in new clause 89(1)(b)(iii)(A). This amount will not be reduced by expenditures in respect of eligible capital property made by the corporation after its adjustment time. Where the corporation is in a "deficit" position under existing subparagraph 89(1)(b)(iii) at its adjustment time, 1/2 of that deficit will be included in clause 89(1)(b)(iii)(F). Reducing this deficit by 1/2 equates this deficit, which was generated when the inclusion rate for eligible capital property was 1/2, with the new 1/4 rate for the un-taxed portion of receipts in respect of dispositions of eligible capital property. This will allow the corporation to "earn back" this deficit with receipts in respect of dispositions of eligible capital property after its adjustment time when the inclusion rate is 1/4. Where the corporation has deducted an amount under new subsection 20(4.2) in respect of a bad debt relating to a disposition of eligible capital property, 1/3 of this amount is deducted under clause 89(1)(b)(iii)(G) -- 1/3 of 3/4 being equal to 1/4 or, in other words, the untaxed portion -- and, where such a bad debt is later recovered and an amount is included in the corporation's income by reason of new paragraph 12(1)(i.1), 1/3 of this amount is added under clause 89(1)(b)(iii)(C).

This amendment is applicable after June 17, 1987 except that, where an amount added under clause 89(1)(b)(iii)(C) or subtracted under clause (G) thereof relates to a bad debt in respect of a disposition of eligible capital property for which the inclusion rate was 1/2, these clauses shall be read without reference to the words "1/3 of".

Subclause 52(3)

ITA
89(1)(c)(ii)(C)

Subparagraph 89(1)(c)(ii) of the Act defines "paid-up capital" in respect of a class of shares of the capital stock of a corporation. Clause 89(1)(c)(ii)(C) provides that after March 31, 1977 paid-up capital is to be calculated without reference to any provision of the Act other than those specified therein. The amendment to this clause simply adds a reference to new subsection 138(11.7) of the Act and is consequential to the addition of that subsection. New subsection 138(11.7) sets out an anti-avoidance rule which prevents the removal of corporate surplus as a tax-free return of capital where a non-resident insurer transfers an insurance business to a taxable Canadian corporation on a rollover basis under the rules as set out in new subsection 138(11.5) of the Act. The amendment to clause 89(1)(c)(ii)(C) ensures that any adjustment required by subsection 138(11.7) to the paid-up capital of shares of the capital stock of the corporation to which the business is transferred will be taken into account in calculating the paid-up capital of those shares. This amendment is applicable after December 15, 1987.

Subclause 52(4)

ITA
89(1.1)

Subsection 89(1.1) of the Act provides for the elimination of the capital dividend account where a private corporation controlled by non-residents becomes a Canadian-controlled private corporation. This is achieved by requiring the amount of a capital dividend account immediately before the change in status to be deducted in computing its capital dividend account after the change. The amendment to subsection 89(1.1), applicable after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, provides that the rule also applies in computing the corporation's capital dividend account at as well as after the time of the change in status.

Subclause 52(5)

ITA
89(1.2)

New subsection 89(1.2) of the Act, applicable after November 26, 1987, provides that where a tax-exempt corporation loses its exempt status, its capital dividend account is eliminated. This is achieved by requiring the amount of its capital dividend account as the time of the change in status to be deducted in computing the corporation's capital dividend account at and after the change in status.

Clause 53

Partnerships

ITA
96

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

Subclauses 53(1) and (2)

ITA
96(1)(e.1) and (g)

Under subsection 96(1) of the Act, the income earned and losses incurred by a partnership are generally calculated at the partnership level but attributed to partners in accordance with their respective interests in the partnership.

New paragraph 96(1)(e.1) is added to require a partnership to deduct in calculating its income for a fiscal period all R&D expenditures made by it in the period. Thus, partnerships will no longer be able to incur R&D expenditures in one year for carry-forward to a subsequent year at which time its partners may differ.

Paragraph 96(1)(g) is amended to provide that, in calculating the share of "specified members" of a partnership of any loss incurred by the partnership for its fiscal period, the loss of the partnership will be reduced by the appropriate portion of the amount deducted by the partnership by reason of section 37 of the Act in respect of R&D expenditures in calculating its income for the period. The expression "specified member" is defined in subsection 248(1) of the Act and includes any member of a partnership who is a limited partner or who is neither actively engaged in the activities of the partnership nor otherwise engaged in a similar business to that carried by the partnership.

These amendments are applicable for fiscal periods of partnerships ending after December 15, 1987 except that they do not apply in respect of partners who acquired their partnership interest before December 16, 1987 or after December 15, 1987

(a) pursuant to an obligation in writing entered into before December 16, 1987,

(b) and before June 1, 1988 pursuant to the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum filed with a public authority before December 16, 1987, or

(c) and before June 1, 1988 pursuant to the terms of an offering memorandum distributed as part of an offering of securities which contained a substantially complete description of the securities, was distributed before December 16, 1987, and in respect of which solicitations were made before December 16, 1987

to the extent that the expenditures were made before December 16, 1987 or after December 15, 1987 and before 1989 pursuant to a written obligation entered into before December 16, 1987, or the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum filed with a public authority before December 16, 1987, or an offering memorandum described in paragraph (c) above.

Subclause 53(3)

ITA
96(1.7) and (1.8)

New subsection 96(1.7) applies, for the purposes of the capital gains exemption provided in section 110.6, to treat each member of a partnership which has disposed of a capital property as having disposed of that property in his taxation year in which the fiscal period of the partnership ends. This subsection has been added, applicable to the 1988 and subsequent taxation years, to ensure that individuals who are members of a partnership will be entitled to utilize their capital gains exemption in respect of their share of gains realized by the partnership.

New subsection 96(1.8) is a transitional provision that applies for taxation years and fiscal periods of a taxpayer ending after 1987 and commencing before 1990 to adjust the taxable capital gain, allowable capital loss or allowable business investment loss of the taxpayer from a partnership that is determined under subsection 96(1). Individuals other than testamentary trusts are not subject to this new provision. New subsection 96(1.8) is enacted as a consequence of the changes to the inclusion rates for capital gains and losses.

New subsection 96(1.8) addresses the situation in which a partnership's inclusion rate for capital gains and losses for a fiscal period differs from the inclusion rate for a taxpayer who is a member of the partnership for his taxation year in which the fiscal period ends. This will occur for partners whose taxation year does not coincide with the calendar year and for corporations that are not Canadian-controlled private corporations since the two-thirds inclusion rate for such corporations has a June 30, 1988 implementation date. The effect of the rule in new subsection 96(1.8) is to calculate the inclusion rate for a capital gain, capital loss or business investment loss of a taxpayer who is a member of a partnership based on the taxpayer's inclusion rate for the year in which the fiscal period of the partnership ends. Therefore, consistent with the taxation of reserves taken with respect to capital gains, the inclusion rate that will be used in determining the portion of the gain or loss to be included in computing the partner's income will be the inclusion rate of the partner for the year the gain or loss is included in computing his income. This calculation is achieved by multiplying the amount of the taxpayer's taxable capital gain, allowable capital loss or allowable business investment loss for the year from the partnership otherwise determined under subsection 96(1) by the fraction determined as the taxpayer's inclusion rate for the year over the partnership's inclusion rate for its fiscal period that ends in that year. The operation of the rule in new subsection 96(1.8) is best illustrated by way of examples.

<u>Example 1</u> - Canadian-controlled private corporation partner (50% interest).

Assume the following facts:

Corporation's taxation year ends June 30, 1988		
Partnership's fiscal period ends January 31, 1988		
Capital gain of partnership for its January 31, 1988 fiscal period	-	$300
Corporation's share of partnership capital gain	-	$150
Corporation's share of partnership taxable capital gain (2/3 X $150)	-	$100

Under new subsection 96(1.8), the recomputed taxable capital gain of the corporation from the partnership for its June 30, 1988 taxation year is calculated as

$$A \times \frac{B}{C} \quad \text{or} \quad \$100 \times \frac{7/12}{2/3} = \$87$$

where

A is the corporation's $100 taxable capital gain from partnership

B is the corporation's 7/12 inclusion rate for its June 30, 1988 taxation year determined as

$$[(1/2 \times 184/366) + (2/3 \times 182/366)] = 7/12$$

C   is the partnership's inclusion rate for its 1988 fiscal period = 2/3.

The $87 produced by the formula is the amount of the taxable capital gain that the corporation would have realized had it sold property for a $150 capital gain in its 1988 taxation year.

Example 2 Testamentary trust as a partner (50% interest).

Assume the following facts:

Testamentary trust's taxation year ends January 31, 1990	
Partnership's fiscal period ends December 31,1989	
Capital gain of partnership for its 1989 fiscal period	$150
Trust's share of partnership capital gain	$ 75
Trust's share of partnership taxable capital gain (2/3 X $75)	$ 50

Under subsection 96(1.8) the recomputed taxable capital gain of the trust from the partnership for its January 31, 1990 taxation year is calculated as

$$A \times \frac{B}{C} \quad \text{or} \quad \$50 \times \frac{3/4}{2/3} = \$56.25$$

where

A   is the trust's $50 taxable capital gain from the partnership
B   is the trust's 3/4 inclusion rate for its 1990 taxation year
C   is the partnership's 2/3 inclusion rate for its 1989 fiscal period

The $56.25 produced by the formula is the taxable capital gain the trust would have realized if it had sold property for a $75 capital gain in its January 31, 1990 taxation year.

Subclause 53(4)

ITA
96(2.1)(a)

Subsection 96(2.1) of the Act deals with the losses of limited partnerships. The amendment to paragraph 96(2.1)(a) is consequential on the amendment to subsection 96(1) and ensures that the losses of a limited partnership are determined having regard to the restrictions in that subsection on the deduction of R&D expenditures made by a partnership. This amendment is effective after December 15, 1987.

Subclause 53(5)

ITA
96(2.2)(b.1)

Subsection 96(2.2) of the Act defines the at-risk amount of a limited partner at any particular time.

Currently, this at-risk amount is calculated as follows:

- the partner's adjusted cost base of his partnership interest,
- plus his share of the current year's income from the partnership,
- less all amounts owing by the partner to the partnership and any amount or benefit to which the partner is entitled, where the amount or benefit is intended to protect him from the loss of this investment.

New paragraph 96(2.2)(b.1) of the Act is consequential on the introduction of new section 66.8 of the Act and provides that a limited partner may include in determining his at-risk amount his share of the partnership's current year's proceeds from the disposition of property or services the original cost of which was included in the limited partner's resource pools. Paragraph 96(2.2)(b.1) is applicable after June 17, 1987.

Clause 54

Partnerships - Ceasing to Exist

ITA
98(1)

Section 98 of the Act provides rules governing partnership properties and partnership interests where partnerships cease to exist.

Paragraph 98(1)(c) of the Act applies to partnership interests where, at the end of a fiscal period of the partnership, the aggregate of the amounts required by subsection 53(2) of the Act to be deducted in computing a taxpayer's adjusted cost base of a partnership interest exceeds the cost to him of the interest and the aggregate of all amounts required by subsection 53(1) to be added to that cost. In such a case and where the partnership has ceased to exist, the amount of the excess is treated as a gain of the taxpayer for the year from a disposition at that time of that interest. In order to ensure that such gains will be eligible for the capital gains exemption, paragraph 98(1)(c) is amended, applicable to the 1988 and subsequent taxation years, to treat the taxpayer as having disposed of that interest in the year for the purposes of section 110.6.

Clause 55

Residual Interest
in Partnership

ITA
98.1(1)(d)(i)

Section 98.1 of the Act provides rules applicable to a taxpayer who ceases to be a member of a partnership but who continues to have a residual interest in the partnership.

Subparagraph 98.1(1)(d)(i) of the Act is amended to delete the reference to existing subsection 110(5) concerning charitable donations made by a partnership which is repealed, and to substitute a reference to new sections 110.1(4) and 118.1(8) where the new rules relating to such donations are now provided. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 56

Disposition of Partnership Interest

ITA
100(1)

Subsection 100(1) of the Act provides for the calculation of a taxpayer's taxable capital gain for a year from the disposition of an interest in a partnership to any person exempt from tax under section 149 as 1/2 of the portion of his capital gain from the disposition that can reasonably be attributed to increases in value of non-depreciable capital property of the partnership and the whole of the remaining portion of such capital gain.

Paragraph 100(1)(a) is amended as a result of the changes to the inclusion rates for capital gains. The portion of the capital gain attributable to increases in value of non-depreciable capital property that is to be included in calculating the taxable capital gain under paragraph 100(1)(a) will be increased from one-half to two-thirds for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. This portion will be further increased from two-thirds to three-quarters for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Clause 57

Disposition of Farmland by Partnership

ITA
101

Paragraph 53(1)(i) of the Act provides a special rule for a taxpayer other than a partnership who has had a restricted farm loss and disposes of his farmland at a gain. In these circumstances, a portion of the undeducted restricted farm losses is added to the adjusted cost base of the property for the purposes of determining the amount of the capital gain. Section 101 of the Act provides a corresponding rule where the farmland is disposed of by a partnership and allows each partner to deduct from income, one-half of his restricted farm losses that are attributable to interest and property taxes paid on the land by the partnership to the extent of his share of the partnership's capital gain from the disposition. Two amendments are being made to section 101 as a consequence of the changes to the inclusion rates for capital gains.

Subclause 57(1)

ITA
101

The first amendment to section 101 increases the portion of restricted farm losses of the taxpayer from the partnership that may be deducted up to the taxpayer's share of the partnership's capital gain from the disposition. This portion is being increased from one-half to two-thirds for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion is further increased from two-thirds to three-quarters for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 57(2)

ITA
101(d)(ii)

Paragraph 101(1)(d) provides that these losses are deductible only to the extent that the aggregate of the losses exceeds two times the taxpayer's share of the taxable capital gain from the disposition of the land. This paragraph is being amended to reduce the ratio of the taxable capital gain from two to three-halves of such taxable capital gains for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The ratio of the taxable capital gains will be further reduced from three-halves to four-thirds for dispositions in taxation years and fiscal periods of individuals and partnerships ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Clause 58

Trusts

ITA
104

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

Subclause 58(1)

ITA
104(3)

While a trust is treated as an individual for tax purposes, subsection 104(3) of the Act denied any deduction to a trust in respect of personal exemptions. That subsection is repealed as a consequence of the repeal of section 109 which was itself repealed as a consequence of the conversion of such exemptions to credits.

Subclause 58(2)

ITA
104(21.1)

Subsection 104(21.1) of the Act sets out rules regarding the treatment of taxable capital gains from Canadian securities of a beneficiary under a trust. Subsection 104(21.1) is repealed, applicable to the 1988 and subsequent taxation years, as a consequence of the changes to section 110.1 effective for the 1985 and subsequent taxation years which removed taxable capital gains from the category of income that was eligible for the $1,000 investment income deduction. A new subsection 104(21.1) is enacted as a consequence of the changes to the inclusion rates for capital gains.

New subsection 104(21.1) of the Act is a transitional provision, applicable to taxation years and fiscal periods of a taxpayer ending after 1987 and commencing before 1990, which adjusts the taxable capital gain of the taxpayer designated to him under subsection 104(21) by a trust of which he is a beneficiary. Individuals other than testamentary trusts are not subject to this new provision.

New subsection 104(21.1) addresses the situation in which the trust's inclusion rate for a taxation year is different than the inclusion rate for a beneficiary of the trust for the taxation year in which the trust's year ends. This will occur for taxpayers whose taxation years do not coincide with the calendar year and for corporations that are not

Canadian-controlled private corporation's since the two-thirds inclusion rate for such corporations has a June 30, 1988 implementation date. The effect of the rule in new subsection 104(21.1) is to calculate the inclusion rate for a capital gain of a taxpayer who is a beneficiary of a trust based on the taxpayer's inclusion rate for the year in which the year of the trust ends. Therefore, consistent with the taxation of reserves taken with respect to capital gains, the inclusion rate that will be used in determining the portion of the gain or loss to be included in computing the beneficiary's income will be the inclusion rate of the beneficiary for the year the gain or loss is included in computing his income. This calculation is achieved by multiplying the amount of the taxpayer's taxable capital gain for the year under subsection 104(21) by the fraction determined as the taxpayer's inclusion rate for the year over the trust's inclusion rate for its year that ends in the beneficiary's year. The operation of the new rule in subsection 104(21.1) is best illustrated by way of example.

Example - Corporate beneficiary that is not a Canadian-controlled private corporation.

Assume the following facts:

Corporation's taxation year ends June 30	
Trusts taxation year ends January 31	
Corporation's capital gain from trust in its 1988 taxation year	\$150
Corporation's taxable capital gain from trust (2/3 X \$150)	\$100

Under new subsection 104(21.1) the recomputed taxable capital gain of the corporation from the trust is calculated as

$$A \times \frac{B}{C} \quad \text{or} \quad \$100 \times \frac{1/2}{2/3} = \$75$$

where

A	is the corporation's \$100 taxable capital gain from trust	
B	is the corporation's inclusion rate for its 1988 year	1/2
C	is the trust's inclusion rate for its 1989 year	2/3

The \$75 that results from the application of the formula represents the taxable capital gain the corporation would have realized if it had sold property for a \$150 capital gain in its 1988 taxation year.

Subclause 58(3)

ITA
104(21.2)

Subsection 104(21.2) of the Act provides rules for determining the extent to which a beneficiary is entitled to claim a capital gains exemption under section 110.6 in respect of his portion of a trust's net taxable capital gains by virtue of a designation made under subsection 104(21) by the trust. Where a trust designates an amount under subsection 104(21) in respect of a beneficiary for a taxation year it must also, in its tax return for the year, designate a portion of its eligible taxable capital gains in respect of the beneficiary. For the purposes of the capital gains exemption, paragraph 104(21.2)(b) provides that the beneficiary's taxable capital gain is the proportion of the trust's eligible taxable capital gains that the designated amount is of the trust's net taxable capital gains for the year.

Paragraphs 104(21.2)(a) and (b) are amended, applicable to the 1988 and subsequent taxation years, to ensure that a beneficiary will be entitled to claim the special capital gains exemption under subsection 110.6(2) or (2.1) of the Act where the trust has disposed of qualified farm property or qualified small business corporation shares. Subparagraphs 104(21.2)(b)(i), (ii) and (iii) provide that the beneficiary's taxable capital gain for the year from the disposition of qualified farm property, qualified small business corporation shares and other capital properties, respectively, will be determined as the proportion that each of these amounts bears to the total of such amounts. In order to ensure that such gains are eligible for the exemption, paragraph 104(21.2)(b) is also amended to treat the beneficiary as having disposed of those properties in the year.

Subclause 58(4)

ITA
104(23)(d)(iv)

Subsection 104(23) of the Act provides for an election to file a separate return where a beneficiary of a testamentary trust died after the end of the trust's fiscal period and before the end of a calendar year. In such cases, the separate return must be filed as if the beneficiary's only income were his income from the trust and the beneficiary were entitled to the personal exemptions and certain other deductions.

Subparagraph 104(23)(d)(iv) of the Act is amended to include a reference to new subsection 118.12 dealing with separate tax returns, to delete the reference to sections 109, 110.1 and 110.2 (concerning personal exemptions, the $1,000 interest and dividend income deduction and the $1,000 pension income deduction, respectively) and include a reference to new sections 110, 118 to 118.6 and 118.9, which govern the remaining deductions in computing taxable income and the various personal tax credits, including the pension income credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 58(5)

ITA
104(26)

Subsection 104(26) of the Act, which allows a flow-through to a beneficiary of a trust of the character of interest income earned by the trust, is repealed as a consequence of the elimination of the $1,000 investment income deduction. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 58(6)

ITA
104(27)

Subsection 104(27) of the Act, which allows the flow-through to a beneficiary of a trust of the character of certain pension income of the trust, is amended to delete the reference to the pension income deduction under section 110.2 which is repealed and to substitute a reference to new subsections 118(3) and (8) -- the pension income tax credit and the definition of "pension income" for purposes of that credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 59

Income Interest in a Trust

ITA
106(1)

Subsection 106(1) of the Act provides for a deduction in computing the income of a beneficiary from a trust in respect of his cost of acquiring an income interest in the trust. This amendment to subsection 106(1) of the Act removes a reference to subsection 110.1(1) as a consequence of the repeal of the $1,000 investment income deduction. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 60

Trusts - Definitions

ITA
108

Section 108 of the Act sets out the definitions and rules that apply for the purposes of Subdivision (k) of the Act which deals with the taxation of trusts and their beneficiaries.

Subclause 60(1)

ITA
108(1)(g.1) and (g.2)

Subsection 108(1) is amended, effective for the 1988 and subsequent taxation years, by adding the definitions "qualified farm property" and "qualified small business corporation share", as those expressions are defined in subsection 110.6(1) of the Act. These terms are relevant under subsection 104(21.2) for the purposes of determining the entitlement of a beneficiary who is an individual to the special capital gains exemption in respect of dispositions of such properties by a trust.

Subclause 60(2)

ITA
108(3)

Subsection 108(3) of the Act provides that, for certain purposes of the Act, the income of a trust is computed without reference to the Act and without including capital dividends received by the trust. The amendment to this subsection simply replaces the reference to dividends that are described in section 83 with a reference to dividends that, by reason of section 83, are not included in the income of a trust for other purposes of the Act. This amendment, applicable to dividends paid after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, is consequential on the introduction of the new anti-avoidance rule in section 83 relating to capital dividends.

Subclause 60(3)

ITA
108(5)

Subsection 108(5) of the Act provides that the nature of income or deductions flowing through a trust to a beneficiary of the trust is retained only where the Act specifically so provides. This rule does not, however, affect the attribution rules in sections 74 to 75 as they apply to income or capital gains flowing from the trust to the beneficiary so that the income from property and the capital gains of the trust keep their nature for the purpose of these rules. The amendment to subsection 108(5) is consequential to the introduction of a new special anti-avoidance rule in subsection 56(4.1) (see commentary on that provision). It simply adds the reference to that subsection to the provisions that are not affected by the rule in subsection 108(5). This amendment is applicable to the 1989 and subsequent taxation years.

Clause 61

Personal Exemptions

ITA
109

Section 109 of the Act provides for the personal exemptions in computing the taxable income of an individual. This section is repealed as a consequence of the conversion of personal exemptions to tax credits. The new credits are now allowed under section 118 in computing tax payable. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 62

Other Deductions

ITA
110

Section 110 of the Act provides for various deductions from income in computing taxable income.

Subclause 62(1)

ITA
110(1)(a), (b), (b.1), (c), (e), (e.1), (g) and (h) and 110(1.1), (1.2) and (1.3)

Paragraphs 110(1)(a), (b), (b.1), (c), (e), (e.1) (g) and (h) and subsection 110(1.1), (1.2) and (1.3) of the Act, which provide for deductions in respect of charitable donations, gifts to the Crown, gifts to certain institutions, medical expenses, mental or physical impairments and education costs are repealed as a consequence of the conversion of the relevant deductions to tax credits for individuals. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 62(2)

ITA
110(1)(d)

Paragraph 110(1)(d) of the Act provides for a deduction in computing taxable income in respect of certain stock option benefits taxable under subsection 7(1) of the Act where stock options are exercised, or the rights under the agreement are transferred or otherwise disposed of. The effect of this deduction is that such benefits are taxable only at capital gains rates. As a result of the changes to the inclusion rate for capital gains of individuals, this paragraph is being amended to reduce the amount of the deduction from taxable income from one-half to one-third of the amount of such benefits arising as a result of shares acquired or rights in respect of shares transferred or otherwise disposed of after 1987 and before 1990 and to one-quarter for such benefits arising as a result of shares acquired or rights in respect of shares transferred or otherwise disposed of after 1989.

Subclause 62(3)

ITA
110(1)(d.1)

Paragraph 110(1)(d.1) of the Act provides for a deduction in computing a taxpayer's taxable income in respect of certain stock option benefits, which are taxable under paragraph 7(1)(a) by virtue of subsection 7(1.1) of the Act, where the taxpayer disposes of a share acquired after May 22, 1985 as a result of exercising a stock option granted by a Canadian-controlled private corporation and the share has not been disposed of or exchanged, otherwise than as a consequence of his death, within two years from the date he acquired it. The effect of this deduction is to tax such benefit at capital gains rates. As a result of the change to the inclusion rates for capital gains, this paragraph is being amended to reduce the amount of the deduction in respect of such benefits from one-half to one-third of the amount of the benefit for shares disposed of or exchanged after 1987 and before 1990 and to one-quarter of the benefit for shares disposed of or exchanged after 1989.

Subclause 62(4)

ITA
110(1)(d.2)

Paragraph 110(1)(d.2) of the Act provides that, where a prospector or grubstaker is required to include an amount in income under paragraph 35(1)(d) with respect to a share of the capital stock of a corporation received by him after May 22, 1985, he will be permitted to claim a deduction in computing his taxable income so that the amount so included in income will be taxed at capital gains rates. As a result of the change to the inclusion rates for capital gains, this deduction is being reduced from one-half of the amount so included to one-third of that amount for shares disposed of or exchanged after 1987 and before 1990 and to one-quarter of that amount for shares disposed of or exchanged after 1989.

Subclause 62(5)

ITA
110(1)(d.3)

Paragraph 110(1)(d.3) of the Act provides for a deduction in computing taxable income where a taxpayer has included an amount in his income for the year under subsection 147(10.4) so that the amounts so included are taxed at capital gains rates. This subsection deals with the disposition of employer shares that had previously been received as part of a single payment on his withdrawal from a deferred profit sharing plan after May 23, 1985. As a result of the change to the inclusion rate for capital gains, this deduction is being reduced from one-half to one-third of the amount so included in income for the year under subsection 147(10.4) in respect of shares disposed of or exchanged after 1987 and before 1990 and to one-quarter of that amount in respect of shares disposed of or exchanged after 1989. Shares acquired on terminations of interests in deferred profit sharing plans occurring before May 24, 1985 continue to be exempt from these provisions.

Subclause 62(6)

ITA
110(2)

Subsection 110(2) of the Act, which allows for a deduction in computing the income of certain individuals who have taken a vow of perpetual poverty, is amended to delete the reference to paragraph (1)(a) dealing with charitable donations as a consequence of the conversion of the deduction for charitable donations by individuals to a tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 62(7)

ITA
110(2.1) to (9)

Subsections 110(2.1) to (9) of the Act provide rules with respect to the deductibility of charitable donations, medical expenses and the disability deduction. The repeal of these subsections is consequential on the conversion of those deductions to tax credits. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 63

Deduction for Gifts

ITA
110.1

Section 110.1 of the Act, which provided for a deduction of up to $1,000 in respect of Canadian investment income, is repealed as a result of the elimination of the investment income deduction.

New section 110.1 provides for the deductibility in computing taxable income of charitable donations and gifts to the Crown made by corporations.

New paragraph 110.1(1)(a) provides for a deduction in respect of charitable gifts made by a corporation in the year and in the five immediately preceding taxation years, to the extent that such amounts were not previously deducted by the taxpayer. The list of eligible donees is the same as those previously included in former paragraph 110(1)(a) dealing with the charitable donations deduction.

New paragraph 110.1(1)(b) provides a deduction in respect of gifts made by a corporation to Her Majesty in right of Canada and Her Majesty in right of the provinces. This deduction was formerly contained in paragraph 110(1)(b). As with former paragraph 110(1)(b), the amount deducted under new paragraph 110.1(1)(b) in respect of gifts to the Crown cannot exceed the amount, if any, remaining after the deduction of charitable donations under paragraph 110.1(1)(a).

New paragraph 110.1(1)(c) provides a deduction in respect of gifts of cultural significance made by a corporation to qualifying cultural institutions. This deduction was formerly contained in paragraph 110(1)(b.1).

New subsection 110.1(2) provides that no deduction may be made in respect of a charitable donation or a gift to the Crown unless the gift is evidenced by a receipt containing prescribed information.

New subsection 110.1(3) incorporates the provisions of former subsection 110(2.2) which allowed for an election in respect of the deemed amount of a gift and the deemed proceeds of disposition in respect of a gift of tangible property.

New subsection 110.1(4) incorporates the provisions of former subsection 110(5), which flowed through the character of gifts made by a partnership to its partners. This rule is now applicable only with respect to corporations that are members of the partnership.

New section 110.1 is consequential on the conversion of the deduction of charitable donations for individuals to a tax credit and is applicable to the 1988 and subsequent taxation years.

Clause 64

Pension Income Deduction
Transfer of Unused Deductions

ITA
110.2 and 110.3

Subsection 110.2 of the Act, which provides for a deduction of up to $1,000 in respect of pension income and section 110.3, which provides for the transfer to a spouse of unused deductions, are repealed as a consequence of the conversion of the pension income deduction to a tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 65

Forward Averaging

ITA
110.4

Subclause 65(1)

ITA
110.4(1)

Subsection 110.4(1) of the Act, which contains the forward averaging election, is repealed.

Subclause 65(2)

ITA
110.4(2)

Subsection 110.4(2) of the Act provides the rule for bringing forward averaged amounts back into the income of a taxpayer. While no amount may qualify for forward averaging after 1987, the amendment to this subsection provides a ten-year period over which amounts forward averaged before 1988 may be brought back into taxable income. Thus the tax credit for amounts forward averaged before 1988 may be obtained in any future year up to and including 1997.

Subclause 65(3) to (6)

ITA
110.4(3) to (8)

The amendments contained in subclauses 65(3) to (5) are strictly consequential on the repeal of subsection 110.4(1) of the Act. Subclause 65(6) is also consequential upon the repeal of subsection 110.4(1), and amends subsection 110.4(8) to delete the reference therein to subsection 110.4(1). As a result, no new amounts will be added to the accumulated averaging amount. In addition, this amendment clarifies that, after 1997, the accumulated averaging amount will be nil. A taxpayer has until 1997 to include in taxable income forward-averaged amounts and receive a tax credit in respect of these amounts computed at the top marginal rate for individuals for the year of inclusion.

Clause 66

Capital Gains Exemption

ITA
110.6

Section 110.6 of the Act contains the basic rules for calculating an individual's capital gains exemption in respect of capital gains arising from dispositions of property after 1984. As a result of the changes to the capital gains exemption and capital gains inclusion rate, extensive amendments are being made to this section.

Subclauses 66(1) to (4)

ITA
110.6(1)

Subsection 110.6(1) of the Act defines a number of expressions for the purposes of the capital gains exemption. The amendments to this subsection alter a number of those definitions and several new expressions are defined.

Annual Gains Limit

The "annual gains limit" of an individual for a taxation year represents the extent to which his net taxable capital gains for the year may qualify for the exemption. It is one of the limiting factors in calculating an individual's permitted deduction under subsections 110.6(2) and 110.6(3). An individual's annual gains limit for a taxation year is calculated as the individual's net taxable capital gains for the year reduced by the amount of his net capital losses from other years deducted in the year and the amount of his allowable business investment losses realized in the year. Except in the case of qualified farm properties, under the existing definition only taxable capital gains realized on properties disposed of in the year by the taxpayer are currently included in the calculation of his annual gains limit. Thus, capital gains reserves arising from dispositions in previous years have not been eligible for the capital gains exemption. As a result of the capping of the exemption at $100,000 of capital gains for the 1988 and subsequent taxation years, capital gains reserves will qualify for the exemption. The amendment to the definition of "annual gains limit" provides that, for the 1988 and subsequent taxation years, capital gains from dispositions of properties after 1984 that are included in the computation of income for a year through the reserve mechanism will be included in the calculation of an individual's annual gains limit and will therefore qualify for the capital gains exemption.

"Cumulative Gains Limit"

The "cumulative gains limit" of an individual at the end of a taxation year represents the extent to which his cumulative net gains after 1984 may qualify for the capital gains exemption. It is one of the limiting factors for the purposes of calculating the individual's permitted deductions under subsections 110.6(2) and 110.6(3).

The definition of "cumulative gains limit" has been amended to reflect the introduction of the new rules relating to cumulative net investment losses which affect the amount of capital gains that qualify for the exemption. Commencing with the 1988 taxation year, an individual's cumulative gains limit will be reduced by the amount of his "cumulative net investment loss", as defined, at the end of his taxation year. "Cumulative net investment loss" is a new term added to subsection 110.6(1) and is explained in the commentary on the new definition.

"Qualified Farm Property"

Subsection 110.6(2) of the Act provides to individuals a special increased exemption for capital gains realized on the disposition of qualified farm property. "Qualified farm property" is defined to include property owned by an individual or his spouse that is a share of his or his spouse's family farm corporation, and an interest in his or his spouse's family farm partnership. It also includes real property owned by an individual that is used by him, his spouse, or any of his children, or used by a family farm corporation or family farm partnership in which he, his spouse or any of his children has a share or interest, provided it is used in the course of carrying on the business of farming in Canada. Real property qualifies as having been used in the course of carrying on the business of farming in Canada if it has been so used in the year of its disposition or in at least five years during which time it was owned by the taxpayer, his spouse or his children.

Effective for the 1988 and subsequent taxation years, the definition of qualified farm property has been extensively revised to:

- include certain trusts and partnerships in the category of owners of qualified farm property

- include an individual's parents and certain trust beneficiaries in the category of eligible users of qualified farm property

- introduce a holding period requirement, a use test and, in some cases, a revenue test for qualified farm property acquired after June 17, 1987, and

- include eligible capital property in the definition, provided certain conditions are met.

Owners of qualified farm property: At present, qualified farm property is restricted to property owned by an individual or by the individual's spouse. As amended, qualified farm property will include property owned by a partnership, an interest in which is an interest in a family farm partnership of the individual or his spouse. In conjunction with new subsection 96(1.7), this will ensure that the individual or his spouse will be entitled to the deduction under subsection 110.6(2) where the property was owned by and disposed of by the family farm partnership.

In addition, real property owned by a trust will qualify as qualified farm property of the trust if the conditions set out in subparagraph (a)(ii) of the definition are satisfied. Shares of the capital stock of a family farm corporation or an interest in a family farm partnership owned by a trust may also constitute qualified farm property of the trust, as an extended definition of these terms has been adopted for the purposes of section 110.6. In conjunction with the amendments to subsection 104(21.2), this will allow certain trust beneficiaries access to the enhanced exemption where the trust itself has disposed of qualified farm property. In conjunction with the amendments to subsection 110.6(12), spousal trusts will be entitled to the enhanced exemption provided the conditions set out in that subsection are satisfied.

Users of qualified farm property: At present, real property may constitute qualified farm property if it is used, in the course of carrying on the business of farming in Canada, by the individual who owns it, his spouse or children, or a family farm corporation or family farm partnership of the individual, his spouse or children. The amendments to paragraph (a) of the definition expand the category of users of qualified farm property to include the individual's parents or a family farm corporation or family farm partnership of the individual's parents. Further, the extended definition of child in paragraph 70(10)(a) of the Act has been adopted for the purposes of section 110.6. This will treat real property used by, for example, the owner's grandchildren as qualified farm property.

Where real property is owned by a trust, it may constitute qualified farm property of the trust if it is used in the course of carrying on the business of farming in Canada by a beneficiary of the trust who is referred to in paragraph 104(21.2)(b) of the Act and who was related to the person or persons from whom the trust acquired the property. Use by a spouse, child or parent of the beneficiary will also qualify, as will use by a family farm corporation or family farm partnership of the trust or beneficiary, or his spouse, child or parent. The beneficiary referred to in paragraph 104(21.2)(b) is a beneficiary in respect of whom an amount has been designated by the trust under subsection 104(21) with respect to taxable capital gains realized by the trust. These amendments will permit designated beneficiaries access to the enhanced exemption where the trust has disposed of qualified farm property.

"Carrying on the business of farming": Under the existing rules, real property will only constitute qualified farm property if it, or property for which it was substituted, was used in the course of carrying on the business of farming in Canada in the year the property was disposed of or in at least five years during which the property was owned by the individual, his spouse or his children. Subject to the changes described above which extend the categories of owners and users of qualified farm property, this test has been maintained, in subparagraph (a)(vi) of the definition, for property acquired on or before June 17, 1987, or after that date pursuant to an agreement in writing entered into on or before that date.

Real property acquired after June 17, 1987, otherwise than pursuant to an agreement in writing entered into on or before that date, will be subject to different requirements to satisfy the test of having been used in the course of carrying on the carrying on the business of farming in Canada. These requirements are set out in subparagraph (a)(vii) of the definition.

First, the property must have been owned by the individual, his spouse, children, parents, or the trust or family farm partnership, throughout the 24 months immediately preceding its disposition. Second, in at least two years while the property was so owned, the gross revenue of the individual who used the property in the course of carrying on the business of farming, and who was actively engaged in that business on a regular and continuous basis, from the farming business in which he used the property must have exceeded that person's income from all other sources for the year. If the property was used by a family farm corporation or partnership, that corporation or partnership must have used the property in the course of carrying on the business of farming in Canada throughout a period of at least 24 months, during which time an individual referred to in any of subparagraphs (i) to (iii) must have been actively engaged on a regular and continuous basis in the farming business in which the property was used.

Eligible Capital Property: Effective for the 1988 and subsequent taxation years, eligible capital property - for example, farm quotas - will constitute qualified farm property if it has been used in the course of carrying on the business of farming in Canada by a person referred to in any of subparagraphs (a)(i) to (v). This characterization is relevant as a result of the amendments to section 14 of the Act, which may deem a portion of the proceeds of disposition of an eligible capital property to be a taxable capital gain qualifying for the capital gains exemption.

In determining whether eligible capital property has been used in the course of carrying on the business of farming in Canada, the tests set out in subparagraph (a)(vi) or (vii) will be applied. Eligible capital property acquired on or before June 17, 1987, or after that date pursuant to an agreement in writing entered into on or before that date, will be subject to the conditions applicable to real property set out in subparagraph (a)(vi) and explained above. Eligible capital property acquired after June 17, 1987, otherwise than pursuant to an agreement in writing entered into on or before that date, must satisfy the conditions set out in subparagraph (a)(vii) in order to constitute qualified farm property.

The amendments to the definition of "qualified farm property" in subsection 110.6(1) are applicable to the 1988 and subsequent taxation years.

"Child"

The extended definition of "child" contained in paragraph 70(10)(a) of the Act has been adopted for the purposes of section 110.6, effective for the 1988 and subsequent taxation years. This will place a taxpayer's grandchildren, great grandchildren and persons who were wholly dependent on the taxpayer while under the age of 19 years in the same position as the taxpayer's children for the purposes of the capital gains exemption in respect of qualified farm property.

"Cumulative Net Investment Loss"

Effective for the 1988 and subsequent taxation years, an individual's "cumulative net investment loss" at the end of a taxation year will limit the individual's access to the capital gains exemption by reducing his cumulative gains limit at the end of the year. The cumulative net investment loss of an individual at the end of a year is defined as the amount by which the aggregate of his investment expenses, as defined, for the year and prior years ending after 1987 exceeds the aggregate of his investment income, as defined, for such years.

"Interest in a Family Farm Partnership"

The definition of "interest in a family farm partnership" found in paragraph 70(10)(c) of the Act has been adopted for the purposes of section 110.6 effective for the 1988 and subsequent taxation years. In addition, a partnership interest owned by a trust, where that interest was acquired by the trust from an individual in whose hands it was an interest in a family farm partnership of the individual immediately before the acquisition, will constitute an interest in a family farm partnership of the trust for the purposes of the capital gains exemption for qualified farm property.

"Investment Expense"

The new definition of "investment expense" of an individual for a year has been added to subsection 110.6(1) and is used in calculating an individual's cumulative net investment loss. Paragraph (a) of that definition includes in investment expense those amounts deducted by the individual for the year in computing his income for the year from property, other than amounts accounted for elsewhere in the definition and other than specified deductions relating to resource expenses. Paragraph (b) includes in investment expense, interest and other specified expenses deducted by an individual in computing his income for the year from a partnership of which he was a specified member (for this purpose, "specified member" is a new term defined in subsection 248(1) of the Act and includes a limited partner and a member of a partnership who is neither actively engaged in the partnership business nor carrying on a business similar to that of the partnership on a regular, continuous and substantial basis). Paragraph (c) includes in an individual's investment expense amounts deducted in computing his income for the year as his share of the amount of any loss of a partnership of which he was a specified member for its fiscal period ending in the year (limited partnership loss carryovers will be included in an individual's investment expense in the year they are deducted by the individual under paragraph 111(1)(e) of the Act). Paragraph (d) includes in an individual's investment expense for the year fifty per cent of amounts deducted by him in the year attributable to certain resource and exploration expenses, as permitted by subsections 66(4), 66.1(3), 66.2(2) and 66.4(2), incurred by a corporation or by a partnership of which he was a specified member in the fiscal period of the partnership in which the expense was incurred. Paragraph (e) includes in an individual's investment expense all losses for the year from property or from renting or leasing a rental property.

Subject to a special transitional provision applicable to certified productions (set out in subclause 66(16)), the definition of investment expense is applicable to the 1988 and subsequent taxation years.

"Investment Income"

The new definition of "investment income" of an individual for a taxation year is used in calculating an individual's "cumulative net investment loss". Paragraph (a) of the definition includes in investment income for a year the individual's income from property for the year (including recaptured depreciation with respect to property the income from which would be income from property). Paragraph (b) includes in investment income the individual's share of the income of all partnerships of which he was a specified member in the year. Paragraph (c) includes in investment income 50% of all amounts included in the individual's income for the year under subsection 59(3.2), relating to the recovery of exploration and development expenses. Paragraph (d) includes in investment income any amount included in computing the individual's income for the year from property or from renting or leasing a rental property.

"Qualified Small Business Corporation Share"

New subsection 110.6(2.1) of the Act provides for a special increased capital gains exemption for individuals who dispose of qualified small business corporation shares. To qualify as a "qualified small business corporation share" of an individual, the share must be a share of the capital stock of a corporation which, at the time it is being disposed of, is a share of a small business corporation, as defined in subsection 248(1) of the Act, owned by the individual or a person or partnership related to him. For this purpose, a small business corporation is defined as a Canadian-controlled private corporation all or substantially all of the assets of which are used in an active business carried on primarily in Canada by the corporation or a related corporation or are shares or debt of connected corporations that are small business corporations. In addition, the share must satisfy a holding period requirement and the share must be a share of a corporation that meets an active business asset test.

The holding period requirement provides that throughout a period of 24 months immediately preceding that time, the share must not have been owned by any person or partnership other than the individual or a person or partnership that was related to him. New subsection 110.6(14) provides special rules for determining when a person or partnership is related to the individual for this purpose. The definition thus permits shareholders of newly incorporated small business corporations to have access to the special exemption for qualified small business corporation shares even where the corporation has existed for less than 24 months. In this manner, a sole proprietor, for example, who is disposing of his active business carried on in Canada can utilize the exemption by transferring the assets of his business to a corporation for shares prior to the sale and then disposing of shares rather than assets.

The active business asset test, imposed by paragraph (c) of the definition, requires that, throughout the holding period determined under paragraph (b) (the holding period is that part of the immediately preceding 24 months during which the share was held by the individual or a person or partnership related to him), more than 50% of the fair market value of the corporation's assets must have been used in an active business.

For this purpose, assets considered to be used in an active business consist of:

(a) assets used in an active business carried on primarily in Canada by the corporation or a related corporation

(b) certain shares or debt of connected corporations, and

(c) a combination of active business assets or certain shares or debt of connected corporations.

Therefore, where a corporation does not hold shares or debt in connected corporations it must use more than 50% of the fair market value of its assets directly in an active business carried on primarily in Canada throughout the required holding period. Where, however, a corporation holds shares or debt of connected corporations, those shares or debt will only qualify as active business assets of the corporation if they meet two conditions. These conditions consist of a holding period test and an active business asset test similar to those which apply to shares of the corporation held directly by the individual. The holding period requirement provides that shares or debt of a connected corporation, in order to qualify as active business assets of a corporation, must not have been held by anyone other than the corporation or persons or partnerships related to it throughout that part of the relevant 24 month period that immediately precedes the time the corporation acquired the shares or debt. Consider the situation of shares or debt of a connected corporation that were held by a corporation within the 24 months immediately preceding the time at which the determination is being made as to whether a share is a qualified small business corporation share of an individual. If the shares of the connected corporation were disposed of to an arm's length person or partnership prior to the time the determination is being made, the disposition will not result in the shares failing to meet the holding period requirement. It is only during that part of the 24 months that is before the acquisition by the corporation in respect of which the determination is being made that the shares of the connected corporation must not have been held by an arm's length person or partnership.

In addition, throughout that part of the 24 month period that is relevant, the connected corporation must have been a Canadian-controlled private corporation that used more than 50% of the fair market value of its assets in an active business as defined above. However, paragraph (d) provides a special requirement with respect to corporations connected with the corporation where all or substantially all of the corporation's assets are not used in an active business.

Paragraph (d) of the definition provides that, where at any time all or substantially all of a corporation's assets are not shares or debt of connected corporations that meet the 50% active business test or assets used directly in an active business carried on primarily in Canada by the corporation or a related corporation, the connected corporations in which the corporation holds shares or debt must use all or substantially all of their assets in an active business. As a result, where paragraph (d) applies, the shares and debt of connected corporations held by the corporation will only qualify as active business assets where the connected corporations are small business corporations, rather than only being required to use more than 50% of the fair market value of their assets in an active business.

The 50% fair market value test described above ensures that the exemption will not be available on shares of corporations where more than half of the value of corporate assets are not active business assets throughout the required ownership period prior to the disposition of the qualified small business corporation shares. In addition, where shares or debt of a subsidiary company are held by a parent company, the subsidiary company must meet a holding period requirement and use more than 50% of the fair market value of its assets in an active business throughout that period in order for the parent company to include those shares or debt towards meeting its 50% fair market value requirement. The exception in paragraph (d) of the definition, which provides that where a parent does not use substantially all of its assets in an active business a subsidiary must be a small business corporation, is intended to ensure that the 50% fair market value requirement cannot be circumvented through the stacking of several holding companies.

Paragraphs (e) and (f) of the definition apply where, at any time during the 24 month period referred to therein, a share has been substituted for another share. Paragraph (e) applies to a share in respect of which a determination is being made as to whether the share is a qualified small business corporation share. If that share has been substituted for another share during the 24 month period preceding the time the determination is being made, the other share must have met the requirements set out in paragraphs (b) and (c) of the definition throughout that portion of the 24 month period which precedes the substitution in order for the substituted share to qualify. Paragraph (f) applies to a share of a connected corporation that has been substituted for another share during that time period. In such a case the other share must have met the requirements set out in subparagraph (c)(ii) throughout that portion of the 24 month period which precedes the substitution in order for the substituted share to meet the requirements of that subparagraph. Paragraphs (e) and (f) ensure that the holding period requirement and the 50% fair market value test cannot be circumvented through the use of substituted shares.

The definition of qualified small business corporation share is applicable with respect to dispositions of shares after June 17, 1987.

"Share of the Capital Stock of a Family Farm Corporation"

The definition of "share of the capital stock of a family farm corporation" in paragraph 70(10)(b) of the Act has been adopted for the purposes of section 110.6 effective for the 1988 and subsequent taxation years. In addition, a share of the capital stock of a corporation owned by a trust, where that share was acquired by the trust from an individual in whose hands it was a share of the capital stock of a family farm corporation of the individual immediately before the acquisition, will constitute a share of the capital stock of a family farm corporation of the trust for the purposes of the capital gains exemption for qualified farm property.

Subclause 66(5)

ITA
110.6(2)

Subsection 110.6(2) of the Act currently provides for the capital gains exemption of an individual (other than a trust) for a taxation year ending before 1990 in respect of net taxable capital gains realized on a disposition of qualified farm property either in the year or in a preceding taxation year ending after 1984. Paragraph 110.6(2)(a) limits the deduction to $250,000 less amounts previously deducted by the taxpayer under this subsection.

The amendments to subsection 110.6(2) are required as a consequence of the changes to the exemption available under subsection 110.6(3) for gains arising on the disposition of properties other than qualified farm properties and the changes to the inclusion rates for capital gains. First, the reference to taxation years ending before 1990 has been deleted. This ensures that the higher deduction available for dispositions of qualified farm property will be preserved, notwithstanding the reduction in the deduction available under subsection 110.6(3) for gains on other types of property. The other changes to subsection 110.6(2) reflect the increases in the inclusion rate for capital gains from one-half to two-thirds in 1988 and to three-quarters in 1990. In order to maintain the deduction at a level which is always equivalent to a total exempt capital gain of $500,000, the amount of the deduction permitted will be increased by one-third to $333,333 in 1988 and again by one-eighth to $375,000 in 1990. This is provided in subparagraph 110.6(2)(a)(ii) which provides for an increase of one-third of the amount deducted under section 110.6 prior to 1988 in calculating the entitlement to the exemption after 1987, and in subparagraph 110.6(2)(a)(iii) which provides for an increase of one-eighth of amounts so deducted prior to 1990 and of the amount determined under subparagraph (a)(ii). Subject to transitional rules set out in subclause (16), the amendments to subsection 110.6(2) are applicable to the 1988 and subsequent taxation years.

Subclause 66(6)

ITA
110.6(2.1)

New subsection 110.6(2.1) of the Act provides for special increased capital gains exemption for individuals (other than trusts) for a taxation year in respect of net taxable capital gains realized on the disposition of qualified small business corporation shares in the year or in a preceding year and after June 17, 1987. The deduction permitted under subsection 110.6(2.1) in respect of qualified small business corporation shares is equal to the least of four amounts:

1) In 1988 and 1989, $333,333, less any amount previously deducted by the taxpayer under section 110.6 of the Act. Where these amounts were deducted prior to 1988, subparagraph 110.6(2.1)(a)(ii) requires that they be increased by one-third to reflect the two-thirds inclusion rate for capital gains. After 1989, the available deduction will be $375,000 less any amounts previously deducted by the taxpayer under subsection 110.6 of the Act. In determining after 1989 the amounts previously deducted by the taxpayer, amounts deducted in 1988 or 1989 will be increased by a factor of one-eighth, which corresponds to the increase in the capital gains inclusion rate from two-thirds to three-quarters. After 1989, amounts deducted prior to 1988 will be increased by a factor of one-third and the resulting amount will be increased by the one-eighth factor to reflect the increase in the inclusion rate from one-half to three-quarters.

2) The individual's cumulative gains limit at the end of the year less any amount deducted under subsection 110.6(2) in respect of qualified farm property in computing his taxable income for the year.

3) The individual's annual gains limit for the year less any amount deducted under subsection 110.6(2) in respect of qualified farm property in computing his taxable income for the year.

4) The individual's net taxable capital gains for the year from dispositions of qualified small business corporation shares after June 17, 1987, less any such amount accounted for in paragraph 110.6(2)(d) of the Act. This provision permits reserves from prior years' dispositions of qualified small business corporation shares to qualify for this special capital gains exemption if the shares were disposed of after June 17, 1987. It also prevents a double benefit where the qualified small business corporation shares are also qualified farm property -- that is, shares of the capital stock of a family farm corporation.

Subject to the transitional rules set out in subclause (16), new subsection 110.6(2.1) is applicable to the 1988 and subsequent taxation years.

Subclause 66(7)

ITA
110.6(3) and (4)

Subsection 110.6(3) of the Act provides for a capital gains exemption for individuals (other than trusts) in respect of net taxable capital gains realized in the year. Subsection 110.6(3) is amended to reflect the introduction of the special $500,000 exemption for qualified small business corporation shares, the capping of the generally-available exemption at $100,000 of capital gains and the increase in the amount of a capital gain of an individual which is taxable from one-half to two-thirds in 1988 and from two-thirds to three-quarters in 1990.

The deduction permitted under amended subsection 110.6(3) with respect to dispositions of property other than qualified farm property or qualified small business corporation shares is equal to the least of three amounts:

1) In 1988 and 1989, the $66,667 exemption limit less any amounts deducted under subsection 110.6(3) in preceding years. Where these amounts were deducted by the taxpayer prior to 1988, subparagraph 110.6(3)(a)(ii) effectively increases the amount previously deducted by one-third for the purposes of calculating the taxpayer's remaining lifetime exemption limit. In this way, the exemption limit will always reflect the inclusion rate in effect for the particular year on $100,000 of capital gains. After 1989, the deduction permitted will be the $75,000 exemption limit less amounts previously deducted by the taxpayer under subsection 110.6(3). The increase to $75,000 reflects the three-quarters inclusion rate for determining taxable capital gains after 1989. In calculating the taxpayer's remaining lifetime exemption limit after 1989, any amounts deducted in 1988 or 1989 will be increased by one-eighth by virtue of subparagraph 110.6(3)(a)(iii). Amounts deducted prior to 1988, together with the one-third factor provided for under subparagraph (a)(ii), will be increased by a factor of one-eighth to reflect the increase in the inclusion rate from one-half to three-quarters.

2) The individual's cumulative gains limit at the end of the year less any amounts deducted by him in the year with respect to qualified farm property or qualified small business corporation shares. This measure prevents amounts already deducted under subsection 110.6(2) or (2.1) from again qualifying for a deduction under subsection 110.6(3).

3) The individual's annual gains limit for the year less any amounts deducted by him in the year with respect to qualified farm property or qualified small business corporation shares.

Calculating Entitlement to the Capital Gains Exemption

Assume that an individual realizes capital gains of $24,000 in each of 1987, 1988 and 1990. He has not claimed the capital gains exemption prior to 1987 and wishes to claim it in respect of these amounts. His deduction entitlement would be calculated as follows:

1987

	Capital Gain		$24,000
38(a)	Taxable Capital Gain (1/2 inclusion rate)		$12,000
110.6(3)(a)	Exemption limit	$50,000	
	Less: amounts previously deducted	NIL	
	Entitlement	$50,000	
110.6(3)	Deduction claimed		$12,000

1988

	Capital Gain		$24,000
38(a)	Taxable Capital Gain (2/3 inclusion rate)		$16,000
110.6(3)(a)	Exemption limit	$66,667	
110.6(3)(a)(i)	Less: amounts previously deducted	(12,000)	
110.6(3)(a)(ii)	one-third adjustment	(4,000)	
	Entitlement	$50,667	
110.6(3)(c)	Deduction claimed		$16,000

1990

	Capital Gain		$24,000
38(a)	Taxable Capital Gain (3/4 inclusion rate)		$18,000
110.6(3)(a)	Exemption limit	$75,000	
110.6(3)(a)(i)	Less: amounts previously deducted	(28,000)	
110.6(3)(a)(ii)	(1/3 x $12,000)	(4,000)	
110.6(3)(a)(iii)(A)	(1/8 x $28,000)	(3,500)	
110.6(3)(a)(iii)(B)	(1/8 x $ 4,000)	(500)	
	Entitlement	$39,000	
110.6(3)(c)	Deduction claimed		$18,000

After 1990, the individual would have a $21,000 ($39,000 - $18,000) exemption limit remaining for use against future taxable capital gains. At the three-quarters inclusion rate this is equivalent to $28,000 of capital gains - the appropriate result, since he has used $72,000 (3 x $24,000) of his $100,000 exemption.

Subsection 110.6(4) of the Act sets out an overall cumulative exemption limit of $250,000 in respect of the total deductions permitted under subsections 110.6(2) and (3). Subsection 110.6(4) is amended by adding a reference to new subsection 110.6(2.1), which permits a deduction in respect of gains realized on qualified small business corporation shares. It is also amended to adjust the maximum amount deductible having regard to the higher inclusion rates for taxable capital gains. For 1988 and 1989, the maximum permissable deduction will be $333,333 less any amounts previously deducted by the individual under section 110.6. Where those amounts were deducted prior to 1988, they will be increased by one-third, by reason of subparagraph 110.6(2)(a)(ii), for the purposes of calculating the maximum deduction remaining. After 1989, the maximum permissable deduction will be $375,000 less any amounts previously deducted under section 110.6. Amounts deducted in 1988 or 1989 will be increased by one-eighth, by reason of subparagraph 110.6(2)(a)(iii), for the purposes of calculating the maximum deduction remaining. Amounts deducted prior to 1988, together with the one-third increase provided for under subparagraph 110.6(2)(a)(ii), will also be increased by the one-eighth factor. The increase in the maximum permitted deduction from $250,000 to $333,333 and $375,000, together with the one-third and one-eighth adjustments to previously deducted amounts, reflect the increase in the inclusion rates in determining taxable capital gains from one-half to two-thirds in 1988 and from two-thirds to three-quarters in 1990. In this way, the maximum permitted deduction under section 110.6 is equivalent to $500,000 of total capital gains, regardless of the inclusion rate in effect in the years in which the deduction is utilized.

Subclause 66(8)

ITA
110.6(5)

The deductions under subsections 110.6(2), (2.1) and (3) of the Act are available to individuals who are resident in Canada throughout the taxation year. Subsection 110.6(5) of the Act is a relieving provision which provides that, for the purposes of section 110.6, where an individual is resident in Canada at any time in a particular taxation year, he shall be deemed to be resident in Canada throughout the particular year if he was a resident in Canada throughout the immediately preceding or the following taxation year. The amendment to subsection 110.6(5) clarifies that the subsection is applicable only for the purposes of subsections 110.6(2), (2.1) and (3) and ensures that subsection 110.6(13) operates as intended to exclude from the exemption gains realized while a taxpayer is a non-resident. The amendment is applicable to the 1988 and subsequent taxation years.

Subclauses 66(9), (10) and (12)

ITA
110.6(6), (7) and (8)

Subsections 110.6(6), (7) and (8) of the Act provide anti-avoidance rules that prohibit an individual from utilizing the capital gains exemption under the circumstances described therein. The opening words of each subsection refer to subsections 110.6(2) and (3). The amendments are strictly consequential on the introduction of the special exemption for qualified small business corporation shares. A reference to new subsection 110.6(2.1) has been added to each of these subsections, effective for the 1988 and subsequent taxation years.

Subclause 66(11)

ITA
110.6(7)(b)

Subsection 110.6(7) of the Act is an anti-avoidance rule to prevent the conversion of taxable capital gains of corporations into exempt capital gains of individuals. Any such gain will be denied the capital gains exemption.

Paragraph 110.6(7)(b) of the Act applies, except in certain specified transactions, when, as part of a series of transactions or events, a corporation or partnership acquires property for consideration that does not <u>approximate</u> its fair market value at the time of acquisition. As worded, paragraph 110.6(7)(b) could apply to certain transactions to deny the capital gains exemption where this result is not appropriate. Effective for the 1988 taxation year, therefore, this paragraph is amended to apply only in situations where a corporation or partnership acquires property for consideration that is <u>significantly less</u> than its fair market value at the time of acquisition.

Subclause 66(13)

ITA
110.6(10)

Subsection 110.6(10) of the Act is an anti-avoidance rule to prevent a taxpayer from using options to defer capital gains in order to maximize the capital gains exemption during the phase-in period. As a result of the capping of the exemption at a level equivalent to $100,000 of total capital gains and the repeal of the phase-in limits, the prohibition with respect to options extended or renewed after November 21, 1985 is no longer required. Subsection 110.6(10) is therefore repealed effective for the 1988 and subsequent taxation years. The subsection has also been amended in its application to taxation years ending after 1984 and before 1988 to exclude from its operation options extended or renewed with respect to qualified farm property. Capital gains arising from such options will qualify for the exemption as the phase-in limits in those years do not apply to gains arising on the disposition of such property. Subclause 66(16) sets out this rule and the effective date of application for the repeal of subsection 110.6(10) of the Act.

Subclause 66(14)

ITA
110.6(12)

Subsection 110.6(12) of the Act permits a spouse trust to claim a deduction, in computing its taxable income for its taxation year in which the spouse died, in respect of its eligible taxable capital gains for that year. The deduction is based on the premise that the spouse trust should be able to claim a capital gains exemption to the extent the spouse would have claimed an exemption if the eligible taxable capital gains of the trust had been realized by the spouse directly. To this end, subparagraph 110.6(12)(a)(i) has been amended to include, as one of the amounts limiting the amount of the deduction available, the spouse's cumulative net investment loss at the end of the taxation year.

New subparagraph 110.6(12)(b)(i) limits the amount of the deduction that may be claimed by the trust in respect of its gains on dispositions of capital properties other than qualified farm properties and qualified small business corporation shares to $66,667 in 1988 and 1989, and $75,000 thereafter, less any amounts deducted by the spouse under subsection (3) in the year the spouse died or a preceding year. Subclause 110.6(12)(b)(i)(B) provides for the appropriate one-third and one-eighth adjustments to amounts deducted by the spouse in prior years with a lower taxable capital gains inclusion rate.

Existing paragraph 110.6(12)(b) of the Act limits the amount of the deduction available to the spouse trust to the spouse's unused lifetime exemption limit for the year in which the spouse died. This limit is now reflected in new paragraph 110.6(12)(c) and has been amended to permit a maximum deduction of $333,333 in 1988 and 1989, less amounts deducted by the spouse under section 110.6 in that year or preceding years. After 1989, the maximum deduction permitted by the spouse trust will be $375,000 less amounts previously deducted by the spouse. Subparagraph 110.6(12)(c)(ii) provides for the appropriate one-third and one-eighth adjustments to amounts deducted in prior years with a lower taxable capital gains inclusion rate, in order to reflect the increased inclusion rates for capital gains.

Subclause 66(15)

ITA
110.6(14)

New subsection 110.6(14) of the Act provides rules that are applicable for the purposes of the definition "qualified small business corporation share" in subsection 110.6(1), and is applicable to dispositions of shares after June 17, 1987.

New paragraph 110.6(14)(a) of the Act provides an ordering rule for the disposition of shares that are identical properties for the purposes of determining whether a share is a qualified small business corporation share. Where a taxpayer disposes of shares only some of which meet the holding requirements of subsection 110.6(1) for qualified small business corporation shares, new paragraph 110.6(14)(a) deems the taxpayer to have disposed of the shares in the order in which he acquired them.

New paragraph of 110.6(14)(b) provides that, for the purposes of the definition qualified small business corporation share, rights referred to in paragraph 251(5)(b) shall not include rights under a purchase and sale agreement relating to a sale of shares. This amendment will ensure that where shares are sold pursuant to an agreement of purchase and sale to, for example, a public corporation or a non-resident, paragraph 251(5)(b) will not operate to cause the corporation whose shares are being sold to cease to be a Canadian-controlled private corporation as of the date of the agreement. Such an agreement would therefore not result in the loss of small business corporation status for the purposes of determining the vendor's entitlement to the special increased exemption on such a disposition.

New paragraphs 110.6(14)(c) and (d) of the Act apply for the purposes of determining whether a share is a qualified small business corporation share as defined in subsection 110.6(1). Those paragraphs treat a trust as being related to a beneficiary of that trust and a partnership as being related to a member throughout that time during which he was a beneficiary of the trust or member of the partnership. New paragraphs 110.6(14)(c) and (d) ensure that, for the purposes of the exemption for qualified small business corporation shares, the period of time during which shares were held by a trust of which the individual was a beneficiary or a partnership of which the individual was a member will be included in determining whether the holding period requirements for qualified small business corporation shares have been met. These provisions also ensure that the period of time during which a corporation was a partner in a partnership or a beneficiary of a trust which held shares or debt of corporations that are connected with the corporation will be included in determining whether the shares or debt satisfy the holding period requirement set out in the definition of qualified small business corporation share.

New paragraph 110.6(14)(e) provides that, for the purposes of the definition of "qualified small business corporation share", a holding corporation will be treated as being related to any of its shareholders from whom it acquired shares in another corporation in respect of the acquired shares if, immediately after the acquisition, the shareholder owned the same number of shares in the other corporation as he owned immediately before the acquisition. For this purpose, shareholders of the holding corporation are treated as owning the acquired shares in a proportion equal to their proportionate shareholding of the holding corporation, determined on a fair market value basis. Paragraph (e) is a relieving provision which ensures that shareholders who held qualified small business corporation shares will not disentitle themselves to the enhanced exemption by reason only of the interposition of a holding company between themselves and the small business corporation.

Clause 67

Northern Allowances

ITA
110.7(1)(d)(i)(c)

Section 110.7 of the Act provides for a special deduction in computing the taxable income of individuals residing in certain prescribed northern and isolated areas.

As a result of the conversion of the medical expense deduction to a tax credit, clause 110.7(1)(d)(i)(c) of the Act is amended to delete the reference to paragraph 110(1)(c) - the medical expense deduction - and substitute a reference to new subsection 118.2(1) - the medical expense tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 68

Loss Carryovers

ITA
111

Section 111 of the Act establishes the extent to which a taxpayer is permitted to deduct amounts in computing his taxable income for the year in respect of losses of other taxation years. The amendments to this section are consequential on the changes to the inclusion rates for capital gains and capital losses.

Subclause 68(1)

ITA
111(1)(b)

Paragraph 111(1)(b) of the Act permits a taxpayer to claim a deduction in computing his taxable income for a year in respect of his net capital losses for all preceding taxation years and the three immediately following taxation years. Subparagraphs 111(1)(b)(i) and (ii) limit the deduction in respect of net capital losses to the aggregate of the taxpayer's net taxable capital gains for the year and, where the taxpayer is an individual, the lesser of $2,000 and his pre-1986 capital loss balance for the year. Those subparagraphs are being repealed, applicable with respect to the computations of taxable incomes for the 1985 and subsequent taxation years and will be included in new subsection 111(1.1) which will determine the amount that may be deducted under paragraph 111(1)(b) in respect of net capital losses claimed under that paragraph.

Subclause 68(2)

ITA
111(1.1)

New subsection 111(1.1) determines the amount that a taxpayer may deduct in respect of a net capital loss claimed under paragraph 111(1)(b) in a taxation year. Subsection (1.1) provides that the amount deductible under paragraph 111(1)(b) for a year in respect of a net capital loss claimed under that paragraph is the lesser of two amounts. The first amount as set out in new paragraph 111(1.1)(a) contains limitations that were contained in former subparagraphs 111(1)(b)(i) and (ii). This amount is the total of the taxpayer's net taxable capital gains for the year plus an additional amount in respect of individuals equal to the lesser of $2,000 and his pre-1986 capital loss balance for the year.

The second amount as set out in new paragraph 111(1.1)(a) is the net capital losses claimed under paragraph 111(1)(b) for that year as adjusted by new paragraph 111(1.1)(b).

New paragraph 111(1.1)(b) adjusts each net capital loss for a taxation year (referred to as a "loss year") claimed in a particular year under paragraph 111(1)(b). The net capital losses are adjusted to compensate for the difference between the inclusion rate for capital gains and losses for the loss year and the inclusion rate for capital gains and losses for the particular year in which the loss is deducted. The purpose of this adjustment is to ensure that a capital loss of a loss year will be able to offset an equal amount of a capital gain in another year where the inclusion rates for capital gains and losses differ between the year the loss arose and the year it is being claimed. The net capital loss claimed by a taxpayer in a particular year will be increased for the purposes of the deduction under paragraph 111(1)(b) where the loss is carried forward from a loss year in which the inclusion rate was lower than the inclusion rate for the particular year in which the loss is to be claimed. The net capital loss claimed by a taxpayer in a year will be reduced for the purposes of the deduction under paragraph 111(1)(b) where the loss is carried back from a loss year in which the inclusion rate is greater than the inclusion rate for the particular year for which the loss is being claimed.

These adjustments are achieved by multiplying the net capital loss claimed under paragraph 111(1)(b) by the ratio of the taxpayer's inclusion rate for the particular year in which the loss is to be claimed over his inclusion rate for the loss year.

The operation of these rules is best illustrated by way of examples.

Example 1:

Assume the following facts:

- An individual has a capital loss in 1987 (the loss year) of $100 which yields a net capital loss of $50 (1/2 X $100)
- He has a capital gain in 1990 (the particular year) of $100 which yields a taxable capital gain of $75 (3/4 X $100)
- The 1987 capital loss of $50 is claimed under 111(1)(b) in 1990

The deduction permitted under new paragraph 111(1.1)(b) in respect of the 1987 net capital loss claimed under paragraph 111(1)(b) is computed by the formula

$$A \times \frac{B}{C} \quad \text{or} \quad \$50 \times \frac{\frac{3}{4}}{\frac{1}{2}} = \$75$$

where

A is the $50 net capital loss for the loss year claimed under 111(1)(b) in the particular year

B is the individual's 3/4 inclusion rate for the particular year

C is the individual's 1/2 inclusion rate for the loss year

Paragraph 111(1.1)(b) effectively permits 1987 capital losses of $100 to shelter the 1990 capital gain of $100 from tax.

Example 2:

Assume the following facts:

- A public corporation with a December 31 year-end has a capital loss of $100 in its 1990 taxation year (the loss year) yielding a net capital loss of $75
- The corporation has a capital gain in its 1988 taxation year (the particular year) of $100 yielding a taxable capital gain of $58[1]
- The 1990 net capital loss is claimed under paragraph 111(1)(b) in 1988

The deduction permitted under new paragraph 111(1.1)(b) in respect of the 1990 net capital loss of $75 claimed under paragraph 111(1)(b) for 1988 is computed by the formula

$$A \times \frac{B}{C} \quad \text{or} \quad \$75 \times \frac{.58}{.75} = \$58$$

where

A is the net capital loss for the loss year claimed under paragraph 111(1)(b) in the particular year ($75)

B is the inclusion rate for the particular year (.58)[1]

C is the inclusion rate for the loss year (.75)

[1]Note: The 58% inclusion rate for the year in which the loss is to be deducted is determined as (182/366 X 1/2) + (184/366 X 2/3) = .58.

Paragraph 111(1)(b) effectively permits the 1990 capital loss of $100 to shelter the 1988 capital gain of $100 from tax.

New subsection 111(1.1) is applicable with respect to computations of taxable incomes for the 1985 and subsequent taxation years.

Subclause 68(3)

ITA
111(2)

Subsection 111(2) of the Act provides a special rule for determining the deduction of net capital losses under paragraph 111(1)(b) in the year in which an individual dies. Under the existing rules, in computing the taxable income of a taxpayer for the taxation year in which he dies and for the immediately preceding taxation year, his net capital losses for all taxation years are deductible from all sources of income in those two years subject to one limitation. This limitation provides that the total net capital losses that can be deducted in the year of death and the immediately preceding year from sources of income other than net taxable capital gains is reduced to the extent of the total of all capital gains exemptions that have been claimed by the individual. This subsection is being amended, applicable with respect to computations of taxable incomes for the 1985 and subsequent taxation years, as a result of the changes to the inclusion rate for capital gains and capital losses of individuals.

Amended subsection 111(2) provides that the amount that may be deducted under paragraph 111(1)(b) in the year of death and in the immediately preceding year is the aggregate of two amounts. The first of these amounts is the amount of net capital losses claimed by a taxpayer in one of those years as adjusted under new subsection 111(1.1) that is sufficient to shelter taxable capital gains from tax for these years. The deduction in respect of net capital losses carried forward from a loss year with a lower inclusion rate for the taxpayer will be adjusted upwards under new subsection 111(1.1) when claimed in a year with a higher inclusion rate. This adjusted amount is deductible only to the extent of the net taxable capital gains for those two years. The adjustment of the net capital losses when deducted against taxable capital gains is intended to ensure that a capital loss will be able to offset an equal amount of a capital gain regardless of when the loss is deducted. For net capital losses that are deducted against other income, it is not appropriate that such losses be adjusted to reflect a change in inclusion rates. Therefore, the excess of the total amount of unadjusted net capital losses claimed for deduction over the amount of such unadjusted losses that were used to offset the net taxable capital gains for the year will be deductible against other income in the year of death or in the preceding year. This excess will continue to be reduced by any previous capital gains exemptions deducted by the individual.

The following example further illustrates the operation of subsection 111(2).

Assume the following facts:

• Year of death	1990
• Net capital loss in 1985 (the loss year)	$10,000
• Net taxable capital gains for year of death (that is the amount determined under paragraph 3(b))	$3,000
• Total capital gains exemptions claimed in prior years under section 110.6	$4,000

The deduction under paragraph 111(1)(b) for the year of death would be $7,000 calculated as follows:

(a) Amount determined under paragraph 3(b) for the year (Amount of net capital losses claimed under paragraph 111(1)(b) to offset the 3(b) gains is $2,000[1]), and — $3,000

(b) The excess of

(i) net capital losses claimed under paragraph 111(1)(b) — ($10,000)

over the aggregate of

(ii) the amount of net capital losses claimed under paragraph 111(1)(b) that was determined under paragraph (a), and — $2,000

(iii) previous capital gains exemptions	$4,000	
Deductible against other income		$4,000
Total deduction		$7,000

[1]Note: This amount can be calculated by multiplying the net taxable capital gains for the year of death by the ratio of the inclusion rate of the individual for the loss year over the inclusion rate for the year of death.

$$\$3,000 \times \frac{\frac{1}{2}}{\frac{3}{4}} = \$2,000$$

Subclause 68(4)

ITA
111(3)(a)(i)

Subsection 111(3) of the Act sets out limitations on the deductibility in a taxation year of a loss carryover. The amendments to this subsection are consequential on the introduction of new subsection 111(1.1) which adjusts the amount of a net capital loss that may be deducted under paragraph 111(1)(b). Subparagraph 111(3)(i) is being amended to exclude net capital losses from the existing rules that provide that the types of losses listed in subsection 111(3) will be reduced by amounts deducted under section 111 in respect of those losses for preceding taxation years. New subparagraph 111(3)(a)(i.1) provides that a net capital loss will be reduced by the amounts that were claimed under paragraph 111(1)(b) in preceding taxation years in respect of that loss. The amount that is deducted in respect of the loss under paragraph 111(1)(b) will differ from the amount claimed under that paragraph whenever new paragraph 111(1.1)(b) adjusts the net capital loss that may be deducted under paragraph 111(1)(b). This adjustment will occur whenever the inclusion rate for the loss year differs from the inclusion rate for the year in which the loss is to be deducted and is described in more detail under the commentary to new subsection 111(1.1). The amendments to subsection 111(3) are applicable with respect to computations of taxable incomes for the 1985 and subsequent taxation years.

Subclause 68(5)

ITA
111(5.2)(a)

Subsection 111(5.2) of the Act provides that, 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:

> (a) the amount deducted by the corporation under paragraph 20(1)(b) of the Act in respect of its cumulative eligible capital in computing its income for the taxation year that is deemed to have ended at that time, and
>
> (b) 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 ending immediately before the change of control. This subsection is amended to replace the references therein to one-half with references to three-quarters as a consequence of the increase in the inclusion rate for eligible capital property from 1/2 to 3/4. This amendment is applicable to acquisitions of control of a corporation occurring after the commencement of the corporation's first taxation year commencing after June 30, 1988.

Subclause 68(6)

ITA
111(8)(b)(i)(A)

Paragraph 111(8)(b) of the Act defines "non-capital loss" of a taxpayer for a taxation year. Clause 111(8)(b)(i)(A) lists certain amounts to be included in a taxpayer's non-capital loss in order that that loss not be understated. Effective for the 1988 and subsequent taxation years, clause 111(8)(b)(i)(A) is amended by changing the reference therein to an amount "deductible" under section 110.6 to an amount "deducted" under section 110.6, to ensure that a non-capital loss is preserved only where the capital gains exemption provided in that section is, in fact, claimed by the taxpayer.

Subclause 68(7)

ITA
111(8)(b.2)

Paragraph 111(8)(b.2) of the Act defines the "pre-1986 capital loss balance" of an individual for a particular taxation year. With the introduction of the capital gains exemption in 1985, net capital losses realized by an individual after May 22, 1985 became deductible only from taxable capital gains, except in the year of death and the preceding year. The "pre-1986 capital loss balance" represents the individual's unutilized pre-May 23, 1985 net capital losses that are potentially deductible from other income in subsequent years. These losses are deductible at the rate of $2,000 per year to the extent that they have not otherwise been utilized and to the extent that they exceed the total capital gains exemptions claimed by the individual in all prior years. As a result of the increased inclusion rates in 1988 and 1990 for determining taxable capital gains and allowable capital losses, it is no longer appropriate in all circumstances to reduce each dollar of pre-1986 net capital loss by each dollar deducted under section 110.6 in measuring a taxpayer's pre-1986 capital loss balance.
Paragraph 111(8)(b.2) is amended to reflect the higher inclusion rates. Amounts deducted under section 110.6 prior to 1988 will continue to reduce the pre-1986 capital loss balance on a dollar- for-dollar basis. However, only three-quarters of any such amounts deducted in 1988 and 1989 will reduce that balance. This reflects the increase in the inclusion rate from one-half to two-thirds for those years. For taxation years ending after 1989, only two-thirds of amounts deducted under subsection 110.6 in those years will be taken into account, reflecting the increase from one-half to three-quarters in the capital gains inclusion rate. The amendments to paragraph 111(8)(b.2) are effective for the 1988 and subsequent taxation years.

Clause 69

Order of Applying Provisions

ITA
111.1

Section 111.1 of the Act provides for the order in which certain deductions must be taken in computing taxable income. Section 111.1 of the Act is amended to delete the references to sections 109 (personal exemptions), 110.1 (investment income deduction), 110.2 (pension income deduction), 110.3 (transfer of certain unused deductions) and 110.4(1) (forward averaging deduction) as a result of the elimination of forward averaging and the $1,000 investment income deduction and the conversion to tax credits of the personal exemptions, the pension income deduction and the spousal transfer of certain unused deductions. This amendment will apply to the 1988 and subsequent years. For the 1987 taxation year, a reference to section 110.7 (the northern allowance deduction) is included in this section. In 1987, this deduction must be claimed before the forward averaging deduction. For subsequent taxation years, the northern allowance deduction will be claimed last, as a result of the repeal of the forward averaging provisions.

Clause 70

Part Year Residents

ITA
114(a)

Section 114 of the Act sets out the rules for the purposes of computing the taxable income of an individual who was resident in Canada during only part of a taxation year. Paragraph 114(a) is amended to clarify that the income to be taken into account in this computation is the income for the period or periods <u>throughout</u> which he was resident, employed or carrying on business, in Canada. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 71

Deductions in Separate Returns

ITA
114.2

Section 114.2 of the Act, which governs the total amount of deductions that may be claimed where a separate return under subsection 70(2), 104(23) or 150(4) is filed with respect to a taxpayer, is amended to delete the reference to sections 110.1 (the investment income deduction) and 110.2 (the pension income deduction) following the elimination of the $1,000 investment income deduction and the conversion of the pension income deduction to a tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 72

Non-Resident's Taxable Income in Canada

ITA
115

Section 115 of the Act provides rules for the calculation of the taxable income earned in Canada by a non-resident.

Subclause 72(1)

ITA
115(1)

Subsection 115(1) of the Act is amended for purposes of clarification. The reference to a non-resident person's taxable income is deleted and the subsection now refers to the taxable income of a person who at no time in the taxation year is resident in Canada.

Subclause 72(2)

ITA
115(1)(d)

Paragraph 115(1)(d) of the Act, which enumerates certain deductions that can be claimed in computing taxable income earned in Canada by a non-resident, is amended to delete the reference to paragraphs 110(1)(a) (charitable donations), (b) (gifts to the Crown), (b.1) (gifts to certain institutions) and (e) (mental or physical impairment) which are repealed as a consequence of the conversion of the personal tax deductions to tax credits and to substitute a reference to new subsection 110.1(1) which permits a deduction for gifts in computing the taxable income of a corporation.

The amendments to section 115 of the Act are applicable to the 1988 and subsequent taxation years.

Clause 73

Dispositions by Non-Residents

ITA
116

Section 116 of the Act establishes procedures for collecting tax from non-residents on the proposed or actual disposition of particular types of taxable Canadian properties.

Subclauses 73(1) to (3)

ITA
116(2)(a), 116(4)(a) and 116(5)(a)(ii)(B)

Subsection 116(2) of the Act requires the Minister to issue a certificate in prescribed form where, prior to the disposition of a property, the vendor has paid on account of tax 25% of the excess of the estimated proceeds of disposition over the adjusted cost base of the property to him or has provided acceptable security to the Minister. A similar rule is provided in subsection 116(4) where, after the disposition, the non-resident vendor has paid on account of tax 25% of the excess of the non-resident's proceeds over his adjusted cost base. Where a certificate has been issued prior to the disposition and the cost to the purchaser of the property exceeds the certificate limit, clause 116(5)(a)(ii)(B) requires the purchaser to pay on account of tax the lesser of 15% of the cost of the property to him or 25% of the amount by which the cost of the property to him exceeds the certificate limit.

The 25% payment imposed under these provisions is intended to approximate the combined federal and provincial tax payable on capital gains at the highest marginal tax rates. As a consequence of the changes to the inclusion rates for capital gains and the reduction in personal and corporate tax rates effective in 1988, these provisions are amended to increase the withholding tax payable on dispositions by non-residents from 25% to 30% for dispositions occurring after 1987 and before 1990 and to 33 1/3% for dispositions occurring after 1989.

Clause 74

Personal Tax Rates

ITA
117

Section 117 of the Act sets out the rates of tax applicable to individuals.

Subclause 74(1)

ITA
117(1)

Subsection 117(1) of the Act, which provides that the tax payable under Part I of the Act by an individual is generally computed without reference to the alternative minimum tax, is amended for the 1987 and subsequent taxation years to delete the reference to paragraph 119(1)(d) which deals with the computation of the "average tax" of farmers and fishermen who have elected to block average. As a result of the amendment, the calculation of previous years' tax payable for the purposes of block averaging is made less complex by not having to take into account any minimum tax paid in any of those years. This amendment is applicable to the 1987 and subsequent taxation years.

Subclause 74(2)

ITA
117(2)

New subsection 117(2) provides the new marginal rates of federal tax: 17% on taxable income not exceeding \$27,500, 26% on the next \$27,500 of taxable income, and 29% on the amount of taxable income in excess of \$55,000. These rates are applicable to the 1988 and subsequent taxation years.

Subclause 74(3)

ITA
117(5.2)

Subsection 117(5.2) of the Act, which contained the former rates and amounts of tax payable by individuals, is repealed effective for the 1988 and subsequent taxation years.

Subclause 74(4)

ITA
117(7)

Subsection 117(7) of the Act permits an individual to claim the medical expenses of a person who, but for his income, would be his dependant. However, in this case, the individual is required to add to his tax otherwise payable on amount equal to 68% of that portion of the person's income that exceeds the basic personal exemption. This provision is amended as a consequence of the conversion of the medical expense deduction to a tax credit. The new provision will operate in essentially the same manner as the former provision, but the reference to the medical expense deduction has been changed to a reference to the new medical expense tax credit. A taxpayer may include in computing his medical expense tax credit for a taxation year, the medical expenses of a person who, but for his income for the year, would have been claimed as a dependant for the year by the taxpayer. To take advantage of this provision, the taxpayer will be required to add to his tax payable for the year the excess, if any, of the person's net income over $6,000. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 75

Annual Adjustment

ITA
117.1

Subsection 117.1(1) of the Act provides for the indexing of various amounts, including personal exemptions.

Paragraph 117.1(1)(a) is amended as a consequence of the conversion of exemptions into tax credits. It now provides for the indexing of the amounts of $5,000 and $6,000 referred to in new paragraphs 118(1)(a) and (b), being the amounts used to compute the married credit and the basic personal credit, respectively.

Paragraph 117.1(1)(b) provides for indexing of the following dollar amounts:

- the amounts of tax payable and of amounts taxable at different taxable income threshholds as set out in the personal rate schedule reflected in subsection 117(2),

- the amount of $6,000, which is used in computing the basic tax credit and is also the threshold amount, the excess over which must be included in a taxpayer's income to claim certain medical expenses of a relative,

- the amounts of $383, $766, $2,500 and $1,471 which are used in computing the tax credits with respect to dependants,

- the amount of $3,236 which is used in computing the age credit and the credit in respect of mental or physical impairment,

- the $559 refundable child tax credit and the $23,500 family income threshhold for the purposes of that credit,

- the $250 threshhold for the purpose of the credit for charitable contributions and the $1,500 threshhold for the purposes of the medical expense credit.

These amounts will be indexed annually for each taxation year after 1988. The indexing formula by which these amounts are to be adjusted remains the same. Essentially, these amounts will be increased by the proportion of those amounts represented by the annual increase in the Consumer Price Index in excess of 3%.

Subsection 117.1(2) of the Act is amended to provide that the amount of $500 referred to in subparagraphs 118(1)(a)(ii) and (b)(iv) (that is, the income of the spouse or person claimed in the equivalent-to-married tax credit beyond which the amount of the spousal and equivalent-to-married tax credits is reduced) shall be adjusted to one-half of the difference between $6,000 and $5,000. The amounts of $6,000 and $5,000 referred to these provisions are adjusted annually themselves in accordance with subsection 117.1(1).

Subsection 117.1(3) of the Act is amended to provide for rounding of the various amounts referred to in new section 117.1. Where an amount as adjusted under this section is not a multiple of $1.00, it shall be rounded to the nearest whole dollar amount. If it is equidistant from two whole dollar amounts it shall be rounded to the higher amount.

New subsection 117.1(4) of the Act incorporates the determination of the Consumer Price Index for a 12 month period, which calculation was previously contained in subsection 117.1(7). There is no substantive change to the method of determining the Consumer Price Index.

These amendments are applicable to the 1988 and subsequent taxation years and the first year to which the indexing adjustments apply will be 1989.

Clause 76

Personal Tax Credits

ITA
118

New section 118 of the Act provides for deductions from tax implementing the conversion of the personal deductions and exemptions into tax credits. Section 118 governs the calculation of the following tax credits: the single, married status, equivalent-to-married, dependants, age and pension credits. Although the White Paper listed the federal tax value of these credits, the legislation which enacts these credits, as well as the conversion of the other deductions from income into tax credits, sets out the calculation as the amount determined by multiplying an aggregate dollar value by the appropriate percentage for the year. The appropriate percentage for the year is defined in subsection 248(1) to be the lowest percentage referred to in section 117. For 1988, this percentage is 17%. The dollar amounts listed in the legislation are the grossed-up amounts which, by applying the appropriate percentage, will give the requisite dollar amounts of the various credits. For example, a single person is entitled to a tax credit of 17% of $6,000, which equals $1,020.

New subsection 118(1) of the Act provides for the calculation of the deduction from tax payable in respect of married status, equivalent-to-married status, single status and dependants. The deduction is calculated as the appropriate percentage (17% in 1988) of the aggregate of such amounts as are applicable. Paragraph 118(1)(a) provides the amount applicable in respect of married status. This amount is calculated by adding $6,000 and the amount determined by subtracting from $5,000, the excess, if any, of the spouse's income for the year over $500. While the amount that may be deducted in respect of an individual's married status has changed, the other conditions of former paragraph 109(1)(a) have been incorporated in new paragraph 118(1)(a). The individual must support his spouse. If the individual was living apart from his spouse at the end of the year by reason of marriage breakdown, the calculation will be made using the spouse's income for the year while married and not separated. For a married person with a spouse with income of $500 or less, the additional credit with respect to the spouse will be 17% of $5,000, or $850, for 1988.

New paragraph 118(1)(b) of the Act provides the amount applicable in respect of a wholly dependent person (the equivalent-to-married credit). This amount, applicable to a person who is not entitled to a married credit is $6,000 plus the amount determined by subtracting from $5,000, the excess, if any of the income for the year of the wholly dependent person over $500. The conditions of former paragraph 109(1)(b) have been incorporated in new paragraph 118(1)(b), with the additional restriction that, except in the case of a parent or grandparent of the individual, the dependant must be either under 18 years of age or dependent by reason of mental or physical infirmity. The additional credit for 1988 for an individual who qualifies for the equivalent-to-married credit will be $850 -- that is, 17% of $5,000 -- where the income of the dependant in respect of whom the credit is claimed does not exceed $500.

New paragraph 118(1)(c) of the Act provides that the amount applicable in respect of an individual not entitled to a deduction under paragraph (a) or (b), is $6,000. For a single person the credit for 1988 will thus be $1,020 -- that is 17% of $6,000.

New paragraph 118(1)(d) of the Act provides that the amount applicable in respect of dependants of the individual is $383 less the excess of the dependant's income over $2,500, where the dependant is under age 18 at any time in the year. Where the individual has more than two such dependants, the reference to $383 will be read as $766 for the third and subsequent dependants. The balance of the formula remains the same. This will double the deduction for these dependants, providing the income of each does not exceed $2,500. With respect to dependant children whose income does not exceed $2,500, the credit for 1988 will thus be $65 for each of the first two dependants and $130 for each such other dependant.

Where a person is dependent on an individual by reason of mental or physical infirmity and is over 18 years of age, the applicable amount is $1,471 less the excess of the dependant's income over $2,500. Thus, the maximum credit in respect of such a dependant in 1988 will be $250 -- that is, 17% of $1,471.

Subsection 118(2) of the Act provides for the age credit (formerly the age exemption in paragraph 109(1)(h)). Where an individual is over 65 or reaches 65 years of age in the year he may deduct $550 from tax payable -- that is, the appropriate percentage (17% in 1988) of $3,235.

New subsection 118(3) of the Act provides for the pension credit (formerly the pension income exemption in 110.2). Where an individual is 65 years of age or over, he may deduct a maximum of $170 from tax payable in 1988 -- that is, the amount determined by applying the appropriate percentage (17% in 1988) to the lesser of $1,000 and his pension income. Where an individual has reached 60 years of age, received a disability pension or survivor's pension under the Canada Pension Plan or provincial pension plan, or where the individual is under 60 years of age and has not deducted an amount in computing his income in respect of a transfer of superannuation benefits to a registered retirement savings plan or a registered pension plan, he may deduct from tax payable the appropriate percentage of the lesser of $1,000 and his qualified pension income for the year.

New subsection 118(4) of the Act provides several rules governing the tax credits available under subsection 118(1). Paragraph 118(4)(a) provides that an individual may claim the married or equivalent-to-married deduction in respect of only one other person. Paragraph 118(4)(b) provides that not more than one individual is entitled to the equivalent-to-married deduction for the same person. Where two or more individuals may be entitled to a deduction in respect of the same person or same self-contained domestic establishment, they must agree which individual will claim the tax credit. If they fail to agree, the credit will not be allowed to any of them.

New paragraph 118(4)(c) of the Act provides that, where an individual is entitled to the equivalent-to-married deduction in respect of a person, neither the individual nor any other individual may claim that person as a dependant for purposes of the tax credit under paragraph 118(1)(d).

New paragraph 118(4)(d) of the Act provides that no amount may be deducted in respect of a dependant under paragraph 118(1)(d) except to the extent of the proportion of the family allowance paid in the year in respect of that person that was included in the individual's income for the year.

New paragraph 118(4)(e) of the Act provides that, where more than one individual is entitled to a tax credit in respect of the same person as a dependant under paragraph 118(1)(d), the total amounts claimed by these individuals cannot exceed the maximum amount that would be allowed if only one individual were claiming the person as a dependant. Where the supporting individuals cannot agree what portion of the total amount each is to deduct, the Minister may allocate the amount between them.

New subsection 118(5) of the Act reintroduces the existing restriction on subsection 109(4) providing that an individual entitled to a deduction under paragraph 60(b),(c) or (c.1) in respect of a support payment made for the maintenance of a spouse or child is not entitled to also claim a credit under section 118 in respect of that spouse or child.

New subsection 118(6) of the Act provides the definition of a dependant for the purposes of paragraph 118(1)(d) and includes a child or grandchild of the individual or of his spouse or, if resident in Canada, a parent, grandparent, brother, sister, uncle, aunt, niece or nephew of the individual or of the individual's spouse.

New subsection 118(7) of the Act provides definitions of "pension income" and "qualified pension income" for the purposes of the pension income tax credit provided in subsection 118(3). There has been no change to the definition of "pension income" formerly contained in paragraph 110.2(3)(a) apart from minor consequential amendments as a result of the repeal of section 110.1. The definition of "qualified pension income", formerly contained in paragraph 110.2(3)(b), has been clarified and is cross-referenced to many of the amounts described in the definition "pension income".

The definitions in subsection 118(7) are subject to the overriding qualification contained in 118(8) which provides that certain amounts are not included in "pension income" and "qualified pension income". These amounts are the old age pension and Canada/Quebec pension plan benefits and death benefits. Also excluded is the portion of any payment that would otherwise qualify which is specifically deductible under another provision of the Act, and a payment received from a salary deferral arrangement, retirement compensation arrangement, an employee benefit plan, employee trust or prescribed provincial pension plan.

Charitable Donations

ITA
118.1

Subsection 118.1(1) of the Act provides definitions of "total charitable gifts", "total crown gifts", "total cultural gifts" and "total gifts" for the purposes of the tax credit available to individuals who make such gifts.

"Total charitable gifts" for a taxation year is defined as the aggregate of all amounts donated by an individual in the year or in one of the 5 immediately preceding taxation years to an institution formerly described in paragraph 110(1)(a), to the extent that the amount of the gifts was not deducted in computing his taxable income for a year preceding 1988 or used in determining a deduction in computing tax payable under Part I for a preceding taxation year. Where the individual has claimed a deduction in computing his taxable income under subsection 110(2) for a taxation year (charitable gifts made by a member of a religious order who has taken a vow of perpetual poverty) the amount of any gift made in that taxation year is excluded from the definition of "total charitable gifts".

"Total crown gifts" for a taxation year is defined as the aggregate of all gifts, formerly described in paragraph 110(1)(b), to Her Majesty, to the extent that these amounts have not been deducted in computing the individual's taxable income for a taxation year preceding 1988, or used in computing a deduction from tax payable for a preceding taxation year.

"Total cultural gifts" for a taxation year is defined as the aggregate of all gifts, formerly described in paragraph 110(1)(c), of Canadian cultural property to the extent that the values of those gifts have not been deducted in computing the individual's taxable income for a taxation year preceding 1988, or used in computing a deduction from tax payable for a preceding taxation year.

"Total gifts" for a taxation year is defined as the aggregate of total crown gifts for the year, total cultural gifts for the year and the lesser of total charitable gifts for the year and one-fifth of the individual's income for the year.

New subsection 118.1(2) provides that a gift shall not be included in computing a tax credit under this section unless the gift is proven by filing a receipt containing prescribed information. This provision was formerly incorporated in paragraphs 110(1)(a), (b) and (c).

New subsection 118.1(3) provides a formula for determining the amount of the deduction from tax payable that is available in respect of an individual's total gifts. This amount is calculated by applying the appropriate percentage for the year (17% for 1988) to the lesser of $250 and the individual's total gifts for the year. To that amount is added 29% (the highest percentage referred to in subsection 117(2)) of the amount of an individual's total gifts for the year in excess of $250.

New subsection 118.1(4) (formerly subsection 110(1.2)) provides special rules allowing certain gifts made in the year of death to be treated as having been made in the preceding taxation year. Subsection 118.1(5) (formerly subsection 110(2.1)) provides rules treating gifts by will as having been made in the year of death. Subsection 118.1(6) (formerly subsection 110(2.2)) provides rules allowing for an elected amount between a taxpayer's adjusted cost base of a gift of capital property and the fair market value of the property to be considered as the amount of the gift and the proceeds of disposition of the property. Subsection 118.1(7) (formerly subsection 110(2.3)) provides a similar rule dealing with gifts by an artist of his own works. Subsection 118.1(8) (formerly subsection 110(5)) provides a special rule concerning gifts made by a partnership.

New subsection 118.1(9) (formerly subsection 110(3)) of the Act provides rules dealing with donations to U.S. charities made by a Canadian resident working in the United States.

There have been no substantive changes to the general scheme of charitable donations apart from those specifically mentioned above.

Medical Expenses

ITA
118.2

New section 118.2 of the Act provides for the amount which may be deducted from tax payable in respect of medical expenses for the 1988 and subsequent taxation years. Subsection 118.2(1) provides the formula for calculating this tax credit. The credit is determined by applying the appropriate percentage (17% in 1988) to the amount obtained by subtracting the lesser of $1,500 and 3% of the individual's income for the year from the total medical expenses of the individual for the year. The medical expenses must be proven by filing receipts therefor, must not have been previously included in determining a deduction for medical expenses and must be paid, where the individual dies in the year, within any period of 24 months that includes the date of death and, in any other case, within any 12 month period ending in the year.

New subsection 118.2(2) of the Act sets out the various expenses that are considered qualifying medical expenses. These expenses were formerly listed in subparagraphs 110(1)(c)(iii) to (xvi) of the Act. There has been no substantive change to the qualifying expenses, apart from the change in the minimum age of the full-time attendant referred to in clause 118.2(2)(e)(ii)(B), formerly subclause 110(1)(c)(iv.1)(B)(II), from 21 years of age to 18 years of age. This is consequential upon the general recognition of age 18 as the age of majority for tax purposes and, in these circumstances, the change is relieving in nature.

New subsection 118.2(3) of the Act (formerly subsection 110(6)) allows certain employee benefits in respect of medical services to qualify as medical expenses. Subsection 118.2(4), (formerly subsection 110(1.1)) allows the costs of certain travelling expenses to qualify as medical expenses. There have been no substantive changes to these subsections.

Mental or Physical Impairment

ITA
118.3

New subsection 118.3(1) of the Act provides the formula for calculating the tax credit for an individual with a mental or physical impairment, and the conditions for entitlement to the deduction. The conditions of entitlement to the credit have not been changed from those formerly contained in paragraph 110(1)(e), except for the fact that optometrists will now be authorized to certify sight impairment. The tax credit amount for 1988 is $550 determined by multiplying $3,236 by the appropriate percentage (17% in 1988).

New subsection 118.3(2) of the Act, which provides for criteria entitling an individual to a tax credit in respect of a dependant with an impairment, replaces the provisions of paragraph 110(1)(e.1). Subsection 118.3(2) expands the scope of the tax credit by including as eligible dependants those persons in respect of whom the individual could have claimed a deduction under paragraph 118(1)(b) (equivalent-to-married credit) if he were not married and the person were the individual's parent, grandparent, child or grandchild and had no income for the year.

While former paragraph 110(1)(e.1) provided for a deduction of the amount by which $2,860 exceeded the dependent person's taxable income, new subsection 118.3(2) provides for a tax credit of the amount by which the amount deductible under 118.3(1) in computing the person's tax payable exceeds the amount that would, but for subsection 118.3(1), be the dependent person's tax payable for the year.

New subsection 118.3(3) of the Act deals with the allocation of the disability tax credit where more than one individual is entitled to the credit in respect of the same dependant. This provision was formerly contained in subsection 110(7). There has been no substantive change to this provision.

Nature of Impairment

ITA
118.4

New section 118.4 of the Act provides a definition of impairment for the purposes of the medical expense and mental or physical impairment tax credits in sections 118.2 and 118.3. Subsection 118.4(1) reintroduces the definition that was formerly provided in subsection 110(1.3).

New subsection 118.4(2) of the Act defines a medical doctor, medical practitioner, dentist, pharmacist, nurse or optometrist as a person authorized to practice as such pursuant to the laws of the jurisdiction in which the service is rendered, pursuant to the laws of a province or of the jurisdiction in which an authorizing certificate is issued or, in respect of the issuance of a prescription, pursuant to the laws of a province or the jurisdiction in which the taxpayer resides or of the jurisdiction in which the prescription is filled.

Tuition

ITA
118.5

New section 118.5 of the Act provides for the tax credit in respect of tuition fees for the 1988 and subsequent taxation years.

New paragraph 118.5(1)(a) of the Act provides for a tax credit in respect of tuition fees paid to an educational institution in Canada. It contains the same conditions as were formerly in paragraph 60(f) except that only fees paid to a university, college or other educational institution providing courses at a post-secondary school level, or an institution certified by the Minister of Employment and Immigration, will now qualify for the tax credit under this paragraph. The deduction itself is determined by applying the appropriate percentage (17% in 1988) to the eligible tuition fees paid in the year where the total of such fees paid to a qualified institution exceeds $100.

New paragraph 118.5(1)(b) of the Act provides for a tax credit in respect of fees paid by a full-time student enrolled at a university outside Canada of an amount determined by applying the appropriate percentage (17% for 1988) to the amount of eligible tuition fees paid in the year. The restrictions of former paragraph 60(e), which previously allowed for a deduction in computing income in respect of such fees, are included in paragraph 118.5(1)(b).

New paragraph 118.5(1)(c) of the Act provides for a tax credit in respect of fees paid by a Canadian resident who commuted to an educational institution providing courses at the post-secondary level in the United States, of an amount determined by applying the appropriate percentage (17% for 1988) to the eligible tuition fees paid in the year, if such fees exceed $100. The restrictions of former paragraph 60(g), which previously allowed a deduction computing income in such circumstances, are included in paragraph 118.5(1)(c).

New subsection 118.5(2) of the Act provides that, where a foreign service officer or other individual is deemed by section 250 to be resident in Canada for all or part of a taxation year, paragraph 118.5(1)(a) shall be read without reference to the words "in Canada" for purposes of computing a tax credit in respect of eligible tuition fees under subsection 118.5(1) for the period of deemed residence.

Definitions of Educational
Institution

ITA
118.6

New section 118.6 of the Act provides definitions for purposes of determining eligibility for the education credit, and the formula for calculating the amount for the 1988 and subsequent taxation years.

Subsection 118.6(1) of the Act provides for the definitions "designated educational institution" and "qualifying educational program." These definitions were formerly provided in paragraphs 110(9)(a) and (b) respectively. There have been no substantive changes to these definitions.

New subsection 118.6(2) of the Act provides the formula for the calculation of the education credit. The amount of this credit is determined by multiplying the appropriate percentage (17% for 1988) by $60 and by the number of months in the year during which the individual was a student in full-time attendance in a qualifying educational program at a designated educational institution. The education deduction in computing taxable income was formerly provided in paragraph 110(1)(g). The restrictions previously contained in that paragraph are included in subsection 118.6(2), namely, that the enrollment must be proven by filing a certificate issued by the educational institution and that, where the student is enrolled at an institution certified by the Minister of Employment and Immigration, the purpose of the enrollment is to obtain or improve skills for an occupation.

Unemployment Insurance Premiums
and Canada Pension Plan
Contributions

ITA
118.7

New section 118.7 of the Act provides the formula for calculating an individual's tax credit for the 1988 and subsequent taxation years in respect of unemployment insurance premiums and Canada Pension Plan contributions. The amount of the tax credit is determined by multiplying the appropriate percentage (17% in 1988) by the total of amounts which are payable by the individual in respect of employee's premiums under the Unemployment Insurance Act, 1971, employee's contributions under the Canada or Quebec Pension Plan and amounts payable by the individual as a contribution under the Canada or Quebec Pension Plan in respect of self-employed earnings.

The deductions previously available in computing taxable income in respect of these amounts were formerly contained in paragraphs 8(1)(k) and (l) and 60(h) of the Act.

Transfer of Unused
Credits to Spouse

ITA
118.8

New section 118.8 of the Act governs the transfer to a spouse of certain unused tax credits for the 1988 and subsequent taxation years. The credits which may be transferred are the tuition fee and education credits (up to a maximum of $600) and the age, pension and mental or physical impairment credits. The amount which may be transferred is the excess of the total of the transferable amounts over the spouse's tax payable before claiming any of those credits.

Transfers to
Supporting Person

ITA
118.9

New section 118.9 of the Act governs the transfer for the 1988 and subsequent taxation years of certain amounts in respect of the tuition fee and education credit of an individual to the parent or grandparent of that individual.

Where the individual was in full-time attendance at any time in the year at a designated educational institution and no tax credit was claimed by the individual's spouse in respect of the individual as a dependant under section 118 or by way of the transfer of unused credits permitted by section 118.8, the parent or grandparent of the individual may deduct, up to a maximum of $600, the excess of those credits over the student's tax payable determined before claiming those credits.

Enrollment at the educational institution must be proven by filing a certificate issued by the institution and, where the institution is certified by the Minister of Employment and Immigration, the individual must have enrolled to obtain or improve skills in an occupation.

New subsection 118.9(2) of the Act provides that, where a parent or grandparent has claimed the individual as a dependant under section 118, that parent or grandparent is the only person entitled to make a claim under subsection 118.9(1). In any other case, the individual must designate the parent or grandparent who will be the person entitled to the transfer of the credit.

Individual Resident in Canada for Part of the Year

ITA
118.10

New section 118.10 of the Act provides the same treatment in respect of the new deductions from tax payable as does existing section 114 in respect of deductions from income. An individual who is resident in Canada for part of the year and for the other part of the year was not resident, not employed and not carrying on business in Canada, may deduct such part of the credits with respect to charitable donations, medical expenses, tuition fees, education, unemployment insurance premiums and C/QPP contributions as may reasonably be considered wholly applicable to the individual for the period of residence in Canada. He will also be allowed such part of the amounts under the personal and mental or physical impairment credits and the transfer of unused credits to a spouse or supporting person as may reasonably be considered applicable to the individual for the period of residence in Canada.

Ordering of Credits

ITA
118.11

Section 118.11 provides that the provisions governing the new tax credits shall be applied in the following order (all before the dividend tax credit) for the 1988 and subsequent taxation years :

- the married, equivalent-to-married, single and dependant tax credits
- the age credit
- the unemployment insurance and Canada and Quebec Pension Plan credits
- the pension credit
- the disability credit
- the tuition fees credit
- the education credit
- the transfer of the tuition fee and education credits
- the transfer of the spouse's credits

Credits in Separate Returns

ITA
118.12

New section 118.12 of the Act provides that where a separate return of income for an individual is filed under subsection 70(2), 104(23) or 150(4) for a period and another return under Part I is filed for a period ending in the calendar year in which the period covered in the separate return ends, the combined amounts deducted in respect of the pension, charitable donation, medical expenses, mental or physical impairment, tuition fees and education credits and the transfer of unused credits to a spouse or supporting person cannot exceed the amount that would be deducted under those provisions if no separate return were filed. This section applies for the 1988 and subsequent taxation years and parallels the treatment contained in existing section 114.2 concerning deductions from income.

Tax Payable by Non-Resident

ITA
118.13

New section 118.13 of the Act provides that a non-resident individual is not entitled to certain of the new personal tax credits, except where all or substantially all of the individual's income for the year is included in computing his taxable income earned in Canada for the year. In this situation, he may deduct such amounts in respect of the personal credits, the medical expenses, deemed medical expenses, tuition fees, education, U.I. and C.P.P. credits, and the transfer of unused credits to a spouse or supporting individual as would be deductible had the individual been resident in Canada throughout the year. This rule, which is effective for the 1988 and subsequent taxation years, conforms to the existing rule in subsection 115(1) of the Act.

Clause 77

Block Averaging

ITA
119

Section 119 of the Act provides for a five-year block averaging for farmers and fishermen.

Subclause 77(1)

ITA
119(1)(h)

Paragraph 119(1)(h) is amended to provide that a taxpayer's average tax for all years in the averaging period will be calculated without reference to the minimum tax carryover provided under section 120.2 of the Act. This amendment is applicable to the 1987 and subsequent taxation years.

Subclause 77(2)

ITA
119(4)

Subsection 119(4) of the Act is amended to eliminate block averaging for farmers and fishermen for any five-year block that commences after 1987.

Clause 78

Forward Averaging

ITA
120.1

Section 120.1 of the Act is amended as a result of the elimination of the forward averaging system. This section provides for an addition in computing tax payable where an amount is deducted in computing taxable income as a result of a forward averaging election and, conversely, a deduction in computing tax payable where an amount previously forward averaged is brought back into taxable income. The amendment is consequential on the elimination of the forward averaging system. It also maintains on an optional basis, the three-year carryback mechanism available in respect of deceased taxpayers.

There are, therefore, various options available to the legal representative of an individual with pre-1988 forward averaging amounts who dies after 1987 but before 1998. The legal representative may decide to do nothing with respect to the amounts previously forward averaged, in which case there will be no further tax consequences. He may elect to bring back into the deceased individual's taxable income for the year of death all or part of those amounts, in which case the usual calculations will apply. If such an election is made only in respect of a portion of the previously forward averaged amounts, there will be no further tax consequences on the remainder, unless the legal representative elects to have the three-year carryback apply on the remainder.

These amendments are applicable to elections filed for the 1988 and subsequent taxation years.

Clause 79

Minimum Tax
Carryover

ITA
120.2

Section 120.2 of the Act provides for a deduction in computing a taxpayer's tax payable for a year in respect of minimum tax paid in preceding years where the taxpayer's regular tax payable exceeds his minimum tax liability for the year. The amendments to section 120.2 are consequential on the exclusion of the minimum tax for the year of death and delete the reference to the carryback of minimum tax that was available in the case of deceased taxpayers.

These amendments are applicable to the 1987 and subsequent taxation years.

Clause 80

Inter Vivos Trusts

ITA
122

Subsection 122(1) of the existing Act sets out the rate of federal tax payable by an inter vivos trust at 34%, the top marginal tax rate for individuals. That subsection is amended as a consequence of the lowering of the top marginal tax rate for individuals. Inter vivos trusts are now taxable at the 29% rate.

New subsection 122(1.1) clarifies that inter vivos trusts are not entitled to any of the new personal tax credits provided for in section 118 of the Act.

These amendments are applicable to the 1988 and subsequent taxation years.

Clause 81

Refundable Child
Tax Credit

ITA
122.2

Section 122.2 of the Act provides a refundable tax credit in respect of eligible children of an individual.

Subclause 81(1)

ITA
122.2(1)(a)

Paragraph 122.2(1)(a) provides the maximum amount of the tax credit in respect of an eligible child where an individual's income does not exceed $23,500 or such increased amount as permitted by indexation. This paragraph is amended for 1988 to increase the maximum amount per eligible child to $559 from $524.

Subclause 81(2)

ITA
122.2(2)(a)

Paragraph 122.2(2)(a) defines an eligible child for the purposes of the tax credit in a taxation year as a child in respect of whom the individual is entitled to receive a family allowance under the Family Allowances Act, 1973 in January of the following year or would be so entitled but for the death of the child in the year while resident in Canada. This amendment, effective for the 1988 and subsequent taxation years, expands the definition of eligible child to remove the residency requirement where a child dies in the year and to include a child who attains the age of 18 in a year.

Subclause 81(3)

ITA
122.2(2)(b)(iii)

Paragraph 122.2(2)(b) of the Act defines a supporting person for the purposes of the refundable child tax credit.
Subparagraph 122.2(2)(b)(iii) is amended as a consequence of the conversion of exemptions into tax credits, by deleting the reference to former section 109, which contained the dependent child exemption , and

substituting a reference to new section 118 which contains the dependent child tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 82

Deduction from Tax
Payable where Employment
Outside of Canada

ITA
122.3

An overseas employment tax credit may be claimed under section 122.3 of the Act by individuals resident in Canada who work abroad for at least six consecutive months for a specified employer in connection with a resource, construction, installation, agricultural or engineering project. The credit is based upon the proportion of tax otherwise payable that an individual's qualifying overseas employment income is of his income for the year. For the purpose of this calculation, his income is then reduced by certain deductions, including the $1,000 investment income deduction. Subparagraph 122.3(1)(e)(iii) is amended to delete the reference to former section 110.1 (the investment income deduction), as a consequence of its elimination for the 1988 and subsequent taxation years.

Clause 83

Refundable Federal
Sales Tax Credit

ITA
122.4

Section 122.4 of the Act provides for the refundable federal sales tax credit.

Subclauses 83(1) to (2)

ITA
122.4(1)

Subsection 122.4(1) of the Act provides definitions for the purposes of the refundable sales tax credit provided for in subsection 122.4(3). The definition "eligible individual" for purposes of the federal sales tax credit is amended, effective for the 1988 and subsequent taxation years, to change the age level from 18 to 19 years of age for an individual who is neither married nor a parent to qualify for the credit. The definition "qualified relation" for purposes of the refundable federal sales tax credit is amended by deleting the reference in subparagraph (b)(i) of the definition to a person who claimed an amount under section 109 (the personal exemptions) and inserting a reference to a person who deducted an amount under new section 118 (the personal credits). This amendment is consequential on the conversion of exemptions into tax credits and is effective after 1987.

Subclause 83(3)

ITA
122.4(2)(c)

Subsection 122.4(2) excludes from the definitions "eligible individual" and "qualified relation" individuals who are not resident in Canada. Paragraph 122.4(2)(c) is amended to clarify that only individuals who, at no time in a taxation year after 1987, were resident in Canada will be disqualified under that paragraph.

Subclause 83(4)

ITA
122.4(3)

Subsection 122.4(3) provides for the refundable sales tax credit. This subsection is amended for the 1988 and subsequent taxation years to increase the amount of the refundable sales tax credit from $50 to $70 for an eligible individual, from $50 to $70 for a qualified relation who was the individual's spouse and from $25 to $35 for each other qualified relation of the individual. As well, subparagraph 122.4(3)(d)(iv) is amended by deleting the reference to the personal exemptions in former section 109 and inserting a reference to new section 118. This is consequential on the conversion of personal exemptions into tax credits. Paragraph 122.4(3)(e) is amended to increase the income threshold beyond which the federal sales tax credit is reduced, from $15,000 to $16,000.

Clause 84

Rate for Corporations

ITA
123

Subsection 123(1) of the Act establishes the rate of income tax payable by corporations under Part I of the Act. The amendment to this subsection reduces the corporate tax rate, before the 10% provincial abatement provided under subsection 124(1), to 38%.

This amendment is applicable to taxation years ending after June, 1987 and is intended to supersede the amendments to subsection 123(1) contained in chapter 55 of the Statutes of Canada 1986; however, a transitional provision in subclause 84(2) modifies the effective corporate tax rate for taxation years ending after June, 1987 and commencing before July, 1988. The effect of this transitional provision is to levy a basic corporate tax rate of 46% for the portion of a taxation year which falls before July, 1987, 45% for the portion of a taxation year falling in the period from July, 1987 to June, 1988, and 38% for the portion of a taxation year falling after June, 1988. The basic corporate tax rate established by this provision is modified in three specific instances: subparagraph 123(1)(a)(iv) establishes an additional 1% tax on the investment income of Canadian-controlled private corporations for the period from July 1, 1987 to December 31, 1987 (thereby maintaining the basic tax rate on such income at 46% until the beginning of 1988); subparagraph 123(1)(a)(v) establishes an additional 1% tax on taxable capital gains of investment corporations and mutual fund corporations for the period from July 1, 1987 to June 30, 1988 (thereby maintaining the basic tax rate on such gains at 46% until July, 1988); and subparagraph 123(1)(a)(vi) provides a 7% rate reduction in respect of the investment income of Canadian controlled private corporations for the period from January 1, 1988 to June 30, 1988 (thereby establishing an effective federal tax rate on such income at 38% after 1987).

To illustrate the operation of this transitional provision, the following example assumes that a Canadian-controlled private corporation has a fiscal period coinciding with the calendar year and has $100,000 of taxable income in each of its 1987 and 1988 years comprised of $80,000 of business income and $20,000 of investment income. The federal tax payable by the corporation under subsection 123(1) of the Act (i.e., prior to any provincial abatement or small business deduction) would be calculated as follows:

	1987	1988
46% of taxable income times number of days in year before July, 1987 over number of days in year (subparagraph 123(1)(a)(i))	$22,810.96	NIL
45% of taxable income times number of days in year after June, 1987 and before July, 1988 over number of days in year (subparagraph 123(1)(a)(ii))	22,684.93	$22,377.05
38% of taxable income times number of days in year after June, 1988 over number of days in year (subparagraph 123(1)(a)(iii))	NIL	19,103.82
1% of the corporation's investment income for the year times number of days after June, 1987 and before 1988 over number of days in year (subparagraph 123(1)(a)(iv))	100.82	NIL
Deduct:		
7% of the corporation's investment income for the year times number of days after 1987 and before July, 1988 over number of days in year (subparagraph 123(1)(a)(vi))	NIL	696.17
Tax Payable under subsection 123(1)	$45,596.71	$40,784.70

Clause 85

Corporation Surtax

ITA
123.2

Section 123.2 of the Act levies a surtax of 3 per cent of federal income tax payable by corporations other than non-resident-owned investment corporations.

The amount of federal tax subject to the corporate surtax is determined before taking into account a number of deductions in computing tax payable such as foreign tax credits and investment tax credits. The addition of a reference to section 125.2 in new paragraph 123.2(a) of the Act provides that the new Part VI tax credit is also not to be deducted in determining federal tax for purposes of the application of the corporate surtax.

The surtax provided under section 123.2 of the Act does not apply to that portion of the tax payable by a Canadian-controlled private corporation that is included in its refundable dividend tax on hand ("RDTOH") for a taxation year under section 129 of the Act. This amendment is consequential on the reduction in the amount of tax credited to a corporation's RDTOH and applies to the 1988 and subsequent taxation years. A transitional provision applies to corporations with a 1988 taxation year commencing before 1988, and provides that, in computing a corporation's surtax liability, a deduction equal to 1/5 of the amount credited to a corporation's RDTOH - representing the difference between the existing and amended rate at which tax is credited to RDTOH under section 129 - may be claimed in respect of the portion of the year that is before 1988.

Clause 86

Small Business Deduction

ITA
125

Section 125 of the Act establishes the special low rate of tax applicable to the income of a Canadian-controlled private corporation from an active business in Canada. The low rate is provided by way of an annual tax credit (referred to as the "small business deduction") currently equal to 21% of the first $200,000 of such active business income.

Subclause 86(1)

ITA
125(1)

This amendment reduces the small business deduction from 21% to 16%. This change, when taken in conjunction with the corporate tax rate reductions provided in subsection 123(1), results in an effective federal tax rate in respect of income qualifying for the small business deduction of 12% beginning July 1, 1988 (i.e. 28% less 16%).

Subclause 86(2)

ITA
125(1)(b)

Paragraph 125(1)(b) of the Act sets out one of three limitations used in determining the portion of a corporation's income that qualifies for the small business deduction. This limitation ensures that the small business deduction will not be available with respect to any part of a corporation's income which may be considered to have borne foreign tax equivalent to Canadian federal tax and which, therefore, will not give rise to actual Canadian tax liability. For the purposes of subsection 125(1), a corporation's foreign income which is considered not to have borne Canadian federal tax is determined by reference to the corporation's foreign tax credit for the year under section 126 of the Act; under the existing Act, the multiplication factor used under subparagraphs 125(1)(b)(i) and (ii) is based upon an assumed federal tax rate of 40% in respect of non-business income and 50% in respect of business income. This amendment, which is consequential on the reduction in the corporate tax rate under subsection 123(1) to 38%, would base the multiplication factor upon an assumed federal rate of 30% in respect of non-business income and 40% in respect of business income.

Subclause 86(3)

ITA
125(7)(d)(i)

Paragraph 125(7)(d) of the Act provides a definition of a personal services business for the purposes of the small business deduction. Subparagraph 125(7)(d)(i) is amended by deleting the reference to paragraph 8(3)(a.1) relating to the employment expense deduction, which paragraph is repealed as a consequence of the elimination of the $500 employment expense deduction. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 87

Deduction from Corporate Tax:
Manufacturing and Processing

ITA
125.1

Section 125.1 of the Act provides a reduced rate of corporate tax on Canadian manufacturing and processing profits.

Subclause 87(1)

ITA
125.1(1)

This amendment to subsection 125.1(1) reduces to 5% the tax credit applicable to manufacturing and processing profits that do not qualify for the small business deduction under subsection 125(1), and repeals the manufacturing and processing tax credit in respect of income that is eligible for the small business deduction. Subject to the transitional provision contained in subclause 87(3) and described below, this amendment will operate in conjunction with the corporate rate reductions provided by the amendments to subsection 123(1) to reduce the federal rate of tax on manufacturing and processing profits not eligible for the small business deduction to 23%.

This amendment also modifies the multiplication factor used in new subparagraph 125.1(1)(b)(ii) of the Act (clause 125.1(1)(a)(ii)(C) of the existing Act) for the purposes of determining the foreign business income component of a corporation's taxable income. The new factor is based upon an assumed 40% federal tax rate in respect of foreign business income.

Subclause 87(2)

ITA
125.1(2)

This amendment repeals subsection 125.1(2) of the Act, which is a transitional provision relating to the determination of a corporation's manufacturing and processing profits qualifying for the tax credit under former paragraph 125.1(1)(b) in respect of the 1973, 1974, 1975 and 1976 taxation years. The amendment is applicable to the 1987 and subsequent taxation years.

Subclause 87(3)

This sets out the effective date for the amendments to subsection 125.1(1) of the Act, and contains a transitional provision pertaining to taxation years ending after June, 1988 and commencing before July, 1991. The effect of this transitional provision is to:

- maintain a 7% manufacturing and processing tax credit (in respect of income not qualifying for the small business deduction) for the portion of a taxation year which falls before July, 1988 (paragraph 125.1(1)(a));

- provide a 2% tax credit for the portion of a taxation year falling between July 1, 1988 and June 30, 1989 (paragraph 125.1(1)(b));

- provide a 3% tax credit for the portion of a taxation year falling between July 1, 1989 and June 30, 1990 (paragraph 125.1(1)(c));

- provide a 4% tax credit for the portion of a taxation year falling between July 1, 1990 and June 30, 1991 (paragraph 125.1(1)(d)); and

- provide a 5% tax credit for the portion of a taxation year falling after June, 1991 (Paragraph 125.1(1)(e)).

In addition, paragraph 125.1(1)(f) maintains the 5% tax credit in respect of manufacturing and processing profits qualifying for the small business deduction for the portion of a taxation year which falls before July, 1988; it should be noted that subclause 46(3) of chapter 55, Statutes of Canada 1986 will also apply to provide an additional 1% tax credit in respect of such income for the same period.

Clause 88

Part VI
Capital Tax Credit

ITA
125.2

Part VI of the Act levies a tax on capital employed in Canada by large financial institutions. For the 1988 and subsequent taxation years this tax will no longer be deductible under paragraph 20(1)(nn) of the Act in computing the financial institution's income, but rather will be creditable against the institution's tax payable under Part I of the Act under new section 125.2.

Under new subsection 125.2(1) a financial institution may deduct in computing its tax payable under Part I of the Act for a taxation year its Part VI tax liability for the year and also such amount as it chooses of its unused Part VI tax credits for the 7 preceding and 3 following taxation years.

New paragraph 125.2(2)(a) provides that unused Part VI tax credits must be utilized in the order they arose. For example, an unused Part VI tax credit for the 1989 taxation year must be claimed before a 1990 unused Part VI tax credit on either a carry-back or carry-forward of those amounts. New paragraph 125.2(2)(b) ensures that an unused Part VI tax credit applied in a taxation year may not be claimed again in a subsequent year.

New subsection 125.2(3) defines the term "unused Part VI tax credit" for purposes of the Part VI tax credit carryover. A corporation's unused Part VI tax credit for a taxation year is the amount of the corporation's Part VI tax for the year that is not deductible in that year under section 125.2.

New section 125.2 applies in computing tax payable for the 1988 and subsequent taxation years, except that no amount may be carried forward from the 1987 or a preceding taxation year as an unused Part VI tax credit. Part VI tax paid for those earlier years may be claimed as a deduction in computing income for those years.

Clause 89

Foreign Tax Deduction

ITA
126

Section 126 of the Act provides rules pursuant to which a taxpayer may deduct from his tax otherwise payable under Part I of the Act, amounts in respect of foreign taxes paid by him.

Subclauses 89(1) to (3)

ITA
126(1), (2.1) and (3)

These subclauses contain consequential amendments to subclauses 126(1)(b)(ii)(A)(III) and 126(2.1)(a)(ii)(A)(III) and subparagraph 126(3)(b)(iii) of the Act, which set out rules with respect to the foreign tax credit. These amendments are consequential on the elimination of the $1,000 interest and dividend income deduction and are applicable to the 1988 and subsequent taxation years.

Subclauses 89(4) and (6)

ITA
126(7)(d)(i) to (iii)

Paragraph 126(7)(d) of the Act defines the "tax for the year otherwise payable" under Part I for the purposes of determining a taxpayer's foreign tax credit under section 126. The amendment to subparagraph 126(7)(d)(i), which defines the amount of "tax for the year otherwise payable" for the purpose of determining a taxpayer's non-business income foreign tax credit, deletes the reference to repealed subparagraphs 123(1)(c)(i) and (ii) and removes the requirement that a taxpayer's tax otherwise payable be determined as if the 10 per cent provincial abatement under section 124 applied in respect of all taxable income.

The amendment to subparagraphs 126(7)(d)(ii) and (iii), which define the amount of "tax for the year otherwise payable" for the purpose of determining a taxpayer's business income foreign tax credit, deletes the references to repealed paragraphs 123(1)(c) and (d).

These amendments are applicable to the 1987 and subsequent taxation years, except that for taxation years ending after 1986 and beginning before July, 1988:

(a) for the purpose of determining a corporation's non-business income foreign tax credit, its tax otherwise payable under subparagraph 126(7)(d)(i) is to be computed as though the 1% "investment income tax" under subparagraph 123(1)(a)(iv) of the Act applied to all of its taxable income; and

(b) for the purpose of determining a corporation's business income foreign tax credit, its tax otherwise payable under subparagraphs 126(7)(d)(ii) and (iii) is to be computed without reference to subparagraphs 123(1)(a)(iv), (v) and (vi) of the Act, all of which pertain to non-business income sources.

Clause 90

Investment Tax Credit

ITA
127(5) to (12.3) and (17)

Subsections 127(5) to (12.3) and (17) of the Act provide rules relating to the deductibility from tax otherwise payable under Part I of the Act of the investment tax credit (ITC) of a taxpayer.

Subclause 90(1)

ITA
127(5)

Subsection 127(5) provides for the deduction of the investment tax credit of a taxpayer from his tax otherwise payable for a taxation year. This subsection is amended to introduce an annual limit on the amount of investment tax credit which may be deducted in a year by the taxpayer. This limit is defined in subsection 127(9) as the taxpayer's "annual investment tax credit limit" for the year. As well, with the introduction of the new limit, the former limit which applied only in respect of investment tax credits earned before April 20, 1983 is repealed. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 90(2)

ITA
127(8)

Subsection 127(8) of the Act provides for the allocation of the ITC of a partnership to its partners. This subsection is amended to exclude from this allocation to a "specified member" of a partnership any ITC earned in respect of R&D expenditures made by the partnership. The expression "specified member" is defined in subsection 248(1) of the Act and includes any member of a partnership who is a limited partner or who is neither actively engaged in the partnership activities nor otherwise engaged in a similar business to that carried on by the partnership.

This amendment is applicable with respect to expenditures made after December 15, 1987 except that, in respect of a member of a partnership who acquired his partnership interest before December 16, 1987, or after December 15, 1987

(a) pursuant to an obligation in writing entered into before December 16, 1987,

(b) and before June 1, 1988 pursuant to the terms of a prospectus, preliminary prospectus, registration statement or offering memorandum filed with a public authority before December 16, 1987, or

(c) and before June 1, 1988 pursuant to the terms of an offering memorandum distributed as part of an offering of securities which contained a substantially complete description of the securities, was distributed before December 16, 1987, and in respect of which solicitations were made before December 16, 1987,

this amendment is not applicable in respect of expenditures made before December 16, 1987 or after December 15, 1987 and before 1989 pursuant to a written obligation entered into before December 16, 1987 or pursuant to a prospectus, preliminary prospectus, registration statement or offering memorandum filed with a public authority before December 16, 1987, or an offering memorandum described in (c).

Subclause 90(3)

ITA
127(9)

"Annual Investment Tax Credit Limit"

Subsection 127(9) provides a number of definitions in respect of the investment tax credit. This subsection is amended by adding the definition of a taxpayer's "annual investment tax credit limit" for a taxation year. This term is used in subsection 127(5) in determining the amount of investment tax credit which may be deducted by a taxpayer in a year.

The annual investment tax credit limit for a year for a corporation represents all of its tax otherwise payable for the year under Part I of the Act (exclusive of surtax) on its income eligible for the small business deduction plus 3/4 of the remainder of its tax otherwise payable under that Part. The new provision defines the limit as 3/4 of a corporation's tax otherwise payable plus 3% of its small business income for the year (based upon a 12% small business tax rate).

The annual investment tax credit limit for an individual is $24,000 plus 3/4 of the amount by which the taxpayer's tax otherwise payable for the year under Part I of the Act exceeds $24,000. An individual's surtax for a year is payable under Part I.1 of the Act and, therefore, the investment tax credit provisions in this respect are dealt with under that Part by way of an amendment to section 180.1.

The introduction of an annual investment tax credit limit is applicable to the 1988 and subsequent taxation years. However, the annual investment tax credit limit of a taxpayer for a taxation year which straddles January 1, 1988 is increased to allow the taxpayer to deduct investment tax credits to fully offset that portion of the tax otherwise payable for the year that, on a pro-rata basis, may be considered to be in respect of the period before January 1, 1988. Similarly, the reference to 3% (1/4 of 12%) of the tax otherwise payable on the income of a corporation eligible for the small business deduction is adjusted to take into account the phase-down of the small business tax rate from 15% to 12% and the elimination of the small business manufacturing and processing profits deduction.

Subclause 90(4)

"Certified Property"

The definition of "certified property", which applies for the purposes of the special investment tax credit, is amended as a consequence of the reduction of the rate of the special investment tax credit from 40% to 30% for qualifying property acquired after 1988. This amendment is applicable to the 1988 and subsequent taxation years.

Subclauses 90(5) to (10)

"Investment Tax Credit"

The definition of "investment tax credit" in subsection 127(9) of the Act provides for a three-year carry-back and a seven-year carry-forward of unused investment tax credits earned in a taxation year. Subclauses 90(5) to (10) amend this definition to extend the carry-forward period from seven years to ten years for investment tax credits earned after April 19, 1983.

Subclauses 90(11) to (14)

"Specified percentage"

The definition of "specified percentage" in subsection 127(9) of the Act sets out the relevant rates at which investment tax credits are earned in different circumstances. The rate of the investment tax credit generally applicable in Atlantic Canada is reduced from 20% to 15% for qualified property acquired after 1988. The rate of the special investment tax credit in respect of certified property is reduced from 40% to 30% for such property acquired after 1988, and of the Cape Breton investment tax credit is reduced from 60% to 45% for approved project property acquired after 1988 and before the expiry of the program. These amendments are applicable to the 1988 and subsequent taxation years.

Subclause 90(15)

ITA
127(11.2)

Subsection 127(11.2) of the Act provides an extended carry-forward period of 10 years in respect of the Cape Breton investment tax credit. With the extention of the carry-forward period for all investment tax credits to 10 years, this subsection is no longer necessary. Accordingly, subsection 127(11.2) is repealed for the 1988 and subsequent taxation years.

Subclause 90(16)

ITA
127(13) to (16)

Subsections 127(13) to (16) of the Act, relating to the employment tax credit, are repealed. This credit, and more specifically its carryover, is no longer available after 1987. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause (17)

ITA
127(17)

Paragraph 127(17) of the Act defines the "tax otherwise payable" of a taxpayer for a taxation year for the purposes of the taxpayer's investment tax credit and other tax credits, such as the logging tax credit, the deduction of which is provided for under section 127. This definition is amended to require that a taxpayer claim all other tax credits provided for in section 127 before calculating his investment tax credit for the year, and that he claim all credits provided for under section 127 before deducting his minimum tax carry-over in the year. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 91

Refundable Investment
Tax Credit

ITA
127.1

Section 127.1 of the Act provides for the refundability of certain investment tax credits.

Subclause 91(1)

ITA
127.1(1)

Subsection 127.1(1) provides that, where a taxpayer files a prescribed form with his return of income for a taxation year, he shall be deemed to have paid on account of his tax under Part I of the Act an amount equal to his refundable investment tax credit for the year. The effect of the existing provision is to require a taxpayer, who wishes to claim a refundable ITC, to claim the full amount of his refundable ITC. The amendment to subsection 127.1(1) allows a taxpayer to elect to receive a partial refund of his refundable ITC. This amendment is applicable to the 1983 and subsequent taxation years.

Subclauses 91(2) to (5)

ITA
127.1(2)

"Refundable Investment Tax Credit"

The definition of "refundable investment tax credit" in subsection 127.1(2) of the Act is amended to extend refundability indefinitely in respect of qualifying corporations, individuals and certain trusts, as well as to terminate refundability in respect of any other taxpayer for acquisitions and expenditures made after 1987 and for qualified Canadian exploration expenditures made in taxation years commencing after 1987. Refundability had been scheduled to terminate at the end of 1988, and for taxation years commencing after 1988 in respect of qualified Canadian exploration expenditures, for all taxpayers. Accordingly, in paragraph (a) of this definition, which applies in respect of qualifying corporations, individuals and certain trusts, the requirement that an acquisition or expenditure be made before 1989, or in a taxation year commencing before 1989 in respect of qualified Canadian exploration expenditures, is eliminated. In paragraph (b) of this definition, which applies in respect of any other taxpayer, this requirement is amended to extend refundability only for credits earned in respect of an acquisition or expenditure made before 1988, or in a taxation year commencing before 1988 in the case of qualified Canadian exploration expenditures.

With the exception of the amendments to paragraph (a) of the definition of "refundable investment tax credit", these amendments are applicable after June 17, 1987. The amendment to paragraph (a) of the definition of "refundable investment tax credit" is applicable after May 23, 1985 because, in addition to the changes outlined above, the changes to this paragraph also correct a technical difficulty with clause (iv)(B) of this paragraph that applies in respect of members of a partnership. This clause currently includes in such a taxpayer's refundable ITC amounts in respect of acquisitions and expenditures made "by him". However, where the taxpayer is a member of a partnership, it is the partnership which makes the acquisition or expenditures, not the partner. Accordingly, the requirement that the acquisition or expenditures be made by the member is deleted.

Clause 92

Share-Purchase Tax Credit

ITA
127.2(6)(b)(ii)

Paragraph 127.2(6)(b) of the Act defines the unused share purchase tax credit of a taxpayer for a taxation year. The amendment to this paragraph clarifies the treatment of the carry-forward of unused share-purchase tax credits where the credit is available in a year in which the taxpayer has a minimum tax liability.
Subparagraph 127.2(6)(b)(ii) is amended to clarify that, in such a situation, the applicable amount for calculation of his unused share-purchase tax credit is the amount, if any, by which his tax otherwise payable under Part I exceeds his minimum tax for the year. This amendment is applicable to the 1986 and subsequent taxation years.

Clause 93

Scientific Research and
Experimental Development
Tax Credit

ITA
127.3(2)(b)(ii)

Paragraph 127.3(2)(b) of the Act defines the unused scientific research tax credit of a taxpayer for a taxation year. The amendment to this paragraph clarifies the treatment of the carry-forward of unused scientific research and experimental development tax credits where the credit is available in a year in which the taxpayer has a minimum tax liability. Subparagraph 127.3(2)(b)(ii) is amended to clarify that, in such a situation, the applicable amount for the calculation of a taxpayer's unused scientific research and experimental development tax credit is the amount, if any, by which his tax otherwise payable under Part I exceeds his minimum tax for the year. This amendment is applicable to the 1986 and subsequent taxation years.

Clause 94

Minimum Tax

ITA
127.51

Section 127.51 of the Act provides for the calculation of an individual's minimum tax for the year. This section is amended as a result of the conversion of exemptions into tax credits. An individual's minimum tax for a taxation year will now be determined in accordance with the formula:

$$A (B - C) - D$$

where A is the appropriate percentage (17%); B is his adjusted taxable income determined in accordance with the rules providing for the minimum tax; C is his basic minimum tax exemption for the year and D is his basic tax credit for the year determined under new section 127.531. Prior to the conversion from exemptions to credits, the basic tax credit for the year would have been available as a deduction in calculating the individual's adjusted taxable income (i.e. the amount referred to as "B").

This amendment is applicable to the 1988 and subsequent taxation years.

Clause 95

Minimum Tax - Adjusted Taxable Income

ITA
127.52

Section 127.52 defines the "adjusted taxable income" of an individual for a taxation year for the purposes of determining his minimum tax liability under Division E.1 of the Act. The adjusted taxable income is calculated on the basis of the various assumptions set out in paragraphs (a) to (j) of subsection (1) thereof.

Subclause 95(1)

ITA
127.52(1)(d)

Paragraph 127.52(1)(d) is being amended as a consequence of the changes to the inclusion rate for capital gains and losses of individuals. Paragraph 127.52(1)(d) provides that, for the purposes of computing the adjusted taxable income of an individual for a year, sections 38 and 41, which calculate the individual's taxable capital gain, allowable capital loss, allowable business investment loss and taxable net gain on listed personal property, are to be read without references to the words "1/2 of". Paragraph 127.52(1)(d) is being amended for the 1988 and subsequent taxation years to require sections 38 and 41 to be read without reference to the fractions set out therein.

Subclause 95(2)

ITA
127.52(1)(g)(ii)

Subparagraph 127.52(1)(g)(ii) of the Act provides that, for the purposes of computing the adjusted taxable income of a trust for a year, the non-taxable portion of certain net taxable capital gains of the trust is to be deducted. These net taxable capital gains are those designated by the trust under subsection 104(21) of the Act, those included by virtue of subsection 104(13) or section 105 of the Act in the income of a non-resident beneficiary of the trust and those paid to a beneficiary by a trust governed by an employee benefit plan.
Subparagraph 127.52(1)(g)(ii) is being amended to provide that only 1/2 of such net taxable capital gains will be deducted by the trust in its 1988 and 1989 taxation years and only 1/3 of such net taxable capital gains in its 1990 and subsequent taxation years.

Subclause 95(3)

ITA
127.52(1)(h)

As a consequence of the introduction of the capital gains exemption available on the disposition of qualified small business corporation shares, paragraph 127.52(1)(h) of the Act is amended to add thereto a reference to subsection 110.6(2.1) of the Act. This ensures that any 110.6(2.1) deduction claimed by the individual with respect to qualified small business corporation shares will reduce adjusted taxable income for the purposes of the minimum tax. In addition, paragraph 127.52(1)(h) is amended as a result of the conversion of personal exemptions and certain other deductions into tax credits. The references to section 109 (personal exemptions), and paragraphs 110(1)(a) to (c), (e) and (g) (charitable donations and other gifts, mental or physical impairment, and education expenses), which have been repealed, are deleted. The deduction of the new credits in computing minimum tax is provided for in new section 127.531.

The amendments to paragraph 127.52(1)(h) are applicable to the 1988 and subsequent taxation years.

Clause 96

Minimum Tax

ITA
127.531

New section 127.531 of the Act is added to the minimum tax provisions in order to determine an individual's basic tax credit for minimum tax purposes as a consequence of the conversion of the personal deductions and exemptions to tax credits. The new section permits an individual to claim a deduction in computing minimum tax in respect of the new personal tax credits to the same extent that the deductions they replace were previously allowed in computing the adjusted taxable income for minimum tax purposes. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 97

Application of Minimum Tax

ITA
127.55

Section 127.55 of the Act, which exempts from the application of minimum tax individuals in certain limited circumstances, is amended to exclude the application of the minimum tax in the year of a taxpayer's death. As a result of this amendment, there is no obligation to pay minimum tax in the year in which a taxpayer dies, nor will there by any liability for minimum tax in the 1986 taxation year where the taxpayer died in 1987. This latter provision is relieving and will exempt those who died in 1987 from any minimum tax liability in 1986, the year minimum tax was first imposed.

Clause 98

Bankruptcies

ITA
128(2)(e)

Paragraph 128(2)(e) of the Act provides rules applicable where an individual has become bankrupt and requires the trustee in bankruptcy, on behalf of the individual, to file a return of the individual's income computed as if the individual were not entitled to any deduction in the computation of taxable income other than certain losses carried over from other years. This paragraph is amended, as a consequence of the conversion of personal exemptions to tax credits, to provide also that the individual's tax payable for the year should be calculated as if he were entitled to none of the personal tax credits permitted under new sections 118, 118.1, 118.2, 118.3, 118.6 or 118.9. This amendment is applicable to the 1988 and subsequent years.

Clause 99

Dividend Refund to Private Corporations

ITA
129

Section 129 of the Act provides the mechanism under which a portion of the taxes paid by a private corporation in respect of its investment income (the portion referred to as "refundable dividend tax on hand" or "RDTOH") is refundable to the corporation when dividends are paid to its shareholders. This refundable tax mechanism provides what is generally referred to as "integration" of investment income and seeks to ensure that the total tax paid on investment income and capital gains earned through a Canadian-controlled private corporation and distributed to an individual shareholder approximates the tax that would, but for the capital gains exemption, have been payable if that income were earned directly by the individual. Because individual shareholders may claim a dividend tax credit in respect of tax paid at the corporate level, a corporation's RDTOH is intended to consist of only the portion of corporate tax exceeding that recognized by the dividend tax credit.

The reduction in the corporate tax rate in section 123 of the Act, as well as the reduction in the dividend tax credit which arises from the amendment to paragraph 82(1)(b) of the Act, requires certain amendments to section 129 in order to maintain the integration of the investment income of private corporations.

Subclause 99(1)

ITA
129(1)(a)(i)

Existing subsection 129(1) of the Act permits certain corporations to claim a refund of their RDTOH for a taxation year equal to $1 for every $3 of taxable dividends paid by them in the year. The amendment to subparagraph 129(1)(a)(i) provides that the dividend refund available under subsection 129(1) will be at a rate of $1 for every $4 of taxable dividends paid by the corporation in the year, effective for taxable dividends paid after 1987.

Subclause 99(2)

ITA
129(1.2)

New subsection 129(1.2) of the Act provides an anti-avoidance rule which is designed to prevent a private corporation from structuring arrangements in order to obtain a dividend refund without the related shareholder tax being paid. For example, a private corporation with refundable dividend tax on hand may seek to issue shares with a high redemption price but low paid-up capital to a tax-exempt entity or other corporation that receives ordinary dividends on a non-taxable basis and obtain a dividend refund on the subsequent share redemption.

New subsection 129(1.2) deems a dividend not to be a taxable dividend and denies a dividend refund in respect of that dividend where the following circumstances exist:

- the dividend is paid on a share of a corporation;
- the share (or a substituted share) was acquired by the holder in a transaction or as part of a series of transactions; and
- one of the main purposes of the transaction or the series of transactions was to obtain a dividend refund.

New subsection 129(1.2) is applicable to dividends paid after 4 p.m. Eastern Daylight Saving Time on September 25, 1987 to a person who is exempt from tax or is a corporation other than a private corporation, and to all dividends paid after November 27, 1987.

The rule provided in new subsection 129(1.2) is not intended to interfere with the normal operation of subsection 129(1) as part of the system for integrating the taxes paid on investment income by a private corporation and the taxes paid by the shareholders on its subsequent distribution.

Subclause 99(3)

ITA
129(3)(a)

Subsection 129(3) of the Act defines the refundable dividend tax on hand of a private corporation. The amount added to the RDTOH of a Canadian-controlled private corporation in respect of the tax payable under Part I of the Act for a taxation year on its net investment income is equal to the least of the amounts determined under subparagraphs 129(3)(a)(i) to (iv) for the year. The reduction of the corporate tax rate and of the dividend tax credit requires the refundable portion of tax payable on the investment income of Canadian-controlled private corporations to be reduced in order to maintain the integration of tax paid on such income by these corporations and their shareholders. The amendment to paragraph 129(3)(a) provides that, effective for taxation years beginning after 1987, the addition to refundable dividend tax on hand will be an amount equal to four-fifths of the least of the amounts described in subparagraphs 129(3)(a)(i) to (iv) of the Act.

Subclause 99(4)

ITA
129(3)(a)(ii)(B)

Subparagraph 129(3)(a)(ii) sets out one of the four limitations in determining a corporation's refundable dividend tax on hand for a taxation year. Clause 129(3)(a)(ii)(B) operates to include in a corporation's RDTOH only the amount by which the Canadian federal tax payable on foreign investment income - which, under existing clause 129(3)(a)(ii)(B), is assumed to be 40% - exceeds the foreign tax credit to which the corporation is entitled under subsection 126(1) of the Act in respect of that income. This amendment, which reduces the assumed rate of federal corporate tax for the purposes of clause 129(3)(a)(ii)(B) to 30%, is consequential on the corporate rate reduction implemented pursuant to amendments to subsection 123(1) of the Act. The amendment is applicable to taxation years ending after June, 1988, subject to a transitional provision set out in clause 99(11) which prorates the 40% and 30% rates based upon the number of days in a taxation year falling before and after the end of June, 1988.

Subclause 99(5)

ITA
129(3)(a)(iii)

Subparagraph 129(3)(a)(iii) of the Act is the third limitation used in determining a corporation's RDTOH for a taxation year. This amendment, which applies with respect to determinations under this subparagraph for taxation years commencing after June, 1988, is intended to achieve three functions: clause (A) substitutes a reference to four times the amount deductible by a corporation under subsection 125(1) of the Act with a reference to the least of the amounts deductible under paragraphs 125(1)(a) to (c), and provides that income eligible for the small business deduction does not qualify for refundable tax treatment under section 129; clause (B) increases from 10/4 to 10/3 the multiplication factor used in determining the amount of a corporation's foreign non-business income in respect of which a foreign tax credit under subsection 126(1) of the Act is available to offset the corporation's Canadian federal tax liability; and clause (C) increases, from 2 to 10/4, the multiplication factor used in determining the amount of a corporation's foreign business income in respect of which a foreign tax credit under subsection 126(2) of the Act is available to offset the corporation's Canadian federal tax liability.

Subclause 99(6)

ITA
129(3)(a)(iv)

Subparagraph 129(3)(a)(iv) of the Act is the fourth limitation used in determining a corporation's RDTOH and is equal to the corporation's net Part I tax liability (exclusive of surtax). It is not intended that this limitation be affected by the amendment to paragraph 129(3)(a) which provides that, for taxation years ending after 1987, a corporation's RDTOH equals 4/5 of the least of the amounts determined under subparagraphs 129(3)(a)(i) to (iv). This amendment, which increases the limitation in subparagraph to 129(3)(a)(iv) to 5/4 of a corporation's Part I tax liability for taxation years commencing after 1987, simply preserves the effective limitation in that subparagraph to an amount equalling a corporation's actual Part I tax.

Subclause 99(7)

ITA
129(3)(e)

The refundable portion of tax payable by a corporation on its investment income is determined by the dividend tax credit. Where a corporation has accumulated RDTOH in respect of investment income earned before 1988, it is necessary to reduce the amount of refundable tax in order to maintain approximately the same rate of tax on such income as if it had been distributed to the corporation's shareholders before the end of 1987. Subsection 129(3) provides for the necessary adjustment to a corporation's RDTOH by reducing the corporation's RDTOH at December 31, 1987 by its "reduction at December 31, 1987 of refundable dividend tax on hand" as determined under new subsection 129(3.5), which is described below.

Subclause 99(8)

ITA
129(3.5)

New subsection 129(3.5) of the Act defines a corporation's "reduction at December 31, 1987 of refundable dividend tax on hand" for the purposes of computing its RDTOH under subsection 129(3) of the Act. The reduction is equal to 1/4 of the amount by which the corporation's RDTOH at the end of its last taxation year beginning before 1988 exceeds the aggregate of:

- any Part IV tax payable by the corporation on dividends received in the year and after 1987,

- 1/3 of any taxable dividends paid by the corporation in the year and before 1988,

- any amount added to the corporation's RDTOH which represents the RDTOH of a subsidiary for a taxation year beginning after 1987, and

- the product obtained by multiplying one-fifth of the least of the amounts determined under subparagraphs 129(3)(a)(i) to (iv) of the Act in respect of the corporation for the year by the proportion of the year that is after 1987.

In effect, subsection 129(3.5) is intended to operate in conjunction with subsection 129(3) to ascertain, and reduce by one-quarter, a corporation's RDTOH as of December 31, 1987 and to provide that refundable dividend tax on hand in respect of investment income earned after 1987 will be accumulated at a rate equal to 20% of such income.

Clause 100

Investment Corporations

ITA
130

An investment corporation is permitted to deduct from its tax otherwise payable on its taxable income, other than its taxed capital gains, an amount which is intended to provide a net tax rate on that income matching the rate of the dividend tax credit provided to its individual shareholders. This special deduction recognizes that investment corporations are required to distribute substantially all of their income, other than net taxable capital gains, to shareholders in the taxation year in which the income is earned.

Subclause 100(1)

ITA
130(1)

The reduction in the dividend tax credit, effective January 1, 1988, would require that this special tax deduction be correspondingly increased; however, the reduction in the basic corporate federal tax rate, effective July 1, 1988, more than offsets the dividend tax credit change and, as a result, it is necessary to reduce this special tax deduction to maintain the integration of tax on investment corporations. This amendment to subsection 130(1) of the Act provides that the deduction from tax otherwise payable by an investment corporation will be reduced to 20 per cent of the amount by which the corporation's taxable income exceeds its taxed capital gains. The amendment is applicable to the 1988 and subsequent taxation years, except that, where a corporation's taxation year overlaps the 1987 and 1988 calendar years, transitional provision increases the deduction to reflect both the higher corporate tax rates which are in effect under subsection 123(1) of the Act prior to July 1, 1988 and the higher dividend tax credit applying before 1988.

Clause 101

Mortgage Investment Corporations

ITA
130.1

Section 130.1 of the Act sets out the special rules that apply to mortgage investment corporations. Such a corporation is essentially treated as a conduit in that its income may be flowed through to its shareholders and taxed in their hands rather than in the hands of the corporation.

Subclause 101(1)

ITA
130.1(1)(a)(ii)

Paragraph 130.1(1)(a) provides for the flow-through of capital gains of a mortgage investment corporation by allowing the corporation a deduction in computing its income in respect of the taxable portion of its capital gains distributed to its shareholders by way of capital gains dividends. In such circumstances, the capital gains of the corporation are taxable to the shareholders as if they had realized the gains directly.

Subparagraph 130.1(1)(a)(ii) is being amended to increase the portion of a capital gains dividend that is deductible under that paragraph from one-half to two-thirds of such dividends paid in taxation years of mortgage investment corporations commencing after June, 1988 and to three-quarters of such dividends paid in taxation years of such corporations commencing after 1989. For taxation years of mortgage investment corporations that straddle any of the effective dates, rules are provided to prorate the relevant deduction rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 101(2)

ITA
130.1(4)(a)(i)

Subsection 130.1(4) contains rules for a mortgage investment corporation making a capital gains dividend election with respect to a dividend paid in the period commencing 91 days after the commencement of a taxation year and ending 90 days after the end of the year.

Paragraph (a) provides that, where such an election has been made, the dividend will be deemed to be a capital gains dividend to the extent that it does not exceed two times the "taxed capital gains of the corporation for the year" minus previous capital gains dividends paid in the year. "Taxed capital gains of a corporation for a year" is defined in paragraph 130(3)(b) as the amount by which its taxable capital gains for the year exceeds the aggregate of its allowable capital losses for the year and the amount deducted under paragraph 111(1)(b) for the year.

Subparagraph 130.1(4)(a)(i) is being amended to reduce the ratio of the corporation's taxed capital gains that are used in calculating the amount on which it can elect a capital gains dividend, from twice to three-halves of such gains for taxation years of mortgage investment corporations commencing after June, 1988 and to four-thirds for taxation years commencing after 1989. For taxation years of such corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Subclause 101(3)

ITA
130.1(4)(b)

Subsection 130.1(4) of the Act provides the rules relating to capital gains dividends for mortgage investment corporations. Provided the corporation so elects, dividends paid by the corporation to its shareholders receive capital gains treatment in the hands of the shareholders. The amendment to paragraph 130.1(4)(b), effective for the 1988 and subsequent taxation years, treats an individual who has received a capital gains dividend as having disposed of capital property, thus ensuring that such dividends are eligible for the lifetime capital gains exemption.

Clause 102

Mutual Fund Corporations

ITA
131

Section 131 of the Act contains special rules relating to the taxation of mutual fund corporations.

Subclause 102(1)

ITA
131(1)(b)

Subsection 131(1) of the Act provides the rules relating to capital gains dividends of mutual fund corporations. It also applies to investment corporations by virtue of subsection 130(2) of the Act. Provided the corporation so elects, dividends paid by the corporation to its shareholders receive capital gains treatment in the hands of the shareholders. The amendment to paragraph 131(1)(b), effective for the 1988 and subsequent taxation years, treats an individual who has received a capital gains dividend as having disposed of capital property, thus ensuring that such dividends are eligible for the lifetime capital gains exemption.

Subclause 102(2)

ITA
131(2)(a)(i)

Subsection 131(2) of the Act provides a mechanism for the determination of a mutual fund corporation's "capital gains refund". Mutual fund corporations are subject to regular corporate tax in respect of their capital gains, but are entitled to a refund of this tax as and when these gains are allocated to shareholders either by way of a capital gains dividend or share redemption.

A mutual fund corporation's capital gains refund for a taxation year is determined by multiplying its capital gains dividends and capital gains redemptions for the year by a rate which is equivalent to the federal tax rate on capital gains (the rate being expressed in subsection 131(2) as a percentage of capital gains rather than taxable capital gains). This amendment increases the rate at which the capital gains refund is made to correspond with the amendments reducing the corporate tax rate under subsection 123(1) of the Act and increasing the taxable portion of capital gains under section 38 of the Act.

This amendment is applicable to taxation years ending after June, 1988, except that for taxation years ending after June, 1988 and before 1990, the capital gains refund rate will be 18 2/3% which reflects the effective federal corporate tax rate applying to capital gains realized during this period.

Subclause 102(3)

ITA
131(5)(a)

Subsection 131(5) of the Act provides that a mutual fund corporation is considered to be a private corporation for certain purposes of the Act, one of which enables it to claim a refund under section 129 of tax paid under Part IV of the Act in respect of its dividend income. Where a mutual fund corporation has accumulated refundable dividend tax on hand in respect of Part IV tax on dividends received in taxation years beginning before 1988, the reduction in the dividend tax credit and the reduction of personal tax rates requires that the corporation's refundable dividend tax on hand be reduced in order to preserve the integration of corporate and individual tax on this income. Provision for this refundable tax reduction is made in new subsection 129(3.5) of the Act and this amendment to subsection 131(5) applies this reduction to the refundable dividend tax on hand of mutual fund corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 102(4)

ITA
131(6)(a)(i)(A)

Paragraph 131(6)(a) of the Act defines the "capital gains redemptions" of a mutual fund corporation for a taxation year.
Clause 131(6)(a)(i)(A) determines the amount of a corporation's previously realized but undistributed capital gains by multiplying the corporation's refundable capital gains tax on hand by the inverse of the federal tax rate applying to such gains. This amendment to that clause changes the multiplication factor from 50/9 to 100/21 to reflect the new effective federal corporate tax rate on capital gains which is attributable to amendments to sections 38 and 123 of the Act. The amendment is applicable to taxation years ending after June, 1988 except that for taxation years ending after June, 1988 and before 1990, the multiplication factor will be 75/14, which is the reciprocal of the effective federal corporate tax rate applying to capital gains realized during this period.

Although the multiplication factor in clause 131(6)(a)(i)(A) of the Act, as amended, is smaller than that in the existing clause -- and will, as a result, understate the amount of a mutual fund corporation's capital gains which were realized before but distributed after the effective date of this amendment - this reduction is offset by the increase in the rate used in subsection 131(2) of the Act to determine the corporation's capital gains refund. Accordingly, a mutual fund corporation will, through capital gains redemptions, be entitled to obtain a refund of its capital gains tax at the same rate as it was originally paid.

Subclause 102(5)

ITA
131(6)(b)(ii)(C)

Paragraph 131(6)(b) of the Act defines the "capital gains dividend account" of a mutual fund corporation. This account is reduced by the amount of any capital gains previously distributed, either by way of capital gains dividends or share redemptions, and the amount of such previously distributed capital gains is calculated by multiplying a mutual fund corporation's capital gains refund for all preceding taxation years by the inverse of the federal tax rate applying to such gains in those years. This amendment reduces the multiplication factor in clause 131(6)(b)(ii)(C) of the Act to reflect the new effective federal corporate tax rate applying to capital gains as a result of the amendments to sections 38 and 123 of the Act. This amendment is applicable to taxation years ending after June, 1988, except that for years ending after June, 1988 and before 1990 the multiplication factor used in determining a mutual fund's previously distributed capital gains will be 75/14 -- the reciprocal of the effective federal corporate tax rate applying to capital gains realized during this period.

Subclause 102(6)

ITA
131(6)(d)(i)

Paragraph 131(6)(d) of the Act defines the "refundable capital gains tax on hand" account of a mutual fund corporation at the end of a taxation year. Existing clause 131(6)(d)(i)(A) limits the amount which is credited to this account for a taxation year to 36% of a mutual fund corporation's taxable income for the year and existing clause 131(6)(d)(i)(B) limits the creditable amount to 36% of the corporation's taxed capital gains for the year (the third limitation, found in clause (C), is the Part I tax payable by the corporation for the year). The 36% rate found in these two clauses is based upon the basic federal corporate tax rate (after the 10% provincial abatement provided in subsection 124(1) of the Act) and this amendment reduces this rate to 28% to correspond with the reduced corporate tax rate established by amendments to subsection 123(1) of the Act. This amendment is applicable to taxation years ending after June, 1988, except that for a taxation year that straddles June 30, 1988, the rate used in the two clauses is increased to reflect the higher federal corporate tax rate that applies for the period before July, 1988.

Clause 103

Mutual Fund Trusts

ITA
132

Section 132 of the Act contains special rules relating to the taxation of mutual fund trusts.

Subclause 103(1)

ITA
132(1)(a)(i)

Subsection 132(1) of the Act provides the mechanism for the determination of a mutual fund trust's "capital gains refund" for a taxation year. A mutual fund trust is subject to the highest personal tax rates, but is entitled to a refund of its capital gains tax as and when these gains are allocated to the trust's unit holders through a redemption.

A mutual fund trust's capital gains refund for a taxation year is determined by multiplying its capital gains redemption for the year by a rate which is equivalent to the trust's tax rate on capital gains (the rate being expressed in subsection 132(1) as a percentage of capital gains rather than taxable capital gains). This amendment to subparagraph 132(1)(a)(i) increases the rate at which the capital gains refund is made to reflect the effect of the amendments increasing the taxable portion of capital gains in section 38 of the Act and reducing the tax rate on <u>inter vivos</u> trusts in section 122 of the Act.

This amendment applies to the 1988 and subsequent taxation years, except that for taxation years ending after 1987 and before 1990 the capital gains refund rate will be set a 19 1/3% to reflect the effective personal tax rate applying to capital gains realized in 1988 and 1989.

Subclause 103(2)

ITA
132(4)(a)(i)(A)

Paragraph 132(4)(a) of the Act defines the "capital gains redemption" of a mutual fund trust for a taxation year. Clause 132(4)(a)(i)(A) determines the amount of a trust's previously realized but undistributed capital gains by multiplying the trust's refundable capital gains tax on hand by the reciprocal of the effective tax rate applying to such gains. This amendment changes the multiplication factor from 100/17 to

100/21.75 to reflect the new effective personal tax rate on capital gains which is attributable to amendments to section 38 and 122 of the Act.

This amendment applies to the 1988 and subsequent taxation years, except that for years ending after 1987 and before 1990 the multiplication factor used in determining a mutual fund trust's previously realized but undistributed capital gains will be 100/19 1/3, which is the reciprocal of the effective personal tax rate applying to capital gains realized in 1988 and 1989.

Subclause 103(3)

ITA
132(4)(b)(i)

Paragraph 132(4)(b) of the Act defines the "refundable capital gains tax on hand" account of a mutual fund trust at the end of a taxation year. Existing clause 132(4)(b)(i)(A) limits the amount which is credited to this account for a taxation year to 34% of a mutual fund trust's taxable income for the year and existing clause 132(4)(b)(i)(B) limits the creditable amount to 34% of the trust's taxed capital gains for the year (the third limitation, found in clause 132(4)(b)(i)(C), is the amount of Part I tax payable by the trust for the year). This amendment reduces this rate to 29% to correspond with the reduced personal tax rates established by amendment to section 122 of the Act. This amendment is applicable to determinations of amounts under clauses 132(4)(b)(i)(A) and (B) in respect of the 1988 and subsequent taxation years.

Clause 104

Non-Resident Owned Investment Corporations

ITA
133

Section 133 of the Act provides rules for the taxation of non-resident owned investment corporations on a basis that approximates the treatment that would apply if its non-resident shareholders had invested directly in Canada.

Subsection 133(1) provides rules for computing the income and taxable income of a non-resident owned investment corporation. The only taxable capital gains and allowable capital losses that are included in computing such a corporation's income are those from dispositions of taxable Canadian property. Paragraph 133(1)(d) includes the full amount of the capital gain or capital loss from those dispositions in the calculation of the corporation's income. This paragraph is amended as a result of the changes to the inclusion rates for capital gains and capital losses of corporations other than Canadian-controlled private corporations.

The ratio of taxable capital gains and allowable capital losses required to be included in computing a non-resident owned investment corporation's income is reduced from twice to three-halves of such taxable capital gains and allowable capital losses for taxation years of the corporation commencing after June, 1988 and to four-thirds for taxation years commencing after 1989. For taxation years of non-resident owned investment corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date. These changes will maintain the current result that, in effect, the full amount of the gain or loss will be taken into account in computing the corporation's income.

Clause 105

Credit Unions

ITA
137

Section 137 of the Act contains special rules relating to the taxation of credit unions.

Subclause 105(1)

ITA
137(1)

Paragraphs 137(1)(a) and (b) allow a credit union to deduct special reserves in lieu of the normal reserve for doubtful debts that is allowed to most other taxpayers under paragraph 20(1)(l). These paragraphs, along with paragraph 137(1)(d) which prohibits a deduction under paragraph 20(1)(l), are repealed for taxation years commencing after June 17, 1987 that end after 1987 since a reserve for doubtful debts will now be determined by a credit union as well as all other financial institutions under paragraph 20(1)(l). Paragraph 137(1)(c), which requires the inclusion in income of the previous year's reserves deducted under paragraphs 137(1)(a) and (b), is repealed applicable to taxation years after the first taxation year that commences after June 17, 1987 and ends after 1987. A special transitional rule exists for paragraph 137(1)(c) for the first taxation year of a credit union that commences after June 17, 1987 and ends after 1987 to reduce the amount to be included in computing the credit union's income by the prescribed amount of its 1971 reserve adjustment as determined under section 8102 of the regulations.

Subclause 105(2)

ITA
137(3)

Subsection 137(3) of the Act provides a special tax credit to enable credit unions to accumulate a reserve in respect of their member's deposits and share contributions. This amendment reduces the tax credit provided in subsection 137(3) from 21% to 16%. In conjunction with the basic corporate tax rate reduction provided by amendments to subsection 123(1) of the Act, the effective federal tax rate on a credit union's income which qualifies for the tax credit under subsection 137(3) will be reduced to 12% before surtax. This amendment is applicable to taxation years ending after June, 1988, except that for such years which commence before July, 1988 a transitional provision set out in subclause 105(5) will maintain the deduction under subsection 137(3) at 21% in respect of the portion of the year which falls before July, 1988.

Subclause 105(3)

ITA
137(4.3)(a)

Paragraph 137(4.3)(a) of the Act defines the "preferred-rate amount" of a corporation at the end of a taxation year. Income qualifying for the small business deduction under section 125 of the Act - which, pursuant to subsection 137(4), includes income qualifying under subsection 137(3) - is intended to be included in a corporation's preferred-rate amount. This amendment increases, from 4 to 25/4, the multiplication factor used in determining the amount of a corporation's income which has qualified under section 125, and is based upon a reduction in the tax credit provided under that section to 16%. This amendment is applicable to taxation years ending after June, 1988, except that a special provision set out in subclause 105(6) applies for the purpose of calculating a corporation's preferred-rate amount for the taxation year immediately preceding its first year ending after June, 1988.

Clause 106

Deposit Insurance Corporations

ITA
137.1

Section 137.1 of the Act sets out special rules relating to the taxation of deposit insurance corporations and their member institutions.

Subclauses 106(1) to (4)

ITA
137.1(1)(b)(iii), (3)(c), (4)(d) and (5)(d)

Paragraph 137.1(3)(c) allows a deposit insurance corporation to deduct a special reserve since paragraph 137.1(4)(d) prohibits the corporation from deducting the normal doubtful debt reserve that is allowed to most other taxpayers under paragraph 20(1)(l) or a reserve under section 33. Paragraphs 137.1(3)(c) and (4)(d), together with paragraph 137.1(5)(d) which defines amortized cost, are repealed for taxation years commencing after June 17, 1987 that end after 1987. As a result, a deposit insurance corporation will now be permitted to claim a reserve for doubtful debts under paragraph 20(1)(l). Subparagraph 137.1(1)(b)(iii), which requires the inclusion in income of the previous year's reserve deducted under paragraph 137.1(3)(c), is repealed applicable to taxation years after the first taxation year that commences after June 17, 1987 and ends after 1987.

Clause 107

Rules Relating to the Taxation of Insurance Corporations

ITA
138

Section 138 of the Act sets out detailed rules relating to the taxation of life insurance corporations.

Subclause 107(1)

ITA
138(3)(a)(ii)

New subparagraph 138(3)(a)(ii) of the Act is consequential on the addition of new paragraph 18(1)(e.1) to the Act. This subparagraph, applicable to taxation years commencing after June 17, 1987 that end after 1987, permits a life insurer to deduct in computing its income for a taxation year a prescribed amount as a reserve in respect of claims under life insurance policies that were received by the insurer before the end of the year and are unpaid at the end of the year. New subsection 1401(4) of the Income Tax Regulations sets out the basis for calculating the prescribed amount and provides for the discounting of such claims.

Subclause 107(2)

ITA
138(3)(a)(iv)

Subparagraph 138(3)(a)(iv) of the existing Act allows a life insurer to accrue and to deduct in computing its income for a taxation year a reserve for policy dividends that will be payable in the following taxation year to the extent that the insurer has undistributed post-1968 income from its participating life insurance business. The maximum amount of this reserve is equal to the least of the following three amounts:

- the amount of policy dividends that will, according to the financial statements of the insurer, become payable by the insurer in the immediately following taxation year under its participating life insurance policies;
- 110% of the aggregate of policy dividends that become payable by the insurer in the immediately following taxation year under its participating life insurance policies; and

- the amount by which the insurer's post-1968 income from its participating life insurance business exceeds the post.1968 deductions claimed by the insurer for policy dividends paid or payable under its participating life insurance policies.

New subparagraph 138(3)(a)(iv) allows a life insurer to deduct in computing its income for a taxation year a reserve for policy dividends that have accrued under participating life insurance policies to or for the benefit of the policyholders. The maximum amount of this reserve is restricted to the least of the following three amounts:

- the portion of policy dividends that has accrued in the year to or for the benefit of participating life insurance policyholders of the insurer to the extent that an amount in respect thereof has not been included, either explicitly or implicitly, in the calculation of the policy reserves of the insurer--clause (A);

- 110% of the amount paid or unconditionally credited in the immediately following taxation year in respect of the portion of accrued policy dividends referred to above--clause (B); and

- the amount by which the insurer's post-1968 income from its participating life insurance business exceeds the post-1968 deductions claimed by the insurer for policy dividends paid, payable or accrued under its participating life insurance policies--clause (C).

The determination of the portion of policy dividends that accrues in an insurer's taxation year is to be made on the basis that policy dividends in respect of a policy accrue in equal daily amounts between anniversary dates of the policy. For example, for a policy with a March 31, 1989 anniversary date issued by an insurer with a calendar year-end, three-quarters of the amount of the policy dividend payable in respect of the policy would be deductible by the insurer in computing its income for its 1988 taxation year.

New subparagraph 138(3)(a)(iv) will provide a better matching of the income and expenses of life insurers since the deduction for policy dividends, which can be considered to be either a distribution of the insurer's earnings or a cost of funds, will be claimable as the income being distributed to the policyholders is earned or as the expense is incurred, as the case may be. The requirement that no amount be provided for, either implicitly or explicitly, in the policy reserves of the insurer in respect of accrued policy dividends ensures that the insurer does not obtain a double deduction in respect of such dividends that have accrued to the end of the year to or for the benefit of its policyholders.

New subparagraph 138(3)(a)(iv) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(3)

ITA
138(3)(c)

Paragraph 138(3)(c) of the Act permits a life insurer to deduct in computing its income for a taxation year an investment reserve calculated on a formula basis. The reserve is discretionary and the maximum amount that may be claimed is calculated as the total of two amounts - the first being 1 1/2% of the first $2 billion of the aggregate of the amortized cost of Canada securities held at the end of the year and any due and unpaid interest in respect of such Canada securities at that time, and the second being 1% of the aggregate of such amounts in excess of $2 billion. For new insurers, full entitlement to this deduction is earned over 3 years.

Paragraph 138(3)(c) is repealed applicable to taxation years commencing after June 17, 1987 that end after 1987. Insurers will be permitted to claim a reserve in respect of doubtful debts under new paragraph 20(1)(l) of the Act in the same manner as other financial institutions. This will provide a more appropriate measure of the income of an insurer since a reserve for doubtful debts will not be calculated on an arbitrary formula basis and will be claimable only when the collection of a debt is established to be doubtful.

Subclause 107(4)

ITA
138(3)(g)

New paragraph 138(3)(g) of the Act provides a deduction in computing a life insurer's income under Part I of the Act for a year from carrying on its life insurance business in Canada equal to the amount of tax payable under new Part XII.3 by the insurer for the year.

New Part XII.3, which is described below, levies a 15% tax on the taxable Canadian life investment income of life insurers, for taxation years commencing after June 17, 1987 and ending after 1987.

Subclause 107(5)

ITA
138(4)(a)

Paragraph 138(4)(a) of the Act requires a life insurer to include in computing its income for a taxation year the policy reserve, policy dividend reserve and investment reserve deducted by it in computing its income for the immediately preceding taxation year. This paragraph is amended in two ways. The first amendment, applicable to taxation years commencing after June 17, 1987 that end after 1987, adds a reference to new subparagraph 138(3)(a)(ii) of the Act which permits the deduction of a reserve for unpaid claims of a life insurer. The second amendment, applicable to taxation years ending after the first taxation that commences after June 17, 1987 and ends after 1987, deletes a reference to paragraph 138(3)(c) of the Act which permits the deduction of an investment reserve of a life insurer and is repealed applicable to taxation years commencing after June 17, 1987 that end after 1987.

The transitional rules dealing with reserves provide that the amount to be included in income under paragraph 138(4)(a) for an insurer's first taxation year that commences after June 17, 1987 and ends after 1987 is to be reduced by the amount of the insurer's 1968 reserve adjustment prescribed under new section 8103 of the Income Tax Regulations.

Subclause 107(6)

ITA
138(4.4) to (4.6)

New subsection 138(4.4) of the Act requires a life insurer to include in computing its income for a taxation year an amount in respect of vacant real property or real property under development. Where a life insurer owns vacant land or alters or constructs a building owned by it for a period in a taxation year and the land or building was property used or held by it in the year in the course of carrying on an insurance business in Canada, subsection 138(4.4) requires a prescribed amount to be added to the insurer's income for the year and to the cost or capital cost of the land or building at the end of the period. New section 2410 of the Income Tax Regulations sets out the basis for calculating the prescribed amount.

New subsection 138(4.5) of the Act is an anti-avoidance rule which prevents a life insurer from transferring or loaning after 1987 any property described in paragraphs 138(4.4)(a) to (d) to a designated corporation or a person or partnership that does not deal at arm's length with the insurer in order to avoid the application of subsection 138(4.4). Where an insurer so transfers or loans property, subsection 138(4.5) provides that subsection 138(4.4) will apply to require an amount to be added to the insurer's income as if the property was owned by the insurer and used or held by it in carrying on an insurance business in Canada. Subsection 138(4.4) will also apply to require that amount to be added to the cost to the insurer of any shares of or interest in the transferee. Alternatively, where the insurer and the transferee have so elected, subsection 138(4.5) will permit that amount to be added to the cost or capital cost to the transferee of the property. An election made under subsection 138(4.5) must be filed no later than the tax return filing due date of any taxpayer making the election for the taxation year that includes the period of time during which the property was property described in paragraphs 138(4.4)(a) to (d) of the transferee.

New subsection 138(4.6) of the Act provides that, for the purposes of subsection 138(4.4), the construction, renovation or alteration of a building is considered to be completed on the day of actual completion or the day on which all or substantially all of the building is used for its intended purpose, whichever is earlier.

New subsections 138(4.4) to (4.6) are applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(7)

ITA
138(5)(a)

Paragraph 138(5)(a) of the Act denies an insurer who is a resident multinational life insurer or a non-resident insurer a deduction under paragraph 20(1)(l) or section 33 of the Act in respect of a premium or other consideration under a life insurance policy in Canada or a Canada security or interest therein. (Life insurers are entitled to claim policy reserves for such premiums and consideration under life insurance policies under subparagraph 138(3)(a)(i) of the Act.) Paragraph 138(5)(a) is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to provide that this paragraph applies to all types of insurers. As well, the reference in paragraph 138(5)(a) to subsection 33(1) is deleted as a consequence of the repeal of that subsection applicable to taxation years commencing after June 17, 1987 that end after 1987 and the reference to a Canada security is deleted. Insurers will be entitled to claim a deduction under new paragraph 20(1)(l) in respect of those Canada securities that are doubtful debts.

Subclause 107(8)

ITA
138(5.2)

New subsection 138(5.2) of the Act denies an insurer a deduction in computing its income for a taxation year from carrying on an insurance business for a "superficial loss" sustained on the sale of a share, bond, debenture, mortgage, note, hypothec, agreement of sale or any other form of indebtedness that was used or held by the insurer in the year in an insurance business. A superficial loss is considered to have been sustained by an insurer on the sale of such property where, within the period commencing 30 days before and ending 30 days after the sale, the insurer or a person or a partnership that does not deal at arm's length with the insurer has acquired or agreed to acquire a "substituted property" which is the same property or a property that is identical to the property that was sold and, at the end of that period, the insurer or the non-arm's length person or partnership owned or had a right to acquire the substituted property. Losses that are denied by subsection 138(5.2) are added in computing the cost of the substituted property to the insurer or the non-arm's length person or partnership. This rule is similar to the superficial loss rule in paragraph 54(i) of the Act that applies to a disposition of capital property. New subsection 138(5.2) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(9)

ITA
138(9)

Subsection 138(9) of the Act requires an insurer who is a resident multinational life insurer or a non-resident insurer to include in computing its income for a taxation year its gross investment revenue derived from property used or held by it in carrying on an insurance business in Canada. For this purpose, section 2400 of the existing Income Tax Regulations provides rules for determining the property of an insurer that is used or held by it in its Canadian insurance businesses. These rules involve the computation of the amount of a Canadian investment fund for the year which represents the total value for the year of investment and non-investment property that must be designated by the insurer as property used or held by it in its Canadian life and other than life insurance businesses. The gross investment revenue and the gains and losses from such property is reported by the insurer as Canadian income. The Canadian investment fund is determined differently for resident multinational life insurers and non-resident insurers but is intended in each case to provide a reasonable allocation of investment property to Canada.

Subsection 138(9) is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to require an insurer to include in computing its income for a taxation year a minimum amount of net investment revenue derived from its life and other than life insurance businesses in Canada. Where the net investment revenue derived from property designated by the insurer as property used or held by it in its Canadian insurance businesses is less than the required minimum amount, a prescribed amount will be added to the insurer's income under paragraph 138(9)(b). New section 2411 of the Income Tax Regulations sets out the basis for calculating the prescribed amount. Further, new section 2400 of the Regulations provides special rules for determining the property of an insurer that is used or held by it in its Canadian insurance businesses and new section 2412 of the Regulations provides rules for computing an insurer's Canadian investment fund for the year.

Subclause 107(10)

ITA
138(9.1)

Subsection 138(9.1) of the Act provides special rules which apply where an insurer has made an election under former subsection 138(9) of the Act. Subsection 138(9) was repealed and replaced by S.C.1977-78, c.1, s.68(12), applicable to the 1978 and subsequent taxation years. Subsection 138(9.1) is, therefore, unnecessary and is repealed applicable to taxation years commencing after June 17, 1987.

Subclause 107(11)

ITA
138(11.3)

Subsection 138(11.3) of the Act provides for a deemed disposition and reacquisition of property at fair market value where an insurer changes the use of the property in the circumstances described therein. These rules apply for all purposes of the Act except the purposes set out in the preamble to that subsection. This preamble is amended as a consequence of the repeal of paragraphs 138(3)(c) and 138(12)(b) of the Act applicable to taxation years commencing after June 17, 1987 that end after 1987. Paragraph 138(12)(b) provided the meaning of "amortized cost" of a Canada security that was used for the purpose of determining the amount deductible by an insurer under paragraph 138(3)(c) as an investment reserve. The references to paragraphs 138(12)(b) and 138(3)(c) in the preamble of subsection 138(11.3) are replaced respectively with references to the new definition of "amortized cost" which is set out in subsection 248(1) of the Act and to new paragraph 20(1)(l) of the Act which provides the deduction of a reserve for doubtful debts. These amendments are applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(12)

ITA
138(11.3)(c) and (d)

Except for the purposes of the Act set out in the preamble of subsection 138(11.3), this subsection provides for a deemed disposition and reacquisition of property at fair market value where an insurer changes the use of the property from a use in an insurance business in Canada to another use, or vice versa. New paragraphs 138(11.3)(c) and (d) ensure that these rules will apply where property that is a bond, debenture, mortgage, hypothec, agreement of sale or any other form of indebtedness acquired by an insurer for use in a life insurance business in Canada is, at a later time, used in an other than life insurance business in Canada, or vice versa. These paragraphs are applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(13)

ITA
138(11.41)

New paragraphs 138(11.3)(c) and (d) of the Act prevent a duplication of tax deductions and preserve the tax attributes of a gain that may ultimately arise on the disposition of a Canada security. This is effected by providing for a deemed disposition and reacquisition of property at fair market value where an insurer changes the use of property that is a bond, debenture, mortgage, hypothec, agreement of sale or any other form of indebtedness from a use in a life insurance business in Canada to a use in an other than life insurance business in Canada, or vice versa. When such dispositions are considered to have taken place, subsection 138(11.4) of the Act defers recognition of any loss for tax purposes to the time of a disposition of the property otherwise than by reason of subsection 138(11.3).

New subsection 138(11.41) defers recognition of any gain for tax purposes to the time of a disposition or deemed disposition of the property otherwise than by reason of new paragraph 138(11.3)(c) or (d) where the property and change of use are the types referred to in those paragraphs. This subsection is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 107(14)

ITA
138(11.5)

Subsection 138(11.5) of the existing Act sets out the rules which allow a non-resident insurer to domesticate (incorporate) a business carried on through a branch in Canada on a tax deferred or "rollover" basis. These rules apply where the insurer transfers all the property used or held in the business to a qualified related corporation of the insurer or to a subsidiary wholly-owned corporation of such a corporation that is resident, and carries on an insurance business, in Canada. New subsection 138(11.5) is designed to deal with certain technical deficiencies in these existing rules.

The technical deficiencies associated with subsection 138(11.5) may be summarized as follows:

1. Policy reserves that may be claimed by a non-resident insurer under subparagraph 138(1)(a)(i) or (ii) of the Act and section 1401 of the Income Tax Regulations in respect of life insurance policies are not transferable to the qualified related corporation. Technically, the non-resident insurer must add back to income in the year of the business transfer the reserves claimed in the previous year and may not claim a reserve in the year of the transfer.

2. Policy reserves that may be claimed by the non-resident insurer under paragraph 20(7)(c) of the Act and section 1400 of the Income Tax Regulations in respect of non-life insurance policies are not transferable to the qualified related corporation. Technically, the non-resident insurer must add back to income in the year of the business transfer the reserves claimed in the previous year and may not claim a reserve in the year of the transfer.

3. Gross investment revenue earned by the non-resident insurer and included in its income under subsection 138(9) of the Act is calculated with respect to investment property determined on a formula basis under section 2400 of the Income Tax Regulations using the insurer's Canadian investment fund (CIF) for the year. That insurer's CIF for the year is computed by reference to its insurance liabilities. In the year that the non-resident insurer transfers the business to the qualified related corporation, its CIF for the year will be understated and, as a result, its reported gross investment revenue will be artificially reduced.

4. Reserves claimable by the non-resident insurer, such as bad debt reserves under paragraph 20(1)(l) or new paragraph 20(1)(l.1) of the Act, are not transferable to the qualified related corporation. Technically, the non-resident insurer must add back to income in the year of the business transfer the reserves claimed in the previous year and may not claim a reserve in the year of the transfer.

5. The deduction for policy dividends is restricted to the insurer's post-1968 undistributed income from its participating life insurance business. This participating income does not flow to the qualified related corporation on the business transfer. As a result, the ability of the corporation to deduct policy dividends will be restricted.

6. The deduction for policy dividends accrued or payable by the non-resident insurer will be denied in the year of the business transfer since, in the subsequent year, the insurer will not be making the payment.

7. A rule similar to that in subsection 85(5) of the Act regarding the rollover of depreciable property is required to permit the recapture of capital cost allowance previously claimed by the non-resident insurer.

8. Subsection 138(11.5) contains no restrictions with respect to the type and amount of consideration that may be received by the non-resident insurer as a result of the business transfer and, as well, it does not deal with the taxation of such consideration. Restrictions are required to protect the Part XIII and XIV tax bases. Further, the cost to the insurer of any non-share consideration should equal its fair market value at the time of the transfer and the cost of share consideration should equal the proportion of the amount by which the proceeds of disposition of the transferred property exceed the amount of the non-share consideration allocated by reference to the relative fair market value of the shares.

9. Subsection 138(11.5) does not deal with obligations of the non-resident insurer arising in the course of carrying on the insurance business in Canada. The qualified related corporation to which the business is being transferred should be required to assume all or substantially all of the obligations arising in the course of carrying on the business in order to ensure a proper measure of the income of the non-resident insurer and the qualified related corporation in subsequent taxation years.

10. Subsection 138(11.5) requires that the business (all the property used in the business) be transferred to a qualified related corporation or to a subsidiary wholly-owned corporation of such a corporation that, at the time of the business transfer, carries on an insurance business in Canada and is resident in Canada. This requirement technically precludes a non-resident insurer from transferring a business to a subsidiary corporation that is incorporated expressly for the purposes of carrying on the transferred business.

11. Subsections 138(11.5), 219(5.1) and 219(5.2) of the Act apply in different circumstances. Subsection 138(11.5) applies with respect to the cessation of a single insurance business carried on by a non-resident insurer. Subsections 219(5.1) and (5.2) apply with respect to the cessation of all the insurance businesses carried on by a non-resident insurer. As a result, there could be an indefinite deferral of Part XIV tax.

New subsection 138(11.5) provides rules for the domestication of an insurance business carried on in Canada by a non-resident insurer on a tax-deferred or "rollover" basis. This provision is elective and, in order to be entitled to elect the rollover treatment, the following conditions set out in paragraphs 138(11.5)(a) to (d) must be met:

1. The non-resident insurer (the "transferor") must cease to carry on all or substantially all of an insurance business in Canada.

2. The transferor must transfer all or substantially all of the property used or held in the insurance business (the "transferred property") at the time of the cessation ("that time") or within 60 days thereafter to a qualified related corporation (the "transferee") that, immediately after that time, commences to carry on the business in Canada and the consideration for the transfer must include shares of the transferee.

3. The transferee must assume or reinsure all or substantially all of the obligations of the business at that time or within 60 days thereafter.

4. The transferor and the transferee must elect in prescribed form and in accordance with subsection 138(11.6) of the Act

The rules that apply to the rollover of the insurance business are set out in paragraphs 138(11.5)(e) to (m) and are designed to deal with the technical deficiencies of the existing law. These rules may be summarized as follows:

1. Paragraph 138(11.5)(e) provides that the transferor's proceeds of disposition and the transferee's cost of the transferred property is the cost amount to the transferor of the transferred property at the time of the cessation. However, where the fair market value of the non-share consideration received or receivable by the transferor for the transferred property exceeds the cost amount to the transferor of that property, the provisions of subsection 85(1) must be applied in respect of the transferred property.

2. Paragraphs 138(11.5)(f) and (g) deal with the consideration received or receivable by the transferor for the transferred property. The cost to the transferor of non-share consideration is the fair market value of such consideration at the time of the cessation. The cost to the transferor of share consideration that is preferred shares of a class of the transferee is the lesser of the fair market value of those preferred shares of that class immediately after the transfer and the amount by which the proceeds of disposition of the transferor of the transferred property exceed the fair market value at the time of the cessation of the non-share consideration received or receivable by the transferor. The cost to the transferor of common shares of a class of the transferee is the amount by which the proceeds of disposition of the transferred property exceed the aggregate of the fair market value at the time of the cessation of the non-share consideration received or receivable by the transferor and the cost of all preferred shares of the transferee receivable by the transferor. Where the consideration includes more than one class of shares, the cost to the transferor of shares of each class will be determined on a pro rata basis.

3. Paragraph 138(11.5)(h) treats the transferor and the transferee as having had taxation years ending immediately before the time of the cessation. This special taxation year rule is necessary in order to measure the income of the transferor and the transferee both for their taxation years in which the transfer took place and for their subsequent taxation years. The transferor will be entitled to claim all reserves provided under sections 20, 33 and 138 of the Act in computing its income for the year and must compute its gross investment revenue for the year under subsection 138(9) as if it had not transferred the business. As a result, neither hardship nor benefit will arise as a result of the business transfer.

4. Paragraphs 138(11.5)(i), (j) and (k) provide assumptions that underlie the calculation of income of the transferor and the transferee both for their taxation years in which the transfer

took place and for their subsequent taxation years. These assumptions are necessary to ensure that tax reserves and other attributes flow from the transferor to the transferee and that the proper amount of gross investment revenue is reported by each party.

5. Paragraph 138(11.5)(l) deals with the amounts deducted by the transferor in its last taxation year before the transfer as a policy reserve, unpaid claims reserve and policy dividend reserve in respect of its obligations assumed or reinsured by the transferee. These amounts are treated as being equal to the fair market value of the consideration received by the transferor for the assumption or reinsurance of the obligations.

6. Paragraph 138(11.5)(m) deals with the case where a reinsurance arrangement was used to effect a business transfer and subsection 138(11.5) applied to the transfer. Any reinsurance premium paid or payable by the transferor or any commission paid or payable by the transferee under such an arrangement is to be included or deducted, as the case may be, in computing the income of the transferor or the transferee but only to the extent necessary to determine the appropriate amount of income of each party.

New subsection 138(11.5) is applicable to transfers of an insurance business after December 15, 1987 and, in limited circumstances, the transfer may be treated as having occurred on January 1, 1988 if it occurred after that date and before 1989.

Subclause 107(15)

ITA
138(11.7) to (11.13)

New subsection 138(11.7) of the Act is an anti-avoidance rule that is consequential on the addition of new subsection 138(11.5) to the Act. Subsection 138(11.5) provides for the transfer of an insurance business by a non-resident insurer to a qualified related corporation of the insurer on a tax-deferred or "rollover" basis. The rule in subsection 138(11.7) prevents the removal of corporate surplus as a tax-free return of capital where there is a rollover of assets on the transfer of an insurance business after December 15, 1987 in respect of which subsection 138(11.5) applied and subsection 85(1) of the Act did not apply. This rule is similar to the paid-up capital rule in subsection 85(2.1) of the Act that applies where there is a rollover of assets on a transfer of property by a person or partnership to a taxable Canadian corporation.

Paragraph 138(11.7)(a) requires a reduction in the the paid-up capital of any class of shares of the qualified related corporation equal to the amount, if any, by which the paid-up capital of all the shares of the corporation exceeds the cost of the transferred property to the corporation (less the fair market value of any non-share consideration received or receivable by the insurer). The paid-up capital reduction is to be allocated among the classes of shares of the corporation based on the increase in the paid-up capital of all the shares of the corporation.

Paragraph 138(11.7)(b) provides for an addition to the paid-up capital of any class of shares of the qualified related corporation where paragraph (a) previously required a reduction in the paid-up capital of that class of shares and subsection 84(3), (4) or (4.1) subsequently applied to deem a dividend to have been paid by the corporation on that class. Any such paid-up capital additions for a class of shares may not exceed the previous paid-up capital reductions for that class.

New subsection 138(11.7) is applicable in computing paid-up capital after December 15, 1987.

New subsection 138(11.8) of the Act provides rules which apply where a non-resident insurer transfers depreciable property to a qualified related corporation of the insurer on a tax-deferred or "rollover" basis pursuant to new subsection 138(11.5) of the Act. These rules are similar to those in subsection 85(5) of the Act that apply where there is a rollover of assets on a transfer of depreciable property, and are intended to permit the recapture of capital cost allowance claimed by the non-resident insurer before the transfer. Under subsection 138(11.8), the qualified related corporation is treated, for the purposes of sections 13, 20 and any regulations made under paragraph 20(1)(a) of the Act, as having the same capital cost of the property as the non-resident insurer if that capital cost exceeds the cost to the corporation of the depreciable property provided under subsection 138(11.5). The excess is treated as having been claimed by the corporation as capital cost allowance in preceding taxation years. New subsection 138(11.8) is applicable to transfers of property occurring after December 15, 1987.

New subsection 138(11.9) of the Act provides rules which deal with the contributed surplus of an insurance corporation resident in Canada to which property has been transferred by a person or partnership under the rules as set out in new subsection 138(11.5) or in subsection 85(1) of the Act. The contributed surplus of the corporation otherwise determined arising on the transfer is to be reduced, for certain purposes of the Act, by the amount by which the aggregate of the fair market value of any non-share consideration received or receivable by the person or partnership and the increase in the paid-up capital of the shares and the contributed surplus of the corporation resulting from the transfer exceeds the aggregate of required reductions in the paid-up capital of the shares of the corporation resulting from the transfer and the cost to the corporation of the transferred property. New subsection 138(11.9) is applicable to transfers of property occurring after December 15, 1987.

New subsection 138(11.10) of the Act provides rules which ensure that a non-resident insurer that commences to carry on an insurance business in Canada, or that ceases to be exempt from tax under Part I of the Act, in a taxation year reports an appropriate amount of the gross investment revenue and the gains and losses derived from its property and is precluded from claiming excess deductions for tax reserves and capital cost allowance.

Paragraph 138(11.10)(c) treats the non resident insurer as having had a taxation year ending immediately before the commencement of the year and as having commenced carrying on the insurance business in Canada in that preceding year.

Paragraph 138(11.10)(d) treats the insurer as having claimed the maximum reserves for that preceding year to which it would have been entitled under section 33, paragraphs 20(1)(l) and (l.1), 20(7)(c) and 138(3)(c), and subparagraphs 138(3)(a)(i), (ii) and (iv) of the Act. Such reserves are included in determining a non-resident insurer's income and Canadian investment fund for the year in which it commences to carry on or ceases to be exempt from tax in respect of the insurance business in Canada.

Paragraph 138(11.10)(e) treats the insurer as having disposed of and reacquired, immediately before the commencement of the year, each property at fair market value where the property was used or held by it in the insurance business in Canada.

Paragraph 138(11.10)(f) treats the insurer, for the purposes of sections 13 and 20 and any regulations made under paragraph 20(1)(a) of the Act, as having disposed of and reacquired each depreciable property at a capital cost equal to its cost to the insurer if that cost is greater than its fair market value. The excess is considered to have been claimed by the insurer as capital cost allowance in preceding taxation years.

New subsection 138(11.10) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

New subsection 138(11.11) of the Act provides rules which apply where an insurer (the "vendor") has disposed of all or substantially all of either an insurance business or a line of an insurance business carried on by it in Canada to another person (the "purchaser") and the purchaser has reinsured the obligations of the business or line of business.

For the purposes of determining the gross investment revenue and the gains and losses derived from property of the vendor and the purchaser, paragraph 138(11.11)(c) treats the vendor and the purchaser as having had a taxation year ending immediately before the time of the disposition of the business or line of business. This deemed taxation year is necessary in order to measure the gross investment income and the gains and losses from property of the vendor and the purchaser, determined under section 2400 of the Income Tax Regulations to be property used or held in an insurance business in Canada, both for their taxation years in which the disposition occurred and for their subsequent taxation years. For those subsequent taxation years, the business or line of business is considered to have been disposed of, and the obligations reinsured by the purchaser are considered to have been disposed of or reinsured, as the case may be, on the last day of the deemed taxation year.

Paragraph 138(11.11)(d) provides that, in computing the income of the vendor and the purchaser for taxation years ending after the time of the disposition, reinsurance premiums paid or payable by the vendor or reinsurance commissions paid or payable by the purchaser, as the case may be, in respect of obligations which arose in the course of carrying on the transferred business or line of business are considered to be on account of income (as opposed to capital). Therefore, the vendor may deduct from income the reinsurance premium paid and include in income the reinsurance commission received in the same taxation year in which it must include policy reserves in respect thereof. On the other hand, the purchaser will include in income the reinsurance premium and deduct from income the reinsurance commission paid in the same taxation year as it may claim policy reserves.

Paragraph 138(11.11)(e) treats the vendor as having ceased to carry on the transferred business at the time when it has disposed of all or substantially all of an insurance business carried on by it in Canada. This rule is necessary for the purpose of determining the branch tax liability of the vendor under Part XIV of the Act.

New subsection 138(11.11) is applicable to dispositions of an insurance business or a line of an insurance business occurring after December 15, 1987.

New subsection 138(11.12) provides rules which apply where an insurer acquires or reacquires property as a result of a debtor's failure to pay an amount in respect of a bond, debenture, mortgage, hypothec, agreement of sale or other form of indebtedness owned by the insurer. In this case, the insurer is deemed to have acquired or reacquired the property at its fair market value and to have disposed of the bond or other form of indebtedness for proceeds equal to that fair market value. In addition, the insurer's unpaid claim is deemed to have a cost amount of nil and to be a bond or other form of indebtedness, as the case may be. The insurer is denied any further reserves for doubtful debts in respect of the Canada security. The debtor, on the other hand, treats the property as having been disposed of for the amount of the insurer's claim and may treat any further payments on the debt as a loss from the disposition of the property. New subsection 138(11.12) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

New subsection 138(11.13) provides rules which apply to the transfer of an insurance business carried on in Canada by an insurer resident in Canada to a corporation resident in Canada that is a subsidiary wholly-owned corporation of the insurer on a tax-deferred or "rollover" basis. This provision is elective and, in order to be entitled to elect the rollover treatment, the following conditions set out in paragraphs 138(11.13)(a) to (d) must be met:

1. The insurer (the "transferor") must cease to carry on all or substantially all of an insurance business in Canada.

2. The transferor must transfer all or substantially all of the property used or held in the insurance business (the "transferred property") at the time of the cessation ("that time") or within 60 days thereafter to a subsidiary wholly-owned corporation (the "transferee") that, immediately after that time, commences to carry on the business in Canada and the consideration for the transfer must include shares of the transferee.

3. The transferee must assume or reinsure all or substantially all of the obligations of the business at that time or within 60 days thereafter.

4. The transferor and the transferee must elect in prescribed form and in accordance with subsection 138(11.6) of the Act.

The rules that apply to the rollover of the insurance business in these circumstances are the same rules that apply to the rollover of an insurance business by a non-resident insurer to its qualified related corporation as set out in new paragraphs 138(11.5)(e) to (m) and new subsections 138(11.7) to (11.9) of the Act. New subsection 138(11.13) is applicable to transfers of an insurance business after December 15, 1987.

Subclause 107(16)

ITA
138(12)(b)

Paragraph 138(12)(b) of the Act provides the meaning of "amortized cost" of a Canada security to an insurer. This paragraph is repealed, applicable to taxation years commencing after June 17, 1987 that end after 1987, as a consequence of the addition of the definition of "amortized cost" of a loan or lending asset in subsection 248(1) of the Act.

Subclause 107(17)

ITA
138(12)(k.1)

Paragraph 138(12)(k.1) of the Act provides the meaning of "policy loan". This paragraph is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to ensure that a policy loan will be considered to be the full amount advanced at a particular time by a life insurer to a policyholder in accordance with the terms and conditions of a life insurance policy in Canada.

New subsection 1401(3) of the Income Tax Regulations is consequential to the amendment to paragraph 138(12)(k.1). This subsection ensures that the amount of the policy reserve that the insurer may deduct in respect of its liabilities under life insurance policies is reduced by the amount of policy loans made under those policies.

Subclause 107(18)

ITA
138(12)(l.1)

New paragraph 138(12)(l.1) of the Act, applicable to taxation years commencing after June 17, 1987 that end after 1987, provides that, for certain purposes of the Act, the term "qualified related corporation" has the meaning assigned by new subsection 219(8) of the Act.

Subclause 107(19)

ITA
138(12)(o)(vi)

Paragraph 138(12)(o) of the Act defines the surplus funds derived from operations of an insurer for the purposes of the rules in section 138 applicable to insurance corporations. Subparagraph 138(12)(o)(vi) is amended to delete the reference to former paragraphs 110(1)(a) or (b) dealing with charitable donations and gifts to the Crown and to add a reference to new paragraphs 110.1(1)(a) or (b). This amendment is consequential on the renumbering of former paragraphs 110(1)(a) and (b) to new paragraphs 110.1(1)(a) and (b) for donations made by corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 107(20)

ITA
138(13)

Subsection 138(13) of the Act provides the meaning of "amortized cost" of a Canada security for the purposes of the definition of that term in paragraph 138(12)(b) of the Act where in a taxation year ending after 1968 a multinational life insurer has not made an election in respect of that year under former subsection 138(9) of the Act as it applied to the 1977 taxation year. This subsection is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to correct certain cross-references as a consequence of the repeal of paragraph 138(12)(b) and the addition of the definition of "amortized cost" of a loan or lending asset in subsection 248(1) of the Act.

Clause 108

Deduction in Computing Income

ITA
140

Section 140 of the Act currently allows an insurance corporation to deduct amounts credited to a policyholder by way of dividend, premium refund or refund of a premium deposit if, during the year or within 12 months thereafter, the amount was paid to the policyholder, applied in discharge of his premium liability or credited to his account on the condition that he be entitled to payment of the credit on or before the expiry or termination of his policy. This deduction is claimable by the corporation in computing its income from an other than life insurance business and, by reason of subparagraph 138(3)(a)(v) of the Act, from a life insurance business.

New subsection 140(1) of the Act allows an insurance corporation to deduct in computing its income for a taxation year amounts credited for the year or any preceding year to a policyholder by way of dividend, premium refund or refund of premium deposit if the amount was paid or unconditionally credited to the policyholder or applied in discharge of his premium liability during the year or within 12 months thereafter. Thus, a deduction will no longer be allowed in respect of any amount credited to the policyholder's account on the condition of payment on or before the expiry or termination of his policy.

New subsection 140(2) of the Act requires an insurance corporation to include, in computing its income for its first taxation year that commences after June 17, 1987 and ends after 1987, the amount by which deductions taken under paragraph 140(c) of the existing Act for taxation years ending before that first taxation year in respect of amounts conditionally credited to a policyholder's account exceed amounts paid or unconditionally credited before that year. The transitional rules dealing with reserves provide that the amount to be included in income under subsection 140(2) for an insurer's first taxation year is taken into account in determining the amount of the insurer's net reserve adjustment prescribed under new section 8101 of the Income Tax Regulations.

New section 140 is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Clause 109

Communal Organizations

ITA
143(2)(a)

Section 143 of the Act provides special rules for the purpose of determining the income of members of certain communal organizations. Paragraph 143(2)(a) is amended to delete the references therein to sections 110.1 and 110.2 as a result of the elimination of the $1,000 investment income deduction and the conversion of the pension income deduction into a tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 110

Employees Profit Sharing Plan -
Allocation Taxable

ITA
144(3)

Section 144 of the Act provides rules applicable to employees profit sharing plans. Subsection 144(3) requires that certain amounts, including interest, allocated to an employee in a year by such a plan must be included in the employee's income. Subsection 144(3) is amended, by repealing paragraph (f) thereof, as a consequence of the elimination of the $1,000 investment income deduction.
Subsection 144(8.2) of the Act which effects an allocation of interest for the purposes of the investment income deduction is repealed for the same reason. These amendments are applicable to the 1988 and subsequent years.

Clause 111

Registered Retirement Savings Plans

ITA
146

Section 146 of the Act deals with registered retirement savings plans (RRSP's).

Subclause 111(1)

ITA
146(1)(c)(iv)

Paragraph 146(1)(c) of the Act defines "earned income" for the purposes of the rules applicable to RRSP's. Subparagraph 146(1)(c)(iv) is amended by deleting the reference to former paragraph 8(1)(l). This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 111(2)

ITA
146(1)(h)(iii)

Paragraph 146(1)(h) of the Act defines "refund of premiums". Subparagraph 146(1)(h)(iii) is amended to provide that, in determining whether an individual was financially dependent upon the annuitant at the time of the annuitant's death for the purpose of the refund of premiums provisions, that person shall not be regarded as financially dependent upon the annuitant if any person other than the annuitant was entitled to the new dependant tax credit, provided for in new paragraph 118.7(b), in respect of that person. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 111(3)

ITA
146(10.1)(b)(ii)

Subsection 146(10.1) provides that income earned by a trust governed by an RRSP from non-qualified investments is taxable under Part I of the Act at the rates appropriate to inter vivos trusts.
Subparagraph 146(10.1(b)(ii) provides that, in computing the income of an RRSP trust, paragraphs 38(a) and (b) are to be read without reference to the words "1/2 of". As a result, income will include the full amount of capital gains in excess of capital losses.

Subparagraph 146(10.1)(b)(ii) is being amended as a result of the changes to the inclusion rate for capital gains and capital losses of individuals to provide that, applicable to the 1988 and subsequent taxation years, paragraphs 38(a) and (b) are to be read without reference to the fractions set out therein.

Clause 112

Registered Education
Savings Plans

ITA
146.1(1)(h)(iv)

Section 146.1 of the Act deals with registered education savings plans. Subparagraph 146.1(1)(h)(iv) of the Act is amended by changing the reference to designated educational institutions in Canada referred to in clause 110(9)(a)(i)(A), which is repealed as a result of the conversion of the education deduction to a tax credit, to new subparagraph (a)(i) of the definition "designated educational institution" in new subsection 118.6(1). The definition itself has not changed. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 113

Registered Retirement Income Funds

ITA
146.3

Section 146.3 of the Act deals with registered retirement income funds (RRIF's). Subsection 146.3(9) provides that income earned by a trust governed by a RRIF from non-qualified investments is taxable under Part I of the Act.

Subparagraph 146.3(9)(b)(ii) provides that, in computing the income of a RRIF trust, paragraphs 38(a) and (b) are to be read without reference to the words "1/2 of". As a result, income for this purpose will include the full amount of capital gains in excess of capital losses. Subparagraph 146.3(9)(b)(ii) is being amended as a result of the changes to the inclusion rate for capital gains and capital losses of individuals to provide that, applicable to the 1988 and subsequent taxation years, paragraphs 38(a) and (b) are to be read without reference to the fractions set out therein.

Clause 114

Exempt Taxpayers

ITA
149

Section 149 of the Act deals with certain categories of taxpayers that are exempt from tax under Part I of the Act.

Subclause 114(1)

ITA
149(1)(j)

Paragraph 149(1)(j) of the Act sets out the criteria which a corporation must satisfy in order to qualify as a non-profit R&D corporation for the purposes of the Act. This paragraph requires that such a corporation expend at least 90% of its income on R&D. The paragraph is amended as a consequence of the amendments to subsection 37(7), which disqualify certain payments in respect of the acquisition of a building or a leasehold interest in a building or in respect of rental expenses related to a building, and allows such expenditures to continue to qualify for the purposes of the expenditure requirements for non-profit R&D corporations. This amendment is applicable after December 15, 1987.

Subclause 114(2)

ITA
149(1)(t)

Paragraph 149(1)(t) of the existing Act provides an exemption from Part I tax for the taxable income for a period of an insurer who was engaged only in the business of insurance and earned 50 per cent of its gross premium income for the period from the insurance of property and residences of farmers and fishermen ("farm risks"). New paragraph 149(1)(t), applicable to the 1989 and subsequent taxation years, provides a Part I tax exemption for the taxable income of an insurer for a period in which not less than 25 per cent of the net premium income of the insurer and of all other insurers that were specified shareholders of, or were related to, the insurer (or, where the insurer is a mutual corporation, that were part of a group that controlled or were controlled by the insurer) was from the insurance of farm risks. The extent of this exemption is described in new subsections 149(4.1) and (4.2) of the Act.

Subclause 114(3)

ITA
149(3)

Paragraph 149(1)(l) of the Act provides an exemption from Part I tax for the taxable income of a fraternal or benevolent society or order for a period. Subsection 149(3) of the Act provides that this Part I tax exemption does not apply to taxable income derived from carrying on a life insurance business. The amendment to subsection 149(3), applicable to taxation years commencing after June 17, 1987 that end after 1987, clarifies that, for this purpose, taxable income from carrying on a life insurance business includes that derived from the sale of property used or held in the course of carrying on that business.

Subclause 114(4)

ITA
149(4.1) and (4.2)

New subsections 149(4.1) and (4.2) of the Act set out the extent of an insurer's Part I tax exemption under new paragraph 149(1)(t) of the Act.

Subsection 149(4.2), in effect, provides that all of an insurer's taxable income for a taxation year is eligible for the Part I tax exemption where, for the year, more than 90 per cent of the net premium income of the insurer and of all other insurers that were specified shareholders of, or were related to, the insurer (or, where the insurer is a mutual corporation, that were part of a group that controlled or were controlled by the insurer) was from the insurance of farm risks.

Subsection 149(4.1) places a restriction on the Part I tax exemption where, for a taxation year, not less than 25 per cent and not more than 90 per cent of the net premium income was from the insurance of farm risks. In this case, the exemption will be restricted to that portion of the insurer's taxable income for the year that the insurer's net premium income from the insurance of farm risks is of its total net premium income for the year. Further, this subsection treats the insurer as having claimed or deducted in preceding taxation years the greater of the reserves which it claimed or deducted and the reserves which it was entitled to claim or deduct under paragraphs 20(1)(a), 20(7)(c) and 138(3)(a) and section 140 of the Act but only to the extent of the insurer's taxable income otherwise determined for those preceding years.

New subsections 149(4.1) and (4.2) are applicable to the 1989 and subsequent taxation years.

Subclause 114(5)

ITA
149(5)(f)(ii)

Subsection 149(5) of the Act provides rules dealing with investment income of certain dining, recreational or sporting clubs. These rules consider such income to be earned by an _inter vivos_ trust for the purposes of the Act and provide a formula for the calculation of the taxable income of the trust. Paragraph 149(5)(f) provides that, in computing the income of the trust, no amount may be deducted in respect of the personal deductions provided under section 109.
Paragraph 149(5)(f)(ii) is amended by deleting the reference to section 109, which is repealed as a consequence of the conversion of the personal deductions to tax credits. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 115

Charities

ITA
149.1

Section 149.1 of the Act contains definitions and rules governing charitable organizations.

Subclause 115(1)

ITA
149.1(1)(b)(iv)

Paragraph 149.1(1)(b) contains the definition of charitable organization. Subparagraph (iv) of the definition is amended, effective for the 1988 and subsequent taxation years, to include a reference to an organization designated as a private foundation or public foundation pursuant to new subsection 149.1(6.3) and an organization which has applied after February 15, 1984 for registration under the definition of "registered charity" in subsection 248(1) of the Act. This is a technical amendment as a consequence of the transfer of the definition of "registered charity" from paragraph 110(8)(c) to subsection 248(1) for the 1988 and subsequent taxation years.

Subclause 115(2)

ITA
149.1(1)(e)

Paragraph 149.1(1)(e) contains the definition of "disbursement quota". Subparagraph (i) of the definition is amended to include a reference to receipts described in new paragraphs 110.1(1)(a) and 118.1(1)(a). This amendment, which is applicable to the 1988 and subsequent taxation years, is consequential on the introduction of new paragraph 110.1(1)(a) for donations made by corporations and the introduction of new paragraph 118.1(1)(a) for donations made by individuals.

Subclause 115(3)

ITA
149.1 (1)(g)

Paragraph 149.1(1)(g) contains the definition of public foundation. Subparagraph (i) of the definition is amended, effective for the 1988 and subsequent taxation years, to include a reference to a foundation designated as a private foundation or charitable organization pursuant to new subsection (6.3).

Subclause 115(4)

ITA
149.1(1)(h)

Paragraph 149.1(1)(h) contains the definition of qualified donee. This definition is amended by deleting the reference to subparagraph 110(1)(a)(i) and paragraph 110(1)(b) and inserting a reference to new paragraphs 110.1(1)(a) and (b) and new section 118.1(1). This amendment, which is applicable to the 1988 and subsequent taxation years, is consequential on the introduction of new section 110.1 dealing with charitable donations made by a corporation and new section 118.1 dealing with charitable donations made by an individual.

Subclause 115(5)

ITA
149.1(6.3)

This new subsection authorizes the Minister to designate a charity as a charitable organization, private foundation or public foundation. The designation may be on the Minister's own initiative or an application by the charity. Notice of the designation shall be sent to the charity by registered mail and the charity shall be deemed, for taxation years commencing after the date of mailing, to be so registered. New subsection 149.1(6.3) of the Act is applicable to the 1988 and subsequent taxation years.

Subclause 115(6)

ITA
149.1(a)

Subsection 149.1(a) deems certain property accumulated by a registered charity for a particular purpose that is not used for that purpose to be income of the charity and the amount of a gift for which it issued a receipt. This technical amendment, which is applicable in respect of gifts made by donors in their 1988 and subsequent taxation years, deletes the reference to paragraph 110(1)(a) and inserts a reference to new paragraph 110.1(1)(a) and new subsection 118.1(2) which deal with receipts in respect of donations made by corporations and individuals respectively.

Subclause 115(7)

ITA
149.1(12)(b)(ii)(A)

Paragraph 149.1(12)(b) excludes certain gifts from the income of a charity for a taxation year. Clause (ii)(A) excludes a gift or portion thereof made by a donor who is not a charity and has not been allowed a deduction in respect of the gift in computing his taxable income. Subclause (A) is amended to delete the reference to paragraph 110(1)(a), which is repealed, and to insert a reference to deductions permitted under new paragraph 110(1)(a) and new subsection 118.1(3) which provide the deduction in respect of charitable donations to corporations and individuals respectively. This amendment is applicable in respect of gifts made by donors in their 1988 and subsequent taxation years.

Clause 116

Death of Partner
or Proprietor

ITA
150(4)(d)

Paragraph 150(4)(d) of the Act contains one of the rules regarding computation of income for a deceased taxpayer who was a partner or proprietor, where the legal representative of the deceased has elected to file a separate return of income for the period commencing after the end of the partnership's or business' fiscal period up to the date of death. This paragraph is amended to add a reference to new section 118.11, regarding credits in separate returns, to delete the reference to the personal exemptions in section 109, the investment income deduction in section 110.1 and the pension income deduction in 110.2 which are repealed, and to insert references to new sections 118 to 118.3, 118.5 and 118.6 which provide the taxpayer with a deduction from tax payable in respect of the personal tax credits, the tax credit for charitable donations, the medical expense tax credit, the disability tax credit and the tuition and education tax credits. This amendment, applicable to the 1988 and subsequent taxation years, is consequential on the conversion of the personal exemptions into tax credits.

Clause 117

Assessments

ITA
152

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

Subclause 117(1)

ITA
152(1.11) and (1.12)

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

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

The Minister must make a determination under new subsection 152(1.11) only when he acts under new paragraph 245(8)(a) following a request made by the taxpayer under new subsection 245(6). Absent such request, the Minister may choose to wait until he can assess a person to determine the tax situation of that person under subsection 245(2). For example, where an avoidance transaction would otherwise result in an inappropriate increase in the capital cost of a depreciable property, the Minister can rely on subsection 152(1.11) to make a determination of the undepreciated capital cost of the class of property to which that property belongs or, provided the taxpayer does not request such a determination, he can wait until capital cost allowance is claimed in respect of that class to make an assessment denying part or all of that claim.

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

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

These amendments are applicable upon Royal Assent.

Subclause 117(2)

ITA
152(1.2) and (1.3)

Subsections 152(1.2) and (1.3) of the Act contain rules which apply where the Minister makes a determination of a taxpayer's non-capital loss, net capital loss or restricted farm loss pursuant to subsection 152(1.1). Under these provisions, such determinations are subject to the taxpayer's rights of objection and appeal and, subject to these rights, the determination is binding on both the taxpayer and the Minister.

The amendments to subsections 152(1.2) and 152(1.3) are consequential on the introduction of new subsection 152(1.11). Following the amendment to subsection 152(1.2), certain provisions of Part I of the Act relating to objections and appeals are applicable to a determination made pursuant to subsection 152(1.11). The effect of the amendment to subsection 152(1.3) is that a determination made under subsection 152(1.11) is binding on both the taxpayer and the Minister, subject to the taxpayer's right to appeal from that determination and to the Minister's power to make a redetermination.

These amendments are applicable upon Royal Assent.

Subclause 117(3)

ITA
152(4)

Subsection 152(4) of the Act provides the time limits within which assessments, reassessments and additional assessments may be made. There is no time limit in cases where there is misrepresentation or where a waiver is filed. A 6 year limit applies to cases relating to retrospective claims under subsection 152(6). In all other cases, a 3 year limit applies. The amendment to paragraph 152(4)(b) adds two more cases where the 6 year limit will apply. The first is where a reassessment results from transactions involving a taxpayer and a non-resident person with whom he was not dealing at arm's length. This amendment is consequential on the new reporting obligation set out in section 231.6 for foreign based information. The second is where an additional income tax payment to, or reimbursement from, the government of a foreign country arises. Since the foreign tax credit or deduction of a taxpayer would have to be changed as a result of such payment or reimbursement, a reassessment will be allowed within 6 years from such adjustment in the foreign country's taxes. The amendment also clarifies that the 6 year limit only applies to the extent that the reassessment relates to the transaction with the non-resident person or to the adjustment in the foreign country's taxes, as the case may be. This amendment will be effective for transactions entered into, payments made and reimbursements received after 1987.

Subclause 117(4)

ITA
152(6)(c)

Subsection 152(6) of the Act provides for the reassessment of a taxpayer's tax payable for a taxation year where the taxpayer has claimed a deduction or credit as a result of a carryback from a subsequent taxation year. Paragraph 152(6)(c) is amended to delete the reference to section 110 relating to charitable donations, which is repealed, and to substitute a reference to new sections 110.1 and 118.1 which reflect the new treatment of charitable donations. This amendment, applicable to the 1988 and subsequent taxation years, is consequential on the renumbering of the deduction for charitable donations made by corporations and the conversion of the deduction in respect of such donations made by individuals into a tax credit.

Subclause 117(5)

ITA
152(6)(e) to (g)

A taxpayer may file an amended return for a taxation year pursuant to paragraph 152(6)(e), (f) or (g) of the Act in order to claim an amount to be carried back from a subsequent year as an unused share-purchase tax credit, an unused scientific research and experimental development tax credit or a minimum tax credit, respectively. As these tax credits may no longer be produced in future years paragraphs 152(6)(e) to (g) are unnecessary and are repealed.

New paragraph 152(6)(e) of the Act is consequential on the introduction of the Part VI tax credit under new section 125.2 which permits a 3-year carryback of unused Part VI tax credits. This amendment, which is applicable to the 1988 and subsequent taxation years, requires the Minister to reassess preceding taxation years in order to give effect to a taxpayer's carryback of unused Part VI tax credits.

Clause 118

Quarterly Instalments

ITA
156(1)(a)

Section 153 of the Act provides rules for determining the time at which instalments on account of tax payable by individuals must be paid. Paragraph 156(1)(a) is amended by changing the dates on which quarterly instalments of tax are payable from March 31, June 30, September 30 and December 31 of a year to the 15th of March, June, September and December of the year. This amendment is applicable to the 1990 and subsequent taxation years.

Clause 119

Instalment Requirements
for Corporations

ITA
157(1)(a)(i)

Subparagraph 157(1)(a)(i) of the Act requires corporations to pay monthly tax instalments. This subparagraph is amended to provide that the amount of a corporation's tax instalments for a taxation year are to be determined on the basis of its estimated tax payable before deducting any amount pursuant to new paragraph 125.2(1)(a) of the Act on account of any tax payable under Part VI of the Act by the corporation for the year. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 120

Interest on Unpaid Taxes

ITA
161

Section 161 of the Act contains various provisions relating to interest charged on unpaid taxes and penalties under the Act.

Subclause 120(1)

ITA
161(1)

Subsection 161(1) of the Act provides that interest is payable by a taxpayer on any outstanding amount of taxes for a taxation year. Such interest is computed from the day the tax return for the year is required to be filed to the date of payment of the outstanding amount. Similarly under subsection 161(2) of the Act, any interest on late or deficient instalments of tax is calculated from the time the instalment was required to be made to the earlier of the time of payment and the time interest becomes payable under subsection 161(1) (i.e. the tax return due date). The amendment to subsection 161(1) provides that interest on the outstanding amount of taxes payable will now be computed under that subsection from the time the remainder of the tax payable for the year is required to be paid. This is the 30th day of April following a taxation year for individuals, the end of the third month following a taxation year for certain small business corporations, and the end of the second month following a taxation year for other corporations. Consequently the period within which interest on late or deficient instalments may be charged pursuant to subsection 161(2) will be shortened. This change will therefore reduce the impact of the new 50 per cent penalty for late or deficient instalments provided in section 163.1. This amendment is applicable to the 1989 and subsequent taxation years.

Subclause 120(2)

ITA
161(4.1)(a)

Paragraph 161(4.1)(a) of the Act provides that for the purpose of determining interest payable on deficient instalment payments by a corporation, the corporation is considered to have been liable to pay instalments calculated by reference to its tax payable for the year, its first instalment base for the year or a combination of its first and second instalment bases for the year, whichever method gives rise to the least amount of interest charges. Tax payable for the purposes of this provision is determined before any addition of the 5-per-cent corporate surtax under section 123.1 of the Act and any deduction for share-purchase and scientific research and experimental development tax credits under sections 127.2 and 127.3 of the Act. The addition of a reference to section 125.2 in new paragraph 161(4.1)(a) provides that the new Part VI tax credit is also not to be deducted in determining federal tax for purposes of calculating interest on deficient instalments. This amendment is applicable to the 1989 and subsequent taxation years.

Subclause 120(3)

ITA
161(7)(a)(iv)

Subsection 161(7) of the Act provides rules for the determination of interest on unpaid taxes where the amount of taxes owing is changed as a result of the carryback of deductions or credits from a subsequent taxation year. Subparagraph 161(7)(a)(iv) is amended by deleting the reference to section 110 dealing with charitable donations, which is repealed, and substituting a reference to new section 118.1 which reflects the new treatment of charitable donations made by individuals. The amendment is consequential on the conversion into a tax credit of the deduction in respect of such donations made by individuals. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 120(4)

ITA
161(7)(a)(vi)

Subsection 161(7) of the Act provides that where the tax payable for a taxation year is reduced as a consequence of the carryback of a loss, tax credit or other amount from a subsequent year, interest on any unpaid tax for the earlier year is calculated without regard to the reduction until the end of the subsequent year or the date of filing of the taxpayer's return for the subsequent year, whichever is later. Subparagraphs 161(7)(a)(vi), (vi.1) and (vii) provide for the application of this rule to the carryback of unused share-purchase tax credits, minimum tax credits and unused scientific research and experimental development tax credits, respectively. As these tax credits may no longer be produced in future years these subparagraphs are unnecessary and are, therefore, repealed.

New subparagraph 161(7)(a)(vi) of the Act is consequential on the introduction of the Part VI tax credit under new section 125.2 which permits a 3-year carryback of unused Part VI tax credits. This amendment, which is applicable to the 1988 and subsequent taxation years, provides that a reduction of tax resulting from the carryback of an unused Part VI tax credit from a subsequent taxation year will not be taken into account in determining interest charges on any unpaid tax until the later of the dates noted above.

Subclause 120(5)

ITA
161(11)

Subsection 161(11) charges interest on any outstanding penalty assessed under Part I of the Act against a taxpayer in respect of a year. Such interest is calculated from the date the taxpayer's return of income is required to be filed for the year or, in the case of penalties unrelated to a return of income, from the notice of original assessment of the penalty. The amendment to 161(11) is strictly consequential on the introduction in sections 162 and 163 of penalties in relation to the new requirements to file various information returns. This amendment is applicable upon Royal Assent.

Clause 121

Penalties

ITA
162

Section 162 of the Act provides penalties for failing to comply with various information and filing requirements.

Subsection 162(1) of the Act imposes a penalty for failure to file a tax return as required by subsection 150(1). The penalty is 5 per cent of the unpaid tax as of the return due date plus 1 per cent of such unpaid tax per month of default not exceeding 12 months. Subsection 163(1) of the Act imposes a penalty of 50 per cent of the tax sought to be evaded for wilful failure to file a tax return. Existing subsections 162(1) and 163(1) are amended to provide a two-tier penalty for failure to file a return as required under subsection 150(1). New subsection 162(1) provides that on a first occurrence the penalty will be a minimum of $25. New subsection 162(2) provides that on a second or further occurrence the penalty will be the greater of $50 and the sum of 10 per cent of the unpaid tax plus 2 per cent of the unpaid tax per month of default, not exceeding 20 months. This second or further occurrence penalty will apply where a taxpayer, at the time of the failure, has already been assessed a penalty under subsection (1) in respect of an earlier failure to file a return of income for any of the three preceding years and a demand for a return for the year has been made under subsection 150(2). The second or further occurrence penalty will replace the penalty under existing subsection 163(1) for wilful failure to file a return. These amendments will apply to failures occurring after Royal Assent. A second or further occurrence penalty may be assessed for a failure after Royal Assent notwithstanding that the earlier penalty for failure to file was assessed before Royal Assent but within the three years preceding the year of the second failure.

Existing subsection 162(2) of the Act is simply renumbered as 162(3). It is applicable upon Royal Assent.

New subsection 162(4) of the Act replaces existing subsections 234(2) and (4) of the Act. Those subsections impose fines on summary conviction for failure to complete or deliver an ownership certificate in respect of the negotiation of certain bearer coupons and warrants. The fines of $10 minimum and $100 maximum are converted into penalties of $50 per failure. This amendment applies to failures occurring, and coupons and warrants cashed, after Royal Assent.

Existing subsection 162(3) of the Act provides for a penalty for failure to complete the information required on a return of income as required by section 150 of the Act. At present, this penalty is equal to 1% of the difference between the tax payable and the tax deemed to be paid under subsection 120(2), with a minimum of $25 and a maximum of $100 or, in the case of an individual, such lesser amount as the Minister may have fixed in respect of the specific failure.

Subsection 162(3) is renumbered as subsection 162(5) and is extended to apply to other reporting obligations provided in the Act and the regulations. The new subsection incorporates the provisions of existing subsection 237(2) of the Act dealing with failures to provide a Social Insurance Number. This penalty will not apply to a failure by a third party to report the Social Insurance Number of an individual where a reasonable effort is made to obtain the Number from the individual nor to a failure by an individual to provide his Social Insurance Number where the individual has applied for a Number but has not yet received it at the time the return is filed. The penalty is changed to a fixed amount of $100 for every failure. The amendment is applicable to failures occurring after Royal Assent.

New subsection 162(6) of the Act introduces a penalty for failure by an individual to provide on request his Social Insurance Number to any person who is required to make an information return in respect of the individual. The penalty will not apply where an application is made for a Social Insurance Number within 3 days of the request and the Number is subsequently provided within 3 days of its receipt. This amendment is applicable to failures occurring after Royal Assent.

New subsection 162(7) of the Act replaces existing section 235 of the Act. Section 235 provides for penalties for failure to file, as and when required by a regulation, certain information returns and for failure to supply copies of such returns. The penalty is $10 for each day of default to a maximum of $2,500. As a consequence of the introduction of expanded reporting obligations, new subsection 162(7) extends to the failure to file any information return required under the regulations or to comply with any duty imposed thereunder. The penalty is increased to the greater of $100 and $25 per day of default not exceeding 100 days. The new penalty is applicable to failures occurring after Royal Assent.

New subsection 162(8) of the Act imposes a penalty for failure to file a return of information in respect of a partnership for a fiscal period. The penalty is in addition to the penalty provided in new subsection 162(7) of the Act. The penalty will only apply where a previous penalty for a failure to file a partnership return has been assessed in respect of any of the three preceding fiscal periods. The penalty is the greater of $200 and $100 per partner for each month or part of a month of default. The new penalty is applicable to failures to make an information return occurring after Royal Assent.

New subsection 162(9) of the Act introduces a penalty in relation to the new reporting requirements in respect of tax shelters in section 237.1 of the Act. The penalty will apply to the filing of false or incomplete information and to the sale or issuance or the arranging for the sale, issuance or acquisition of interests in a tax shelter before obtaining an identification number. The new penalty is the greater of $500 and 3 per cent of the aggregate of the costs to all persons who acquire interests in the tax shelter before the correct or complete information is provided or before the identification number is issued. This amendment will become effective at the same time as new section 237.1 becomes effective, on a day to be fixed by order of the Governor in Council.

New subsection 162(10) of the Act introduces a penalty for failure to comply with the new reporting requirement in section 233.1 of the Act in respect of non-arm's length transactions between a non-resident person and a corporation resident in Canada or carrying on business therein. In addition to the penalty provided under subsection 162(7) of the Act, a defaulting corporation will be liable to a penalty in the amount of $1,000 in respect of each non-resident. If the failure continues more than 90 days after a demand for information has been served under section 233, the corporation is also liable to a penalty of $1,000 for each month or part of a month during which such failure continues after the expiration of the 90 day period. This amendment is applicable to failures occurring after Royal Assent.

New subsection 162(11) of the Act imposes a penalty of $10 for every cheque issued in payment of an amount under the Act that is not honoured when duly presented for payment. This amendment will become applicable on a day to be fixed by order of the Governor in Council.

Clause 122

Penalties

ITA
163

Section 163 of the Act imposes penalties in respect of more serious failures such as attempting to evade the payment of tax, making false statements or omitting to report income.

The penalty provided in existing subsection 163(1) of the Act in respect of failures to file returns has been replaced by the second or further occurrence penalty of new subsection 162(2). New subsection 163(1) introduces a penalty for repeated failures to report income in returns that have been filed. This penalty, which applies only to a second or further occurrence within a period of three years and only where the taxpayer is not liable to a penalty under subsection 163(2), does not require a wilful failure and amounts to 10 per cent of the unreported income.

Subsection 163(2) of the Act imposes a penalty where a taxpayer knowingly or in circumstances amounting to gross negligence, participates in or makes a false statement or omission, in a return, form, certificate, statement or answer. The subsection is amended to increase this penalty from 25 per cent to the greater of $100 and 50 per cent of the tax attributable to the false statement or omission. The amendment also clarifies that the penalty will apply to a false statement or omission that impacts on tax credits and other similar deductions from tax otherwise payable. Existing paragraph 163(2)(d) dealing with omissions and false statements in respect of share purchase tax credits is repealed.

The amendments to subsections 163(1) and (2) are applicable upon Royal Assent.

Clause 123

Penalty for Late or
Deficient Instalments

ITA
163.1

New Section 163.1 of the Act introduces a penalty for late or deficient instalment payments in addition to the interest charged under subsection 161(2) of the Act. The new penalty is 50 per cent of the interest payable in respect of such instalments under subsection 161(2) of the Act. The penalty does not apply in respect of the first $1,000 of interest. This new section is applicable to instalments of tax payable for the 1989 and subsequent taxation years.

Clause 124

Refunds

Subclause 124(1)

ITA
164(1)

Subsection 164(1) of the Act is amended to authorize the Minister of National Revenue to issue a partial refund in respect of a qualifying corporation's refundable investment tax credit in respect of scientific research and experimental development expenditures for a taxation year before having issued an assessment in respect of the corporation for the year. This amendment is applicable upon Royal Assent.

Subclause 124(2)

ITA
164(5)(d)

Subsection 164(5) of the Act provides rules for the determination of interest payable on refunds or overpayments of tax where the overpayment of tax for a year arises as a result of the carryback of a deduction on a tax credit from a subsequent year. Paragraph 164(5)(d) is amended by deleting the reference to section 110 relating to charitable donations and substituting a reference to new sections 110.1 and 118.1 which now govern deductions from income (for corporations) and tax credits (for individuals) in respect of charitable donations. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 124(3)

ITA
164(5)(g) and (h)

Subsection 164(5) of the Act provides that where the tax payable for a taxation year is reduced as a consequence of the carryback of a loss, tax credit or other amount from a subsequent year, interest payable to a taxpayer on any resulting overpayment of tax is to be calculated as if the overpayment had arisen after the end of the subsequent year or on the date of filing of the return for the subsequent year, whichever is later. Paragraphs 164(5)(g) and (h) provide for the application of this rule to the carryback of unused share-purchase tax credits and unused scientific research and experimental development tax credits, respectively. As these tax credits may no longer be produced in future years these paragraphs are unnecessary and are, therefore, repealed.

New paragraph 164(5)(g) of the Act is consequential on the introduction of the Part VI tax credit under new section 125.2 which permits a 3-year carryback of unused Part VI tax credits. This amendment, which is applicable to the 1988 and subsequent taxation years, provides that an overpayment of tax resulting from the carryback of an unused Part VI tax credit from a subsequent taxation year will not be taken into account in determining interest payable on a refund of the overpayment until the later of the dates noted above.

These amendments are applicable to the 1988 and subsequent taxation years.

Subclause 124(4)

ITA
164(5)(h.2)

Paragraph 164(5)(h.2) is repealed as a consequence of the repeal of subsection 120.2(2) relating to the minimum tax implications in the year of death. This amendment is applicable to the 1988 and subsequent taxation years.

Subclauses 124(5) and (7)

ITA
164(5.1)(d) and (h.2)

Paragraphs 164(5.1)(d) and (h.2), which apply in respect of overpayments of tax in dispute, are amended in a similar manner and for the same reasons as the amendments to paragraphs 164(5)(d) and (h.2). These amendments are applicable to the 1988 and subsequent taxation years.

Subclause 124(6)

ITA
164(5.1)(g) and (h)

The provisions of subsection 164(5.1) of the Act parallel the rules contained in subsection 164(5) except that this provision deals with interest payable in the case of repayment of an amount in controversy rather than a refund of an overpayment of tax. The amendments to subsection 164(5.1) are similar to those made to subsection 164(5) which are discussed in the commentary under that subsection. These amendments are applicable to the 1988 and subsequent taxation years.

Clause 125

Application for Time Extension

ITA
167

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

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

These amendments are applicable upon Royal Assent.

Clause 126

Appeals

ITA
172

Subsection 172(3) of the Act provides that, where the Minister has refused to register an applicant as a charitable organization, public foundation, private foundation or Canadian amateur athletic association, the applicant may appeal the decision to the Federal Court of Appeal.
Paragraph 172(3)(a.1) is amended by adding a reference to new subsection 149.1(6.3), which entitles an applicant to apply to be registered as a charitable organization, private foundation or public foundation.

Subsection 172(4) of the Act provides a similar rule allowing an applicant to appeal to the Federal Court of Appeal where the Minister is deemed to have refused the application by virtue of no decision having been made within 180 days of the application. Paragraph 172(4)(a.1) is amended to provide that, where the Minister has refused or is deemed to have refused an application for registration pursuant to subsection 149.1(6.3), the applicant may appeal to the Federal Court of Appeal.

These amendments are applicable to the 1988 and subsequent taxation years.

Clause 127

Surtax on Individuals

ITA
180.1(1.2) and (1.3)

Section 180.1 of the Act imposes a surtax on individuals for a taxation year equal to 3% of the individual's tax payable under Part I of the Act for the year. New subsection 180.1(1.2) will allow an individual to offset up to three-quarters of this surtax, after deducting his foreign tax credit for the year for the purposes of Part I.1 of the Act, by claiming investment tax credits. This will equate the treatment of individuals and Canadian-controlled private corporations in respect of their surtaxes and ITC claims. Subsection 180.1(1.3) will treat an amount deducted under subsection (1.2) as if it had been deducted under subsection 127(5) in the year for the purposes of the Act. These amendments are applicable to the 1988 and subsequent taxation years.

Clause 128

Tax on Excessive Elections

ITA
184

Under subsection 83(3) of the Act, a corporation may elect to have the whole amount of a dividend that is payable by it treated as a capital dividend paid out of its capital dividend account. Where a corporation elects in respect of a dividend payable by it and that dividend exceeds its capital dividend account at that time, subsection 184(2) requires the corporation to pay a special tax equal to three-quarters of the amount of the excess.

New subsection 184(2.1) provides relief from this tax on excessive elections made in respect of dividends paid prior to June 18, 1987 by a Canadian-controlled private corporation in its 1988 taxation year where the excessive election arose as a result of the changes to the inclusion rates for capital gains and losses of such corporations. New subsection 184(2.1) provides that the amount of the excess referred to in subsection 184(2) in respect of such a dividend will be equal to the amount of the excess that would have been determined if the corporation's taxation year had ended on December 31, 1987. Therefore, the relief from Part III tax is restricted to the portion of the excessive election that relates to the changes in the inclusion rates for capital gains and losses of corporations. This amendment is applicable upon Royal Assent.

Clause 129

Part IV Tax

ITA
186

The purpose of Part IV of the Act is to prevent the deferral of tax on portfolio dividend income through the use of a private or closely-held corporation. While dividends received by individuals will be subject to tax in their hands, corporations are generally permitted to deduct such amounts from their taxable income. In order to eliminate the incentive for individuals to obtain a significant deferral of tax on their dividend income by transferring their portfolio shareholdings to a private corporation, Part IV currently imposes a 33 1/3 per cent tax on dividends received by such corporations which is intended to approximate the tax that would be paid by an individual taxable at the highest marginal tax rate had he received the dividends directly. This tax is fully refundable to the corporation, as a dividend refund, when its earnings are distributed to its shareholders, since the shareholders will then be subject to tax at their marginal rates on the distribution.

Subclause 129(1)

ITA
186(1)

Because of the reduction of the dividend tax credit provided to individuals in receipt of taxable dividends paid after 1987, as well as the reduction in personal tax rates which is effective in 1988, the rate of tax imposed under Part IV is reduced from 33-1/3 per cent to 25 per cent for dividends received after 1987 to reflect the reduction in the rate of tax payable by individuals on such dividends.

Subclause 129(2)

ITA
186(1)(b)(i)

A corporation will be entitled to claim a refund of the special tax which it has paid under Part IV of the Act when it distributes dividends to its shareholders. Where the dividend is paid by a connected corporation, paragraph 186(1)(b) imposes a tax on the dividend in the hands of the shareholder corporation equal to the dividend refund obtained in respect thereof by the connected corporation.

An amendment to subsection 129(1) of the Act provides that the dividend refund rate on dividends paid after 1986 will be reduced to $1 for every $4 of dividends paid. This amendment to subparagraph 186(1)(b)(i) of the Act is consequential on the amendment to subsection 129(1) and provides that the 25 per cent tax under Part IV on dividends received from a connected corporation will apply to four times the appropriate portion of the dividend refund in respect thereof. This amendment is applicable to dividends received in the 1988 and subsequent taxation years. However, a transitional rule applies where a taxation year overlaps the 1987 and 1988 calendar years - in this case, Part IV tax is levied with respect to a dividend received in the year and before 1988 on the recipient's share of three times the payer's dividend refund.

Subclause 129(3)

ITA
186(5)

Subsection 186(5) of the Act provides that a subject corporation (as defined in subsection 186(1) of the Act) is considered to be a private corporation for certain purposes of the Act, one of which enables it to claim a dividend refund under section 129 of Part IV tax paid in respect of its dividend income. Where a subject corporation has accumulated refundable dividend tax on hand in respect of Part IV tax paid on dividends received before 1988, the reduction in the effective personal tax rate applying to dividend income requires that the corporation's refundable dividend tax on hand be correspondingly reduced in order to preserve the integration of corporate and individual tax on this income. Provision for this refundable tax reduction is provided in new subsection 129(3.3) and this amendment to subsection 186(5) applies this reduction to the refundable dividend tax on hand of subject corporations. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 130

Registered Charities
Revocation Tax

ITA
188(1)(b)

Section 188 of the Act requires that Part V tax must be paid by a charity the registration of which has been revoked by the Minister. Paragraph 188(1)(b) is amended by deleting the reference to paragraph 110(1)(a) (the charitable donation deduction) which is repealed and substituting a reference to new paragraph 110.1(1)(a) and subsection 118.1(2), which provide for the new charitable donations deduction for corporations and the charitable donations tax credit for individuals, respectively. This amendment, applicable to the 1988 and subsequent taxation years, is consequential on the repeal of paragraph 110(1)(a).

Clause 131

Part VI Tax Calculation

ITA
190.1(2)

Subsection 190.1(2) of the existing Act sets the annual rate of Part VI tax on a financial institution as 1 per cent of its taxable capital. This amendment increases the rate of tax to 1 1/4 per cent for the 1988 and subsequent taxation years. Financial institutions will for those years be entitled to claim a capital deduction in computing taxable capital equal to $200 million plus the lesser of $20 million and 1/5 of capital in excess of $200 million. Thus, tax will effectively be levied at a rate of 1 per cent on capital between $200 million and $300 million and at a rate of 1 1/4 per cent on capital in excess of $300 million.

Clause 132

Canadian Assets of a Corporation

ITA
190.14

Part VI of the Act is intended to levy a tax on only that portion of a financial institution's capital that is employed in Canada. The Canadian component of a corporation's capital is calculated under section 190.11 of the Act as that proportion of its capital that the corporation's Canadian assets is of its total assets. Canadian assets for this purpose is defined in section 190.14 of the Act. In order to exclude from a financial institution's taxable capital the portion of its capital that is used in deposits made with the international banking centre business of another financial institution, new section 190.14 of the Act provides a deduction in computing Canadian assets for a taxation year equal to the total of amounts outstanding at the end of the immediately preceding year that are described in paragraph (c) of the definition "eligible loan" in subsection 33.1(1) of the Act. This amendment applies to the 1988 and subsequent taxation years.

Clause 133

Capital Deduction

ITA
190.17

In order to confine the application of the Part VI tax to larger financial institutions, an institution is permitted to claim a capital deduction of $300 million in computing its taxable capital. In the case of a group of related financial institutions, the members of the group must share the capital deduction. Under new section 190.17 of the Act, the amount of the capital deduction is reduced to $200 million plus the lesser of $20 million and 1/5 of capital in excess of $200 million. This amendment applies to the 1988 and subsequent taxation years. Where a financial institution's taxation year straddles the end of 1987 the institution will be entitled under subclause 133(3) to an addition to its capital deduction based on the number of days in the year that are before 1988. This adjustment is intended to ensure that the reduction in the capital deduction effectively commences to apply on January 1, 1988 regardless of the date of the taxation year-end of any financial institution subject to tax under Part VI of the Act.

Clause 134

Instalments

ITA
190.21

Section 190.21 provides that capital tax is payable in quarterly instalments in each taxation year. The amendment to this section provides that, for the 1989 and subsequent taxation years, the amount of a quarterly instalment is to be reduced by any monthly tax instalments required under Part I of the Act during that quarter.

Clause 135

Part XII.3 Tax on Investment Income of Life Insurers

ITA
211

New Part XII.3 of the Act levies a special tax on the accumulated investment income of life insurance companies. Such investment income was subject to a similar tax from 1969 to 1977 under former Parts IIF and XII.

The tax payable under new Part XII.3 is 15 per cent of the taxable Canadian life investment income of a life insurer for taxation years commencing after June 17, 1987 and ending after 1987.

New section 211 of the Act provides definitions of certain terms to be used in new Part XII.3, as described below.

The terms "Canada security", "gross investment revenue", "non-segregated property", "participating life insurance policy", "policy loan" and "segregated fund" will have the meanings assigned by subsection 138(12).

"Guaranteed interest" in respect of a life insurance policy is defined as an amount to be determined in accordance with prescribed rules in respect of the policy for the year, with certain exceptions as described below. Guaranteed interest will be determined only for policies which were in force on March 2, 1988, when the technical details of the new tax were announced, and certain renewals of such policies, as described below. Guaranteed interest will cease to be computed in respect of a policy when the amount of the death benefit that was provided under the policy on or before March 2, 1988 is changed, except in the specific circumstances described in paragraphs (a), (b) and (c) of the definition. In addition, guaranteed interest will only be computed for policies issued after March 2, 1988 as renewal policies if the premiums payable under such policies were fixed and determined on or before March 2, 1988.

"Life insurance policy" and "life insurance policy in Canada" are defined to exclude that portion of the policy which represents a segregated fund policy.

"Property used in the year in, or held in the year in the course of" carrying on a life insurance business in Canada is defined to have the meaning assigned by paragraph 138(12)(l) of the Act in the case of a multi-national insurer and, in any other case, will have its ordinary meaning.

"Registered life insurance policy" is defined as a life insurance policy which constitutes a registered retirement savings plan or is issued pursuant to such a plan, a deferred profit sharing plan or a registered pension fund or plan, other than a policy that is an annuity contract.

New subsection 211.1(1) of the Act levies the new Part X11.3 tax upon a life insurer at a rate of 15% of its taxable life investment income for a taxation year. The taxable Canadian life investment income of an insurer is determined under new subsection 211.1(2), as described below.

New subsection 211.1(2) of the Act provides the method for determining the amount of an insurer's taxable Canadian life investment income for a particular year for the purposes of new Part XII.3. Such amount for a particular taxation year of an insurer is the excess of the insurer's Canadian life investment income for the particular year over the aggregate of the insurer's unused Canadian life investment losses from the seven preceding taxation years which may be carried forward for this purpose. Only losses arising in taxation years which commence after June 17, 1987 and end after 1987 are eligible for such carry-forward. The Canadian life investment income or loss, as the case may be, of an insurer for a taxation year is determined under new subsection 211.1(3), as described below.

New subsection 211.1(3) sets out the method for determining the amount of a life insurer's Canadian life investment income for a taxation year, for the purposes of new Part XII.3. This amount is to be determined by the formula A - B - C - D + E - F - G. The use of a formula simplifies the expression of this determination, which would otherwise be even more complicated by the fact that the amounts described at A, C, D and E may be either positive or negative amounts.

The formula in new subsection 211.1(3) requires that amounts be determined for each of the seven components A to G, which are briefly described below:

"A" The description of A generally represents the net investment revenue (or loss) and net taxable capital gains of the insurer for the year. It is determined by first aggregating the insurer's gross investment revenue (as determined for the purposes of Part I of the Act) for the year, gains and amortized discounts on Canada securities for the year, interest earned for the year under policy loans and other income gains and net taxable capital gains for the year from dispositions of property used in a life insurance business in Canada. In computing an insurer's net taxable capital gains for these purposes, capital losses realized in a taxation year commencing after June 17, 1987 and ending after 1987 will first be used to reduce capital gains for the year and any such unused capital losses may be carried forward indefinitely to be applied against capital gains of the insurer for future years. The next step in the determination of "A" is the aggregation of the insurer's losses and amortized premiums on Canada securities for the year, income losses for the year on dispositions of properties used in a life insurance business in Canada, expenses incurred in the year in managing its investments which produce income which is subject to the tax, interest payable by the insurer for the year on amounts on deposit with the insurer under its life insurance policies, and interest expense, capital cost allowance and bad debt losses deducted under Part I for the year which relate to the sources of income which are subject to the tax. Last, the aggregate of loss and expense amounts is deducted from the aggregate of income and gain amounts.

"B" The description of B represents the aggregate of the insurer's expenses for the year, to the extent deducted in computing its income from carrying on a life insurance business in Canada under Part I of the Act for the year, other than amounts included under the description of A, payments under policies and expenses related to the segregated funds of the insurer and amounts deducted under subsection 138(3) of the Act. Amounts deducted under subsection 20(26) and paragraphs 20(1)(l) and (l.1) are also excluded in the description of B, since such deductions are similarly reversed in the adjustments to the insurer's income for the year, as described under "C" below.

"C" The description of C represents the insurer's income (or loss) for the year from carrying on a life insurance business in Canada, adjusted as described below. Since this income is effectively being taxed under Part I, it is appropriate that such amount be deducted in the determination of the new Part XII.3 tax base; since losses may reduce the insurer's income for the year or for other years, it is also appropriate that the amount of any loss for the year be added back in the determination of the tax base.

The insurer's income (or loss) from the life insurance business in Canada for the year, determined under Part I, is adjusted for the following items:

(a) any income or loss arising from the insurer's segregated fund business is excluded,

(b) any amounts included or deducted in computing such income in respect of the current or prior years' investment and doubtful debt reserves of the insurer are excluded,

(c) the insurer's net taxable capital gains from property used in or held in the course of carrying on a life insurance business in Canada are included, and

(d) the maximum amounts allowable in computing the insurer's income in respect of policy reserves, unpaid claims reserves and dividend reserves are assumed to be deducted for the particular taxation year and the immediately preceding taxation year.

The adjustment referred to in (d) above is intended to avoid the distortion that could otherwise result where less than maximum amounts of policyholder reserves are deducted under Part I, and will simplify the determination of the related amounts in the description of D. It also eliminates the need for special rules dealing with the application of loss carry-overs under Part I in determining the new tax base.

"D" The description of D removes from the new tax base those portions of the amounts in the description of A, B and C which are attributable to the insurer's annuities business, registered life insurance policies and group term life insurance policies, except for an amount in respect of the income accumulating under the insurer's reserves for group term life insurance policies for the year. The detailed rules for calculating the amounts referred to in the description of D will be contained in the regulations.

"E" The description of E offsets a portion of the amounts deducted in the description of B and C to reflect

(a) the term insurance component in respect of all of the insurer's non-segregated life insurance policies in Canada (other than annuity contracts or registered or group term life insurance policies), and

(b) an amortization adjustment in respect of the insurer's expenses (other than those attributable to the term insurance component or in respect of annuity contracts or registered or group term life insurance policies).

The adjustment in (a) recognizes that the expenses in the description of B and the income in the description of C are recovered from or generated by both the insurance underwriting business and the investment business of the insurer. The adjustment referred to in (b) takes into account an appropriate amortization of the expenses in the description of B over the life of a typical policy. The detailed rules for determining the amounts in the description of E will be contained in the regulations.

"F" The description of F removes from the new Part XII.3 tax base guaranteed interest under those policies in force on March 2, 1988, the date of the announcement of the technical details of the tax, other than annuity contracts and registered or group term life insurance policies. As described above, the definition of guaranteed interest in new section 211 provides that no deduction will be available in respect of such policies after such time as the amount of the life insurance coverage in force on March 2, 1988 is changed, except in the certain circumstances described therein.

"G" The description of G removes from the new Part XII.3 tax base portions of amounts which policy holders are required to include in their income in respect of the year, which may be the result of policy loans or policy dividends, the surrender or partial surrender of policies or the application of the accrual rules to policies which are not "exempt policies" for the purposes of the accrual rules. Only those portions of such amounts which have been subject to the new Part XII.3 tax in prior years will be included in the description of G. The detailed rules for determining the non-deductible portions of such amounts will be contained in the regulations.

New section 211.2 of the Act requires every life insurer to file a return of taxable Canadian life investment income for a taxation year under new Part XII.3 at the same time as the filing required under section 150 in Part I of the Act.

New section 211.3 of the Act requires every life insurer to pay quarterly instalments of Part XII.3 tax. These instalments are determined by reference to the tax payable under Part XII.3 for the immediately preceding year.

New section 211.4 of the Act requires any Part XII.3 tax not paid as instalments during a taxation year to be paid within two months after the year-end.

New section 211.5 of the Act provides that an insurer who is liable to pay tax under new Part XII.3 is also liable to pay interest (at the rate prescribed for the purposes of section 161) in respect of late or deficient payments of taxes and instalments under new sections 211.3 and 211.4.

New section 211.6 of the Act provides that certain rules concerning assessments, interest penalties, refunds, objections and appeals, contained in sections 152, 158, 162 to 167, subsection 161(1) and Division J of the Act are applicable, with such modifications as the circumstances require, to new Part XII.3.

Clause 136

Deemed Payments to Spouse, etc.

ITA
212(12)

Subsection 212(12) of the Act provides that non-resident withholding tax is not payable in respect of an amount paid to a non-resident person where the amount is included in computing another person's income by virtue of the application of subsection 56(4) of the Act or the existing attribution rules. The amendment to this subsection extends that rule to amounts included in computing another person's income by virtue of new subsection 56(4.1) of the Act (see commentary on that provision). This amendment is applicable to the 1989 and subsequent taxation years.

Clause 137

Rules Relating to Non-Resident Withholding Tax

Section 214 of the Act contains special rules applicable to non-resident withholding tax.

Subclause 137(1)

ITA
214(2)

Subsection 214(2) of the Act provides that where subsection 16(1) of the Act would, if Part I were applicable, require part of a payment to be included in computing a recipient's income because it can reasonably be regarded as a payment of interest, that part of the payment shall be deemed to be a payment of interest for the purposes of the Part XIII tax applicable to amounts paid or credited to non-residents.

This subsection is amended to provide that where subsection 16(1) would, if Part I were applicable, result in part of a payment being included in a non-resident's income (either as interest or as any other type of income), that part will be deemed to have been paid or credited to the non-resident. Thus, depending on the nature of the income, Part XIII may apply to that part of the payment. The amendment to this subsection, which is applicable to amounts paid or payable after June, 1988, is consequential on the amendment to subsection 16(1).

Subclause 137(2)

ITA
214(3)

Subsection 214(3) of the Act treats certain amounts that would, if a non-resident person were resident in Canada, be required to be included in his income as payments to the non-resident and thereby subject to the non-resident withholding tax. This amendment, which repeals paragraph 214(3)(h), is strictly consequential on the repeal of subsection 247(1) which deals with dividend stripping. This amendment is applicable to transactions entered into on or after Royal Assent other than transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that time and completed before 1989.

Clause 138

Income of Non-Residents

ITA
216(1)

Subsection 216(1) of the Act allows non-residents to be taxed under Part I of the Act in respect of certain rent and timber royalty income rather than under Part XIII of the Act which would normally apply in such circumstances. Where such an election is made, the non-resident's income is computed without reference to any of the personal deductions. Subsection 216(1) is amended by adding new paragraph (d) consequential on the conversion of certain deductions into tax credits. New paragraph 216(1)(d) provides that, where a non-resident who receives income from real property or timber elects to pay tax on that income under Part I instead of Part XIII, the tax shall be calculated as if the taxpayer were not entitled to any of the personal tax credits under sections 118 to 118.9.

Subsection 216(5) of the Act requires that a person, who has previously made an election under 216(1) and who has claimed capital cost allowance in computing his income under that subsection, must file a return of income for the year in which he disposes of the property which was the subject of the election. Subsection 216(5) is amended consequential on the conversion of the personal tax deductions to tax credits to ensure that the personal tax credits are not taken into account in computing the non-resident's tax payable in these circumstances.

These amendments are applicable to the 1988 and subsequent taxation years.

Clause 139

Election Respecting Certain Payments

ITA
217

Section 217 of the Act provides that a non-resident may elect to pay tax on certain amounts under Part I of the Act, within six months after the end of the taxation year, rather than under Part XIII. Paragraph 217(b) permits the non-resident, in such a situation, such deductions in respect of personal exemptions as would be applicable if he had been resident for the whole year, such other deductions as may be considered wholly applicable and such part of those deductions which may be reasonably considered applicable. Paragraph 217(b) is amended consequential on the conversion of personal exemptions into tax credits. New subparagraph (ii) was formerly contained in subparagraph (iii), now repealed. New paragraph (c) permits the non-resident such part of the new tax credits contained in any of sections 118.1, 118.2, subsections 118.3(2) and (3) and sections 118.5 to 118.9 as may reasonably be considered wholly applicable and the amounts that would have been deductible under section 118 and 118.3(1) had the individual been resident in Canada throughout the year.

This amendment is applicable to the 1988 and subsequent years.

Clause 140

Part XIV - Branch Tax

ITA
219

Part XIV of the Act imposes a special tax, generally referred to as the "branch tax", at a rate of 25 per cent on the after-tax earnings of a Canadian branch of a non-resident corporation, subject to an allowance for investment in property in Canada. Subsections 219(4) to (8) in Part XIV provide rules relating to the collection and deferral of branch tax in respect of a non-resident insurer that carries on business in Canada or ceases to carry on its insurance businesses in Canada. The amendments to these subsections address certain technical deficiencies in these rules and are applicable only to non-resident insurers.

The technical deficiencies associated with subsections 219(4) to (8) may be summarized as follows:

1. The 25 per cent branch tax under subsection 219(5.1) is imposed only where a non-resident insurer ceases to carry on its insurance businesses in Canada in a taxation year. Therefore, unless the non-resident insurer has ceased to carry on all its insurance businesses in Canada, no branch tax will apply on the surplus attributable to any business that has been discontinued.

2. Subsection 219(5.2) provides for a deferral of the branch tax payable under subsection 219(5.1). However, as in the case of subsection 219(5.1), no deferral will be available unless the non-resident insurer has ceased to carry on all its insurance businesses in Canada.

3. There is no relationship between subsection 219(5.2) which provides a deferral of branch tax on the incorporation of an insurance business and subsection 138(11.5) of the Act which provides a rollover on the incorporation of an insurance business. The amount of the deferral in subsection 219(5.2) should be related to the consideration received on the business transfer referred to in subsection 138(11.5).

4. The base upon which the branch tax is levied under subsection 219(5.1) is determined under paragraph 219(4)(a). This base approximates surplus funds (tax surplus) derived from the Canadian operations of a non-resident insurer. Under subparagraph 219(4)(a)(i.1), this base includes accrued but unrealized gains arising on a disposition of property by the

insurer to a qualified related corporation or to a subsidiary wholly-owned corporation of such a corporation. This base should also include accrued but unrealized losses arising on such a disposition as well as on other tax-deferred dispositions.

5. The definition of a "qualified related corporation" in subsection 219(8) should permit a non-resident insurer to take back shares on a business transfer to a newly incorporated corporation and to elect to defer the tax payable under subsection 219(5.2).

Subclause 140(1)

ITA
219(4)(a)(i.1)

Paragraph 219(4)(a) of the Act sets out the base upon which the branch tax is imposed under subsection 219(4) in respect of a non-resident insurer that has made an election to reduce its Canadian investment fund and under subsection 219(5.1) of the Act in respect of a non-resident insurer that has ceased to carry on its insurance businesses in Canada. Subparagraph 219(4)(a)(i.1) provides that this base includes accrued but unrealized gains arising on a disposition by the insurer of property used or held by it in its insurance business in Canada to a qualified related corporation of that insurer or to a subsidiary wholly-owned corporation of such a corporation. This subparagraph is amended to include in the branch tax base all accrued but unrealized gains net of accrued but unrealized losses arising on a disposition by the insurer of such property to a taxable Canadian corporation that does not deal at arm's length with the insurer. The amendment to subparagraph 219(4)(a)(i.1) is applicable to taxation years commencing after June 17, 1987 that end after 1987 and, where a non-resident insurer has transferred a business after December 15, 1987, to taxation years of the insurer that end after December 15, 1987.

Subclause 140(2)

ITA
219(5.1) to (5.3)

New subsection 219(5.1) of the Act imposes branch tax where a non-resident insurer ceases to carry on all or substantially all of an insurance business in Canada in a particular taxation year. This 25 per cent tax is imposed on the amount by which the aggregate of the surplus funds derived from the discontinued business and net accrued but unrealized gains arising on the disposition of property held or used in that business exceed the amount that the non-resident insurer and its qualified related corporation have elected under new subsection 219(5.2) of the Act as a deferral of branch tax in respect of the discontinued business. Accordingly, as in the case of other non-resident corporations, a non-resident insurer will be subject to the branch tax once it begins to wind down its Canadian operations.

New subsection 219(5.2) of the Act is an elective provision which permits a non-resident insurer to defer the branch tax arising under new subsection 219(5.1) where it has ceased to carry on all or substantially all of an insurance business in Canada, the discontinued business has been transferred to a qualified related corporation of the insurer and both parties have elected to have new subsection 138(11.5) of the Act apply in respect of the transfer. The election under subsection 219(5.2) to defer tax under subsection 219(5.1) is made jointly by the insurer and the corporation. The maximum amount in respect of which a deferral is permitted is equal to the lesser of the maximum amount upon which the branch tax is levied under subsection 219(5.1) in respect of the discontinued business and the aggregate of the paid-up capital of the shares of the qualified related corporation received by the non-resident insurer on the transfer and the contributed surplus arising on the issue of those shares.

New subsections 219(5.1) and (5.2) are applicable to cessations of an insurance business after December 15, 1987.

New subsection 219(5.3) of the Act provides for the collection of the branch tax that was deferred under new subsection 219(5.2). All or a portion of the deferred branch tax will be collected where a qualified related corporation of a non-resident insurer ceases to be such a corporation. It will also be collected where the deferred tax account of a qualified related corporation of a non-resident insurer exceeds the aggregate of the paid-up capital of shares and the contributed surplus of the corporation. The collection is effected by deeming a dividend to have been paid to the non-resident insurer that is subject to withholding tax at a rate of 25 per cent under Part XIII of the Act. New subsection 219(5.3) is applicable after December 15, 1987.

Subclause 140(3)

ITA
219(8)

Subsection 219(8) of the existing Act defines a "qualified related corporation" of a non-resident insurer for the purposes of Part XIV. New subsection 219(8) provides that a corporation will qualify as a qualified related corporation of a non-resident insurer if it is resident in Canada and all of its issued and outstanding voting shares (other than directors' qualifying shares) are owned by the insurer, a subsidiary wholly-owned corporation of the insurer, a subsidiary wholly-owned corporation of a corporation of which the insurer is also a subsidiary wholly-owned corporation, or any combination of these.

The new definition of "qualified related corporation" is designed to permit a non-resident insurer to use a newly incorporated corporation established for the purpose of acquiring a business and to defer the branch tax payable under subsection 219(5.2). This definition is applicable after December 15, 1987.

Clause 141

Regulations

ITA
221(1)(d.1) and (e)

Paragraph 221(1)(d.1) of the Act enables the Governor in Council to make regulations requiring a person who acquired a debt obligation in bearer form to provide certain information including his Social Insurance Number to other persons who are required to report the transaction. The amendment to paragraph 221(1)(d.1) of the Act extends the power to make such regulations so as to require any person to provide his Social Insurance Number and other relevant information for purposes of any information return required to be made by any class of person.

Paragraph 221(1)(e) of the Act allows the Governor in Council to make regulations requiring a person who is required to make an information return under a regulation to supply copies to the other persons to whom the return relates. The amendment merely makes a grammatical change to the paragraph.

These amendments are applicable upon Royal Assent.

Clause 142

Withholding Taxes

ITA
227

Section 227 of the Act provides special rules relating to withholding taxes. These rules generally apply to source deductions and non-resident withholding tax under sections 153 and 215, respectively.

Subclause 142(1)

ITA
227(8) and (8.1)

Subsection 227(8) of the Act provides a penalty for failure to withhold or deduct an amount of tax at source where required under the Act or regulations. The present penalty is, in respect of an amount that should have been deducted or withheld under subsection 153(1) or section 215 of the Act, 10% of that amount and, in any other case, 100% of that amount. This subsection is amended to provide for a two-tier penalty in respect of failures to comply with subsection 153(1) or section 215 of the Act. A first occurrence penalty will be 10 per cent of the amount not deducted or withheld and a second or further occurrence penalty will be 20 per cent of that amount. The 20 per cent penalty will apply only where another penalty has previously been assessed under this subsection against the same person during the same calendar year. The amendment to this subsection also removes the part of the provision that charges interest on the amount not deducted or withheld as such interest is provided for in new subsection 227(8.3) of the Act.

Subsection 227(8.1) of the Act provides that where a taxpayer fails to deduct or withhold from any amount paid to a non-resident person, that person is jointly and severally liable with the taxpayer to any interest charges under subsection 227(8) of the Act. The reference in this subsection is changed from subsection (8) to new subsection (8.3) that now provides for the payment of interest in respect of taxes not deducted or withheld. The amendment to subsection (8.1) also extends the joint and several liability to interest on amounts that a person fails to deduct or withhold from a non-resident person in contravention of subsection 153(1).

These amendments are applicable upon Royal Assent.

Subclause 142(2)

ITA
227(8.3) and (8.4)

New subsection 227(8.3) of the Act provides that a person who fails to deduct or withhold an amount as required by subsection 153(1) or section 215 of the Act is liable to interest on that amount at the prescribed rate. This obligation replaces that provided in existing subsection 227(8) of the Act. The amendment provides that interest is calculated from the fifteenth day of the month following the month of the default under subsection 153(1) (or from such earlier date as may be prescribed for purposes of that subsection) or from the day an amount was required by section 215 to be deducted or withheld, as the case may be. The new subsection further provides that interest will cease at the time of payment unless the outstanding amount was required to be deducted or withheld under subsection 153(1) from a payee who is resident in Canada, in which case interest under this subsection will cease on the 30th day of April of the year following the year during which the default occurred or at the time of payment, whichever occurs first.

New subsection 227(8.4) of the Act provides that where a payor who is required under subsection 153(1) to deduct or withhold an amount from a payment to a non-resident person has failed to do so, the payor is liable to pay as tax under this Part the whole of the amount that should have been deducted or withheld from the non-resident person and the payor may recover from the non-resident person any such amount paid on his behalf. This subsection restates an obligation contained in existing paragraph 227(8)(b) of the Act and extends it in respect of payments to persons who would be non-residents but are deemed to be residents by reason only of having sojourned in Canada for 183 days or more in the year. The amendment ensures that the taxes paid by the payor on behalf of the non-resident person or the sojourner may properly be recovered.

These amendments are applicable upon Royal Assent.

Subclause 142(3)

ITA
227(9)

Subsection 227(9) of the Act imposes a penalty for failure to remit or pay an amount deducted or withheld as required under the Act or a regulation. The penalty currently is the greater of $10 and 10 per cent of the amount not remitted or paid. Subsection 227(9) is amended to provide for a two-tier penalty. A first occurrence penalty will be

10 per cent of the amount not remitted or paid and a second or further occurrence penalty will be 20 per cent of that amount. The 20 per cent penalty will apply only where, at the time of the failure, another penalty has previously been assessed under this subsection against the same person during the same calendar year. This amendment also removes the part of the provision that charges interest on the amount not withheld or deducted. Such interest will be provided for in new subsections (9.2) and (9.3). This amendment is applicable upon Royal Assent.

Subclause 142(4)

ITA
227(9.2) and (9.3)

New subsections 227(9.2) and (9.3) of the Act provide that a person who fails to remit or pay an amount deducted or withheld under the Act as and when required must pay interest on that amount at the prescribed rate. This obligation replaces that provided in existing subsection 227(9) of the Act. The amended subsection provides that interest is charged from the date the person is required to remit or pay an amount to the date of the remittance or payment, as the case may be. These amendments are applicable upon Royal Assent.

Subclauses 142(5) and (6)

ITA
227(10)(a) and (10.1)(a)

Paragraphs 227(10)(a) and (10.1)(a) authorize the Minister to assess penalties imposed under subsections 227(8) and (9). The amendments to these paragraphs, which are consequential on the introduction of subsections 227(8.1), (8.2), (8.3), (8.4), (9.2) and (9.3), empower the Minister to assess penalties imposed under those provisions. These amendments are applicable to assessments issued after Royal Assent.

Clause 143

Interpretation

ITA
231

Section 231 of the Act defines various terms used in sections 231.1 to 231.5. The amendment to subsection 231 extends the use of these definitions to new section 231.6 dealing with access to foreign information. This change is applicable upon Royal Assent.

Clause 144

Compliance Orders

ITA
231.2(7)

Subsection 231.2(7) of the Act enables a Court to make a compliance order where a person is found guilty of an offence under subsection 238(2) for failure to comply with a requirement under subsection 231.2(1). This order allows the Court to set out further sanctions if non-compliance persists after conviction for an offence in respect of a failure to comply with the requirement. The repeal of subsection (7) is consequential on the introduction of a general power to make compliance orders in subsection 238(2).

Clause 145

Access to Foreign Information

ITA
231.6

New section 231.6 of the Act provides rules which enable the Minister to obtain such foreign-based information or documentation as is necessary to permit a proper assessment for Canadian tax purposes.

New subsection 231.6(1) of the Act contains the definition of "foreign-based information of document". This term is defined as being any information or any document available or located outside Canada that may be relevant to the administration or enforcement of the Act.

New subsection 231.6(2) of the Act provides that a person resident in Canada or a non-resident person carrying on business in Canada must provide, when required by notice of the Minister, any foreign-based information or document.

New subsection 231.6(3) of the Act sets out a list of what must be included in a notice referred to in subsection (2). The notice must contain: a reasonable time period for compliance of at least 90 days, a description of the information or documentation being sought and the consequences of a failure to comply.

New subsection 231.6(4) of the Act permits the person served with a notice under subsection (2), within 90 days of the service thereof, to apply to a judge for a review of the requirement to provide the foreign-based information or document.

New subsection 231.6(5) of the Act sets out the powers of a judge on hearing an application for review under subsection (4). Paragraph 231.6(5)(a) provides that the judge may confirm the requirement. Paragraph 231.6(5)(b) allows the judge to vary the requirement. If, for example, the time period set forth in the notice was not reasonable in the circumstances, the judge could increase such period. The judge could also vary the description of the information or document being sought. If the judge is satisfied that the requirement to provide the foreign-based information or document is unreasonable, the judge may set aside the requirement under paragraph 231.6(5)(c).

New subsection 231.6(6) of the Act contains a limitation in determining the reasonableness of a requirement for the purposes of paragraph 5(c). A requirement is not to be considered unreasonable where the foreign-based information or document being sought is under the control of or available to a related non-resident person merely because that person is not controlled by the person served with the notice under subsection (2). For example, the requirement could not be set aside on the basis that a Canadian corporation served with a notice under subsection (2) does not control the foreign corporation which has the information or document being sought where the Canadian company is a subsidiary of the foreign corporation. However, a requirement could be held to be unreasonable where the information or document is under the control of or available to an unrelated foreign person. Apart from this specific limitation, the reasonableness of a requirement in any situation will depend on the particular circumstances.

New subsection 231.6(7) of the Act provides that the period of time that elapses between the application for review and its final disposition does not count in the computation of the time permitted for production of the information or document, nor in the statutory limit for making tax assessments relating to foreign transactions between non-arm's length taxpayers that is now extended to 6 years under new subparagraph 152(4)(b)(iii).

New subsection 231.6(8) of the Act sets out the consequences to a person of failing to comply with a requirement under section 231.6. Failure to provide all information or documents as required may result in a prohibition on the introduction into evidence of any such information or document in a civil proceeding relating to the administration or enforcement of the Act. For example, if a person provides five out of ten documents required, that person may be prohibited from introducing into evidence any of the ten documents required, including those that were provided to the Minister. As a result, a person cannot selectively provide only the information or documents which are advantageous while refusing to provide the information or documents which could assist the Minister in arriving at a proper assessment.

New section 231.6 is applicable upon Royal Assent.

Clause 146

Information Return

ITA
233.1

New section 233.1 of the Act provides that every corporation resident in Canada or carrying on business in Canada at any time in a taxation year shall, within 6 months from the end of the year, file an information return for the year containing prescribed information regarding transactions with non-resident non-arm's length persons. A separate information return must be filed in respect of each non-resident person with which the corporation did not deal at arm's length at any time in the year. This section is applicable upon Royal Assent.

Clause 147

Ownership Certificate

ITA
234(2) and (4)

Subsection 234(2) of the Act is amended to delete the penalty now incorporated in new subsection 162(4); subsection 234(4) of the Act is repealed for the same reason.

These amendments are applicable with respect to failures occurring, and coupons and warrants cashed, after Royal Assent.

Clause 148

Penalty for Failure
to Make Returns

ITA
235

Section 235 sets out penalties for failure to file various information returns and for failure to provide copies of such returns. The penalty imposed is $10 a day to a maximum of $2,500. This section is replaced by new subsection 162(7) of the Act. That subsection also increases the penalty to an amount equal to the greater of $100 and $25 per day of default up to a maximum of 100 days. This amendment is applicable upon Royal Assent.

Clause 149

Social Insurance Number

ITA
237(1) and (2)

Section 237 of the Act obliges every individual who is required by paragraph 150(1)(d) to file a return of income and who does not have a Social Insurance Number or has not applied to be assigned a Number to apply for the assignment of a Number for the purpose of filing his return. The amendment to subsection 237(1) extends the obligation to apply for a Social Insurance Number and to provide that number for all information reporting purposes under the income tax regulations. Most notably this will require individuals to provide their Social Insurance Number to a person required under a regulation to make any information return including the new investment transaction return, partnership return or tax shelter return. As noted in the comments under subsection 162(5) and (6), the penalties for failure to apply for, or to provide, the Social Insurance Number are now contained in those provisions.

The amendment to subsection 237(2) provides that any person making an information return has to make a reasonable effort to obtain the Social Insurance Number from the individual to whom the return relates. The amendment to subsection 237(2) also prohibits that person from knowingly using or communicating the Social Insurance Number without the express consent of the holder thereof.

These amendments are applicable upon Royal Assent.

Clause 150

Tax Shelters

ITA
237.1

New section 237.1 of the Act introduces a requirement for a promoter of a tax shelter to obtain an identification number from the Minister for the shelter before the sale or issue of a tax shelter can be made. Every promoter of a tax shelter will be required to ensure that this number is provided to all purchasers of an interest in the shelter and no deduction or credit will be allowed in respect of a tax shelter unless an identification number is provided. Section 237.1 also requires that an annual information return be made containing the name, address, Social Insurance Number and other prescribed information regarding all persons who have acquired an interest in the shelter.

New subsection 237.1(1) of the Act provides the definitions of "promoter" and "tax shelter" for the purposes of section 237.1. A tax shelter promoter is any person who sells, issues or promotes the sale, issuance or acquisition of a tax shelter or who acts as an agent or advisor in respect of such activities. This definition will apply to all persons responsible for the sale of a tax shelter, as well as the issuer itself. Typically, brokers, sales agents and advisors will be included. There will usually be more than one promoter for the same tax shelter. Subsection 237.1(1) also defines a tax shelter for the purpose of the new section. A tax shelter is defined as any property in respect of which it is expected that a purchaser will be entitled to deduct losses or other amounts in the four years following the acquisition in excess of the cost of the interest in the property to the purchaser computed in any such year after the deduction of prescribed benefits. The ascertainment of losses or other amounts deductible and of the cost to a purchaser is to be made on a prospective basis based upon the statements or representations made or proposed to be made in connection with the property. Prescribed benefits to be received or enjoyed by the purchaser or a person with whom the purchaser does not deal at arm's length are deducted from the cost to the purchaser of his interest in the property for the purpose of determining whether losses and other deductions exceed the cost of his interest. Such benefits will include tax credits, revenue guarantees, contingent liabilities, limited recourse debt and rights of exchange or conversion.

New subsection 237.1(2) of the Act requires the promoters of a tax shelter to apply in prescribed form for an identification number for the tax shelter. Where there is more than one promoter of the same tax shelter, an application by one such promoter discharges the others from the obligation to make an application.

New subsection 237.1(3) of the Act empowers the Minister to issue an identification number for a tax shelter. The Minister will issue an identification number upon application provided that the prescribed information is submitted and that an undertaking satisfactory to the Minister in respect of the custody of the books and records of the tax shelter is given. An undertaking by the persons who propose to sell or issue interests in the tax shelter to keep the requisite books and records at their normal place of business in Canada will normally be satisfactory to the Minister.

New subsection 237.1(4) of the Act requires that an identification number for a tax shelter be obtained before interests in the tax shelter can be sold or issued or before the sale, issuance or acquisition of such interests can be arranged. Preliminary arrangements are not prohibited by this subsection, provided that no actual sales are concluded before the identification number is issued.

New subsection 237.1(5) of the Act requires that the promoters of a tax shelter make reasonable efforts to ensure that the identification number assigned to a tax shelter be provided to every person who acquires an interest in the tax shelter. In the case of a sale or issuance of an interest by any promoter of a tax shelter, this section effectively requires the promoter to provide the identification number to the purchaser directly. In the case of subsequent sales of interests in the tax shelter in respect of which the promoter is not actually involved, his duty will normally be satisfied where he has arranged for certificates of ownership of interests in the tax shelter to have indicated thereon its identification number.

New subsection 237.1(6) of the Act provides that no amount may be claimed or deducted by a person in respect of an interest in a tax shelter unless the person provides the identification number for the tax shelter. This rule will ensure that investors identify their tax shelter deductions and credits to valid tax shelters with an identification number.

New subsection 237.1(7) of the Act imposes an obligation to make an information return in respect of all acquisitions of an interest in a tax shelter. This information return is in addition to and separate from the information that must be submitted upon application for an identification number. The obligation is imposed on every promoter of a tax shelter in respect of the acquisitions in a calendar year for which he was a promoter. The return is to be filed annually and is to provide the name, address and Social Insurance Number of every person who acquired an interest in the tax shelter in the year and the amount paid for the interest. A promoter may be a tax shelter promoter in respect of more than one tax shelter, in which case he is required to report separately the acquisitions for the year in respect of each tax shelter for which he is a promoter. Where more than one promoter is responsible for reporting the same acquisition, a report by one promoter discharges the others.

New subsection 237.1(8) of the Act ensures that the provisions of sections 231 to 231.3 dealing with audits, inspections and powers of enforcement apply to a promoter of a tax shelter or an investor in the tax shelter notwithstanding that a return of income may not have been filed for the year at the time of such audit or inspection.

New section 237.1 will be applicable upon a day to be fixed by order of the Governor in Council.

Clause 151

Offences

ITA
238

Section 238 of the Act sets out various offences for failing to comply with specified provisions of the Act.

Subsection 238(1) of the existing Act provides for a fine upon summary conviction of $25 per day of default for failing to file a return or to provide prescribed information upon acquisition of a debt obligation in bearer form pursuant to regulations made under paragraph 221(1)(d.1) of the Act. Subsection 238(2) of the existing Act provides for a fine of not less than $200 or more than $10,000 or both that fine and imprisonment for a term not exceeding six months, for failing to comply with certain provisions of the Act. The amendment to subsection 238(1) combines the existing subsections 238(1) and (2). The reference to paragraph 221(1)(d.1) is removed; failure to provide this type of information will now be sanctioned by subsections 162(5) and (6). In addition, failure to comply with an order made under amended subsection 238(2) is also added as an offence under amended subsection 238(1). The amended subsection provides for a fine of not less than $1,000 or more than $25,000, imprisonment for up to 12 months or both.

New subsection 238(2) of the Act provides that where a person has been convicted by a court under new subsection 238(1) of the Act, the court may make such order as it deems proper in order to enforce compliance with the provision. This general power to make compliance orders will eliminate the need for existing subsection 231.2(7) of the Act. A compliance order allows the Court to impose further sanctions where non-compliance continues after a person is convicted of an offence for a particular failure.

Subsection 238(3) of the Act provides that where a person has been convicted of an offence under section 238, that person is not liable to a penalty under section 162 or 227 for the same failure unless the person was assessed for that penalty before the information or complaint giving rise to the conviction was laid or made. The subsection has been amended to remove the reference to section 235 because the penalty presently provided for by that section is now provided for by subsection 162(7).

These amendments are applicable upon Royal Assent.

Clause 152

Offences

ITA
239

Section 239 of the Act establishes various offences involving wilful contraventions and other contraventions that are considered serious.

Subclause 152(1)

ITA
239(1)(f)

Paragraph 239(1)(f) of the Act provides for a fine upon summary conviction for tax evasion of a minimum of 25 per cent and a maximum of twice the amount of tax sought to be evaded, or to both the fine and a term of imprisonment of a maximum of two years. New paragraph 239(1)(f) increases the minimum fine to 50 per cent of the amount of tax sought to be evaded. This amendment is applicable to offences committed after Royal Assent.

Subclause 152(2)

ITA
239(2), (2.1), (2.2), (2.3) and (3)

Subsection 239(2) of the Act provides for prosecution by indictment for a subsection 239(1) offence where the Attorney General so elects. A person found guilty pursuant to an indictment under existing subsection 239(2) is liable to a term of imprisonment of a minimum of two months and a maximum of five years. Subsection 239(2) is amended to provide that a person found guilty upon indictment is liable to a fine of a minimum of 100 per cent and a maximum of 200 per cent of the amount of tax sought to be evaded, imprisonment for a term not exceeding five years, or to both such fine and imprisonment. This amendment is applicable to offences committed after Royal Assent.

New subsection 239(2.1) of the Act creates an offence applicable to any person who wilfully provides an incorrect identification number to another person for a tax shelter. Any person convicted is liable to a fine of not less than 100 per cent and not more than 200 per cent of the cost to the other person of his interest in the shelter, to imprisonment for a term not exceeding two years, or to both such fine and imprisonment. This new offence is introduced as a consequence of the new reporting requirements in respect of tax shelters found in new section 237.1, and more particularly the obligation imposed on the promoters of such shelters to obtain from the Minister an identification number for a shelter before any interest therein can be sold and to provide such number to purchasers of that interest. This amendment will be applicable upon a day to be fixed by order of the Governor in Council.

New subsection 239(2.2) of the Act replaces existing paragraph 241(9)(b). Subsection 241(1) of the Act prohibits disclosure of information obtained for the purposes of the Act and made knowingly by an official or authorized person except as authorized by that section. Existing paragraph 241(9)(b) Act provides that the unauthorized use or communication of tax information constitutes an offence and that any person convicted thereof is liable to a fine not exceeding $1,000, imprisonment for a term not exceeding two months, or both such fine and imprisonment. Under new subsection 239(2.2), the sentence has been increased to a fine not exceeding $5,000, imprisonment for a term not exceeding 12 months, or both such fine and imprisonment. This amendment is applicable to offences committed after Royal Assent.

New subsection 239(2.3) of the Act is introduced to sanction violations of the new secrecy obligations imposed under subsection 237(2). This offence will apply to any person who knowingly uses, communicates or allows to be communicated an individual's Social Insurance Number provided to that person pursuant to this Act or a regulation for any purpose other than that for which it was so provided or for which the person has been authorized in writing by the individual. Upon conviction an offender is liable to a fine not exceeding $5,000, imprisonment for a term not exceeding 12 months, or both such fine and imprisonment. This amendment is applicable to offences committed after Royal Assent.

Subsection 239(3) of the Act provides that where a person has been convicted under section 239 of wilfully evading or attempting to evade payment of taxes imposed by Part I, that person is not liable to a penalty imposed under section 163 of the Act for the same evasion or attempt unless the person was assessed for that penalty before the information or complaint giving rise to the conviction was laid or made. A reference to section 162 of the Act has been added in the amended subsection 239(3) to extend the protection afforded therein to assessments of the new penalties created under section 162. This amendment is applicable to offences committed after Royal Assent.

Clause 153

Communication of Information

ITA
241

Section 241 of the Income Tax Act prohibits the communication of information by an official or an authorized person unless specifically authorized by one of the exceptions found in that section.

Subclause 153(1)

ITA
241(4)(d)

Paragraph 241(4)(d) of the Act authorizes an official or authorized person to communicate or allow to be communicated to a taxpayer information obtained under the Act or the Petroleum and Gas Revenue Tax Act regarding the income of his spouse or of any other person that is necessary for the purpose of determining any tax, interest, penalty or other amount payable by the taxpayer or of any refund to which he is entitled under the Act or the Petroleum and Gas Revenue Tax Act. Paragraph 241(4)(d) is being amended to permit the communication by an official or authorized person to a taxpayer of information obtained from a third party that may reasonably be regarded as necessary for determining, in respect of that taxpayer, the tax, interest, penalty or other amount payable by the taxpayer, or of any credit or refund to which he may be entitled under the Act or the Petroleum and Gas Revenue Tax Act.

This amendment is necessary because, in a number of situations, information provided to Revenue Canada by one taxpayer in the normal course of filing a return or other document under the Act or the Petroleum and Gas Revenue Tax Act may be the basis upon which the Minister assesses or proposes to assess another taxpayer. For example, information provided by a company in connection with a flow-through share issue may reveal that a number of expenses allocated to investors are required to be recategorized or otherwise do not meet statutory requirements. The amount claimed by investors as a deduction would accordingly have to be altered.

Section 241, as presently worded, precludes the communication of that information by Revenue Canada to the taxpayer being assessed. When existing paragraph 241(4)(d) was introduced, its purpose was solely to deal with child tax credit situations. Further, it refers only to the "income" of the spouse or other person and is therefore too narrow in scope to encompass the range of situations where it is appropriate to communicate third party information to a taxpayer. In many cases, it will not be the "income" of the third party which is relevant, but rather, for example, the date on which a particular transaction occurred or a document was filed by the third party. In such cases, under the existing provision, the taxpayer could not be made aware by Revenue Canada of the basis of the assessment or proposed assessment, could not therefore make informed representations in respect of the assessment where the relevant information could not be obtained from the third party, and would have access to the information provided to Revenue Canada by the third party only by challenging the assessment in court.

The amendment to paragraph 241(4)(d), which becomes effective upon Royal Assent, will ensure that this situation is corrected and that such information can be communicated in appropriate cases.

Subclause 153(2)

ITA
241(4)(i) and (j)

New paragraph 241(4)(i) authorizes the communication to a taxpayer of information regarding expenses the deduction of which is denied to another taxpayer by reason of subsections 18(2) or 18(3.1), which information is necessary for the purpose of determining the cost or adjusted cost base of property to the taxpayer. This paragraph is introduced as a consequence of the amendments to subsections 18(3) and (3.2) and is applicable after 1987.

New paragraph 241(4)(j) authorizes the communication of information to a taxpayer relating to the control or the tax status of a corporation that previously owned property where, under any provision of the Act, it is necessary to determine whether a gain from the disposition of that property by the taxpayer accrued while that corporation was controlled by non-residents or was a tax-exempt corporation. This new paragraph, applicable after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, is consequential on the introduction of the new anti-avoidance rule in section 83 relating to capital dividends.

Subclause 153(3)

ITA
241(9)

As noted in the commentary under subsection 239(2.2), existing subsection 241(9) is repealed and replaced by new subsection 239(2.2). This amendment is applicable upon Royal Assent.

Clause 154

Mailing Date

ITA
244(14)

Subsection 244 of the Act provides a rule presuming the date on which various notifications made by the Minister under the Act to be the date of mailing thereof. Subsection 244(14) is amended to include a reference to the notification under new subsection 149.1(6.3) in respect of registered charities for these purposes. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 155

General Anti-Avoidance Rule

ITA
245

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

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

Transactions that comply with the object and spirit of other provisions of the Act read as a whole will not be affected by the application of this general anti-avoidance rule. For example, a transaction that qualifies for a tax-free rollover under an explicit provision of the Act, and that is carried out in accordance not only with the letter of that provision but also with the spirit of the Act read as a whole, will not be subject to new section 245. However, where the transaction is part of a series of transactions designed to avoid tax and results in a misuse or abuse of the provision that allows a tax-free rollover, the rule may apply. If, for example, a taxpayer, for the purpose of converting an income gain on a sale of property into a capital gain, transfers the property on a rollover basis to a shell corporation in exchange for shares in a situation where new section 54.2 of the Act does not apply and subsequently sells the shares, the new section could be expected to apply.

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

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

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

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

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

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

Where subsection 245(2) applies, the tax consequences to a person are to be determined so as to deny the tax benefit on a basis that is reasonable in the circumstances. New subsection 245(5) provides a non-exhaustive list of what may be done to achieve that result. In many cases the manner in which this should be accomplished will be obvious or will be provided for in the Act. However, the "reasonable basis" approach adopted in subsection 245(2) recognizes that it is not possible to exhaustively prescribe the appropriate tax consequences for the range of avoidance transactions to which the rule might apply.

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

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

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

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

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

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

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

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

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

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

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

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

Therefore, the application of new subsection 245 must be determined by reference to the facts in a particular case in the context of the scheme of the Act. For example, the attribution provisions of the Act set out detailed rules that seek to prevent a taxpayer from transferring property by way of a gift and thereby transferring income to a spouse or minor children. A review of the scheme of these provisions indicates that income splitting is only of concern in transfers of property involving spouses or children under 18 years of age. The attribution rules are not intended to apply to other transfers of property such as gifts to adult children. This can be discerned from a review of the scheme of the Act, its relevant provisions and permissible extrinsic aids. Thus a straightforward gift from a parent to his adult child will not be within the scope of section 245 either because it is made primarily for non-tax purposes or because it may reasonably be regarded as not being an abuse of the provisions of the Act. If, however, the gift is made so that the adult child acquires an investment and, through a series of transactions, disposes of it and subsequently transfers the proceeds, including any income therefrom, to the parent, proposed section 245 should apply where the purpose of the transaction is the reduction, avoidance or deferral of tax.

As another example, "estate freezing" transactions whereby a taxpayer transfers future growth in the value of assets to his children or grandchildren will not ordinarily be avoidance transactions to which the proposed rules would apply despite the fact that they may result in a deferral, avoidance or reduction of tax. Apart from the fact that many of these transactions may be considered to be primarily motivated by non-tax considerations, it would be reasonable to consider that such transactions do not ordinarily result in a misuse or abuse given the scheme of the Act and the recent enactment of subsection 74.4(4) of the Act to accommodate estate freezes.

Another example involves the transfer of income or deductions within a related group of corporations. There are a number of provisions in the Act that limit the claim by a taxpayer of losses, deductions and credits incurred or earned by unrelated taxpayers, particularly corporations. The loss limitation rules contained in subsections 111(4) to (5.2) of the Act that apply on a change of control of a corporation represent an important example. These rules are generally restricted to the claiming of losses, deductions and other amounts by unrelated parties. There are explicit exceptions intended to apply with respect to transactions that would allow losses, deductions or credits earned by one corporation to be claimed by related Canadian corporations. In fact, the scheme of the Act as a whole, and the expressed object and spirit of the corporate loss limitation rules, clearly permit such transactions between related corporations where these transactions are otherwise legally effective and comply with the letter and spirit of these exceptions. Therefore, even if these transactions may appear to be primarily tax-motivated, they ordinarily do not fall within the scope of section 245 since they usually do not result in a misuse or abuse.

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

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

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

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

Where new subsection 245(2) applies, the tax consequences to a person are to be determined so as to deny the tax benefit on a basis that is reasonable in the circumstances. For that purpose, by virtue of new subsection 245(5), among other things

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

- all or part of any deduction, income, loss or other amount may be allocated to any person,

- a payment or other amount may be recharacterized, or

- the tax effects that would otherwise result from the application of other provisions of the Act may be ignored.

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

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

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

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

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

A request for adjustment may be made by that other person within 180 days after the day of mailing to the taxpayer of a notice of assessment, reassessment or determination, as the case may be. Amendments to section 167 of the Act allow that other person to make an application to the Tax Court of Canada for a time extension in the circumstances considered in existing subsection 167(5).

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

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

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

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

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

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

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

Section 245 of the Act is applicable with respect to transaction entered into on or after Royal Assent other than transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that time and completed before 1989.

Clause 156

Benefit Conferred on a Person

ITA
246

New section 246 of the Act replaces subsections 245(2) and (3) of the Act. Since these subsections do not relate to the general anti-avoidance rule in new section 245, they are renumbered as subsections 246(1) and (2). The language of these subsections is also substantially modified.

Subsection 245(2) of the Act currently provides that where a person confers a benefit on a taxpayer through one or more sales, exchanges, declarations of trust or other transactions of any kind, that person shall be deemed to have made a corresponding payment to that taxpayer. Depending on the circumstances, that payment shall then be either included in the income of the taxpayer, deemed to be a payment subject to Part XIII tax or deemed to be a disposition by way of gift. New subsection 246(1) provides that where a person confers a benefit, directly or indirectly, in any manner whatever, on a taxpayer, the amount of that benefit, if it is not otherwise included in the taxpayer's income and would have been so included if it had been a payment made directly to the taxpayer and if the taxpayer had been resident in Canada, shall either be included in the taxpayer's income or, if the taxpayer is a non-resident, shall be deemed to be a payment made to the taxpayer (to which the non-resident withholding tax may apply depending on the nature of that payment).

Subsection 245(3) of the Act generally prevents the application of subsection 245(2) where it is established that a sale, exchange or other transaction was entered into by persons dealing at arm's length, bona fide and not pursuant to, or part of, any other transaction and not to effect payment of an existing or future obligation. New subsection 246(2) deletes the reference to sales or exchanges since these are already included within the meaning of "transaction".

These amendments are applicable to benefits conferred on or after Royal Assent other than benefits conferred through transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that time and completed before 1989. This parallels the coming-into-force of new section 245.

Clause 157

Dividend Stripping

ITA
247

Subsection 247(1) of the Act is an anti-avoidance provision aimed at a transaction or series of transactions one of the purposes of which is to effect a significant reduction of, or disappearance of, assets of a corporation in order to avoid the whole or part of the tax that would have been payable on the distribution of property of a corporation.

Subsection 247(1) is repealed as a consequence of the introduction of new section 245 of the Act, which constitutes a general anti-avoidance rule. Because the scope of that general anti-avoidance rule is broad enough to cover the transactions to which subsection 247(1) was intended to apply, that subsection is no longer necessary.

Subsection 247(1) is repealed with respect to transactions entered into on or after Royal Assent other than transactions that are part of a series of transactions, determined without reference to subsection 248(10) of the Act, commencing before that time and completed before 1989. This parallels the coming-into-force of new section 245.

Clause 158

Definitions

ITA
248

Section 248 of the Act defines many of the terms used in the Act and contains a number of special rules for the purposes of applying other provisions of the Act.

Subclause 158(1)

ITA
248(1)

Subclause 158(1) amends several definitions currently contained in subsection 248(1).

"business"

The definition of "business" is amended, with respect to dispositions occurring after 1987, to exclude an "adventure or concern in the nature of a trade" for the purposes of new section 54.2 of the Act. New section 54.2 provides that where a taxpayer disposes of all or substantially all of the assets used in a business carried on by him to a corporation in exchange for shares of that corporation, the shares are deemed to be capital property of the taxpayer. Thus this amendment to the definition of "business" will prevent the application of section 54.2 where the assets that are transferred to a corporation are used in an adventure or concern in the nature of a trade that would not otherwise comprise a business.

"capital dividend"

The definition of "capital dividend" is amended simply to replace the reference to "subsection 83(2)" with a reference to "section 83". This amendment, applicable after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, is consequential on the introduction of the new anti-avoidance rule in section 83 relating to capital dividends.

"exempt income"

The definition of "exempt income" is amended with respect to transactions entered into on or after Royal Assent, other than transactions that are part of a series of transactions commencing before that time and completed before 1989. This amendment is strictly consequential on the repeal of subsection 247(1). Because of this repeal, the part of the definition referring to subsection 247(1) is repealed.

"group term life insurance policy"

The definition of "group term life insurance policy" is amended, applicable after 1987, to ensure that this definition includes a group policy in which there is a provision for either an experience rating refund or a dividend.

"private health services plan"

"registered Canadian amateur athletic association"

"registered charity"

The definitions of "private health services plan", "registered Canadian amateur athletic association" and "registered charity" were formerly contained in paragraphs 110(8)(a), (b) and (c) respectively and have been included in subsection 248(1) due to the repeal of those paragraphs. There has been no substantive change to the definitions.

Subclause 158(2)

ITA
248(1)

Subclause 158(2) adds several new definitions to subsection 248(1).

"adjustment time"

The definition of "adjustment time" in respect of a taxpayer, which relates to the rules in respect of eligible capital property, is provided in paragraph 14(5)(c) of the Act. Accordingly, subsection 248(1) is amended to incorporate that definition for all purposes of the Act. This amendment is applicable after 1987.

"amortized cost"

Subsection 248(1) of the Act is amended to add a definition of "amortized cost" of a loan or lending asset to a taxpayer as used in determining a reserve under paragraph 20(1)(l) of the Act. A "lending asset" is also defined in subsection 248(1). The starting point for determining amortized cost in the case of a loan made by the taxpayer is the amount advanced on the loan at or before the relevant time. In the case of a loan or lending asset acquired by the taxpayer, the starting point is its cost to the taxpayer. This amount is then increased by the excess of the amount of the principal amount of the loan or lending asset at the time it was acquired by the taxpayer over the cost to the taxpayer of acquiring it to the extent this excess has been included in computing the taxpayer's income. A further addition is provided for insurers of an amount deemed by reason of paragraph 142(3)(a), as it read in its application to the 1977 taxation year, to be a gain for a taxation year in respect of the loan or lending asset. Amounts included in respect of the loan or lending asset under paragraph 12(1)(i) in respect of recoveries of bad debts also increase the amortized cost. The amortized cost of the loan or lending asset is then reduced by the excess of the cost to the taxpayer of acquiring the loan or lending asset over its principal amount at the time it was acquired by the taxpayer to the extent this excess has been deducted in computing the taxpayer's income. A further reduction is provided for amounts the taxpayer received in respect of the principal amount of the loan or lending asset before that time. An insurer is required to deduct an amount deemed by reason of paragraph 142(3)(b), as it read in its application to the 1977 taxation year, to be a loss for a taxation year in respect of the loan or lending asset. Lastly amounts deducted as bad debts under paragraph 20(1)(p) in respect of the loan or lending asset will reduce its amortized cost. The definition of "amortized cost" is applicable to taxation years commencing after June 17, 1987 that end after 1987.

"appropriate percentage"

The definition of "appropriate percentage" is added to subsection 248(1) and means the lowest marginal tax rate referred to in subsection 117(2) of the Act that is applicable in determining an individual's tax payable under Part I. For 1988, this is 17%. This definition is applicable to the 1988 and subsequent taxation years.

"automobile"

The definition of "automobile" is added to subsection 248(1) and means a motor vehicle designed primarily to carry individuals and having a seating capacity of not more than 9 people and a motor vehicle that is a station wagon or van if it is equipped to carry more than the driver and 2 passengers but not more than the driver and 8 passengers. Vehicles such as an ambulance, a motor vehicle acquired for use as a taxi or in connection with funerals, and motor vehicles acquired for the business of renting or leasing are excluded from the definition. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

"eligible capital amount"

The definition of a taxpayer's "eligible capital amount" contained in subsection 14(1) of the Act is incorporated into subsection 248(1) of the Act and will therefore be applicable for all purposes of the Act. This amendment is applicable after 1987.

"lending asset"

The definition of "lending asset" is added to subsection 248(1). Lending assets are eligible for a doubtful debt reserve under paragraph 20(1)(l) and are used in the definition of "amortized cost" added to subsection 248(1). A lending asset is defined as a bond, debenture, mortgage, note, hypothec, agreement of sale or any other indebtedness or a prescribed share but does not include a prescribed security. A prescribed share is defined in new paragraph 6209(a) of the regulations as a preferred share of a corporation owned by a bank that is reported as a substitute or alternative for a loan to the corporation in the bank's annual report to the relevant authority. These shares were previously eligible for a reserve of the bank under the Minister's rules enacted pursuant to section 26 of the Act. Therefore, those debt substitutes that are prescribed shares will be eligible for a doubtful loan or lending asset reserve under subparagraph 20(1)(l)(ii) where the cost of the share is doubtful of collection. A prescribed security is defined in new paragraph 6209(b) of the regulations as a security which is part of the trading account of a bank or part of the inventory of any other taxpayer. Prescribed securities will not be eligible for a doubtful loan or lending asset reserve under subparagraph 20(1)(l)(ii). This treatment is appropriate in the case of securities included in the inventory or the trading account of a taxpayer since the taxpayer does not intend to hold these securities to maturity and therefore should not be entitled to reserve against the ultimate collectibility of the principal of the security. A write-down in valuing inventory would ordinarily be permitted. The definition of "lending asset" is applicable to taxation years commencing after June 17, 1987 that end after 1987.

"motor vehicle"

The definition of "motor vehicle" is added to subsection 248(1) and means an automotive vehicle designed for use on highways and streets. Excluded from this definition are trolley buses or vehicles designed or adapted for use exclusively on rails. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

"passenger vehicle"

The definition of "passenger vehicle" is added to subsection 248(1) and means an automobile acquired after June 17, 1987 other than an automobile acquired after that date pursuant to an obligation in writing entered into before June 18, 1987. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

"personal services business"

The definition of "personal services business", contained in subsection 125(7) of the Act for the purposes of that section, is incorporated into subsection 248(1) and will therefore be applicable for all purposes of the Act. This amendment is applicable to the 1988 and subsequent taxation years.

"specified investment business"

The definition of "specified investment business", contained in subsection 125(7) of the Act for the purposes of that section, is incorporated into subsection 248(1) and will therefore be applicable for all purposes of the Act. This amendment is applicable to the 1988 and subsequent taxation years.

"specified member"

The definition of a "specified member" of a partnership is added to subsection 248(1) of the Act, applicable after December 15, 1987. Generally, a "specified member" of a partnership in a fiscal period or taxation year of the partnership is

(a) a member who was a limited partner of the partnership at any time in the period or year, or

(b) a member who was neither

(i) actively engaged in the business of the partnership, nor

(ii) otherwise engaged in a similar business as that carried on by the partnership,

throughout that part of the period or year that the business is ordinarily carried on and during which he was a member of the partnership.

This definition is used in new subsection 96(1) relating to partnership losses, subsection 110.6(1) relating to the cumulative net investment loss rules as they apply to members of partnerships, and subsection 127(8) relating to partnership investment tax credits.

"tax shelter"

The definition of "tax shelter" is added to subsection 248(1) consequential on the introduction of the new information reporting requirements contained in new section 237.1 in respect of tax shelters.

Subclause 158(3)

ITA
248(1)

"cost amount"

Paragraph (e) of the definition of "cost amount" in subsection 248(1) of the Act defines the cost amount to a taxpayer at any time of a debt owing to the taxpayer as the amount outstanding on account of the debt at that time. This paragraph is amended, applicable after 1986, to provide that the cost amount of such property is the amortized cost to the taxpayer of the property at that time or, where the property does not have an amortized cost, the amount of the debt outstanding at that time. New paragraph (e.1) of the definition of "cost amount", applicable after 1986, defines the cost amount to a taxpayer of a property that was a policy loan of an insurer, within the meaning of new paragraph 138(12)(k.1) of the Act, to be nil. The cost amount of a policy loan of an insurer is treated as nil since the insurer is permitted to deduct the amount advanced on a policy loan in computing its income for the year in which the advance is made.

Subclause 158(4)

ITA
248(11)

Subsection 248(11) of the Act provides for the daily compounding of interest payable under the Act. References are added to new subsections 227(8.3), (9.2) and (9.3) in respect of interest payable on amounts that were not deducted or withheld or paid, as the case may be, under subsection 153(1) or section 215 or that were not remitted as required under the Act or the regulations.

Subclause 158(5)

ITA
248(12)

New subsection 248(12) contains the rule previously set out in repealed subsection 47(3) for determining when a bond, debenture, bill, note or other similar obligation issued by a debtor is identical to another such obligation issued by the debtor. This subsection states that in order for the obligations to be identical the rights attaching to both obligations, other than the principal amount, must be identical. This rule, in addition to applying to the identical property rules in subsection 47, applies to the superficial loss rule in new subsection 18(13). This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Clause 159

Extended Meaning of Resident

ITA
250

Section 250 of the Act provides an expanded definition of a resident of Canada for purposes of the Act.

Subclause 159(1)

ITA
250(1)(f)

Paragraph 250(1)(f) of the Act is amended as a consequence of the repeal of paragraph 109(1)(d) (dependent children deduction) and the definition "dependant" of an individual contained in subsection 109(6). New paragraph 250(1)(f) now refers to a dependant described in paragraph 118(1)(d) which contains the dependant child tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 159(2)

ITA
250(2)

Subsection 250(2) of the Act provides a rule including an individual in the expanded definition of resident in Canada for any part of a taxation year. Subsection 250(2) of the Act is amended by deleting the word "during" where it occurs in that subsection and substituting the word "throughout". This amendment clarifies that a person and his dependants described in that subsection will be deemed to have been resident in Canada for the whole period described in that subsection. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 160

Persons Related by
Blood Relationship

ITA
251(6)

Subsection 251(6) of the Act provides rules defining the circumstances in which persons will be considered to be connected by blood relationship, marriage or adoption. Subsection 251(6) is amended by deleting the reference in the preamble to clause 109(1)(b)(ii)(c) as a result of the repeal of that clause. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 161

Extended Meaning of
Child

ITA
252(1)(b)

Subsection 252(1) of the Act provides an extended meaning of a child of a taxpayer for the purposes of the Act. Paragraph 252(1)(b) of the Act is amended to delete the reference to dependants aged 21, and substitute a reference to age 19, as a result of the lowering of the age limit for dependent children contained in new paragraph 118(1)(d). This amendment is applicable to the 1988 and subsequent taxation years.

Clause 162

Acquisition of Control

ITA
256

Subsection 256(7) of the Act contains rules for determining whether or not there has been an acquisition of control of a corporation for the purposes of certain provisions of the Act. Subsection 89(1.1) provides for a reduction in the capital dividend account (CDA) of a corporation that was controlled by non-residents by the amount of that account at the time the corporation becomes a Canadian-controlled private corporation. Subsection 256(7) is amended, applicable after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, by adding a reference to subsection 89(1.1) which, in effect, provides for a reduction in the CDA of a predecessor corporation controlled by non-residents where it amalgamates with another corporation and the new amalgamated corporation is a Canadian-controlled private corporation.

Clause 163

Private Corporation Year-End Election

Clause 163 permits Canadian-controlled private corporations to terminate taxation years on December 31, 1987 that would otherwise end after that date and permits other private corporations to terminate taxation years on June 30, 1988 that would otherwise end after that date.

A corporation which elects to terminate its taxation year on December 31, 1987 is required to be a Canadian-controlled private corporation from the beginning of that year to the end of 1987. The effect of the election, which is to be made by the corporation in its return of income for the year, is that the year will be deemed to have ended on December 31, 1987 and a new year deemed to have begun on January 1, 1988.

A corporation which elects to terminate its taxation year on June 30, 1988 is required to be a private corporation (other than a Canadian-controlled private corporation) from the beginning of that year to the end of June, 1988. The effect of the election is that the year will be deemed to have ended on June 30, 1988 and a new year deemed to have begun on July 1, 1988.

In either situation described above, a corporation will not be considered to have adopted a fiscal period prior to the date on which its taxation year is terminated and, accordingly, will be able to select a new fiscal period for taxation years commencing after that date.

Clause 164

Capital Tax

ITA

Part VI

Clause 164 provides that, effective for the 1988 and subsequent taxation years, the Act is to be amended in accordance with Schedule I. Pursuant to Schedule I, the references to the words "capital tax" in the provisions of Part VI of the Act are to be changed to references to the word "tax".

Clause 165

Income Tax Application Rules, 1971

ITAR
62(3)

Subsection 62(3) of the Income Tax Application Rules, 1971 provided the effective dates for subsections 163(1) and (3) of the Act when they were introduced in 1971. As a consequence of the amendment made to subsection 163(1) of the Act, and having regard to the period of time that has elapsed since the introduction of subsections 163(1) and (3), subsection 62(3) of the ITARs is no longer needed and is repealed, applicable upon Royal Assent.

Clause 166

S.C.1986, c.6, s.33(7)

Small Business Corporation Shares

ITA
70(9.4), (9.5) and (9.7)

Subsections 70(9.4) and (9.5) of the Act formerly provided for an inter-generational rollover of small business corporation shares on the death of a taxpayer. Subsection 70(9.7) of the Act formerly provided for a rollover of small business corporation shares to the parent of a deceased child who had acquired the shares where subsections 70(9.4), (9.5) or 73(5) applied. As a result of the acceleration of the phase-in of the capital gains exemption in respect of such shares, these subsections have been repealed with respect to transfers or dispositions made after 1987. Difficulties can arise, however, where the taxpayer died prior to 1988 but the shares were not transferred until after 1987. Subsection 33(7) of the amending legislation, S.C.1986, c.6, is therefore amended to provide that subsections 70(9.4), (9.5) and (9.7) of the Act are repealed effective for deaths occurring after 1987.

Clause 167

S.C.1986, c.55, subs.26(5)

Partnership Ceasing to Exist

ITA
98(3)

Subsection 98(3) of the Act is an elective provision permitting property of a Canadian partnership which has ceased to exist to be distributed to its members, for proceeds to the partnership, and at a cost to the members, equal to the cost amount of the property to the partnership, provided certain conditions are met. Where those conditions are met, this provision allows a special increase or "bump-up" in the tax value of the distributed partnership property where the adjusted cost base of a member's partnership interest exceeds the amount of any money and the cost amount to the partnership of the property which he has received upon the dissolution. Paragraph 98(3)(d) which allowed half of this excess to be allocated to property other than non-depreciable capital property up to the fair market value of the property was repealed, applicable in respect of certain events occurring after December 4, 1985. This paragraph which continues to apply to certain "grandfathered" partnership property is amended as a result of the changes to the inclusion rates for capital gains.

Paragraph 98(3)(d) is amended to increase the portion of the excess that may be allocated to property other than non-depreciable capital property from one-half to two-thirds in respect of partnerships which cease to exist in taxation years of individuals ending after 1987 and before 1990, in taxation years of Canadian-controlled private corporations commencing after 1987 and in taxation years of other corporations commencing after June, 1988. The portion of the excess which may be so allocated is further increased from two-thirds to three-quarters in respect of partnerships which cease to exist in taxation years of individuals ending after 1989 and in taxation years of corporations commencing after 1989. For taxation years of corporations that straddle any of the effective dates, rules are provided to prorate the relevant inclusion rates based on the number of days in the corporation's year that fall on either side of that date.

Clause 168

S.C.1986, c.55, subs.45(1) and (3)

Small Business Deduction

ITA
125

Subsections 45(1) and (3) of chapter 55 of the Statutes of Canada 1986 provide that the small business deduction under subsection 125(1) of the Act is to be reduced to 20% effective July 1, 1989. This clause repeals these subsections as they have been superseded by the amendments to section 125 in clause 86.

Clause 169

S.C.1986, c.55, subs.46(3)

Manufacturing and Processing Tax Credit

ITA
125.1

Subsection 46(3) of S.C.1986, c.55, provides an additional 1% manufacturing and processing tax credit under section 125.1 of the Act for the period between June, 1987 and July, 1988. This additional credit is calculated by reference to certain provisions in subsection 125.1(1) of the Act which have been amended by clause 87. This amendment to subsection 46(3) is intended to reflect these amendments to subsection 125.1(1).

Clause 170

S.C.1986, c.55, subs.52(2)

Investment Corporations

ITA
130

Subsection 52(2) of S.C.1986, c.55, provides certain adjustments to the amount of the tax deduction allowed to investment corporations under subsection 130(1) of the Act. This clause amends paragraph 55(2)(2)(b) to restrict its application to taxation years ending after 1986 and before 1988; for taxation years ending after 1987, the amendments to subsection 130(1) of the Act contained in clause 100 are applicable.

Clause 171

Canada Pension Plan

CPP
22(6) and (7)

Subsection 22(6) of the Canada Pension Plan imposes a penalty on an employer who fails to remit to the Receiver General any employer or employee contributions to the Plan that the employer is required to remit. The subsection also requires the employer to pay interest to the Receiver General on the amount of contributions not remitted as required. Subsection (6) is replaced by new subsection (6), which maintains the existing requirement to pay interest, and new subsection (7), which replaces the existing penalty with a two-tier penalty similar to the penalty under amended subsection 227(9) of the Income Tax Act. The new penalty is 10 per cent of the amount that the employer failed to remit. Where a penalty has already been assessed for a failure to remit an amount of contribution during the same year, the rate of the penalty on a subsequent occurrence in the year is 20 per cent rather than 10 per cent. New subsections 22(6) and (7) are applicable upon Royal Assent.

Clause 172

Unemployment Insurance Act, 1971

Subclause 172(1)

UI
68(6) and (7)

Subsection 68(6) of the Unemployment Insurance Act, 1971 imposes a penalty on an employer who fails to remit to the Receiver General any employer or employee premiums that the employer is required by the Act to remit. The subsection also requires the employer to pay interest to the Receiver General on the amount of premiums not remitted as required. Subsection (6) is replaced by new subsection (6), which maintains the existing requirement to pay interest, and new subsection (7), which replaces the existing penalty with a two-tier penalty similar to the penalty under new subsection 227(9) of the Income Tax Act. The new penalty is 10 percent of the amount that the employer failed to remit. Where a penalty has already been assessed for a failure to remit an amount of contribution during the same year, the rate of the penalty on a subsequent occurrence in the year is 20 per cent rather than 10 per cent. New subsections 68(6) and (7) are applicable upon Royal Assent.

Subclause 172(2)

UI
145.2(2)

Subsection 145.2(1) of the Unemployment Insurance Act, 1971 allows the Minister of National Revenue to disclose confidential income tax information to an official or authorized person of the Canada Employment and Immigration Commission for the administration and enforcement of the provisions of the Act relating to the repayment of excess unemployment insurance benefits. Subsection 145.2(2) of the Act subjects the officials or authorized persons to whom such information is disclosed to the confidentiality provisions of the Income Tax Act, including subsection 241(9) of that Act which makes it an offence to contravene the confidentiality requirements. Subsection 241(9) of that Act is repealed and replaced with a new offence provision in subsection 239(2.2). The amendment to subsection 145.2(2) of the Unemployment Insurance Act, 1971 changes the reference to new subsection 239(2.2) of the Income Tax Act. The new offence is an offence punishable on summary conviction by a fine not exceeding $5,000 or imprisonment for up to 12 months or both the fine and imprisonment. The amendment to subsection 145.2(2) is applicable to offences committed after Royal Assent.

Appendix A

Draft Income Tax Regulations: Financial Institutions Explanatory Notes

APPENDIX A

DRAFT INCOME TAX REGULATIONS - FINANCIAL INSTITUTIONS

EXPLANATORY NOTES

Clause 1

Regulations 600 to 602

Part VI of the Regulations sets out the formulae for calculating doubtful debt reserves of credit unions. This Part is repealed applicable to taxation years commencing after June 17, 1987 that end after 1987 as a result of the repeal of the special reserves currently available for credit unions under paragraphs 137(1)(a) and (b) of the Act. Credit unions will now claim a doubtful debt reserve under paragraph 20(1)(1) of the Act.

Clause 2

Regulation 808

Part XIV of the Act imposes a special tax, generally referred to as the "branch tax", at a rate of 25% on the after-tax earnings of a Canadian branch of a non-resident corporation. Paragraph 219(1)(h) of the Act permits the deduction of an allowance in calculating the branch tax base for investment in property in Canada not exceeding a prescribed amount. Section 808 of the Regulations sets out the rules for determining the investment allowance. This allowance is reduced by certain reserves, including those deducted under paragraphs 20(1)(l) and (n) and under section 33 of the Act which provides a special reserve for a taxpayer whose ordinary business includes the lending of money on security. Paragraph 808(2)(j), subparagraph 808(2)(p)(i) and paragraph 808(5)(h) of the Regulation are amended to add a reference to new paragraph 20(1)(l.1) and to delete the reference to repealed section 33 of the Act. New paragraph 20(1)(l.1) provides a reserve for losses expected to arise under certain instruments or commitments issued, made or assumed by a taxpayer who is an insurer or whose ordinary business includes the lending of money. These amendments are applicable to taxation years commencing after June 17, 1987 that end after 1987.

Clause 3

Regulation 6209

New section 6209 of the Regulations defines a prescribed share and a prescribed security for the purposes of the new definition "lending asset" in subsection 248(1) of the Act. An asset that is a lending asset of an insurer or a taxpayer whose ordinary business includes the lending of money is eligible for a doubtful debt reserve under subparagraph 20(1)(l)(ii). A lending asset includes assets that are debts or prescribed shares but does not include a prescribed security.

A prescribed share is defined in new paragraph 6209(a) of the Regulations as a preferred share of a corporation owned by a bank that is reported as a substitute or alternative for a loan to the corporation in the bank's annual report to the relevant authority. This type of share was also eligible for a reserve under the Minister's rules issued pursuant to section 26 of the Act.

A prescribed security, which is not eligible for a doubtful debt reserve under subparagraph 20(1)(l)(ii), is defined in new paragraph 6209(b) as a security that forms part of the trading account of the bank or that forms part of the inventory of any other taxpayer. It is not appropriate that a doubtful debt reserve against the ultimate payment of the principal amount of the security be provided in the case of a security in the trading account or the inventory of a taxpayer since such securities are generally not intended to be held to maturity. The deduction for tax purposes in respect of any such security is provided in the Act by way of an inventory write-down where its value falls below its cost to the taxpayer.

The definitions prescribed share and prescribed security are applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Clause 4

The Regulations are amended by adding two new parts.

Regulations 8000 to 8002

New Part LXXX establishes the prescribed reserve amount of a taxpayer and the prescribed recovery rate for the purposes of amended subparagraph 20(1)(1)(ii) and new paragraph 20(1)(1.1) of the Act. Subparagraph 20(1)(1)(ii) and new paragraph 20(1)(1.1) of the Act provide a doubtful debt reserve in respect of loans and lending assets of a taxpayer and a reserve in respect of losses expected to arise under or in respect of certain instruments and commitments issued, made or assumed by the taxpayer. These reserves are applicable to insurers and taxpayers whose ordinary business includes the lending of money.

Clause 20(1)(1)(ii)(A) of the Act provides that a taxpayer can deduct his prescribed reserve amount for the year as defined in section 8000 of the Regulations. The prescribed reserve amount of a taxpayer, unlike other reserves claimed under subparagraph 20(1)(1)(ii), is not reduced by a prescribed recovery rate. Two types of reserves are included in computing a taxpayer's prescribed reserve amount.

The first type of reserve is a reserve reported by a bank to the Superintendent of Financial Institutions for the year as general provisions in respect of exposures to designated countries or as a special provision for losses on transborder claims of the bank. The prescribed reserve amount for this type of reserve is the amount reported to and accepted by the Superintendent of Financial Institutions for the year in respect of those provisions, not exceeding 40% of the amortized of the loans or lending assets included in calculating those provisions that were made or acquired in the ordinary course of the bank's business. Lending assets are defined in subsection 248(1) of the Act as including debt and certain preferred shares held by banks that are debt substitutes.

The second type of reserve included in computing the prescribed reserve amount is a reserve determined by segregating doubtful loans and lending assets of a taxpayer into different classes based on the length of time interest or principal has been in arrears and multiplying the amount of the amortized cost of loans and lending assets of a class by an historical loss experience of the taxpayer for that class. Historical loss experience of a taxpayer in respect of a class of loans or lending assets, as defined in new section 8002 of the Regulations, means a reasonable percentage of the amortized cost to the taxpayer of the loans or lending assets of that class that is a representation of prior years' losses net of recoveries with respect to loans or lending assets of that class.

New section 8001 of the Regulations sets the prescribed recovery rate at 10% for the purposes of clause 20(1)(1)(ii)(B) and subparagraph 20(1)(1.1)(ii) of the Act. The prescribed recovery rate is the percentage reduction required for a doubtful debt reserve determined under subparagraph 20(1)(1)(ii) on an asset by asset basis rather than on a pooled basis. It also reduces the amount determined under paragraph 20(1)(1.1) in respect of losses expected to arise under certain instruments or commitments such as loan guarantees and letters of credit. This percentage reduction reduces the amount of the reserves allowed for tax purposes and recognizes that a portion of the reserves of financial institutions includes a prudential element.

New section 8002 defines the term "historical loss experience" of a taxpayer for the purposes of new section 8000 of the Regulations. This term is used for the purposes of determining the prescribed reserve amount of a taxpayer and is discussed in the commentary to section 8000.

Regulations 8100 to 8105

New Part LXXXI deals with the transitional rules for reserves of financial institutions provided for in the June 18, 1987 tax reform proposals.

New section 8100 of the Regulations sets out several rules for the purposes of determining the prescribed amount of a taxpayer's net reserve inclusion under section 12.3 of the Act where the taxpayer has deducted an amount in respect of his prescribed amount of net reserve adjustment under subsection 20(26) of the Act in his first taxation year or fiscal period that commences after June 17, 1987 and ends after 1987 (referred to in section 8100 as an "amount of net reserve adjustment").

New subsection 8100(1) provides that the prescribed amount of a taxpayer's net reserve inclusion for a year is 15% for 1989, 25% for 1990, 25% for 1991 and 35% for 1992 of his amount of net reserve adjustment where his taxation year or fiscal period coincides with the calendar year. In other cases, the percentage of his amount of net reserve adjustment to be included in computing his income for a taxation year will be determined by prorating the percentages based on the number of days of his taxation year or fiscal period within such calendar years.

New subsection 8100(2) provides a special rule for the purposes of subsection (1) where a new corporation has been formed as a result of an amalgamation of two or more predecessor corporations at least one of which has deducted an amount of net reserve adjustment. In any such case, the new corporation is deemed to have an amount of net reserve adjustment equal to the amount of net reserve adjustments of the predecessor corporations. Therefore, any portion of the amount of net reserve adjustment not previously included in income by the predecessor corporations will be required to be included in income by the new corporation for its taxation years ending after 1988 and commencing before 1993. New paragraph 87(2)(g.1) of the Act treats the new corporation as being the same corporation as and a continuation of each predecessor corporation for the purposes of new section 12.3 of the Act.

New subsection 8100(3) provides special rules for the purposes of subsection (1) where a subsidiary that has an amount of net reserve adjustment is wound-up into its parent pursuant to subsection 88(1) of the Act. In such cases, the parent corporation is required to include the remaining amount of the subsidiary's amount of net reserve adjustment in its income. As a result, the appropriate percentage of this amount will be included in the parent's income under new section 12.3 of the Act for its taxation years ending after the transfer of the property to and the assumption of liabilities of the subsidiary by the parent.

New subsection 8100(4) provides special rules for the purposes of subsection (1) where a partnership would have ceased to exist but for the fact that another partnership is deemed to be a continuation of that partnership under subsection 98(6) of the Act. This subsection requires the remaining amount of the predecessor partnership's amount of net reserve adjustment that has not previously been included in its income to be included in the income of the other partnership. As a result, the appropriate percentage of this amount will be included in the other partnership's income under section 12.3 of the Act for its fiscal periods ending after the time the property of the predecessor partnership was transferred to and the liabilities of the predecessor partnership were assumed by the other partnership.

New subsection 8100(5) provides special rules for the purposes of subsection (1) where a non-resident insurer that carried on an insurance business in Canada has transferred that business pursuant to subsection 138(11.5) of the Act to another corporation. This subsection requires the appropriate percentage of the remaining amount of the non-resident insurer's amount of net reserve adjustment that has not previously been included in its income to be included in the other corporation's income under section 12.3 of the Act for its taxation years ending after the transfer of the insurance business.

New subsection 8100(6) overrides subsection (1) and applies where a person or a partnership that has an amount of net reserve adjustment that can reasonably be attributed to a particular business discontinues or transfers that business. This paragraph requires the person or partnership to include in its income in the year that it discontinued or transferred its business the remaining amount of its amount of net reserve adjustment attributable to that business that has not previously been included under section 12.3 of the Act. For taxation years of the person or partnership commencing on or after the time of the discontinuance or the transfer of the business, it is treated as having no amount of net reserve adjustment in respect of that business. This provision will not apply to cases where the person or partnership is a corporation that amalgamates within the meaning of section 87 of the Act, a corporation that is wound-up into its parent pursuant to subsection 88(1) of the Act, a partnership that transfers its business under subsection 98(6) of the Act or an insurer that transfers its business under subsection 138(11.5) of the Act.

Section 8101 of the Regulations determines a taxpayer's prescribed amount of net reserve adjustment for the purposes of determining the amount that a taxpayer who is an insurer or whose ordinary business includes the lending of money may deduct under subsection 20(26) of the Act in his first taxation year or fiscal period that commences after June 17, 1987 and ends after 1987. The amount deducted is then required to be included in the taxpayer's income under section 12.3 of the Act over the next five years -- that is, for his taxation years and fiscal periods ending after 1988 that commence before 1993.

Subsection 8101(1) of the Regulations defines the prescribed amount of a taxpayer's net reserve adjustment as the amount of his preliminary reserve adjustment, as defined in subsection 8101(2), minus the following undeducted tax deductions and other amounts determined at the end of his taxation year or fiscal period immediately preceding his first taxation year that commences after June 17, 1987 and ends after 1987:

- the amount of his non-capital loss carryforward at the end of that year or fiscal period;

- where the taxpayer is a bank, the amounts as determined under the Minister's rules, that are undeducted at the end of that year and that may be deducted under subsection 26(2) of the Act in the year immediately following that year, including its undeducted five-year average loan loss experience, its undeducted transfers to its tax allowable appropriations account (also referred to as PAR transfers), its undeducted special provision for losses on transborder claims for that year, any negative balance in its tax allowable appropriations account and its undeducted amounts calculated under Procedure 8 of the Procedures for the Determination of the Provision for Loan Losses; and

- an amount in respect of undeducted capital cost allowance for that year determined as the amount by which the maximum amount thereof that could have been claimed for that year in respect of property of a prescribed class exceeds the amount actually claimed for that year in respect of that class.

Subsection 8101(2) defines the preliminary reserve adjustment of a taxpayer for the purposes of calculating his prescribed amount of net reserve adjustment under subsection 8101(1). This amount is generally the excess of the amount of reserves and certain other deductions claimed by the taxpayer in his taxation year or fiscal period preceding his first taxation year that commences after June 17, 1987 and ends after 1987 over the amount that could have been claimed in that year if the tax reform proposals had applied to that year.

Paragraph 8101(2)(a) calculates an amount in respect of the preliminary reserve adjustment for financial institutions in general. This paragraph includes in a taxpayer's preliminary reserve adjustment the excess of reserves claimed under subparagraph 20(1)(1)(ii), subsection 33(1), paragraph 137(1)(a) or (b), 137.1(3)(c) or 138(3)(c) of the Act in his taxation year preceding his first taxation year that commences after June 17, 1987 and ends after 1987 over the greater of two amounts. These two amounts are intended to calculate a notional doubtful debt reserve for that preceding year equal to the amount that could have been claimed if the tax reform proposals had applied to that preceding year. The first amount is the maximum amount that could have been deducted by the taxpayer for that preceding year under subparagraph 20(1)(1)(ii) in respect of doubtful loans or lending assets or under new paragraph 20(1)(1.1) in respect of losses expected to arise under certain instruments and commitments if those provisions applied. The second amount ensures that the notional reserve is not less than a minimum amount by applying a ratio to the doubtful debt reserve taken for the year immediately preceding his first taxation year or fiscal period that commences after June 17, 1987 and ends after 1987. This ratio is determined as the doubtful debt reserve determined under the tax reform proposals in the first taxation year or fiscal period commencing after June 17, 1987 that ends after 1987 over the doubtful debt reserve that could have been claimed for that first taxation year or fiscal period if the pre-tax reform rules had continued to apply.

The following example illustrates the application in the case of a credit union of the restriction set by the notional reserve in paragraph 8101(2)(a):

Facts

		Year Prior to Tax Reform	First Year of Tax Reform[1]
1.	Maximum reserve under paragraph 137(1)(a) and (b)	$2,000	$3,000
2.	Reserve based on tax reform proposals under subparagraph 20(1)(1)(ii) and paragraph 20(1)(1.1)	$200	$500

Calculation of preliminary reserve adjustment

The preliminary reserve adjustment is $1,667 determined as:

Maximum reserve under paragraphs 137(1)(a) and (b) for year prior to tax reform.	$ 2,000
Minus greater of	
(a) Maximum reserve under tax reform proposals for year prior to tax reform. ($200)	
(b) $A \times \frac{B}{C} = 2{,}000 \times \frac{500}{3{,}000}$ ($333)	$ 333

where

A = Maximum reserve under paragraph 137(1)(a) and (b) for year prior to tax reform ($2,000)

B = Reserve based on tax reform proposals for first year of tax reform ($500)

C = Maximum reserve under paragraph 137(1)(a) and (b) for first year of tax reform ($3,000)

$ 1,667

Note:

1. First year of tax reform is the first year that commences after June 17, 1987 and ends after 1987.

Where the taxpayer is a credit union, this amount is then reduced by an amount prescribed to be a credit union's 1971 reserve adjustment as determined under new section 8102 of the Regulations. The 1971 reserve adjustment of a credit union reduces the amount of the recaptured investment reserves required to be included in computing the credit union's income under paragraph 137(1)(c) of the Act for the taxation year immediately following that year to take into account amounts the credit union was deemed to have deducted as a reserve under paragraph 137(1)(a) or (b) of the Act in its 1971 taxation year.

Paragraph 8101(2)(b) calculates an amount in respect of the preliminary reserve adjustment of a bank. This paragraph includes in a bank's preliminary reserve adjustment the amount by which the amount included in computing its income under new subsection 26(1) of the Act in its first taxation year that commences after June 17, 1987 and ends after 1987 exceeds the maximum amount that could have been deducted by the bank for the immediately preceding taxation year under subparagraph 20(1)(l)(ii) or new paragraph 20(1)(l.1) if those provisions applied in that preceding year. Subsection 26(1) includes in a bank's income its specific and general provisions, its special provision for losses on transborder claims minus any part of that provision that is a realized loss and any positive balance in its tax allowable appropriations account at the end of its taxation year immediately preceding its first taxation year that commences after June 17, 1987 and ends after 1987.

Paragraph 8101(2)(c) calculates an amount in respect of the preliminary reserve adjustment of an insurer. First the total of the following amounts is determined in respect of the insurer for its taxation year immediately preceding its first taxation year that commences after June 17, 1987 and ends after 1987:

- the amount deducted by it in that year under paragraph 20(7)(c) in respect of claims received and unpaid at the end of that year under insurance policies;
- the amount deducted under subparagraph 138(3)(a)(i) in that year in respect of a policy reserve for life insurance policies of a particular class as is allowed by regulation;
- the amount deducted in that year under subparagraph 138(3)(a)(iv) in respect of a reserve for policy dividends;
- where the insurer is a life insurer, the amounts deducted by it in respect of claims made under insurance policies that were unpaid at the end of that year; and

- the amount included the insurer's income under subsection 140(2) of the Act in its first taxation year that commences after June 17, 1987 and ends after 1987.

This total amount so determined in respect of the insurer is then reduced by the total of the following amounts determined in respect of the insurer for its taxation year immediately preceding its first taxation year that commences after June 17, 1987 and ends after 1987:

- the maximum amount that would have been deductible by the insurer in that year under paragraph 20(7)(c) or subparagraph 138(3)(a)(i) or (iv) or under new subparagraph 138(3)(a)(ii) (which provides a deduction for a prescribed amount as a reserve in respect of claims received before the end of the year and unpaid at the end of the year under life insurance policies of a particular class of the insurer) if those provisions applied to that preceding year.

- the amount by which the greater of

  (a) the amount that would have been deductible by the insurer for that year under subparagraph 20(1)(1)(ii) or new paragraph 20(1)(1.1) if those provisions applied to that preceding year, and

  (b) that proportion of the amount deducted by the insurer under paragraph 138(3)(c) for that year that the amount deductible by the insurer under subparagraph 20(1)(1)(ii) or new paragraph 20(1)(1.1) for the first taxation year that commences after June 17, 1987 and ends after 1987 is of the amount that would have been deductible by the insurer for that first taxation year under paragraph 138(3)(c) if it had applied to that year

  exceeds

  (c) the amount deducted by the insurer for that year under paragraph 138(3)(c); and

- an amount prescribed to be the insurer's 1968 reserve adjustment, as determined under section 8103 of the Regulations, which reduces the amount of recaptured reserves required to be included in computing the insurer's income for the taxation year immediately following that year to take into account amounts the insurer was deemed to have deducted as reserves in its 1968 taxation year.

Section 8102 of the Regulations defines the prescribed amount of a credit union's 1971 reserve adjustment to take into account amounts the credit union was deemed to have deducted as a reserve under paragraph 137(1)(a) or (b) of the Act in its 1971 taxation year. The amount of a credit union's 1971 reserve adjustment reduces its income inclusion under paragraph 137(1)(c) of the Act in its first taxation year that commences after June 17, 1987 and ends after 1987. Paragraph 137(1)(c) requires a reserve claimed under paragraph 137(1)(a) or (b) of the Act in the immediately preceding year to be included in the current year's income. The amount of its 1971 reserve adjustment also reduces the amount of transitional relief to which the credit union is entitled by reducing its preliminary reserve adjustment under paragraph 8101(2)(a) of the Regulations.

A credit union's 1971 reserve adjustment is basically the difference between the 1971 deemed reserve and a notional reserve that is intended to represent the amount that would have been the deemed reserve for that year if the tax reform proposals had applied to that year. The notional reserve is determined as that proportion of the 1971 deemed reserve that the maximum amount deductible by the credit union under subparagraph 20(1)(1)(ii) or paragraph 20(1)(1.1) of the Act in computing its income for its first taxation year that commences after June 17, 1987 and ends after 1987 is of the maximum amount that would have been deductible by the credit union under subparagraph 20(1)(1)(ii) or paragraph 137(1)(a) or (b) of the Act in computing its income for that year if those provisions had applied to that year as they read in their application to the preceding year.

The following example illustrates the calculation of a credit union's 1971 reserve adjustment:

Facts

1971 deemed reserve	$ 100
Maximum subparagraph 20(1)(1)(ii) reserve first year of tax reform	$ 600
Maximum paragraphs 137(1)(a) and (b) reserves first year of tax reform on the assumption that those paragraphs applied	$1,000

Calculation of 1971 reserve adjustment

1971 reserve adjustment is $40 determined as

1971 deemed reserve ($100) - 1971 reserve under tax reform ($60)

1971 reserve under tax reform is $60 determined as

$$A \times \frac{B}{C} = 100 \times \frac{600}{1{,}000} = \$60$$

where

A = 1971 deemed reserve ($100)
B = Maximum subparagraph 20(1)(1)(ii) reserve first year of tax reform ($600)
C = Maximum paragraphs 137(1)(a) and (b) reserves first year of tax reform ($1,000)

1971 reserve adjustment = 100 - 60 = $40

Note

1. First year of tax reform is the first year of the credit union that commences after June 17, 1987 and ends after 1987.

Regulation 8103 defines the prescribed amount of an insurer's 1968 reserve adjustment to take into account amounts the insurer was deemed to have deducted as reserves under the equivalent of subparagraph 138(3)(a)(i) or (iv) or paragraph 138(3)(c) of the Act in its 1968 taxation year. The amount of the insurer's 1968 reserve adjustment reduces the amount included in its income under paragraph 138(4)(a) of the Act in its first taxation year that commences after June 17, 1987 and ends after 1987 in respect of a reserve claimed under subparagraph 138(3)(a)(i) or (iv) or paragraph 138(3)(c) of the Act in the immediately preceding year. The amount of the insurer's 1968 reserve adjustment also reduces the amount of transitional relief to which it is entitled by reducing its preliminary reserve adjustment.

An insurer's 1968 reserve adjustment is basically the difference between the 1968 deemed reserves and the amounts that would have been the deemed reserves for that year if the tax reform proposals had applied to that year. The 1968 reserve adjustment is calculated as the aggregate of the three following amounts:

- the excess of the amount that would have been the insurer's maximum tax actuarial reserve for its 1968 taxation year if that reserve had been determined on the basis of the rules that applied to its 1978 taxation year over the amount that would have been its maximum tax actuarial reserve for its 1968 taxation year if that reserve had been determined on the basis of the rules that applied to its first taxation year that commences after June 17, 1987 and ends after 1987;

- the excess of the amount that the insurer was deemed, for the purposes of paragraph 68A(4)(a) as it read in respect of its 1969 taxation year, to have deducted in respect of policy dividends under its participating life insurance policies under subparagraph 68A(3)(a)(iv) of the Act in its 1968 taxation year over the maximum amount that would have been deductible under subparagraph 138(3)(a)(iv) of the Act for its 1968 taxation year if that subparagraph had applied to that year as it read in its application to its first taxation year that commences after June 17, 1987 and ends after 1987; and

- the excess of the amount the insurer was deemed, for the purposes of paragraph 68A(4)(a) as it read in respect of its 1969 taxation year, to have deducted in respect of an investment reserve under paragraph 68A(3)(c) in its 1968 taxation year over that proportion of the 1968 deemed reserve that the maximum amount deductible by it under subparagraph 20(1)(l)(ii) or paragraph 20(1)(l.1) for its first taxation year that commences after June 17, 1987 and ends after 1987 is of the maximum amount that would have been deductible under paragraph 138(3)(c) for that year if that paragraph had applied to that year.

The following example illustrates the calculation of an insurer's 1968 reserve adjustment:

Facts

1968 Deemed Deductions

1968 Maximum tax actuarial reserve (Maxtars) under 1978 rules	$ 100
Subparagraph 68A(3)(a)(iv) policy dividend deduction	$ 50
Paragraph 68A(3)(c) investment reserve deduction	$ 200

Deductions under Tax Reform

1968 Maxtars under tax reform rules	$ 25
1968 policy dividend deduction under tax reform rules	$ 30
Maximum subparagraph 20(1)(l)(ii) first year of tax reform[1]	$ 300
Maximum paragraph 138(3)(c) investment reserve first year of tax reform	$1,000

Calculation of 1968 Reserve Adjustment

(a) Policy Reserves

= 1968 Maxtars under 1978 rules - 1968 Maxtars under tax reform rules
= 100 - 25
= $75

(b) Policy Dividends

= 1968 deemed deduction - 1968 deduction under tax reform
= 50 - 30
= $20

(c) Investment Reserve

= 1968 deemed deduction ($200) - 1968 deduction under tax reform ($60)

1968 deduction under tax reform $= A \times \frac{B}{C} = 200 \times \frac{300}{1{,}000} = \$60$

where

A = 1968 deemed deduction under paragraph 68A(3)(c)($200)
B = Maximum subparagraph 20(1)(1)(ii) reserve first year of tax reform ($300)
C = Maximum paragraph 138(3)(c) reserve first year of tax reform ($1,000)

200 - 60	=	$140
1968 Reserve Adjustment ($75 + $20 + $140)		$235

Note

1. First year of tax reform is the first year of the insurer that commences after June 17, 1987 and ends after 1987.

Section 8104 of the Regulations applies to treat, for the purposes of Part LXXXI of the Regulations, a new corporation formed as a result of an amalgamation of two or more predecessor corporations, a parent of a subsidiary wholly-owned corporation that has been wound-up into the parent, and an insurer to which a non-resident insurer that carried on an insurance business in Canada has transferred that business pursuant to subsection 138(11.5) of the Act, as a continuation of the predecessors, subsidiary or non-resident insurer.

Section 8105 of the Regulations defines the terms "maximum tax actuarial reserve" and "Minister's rules" for the purposes of Part LXXXI of the Regulations.

Examples of Transition for Financial Institutions

Example 1: Bank with October 31, Year End

Calculation

Amount included under subsection 26(1) for 1988 taxation year	$3000
Less: Maximum deduction in 1987 under subparagraph 20(1)(1)(ii) and paragraph 20(1)(1.1) under 1988 rules	(1000)
Preliminary Reserve Adjustment	2000
Less: Undeducted Five-year Average Loan Loss Experience	(1350)
Unutilized CCA in 1987	(50)
Prescribed amount of Net Reserve Adjustment (Deduction in 1988)	$ 600

Transition Schedule with October 31 Year Ends

Taxation Year	Inclusion Percentage[1]	Prescribed Amount of Net Reserve Inclusion
1989	12 1/2	$ 75
1990	23 1/3	140
1991	25	150
1992	33 1/3	200
1993	5 5/6	35
Total		$600

Note:

1. These fractions are approximate. The actual percentage would be based on the number of days in the bank's taxation year that is in each applicable calendar year.

Example 2: Insurance Company

Calculation of Preliminary Reserve Adjustment	YEAR PRIOR TO FIRST YEAR OF TAX REFORM[1] Actual Reserve with Pre-Reform Tax Rules	Maximum Amount with Post-Reform Tax Rules	Difference
Policy Reserves	$10,000	$ 9,500	$ 500
Policy Dividend Reserves	1,000	500[2]	500
Unpaid Claim Reserve	1,000	800	200
Provision for Doubtful Accounts	500	200	300
Preliminary Reserve Adjustment	$12,500	$11,000	$1,500
Less			
Non-Capital Loss Carryforward			(1,000)
Prescribed Amount of Net Reserve Adjustment (Deduction in First Year of Tax Reform)			$500

Note:

1. First year of tax reform is first year that commences after June 17, 1987 and ends after 1987.

2. This amount represents accrued but unpaid policy dividends at the end of the year prior to first year of tax reform.

Appendix B

Draft Income Tax Regulations: Insurance Corporations Explanatory Notes

APPENDIX B

DRAFT INCOME TAX REGULATIONS - INSURANCE CORPORATIONS

EXPLANATORY NOTES

Clause 1

REG 801

Section 801 of the Regulations sets out the requirements in respect of the filing of a tax return by a non-resident insurer. The section requires a registered non-resident insurer to file a T2016 return in respect of a taxation year on or before April 30 in the immediately following year. Section 150 of the Income Tax Act requires a non-resident insurance corporation to file a T2 return in respect of a taxation year within 6 months from the end of the year. The timing difference for the filing of these returns causes practical difficulties for non-resident insurers and problems in terms of effecting any necessary reassessments. Accordingly, the amendment to section 801 will eliminate the timing difference by requiring a registered non-resident insurer to file the T2016 return in respect of a taxation year within 6 months from the end of the year. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Clause 2

REG 1400(e)

Section 1400 of the Regulations sets out the amounts which an insurance corporation is permitted to deduct as a policy reserve under paragraph 20(7)(c) of the Income Tax Act in respect of its policies arising out of its other than life insurance businesses.

Paragraph 1400(e) provides for a policy reserve in respect of unpaid claims of an insurer arising in the course of its other than life insurance business. The amount of this reserve is equal to the lesser of a reasonable amount in respect of the insurer's liability for unpaid claims and the reserve in respect of the liability reported by the insurer in its annual report for the year to the relevant authority. The amendments to this paragraph are consequential to the introduction of new paragraph 18(1)(e.1) of the Act which prohibits the deduction of a reserve for unpaid claims except as otherwise expressly permitted. Paragraph 20(7)(c) of the Act allows a reserve for unpaid claims of an other than life insurance business and the amendments to paragraph 1400(e) provide for the discounting of the amount of such reserves.

The amendments to paragraph 1400(e) set out the basis of calculation of the amount deductible as a reserve in respect of an insurer's liability for unpaid claims by reference to the amount that is reported by the insurer in its annual report for the year to the relevant authority or, where the insurer was subject to the supervision of the relevant authority but was not required to file an annual report for the year, in its financial statements for the year.

Where the amount of the reserve reported by the insurer was computed as the present value as at the end of the year of the amount of the liability, the insurer is permitted to claim a reserve under subparagraph 1400(e)(i) up to the lesser of a reasonable amount in respect of the present value of the liability and 95 per cent of the amount of the reserve reported by the insurer. Where the amount of the reserve reported by the insurer was not computed in the manner referred to above, the insurer is permitted to claim a reserve under subparagraph 1400(e)(ii) up to the lesser of a reasonable amount in respect of the liability and an amount calculated on a formula basis. This formula may be expressed as follows:

$$A - \frac{1}{3}(A - B)$$

where

A is the lesser of a reasonable amount in respect of the liability as at the end of the year and the amount of the reserve reported by the insurer; and

B is the present value of the amount of the liability as at the end of the year calculated on the basis of a reasonable interest rate.

Further, notwithstanding subparagraph 1400(e)(i) or (ii), where the liability relates to a structured settlement in respect of damages for personal injury or death, the insurer is permitted to claim a reserve under subparagraph 1400(e)(iii) equal to the present value of the amount of the reserve reported by the insurer.

The amendments to paragraph 1400(e) are applicable to the 1987 and subsequent taxation years. However, for taxation years ending before the first taxation year that commences after June 17, 1987 and ends after 1987, the amount deductible as a reserve in respect of an insurer's liability for unpaid claims shall be calculated as the lesser of a reasonable amount in respect of the liability and the amount of the reserve reported by the insurer.

Clause 3

REG 1401

Section 1401 of the Regulations sets out the amounts which a life insurer is permitted to deduct as a policy reserve under subparagraph 138(3)(a)(i) of the Income Tax Act in respect of its life insurance policies in Canada.

Subclause 3(1)

Paragraph 1401(1)(a) of the Regulations permits a life insurer to deduct a reasonable amount in respect of deposit administration fund policies based on the amount of the insurer's liabilities under those policies as calculated in the manner required for the purposes of the insurer's annual report to the relevant authority. The amendment to this paragraph is technical in nature and provides that, where the insurer was subject to the supervision of the relevant authority but was not required to file an annual report for the year, the amount of the insurer's liabilities is the amount calculated in its financial statements for the year. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 3(2)

Paragraph 1401(1)(d) of the Regulations permits a life insurer to deduct an amount in respect of certain benefits, risks or guarantees under a policy that does not exceed the lesser of a reasonable amount and the reserve in respect of the benefit, risk or guarantee as reported by the insurer in its annual report to the relevant authority. The amendment to subparagraph 1401(1)(d)(xi) is technical in nature and provides that, where the insurer was subject to the supervision of the relevant authority but was not required to file an annual report for the year, the reserve in respect of the benefit, risk or guarantee is the reserve reported by the insurer in its financial statements for the year. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 3(3)

New subsection 1401(3) of the Regulations is consequential on the amendment to the definition of "policy loan" in paragraph 138(12)(k.1) of the Income Tax Act. The amended definition provides that a policy loan is the full amount advanced by a life insurer to a policyholder under the terms of a life insurance policy. Paragraph 138(3)(e) of the Act provides that the amount of policy loans advanced by a life insurer is deductible in computing its income. Pursuant to subparagraph 138(3)(a)(i) and paragraph 1401(1)(c) of the Regulations, this same amount reduces the amount of the policy reserve that the insurer may deduct in respect of its liabilities under life insurance policies. New subsection 1401(3) ensures that the amount of this deduction is reduced by the amount of policy loans made under those policies. Accordingly, as before, the net effect of a policy loan on the income of an insurer is nil while interest earned by the insurer on the loan is taxable under paragraph 138(4)(d) of the Act. New subsection 1401(3) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

New subsection 1401(4) of the Regulations is consequential on the introduction of new paragraph 18(1)(e.1) and subparagraph 138(3)(a)(ii) of the Income Tax Act which allow a reserve for unpaid claims of a life insurance business and provide for the discounting of the amount of such reserves. This subsection sets out the basis of calculation of the amount deductible as a reserve in respect of unpaid claims under life insurance policies in Canada of a life insurer. The amount of this reserve is equal to the present value of the amount of such claims as at the end of the year calculated on the basis of a reasonable interest rate. New subsection 1401(4) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 3(4)

This sets out the effective date for the amendments to paragraph 1401(1)(a) and subparagraph 1401(1)(d)(xi) and for new subsections 1401(3) and (4) of the Regulations.

Clause 4

REG 1404(2)

Subsection 1404(2) of the Regulations defines several terms for the purposes of Part XIV.

The amount of a "modified net premium" as presently defined is calculated using the 1-year preliminary term method. This amount is used in determining the policy reserve of a life insurer under paragraph 1401(1)(c) of the Regulations in respect of its life insurance policies in Canada. This definition is replaced by a new definition, applicable to taxation years commencing after June 17, 1987 that end after 1987, to require the calculation of the modified net premium using a 1 1/2-year preliminary term method.

Clause 5

REG 2400

Section 2400 of the Regulations sets out rules for the purpose of determining the property of an insurer that is used or held by it in the year in the course of carrying on an insurance business in Canada.

Resident multinational life insurers and non-resident insurers must include in computing their income for a taxation year the gross investment revenue and the gains and losses derived from property used or held in an insurance business in Canada. For this purpose, section 2400 of the existing Regulations provides rules for determining the property of an insurer that is used or held by it in an insurance business in Canada. These rules involve the computation of the amount of a Canadian investment fund for the year which represents the total value for the year of investment and non-investment property that must be designated by the insurer as property used or held in its life and other than life insurance businesses in Canada. The gross investment revenue and gains and losses from such property is reported by the insurer as Canadian income. The Canadian investment fund is determined differently for resident multinational life insurers and non-resident insurers but is intended in each case to provide a reasonable allocation of investment property to Canada.

New section 2400, applicable to taxation years commencing after June 17, 1987 that end after 1987, provides special rules for determining the property of an insurer that is used or held by it in an insurance business in Canada. These rules are designed to ensure the taxation of an appropriate amount of investment revenue earned by insurers in Canada.

Subsection 2400(1) sets out rules to be used in determining for a taxation year the property ("insurance property") of the insurer used or held by it in the year in the course of carrying on an insurance business in Canada ("the particular insurance business"). The rules in paragraphs 2400(1)(a) to (c) are to be used first in respect of an insurer's other than life insurance business and then in respect of the insurer's life insurance business.

Paragraph 2400(1)(a) requires an insurer to designate in respect of a particular insurance business such investment property owned by it at the beginning of the year as was actually used or held by it in the year in the course of carrying on that business and was insurance property of the insurer in respect of another insurance business in Canada of the insurer in the immediately preceding taxation year.

Paragraph 2400(1)(b) requires an insurer to designate in respect of the particular insurance business such investment property owned by it at the beginning of the year as has not been designated under paragraph (a) in respect of another insurance business in Canada for the year and was insurance property of the insurer in respect of the particular insurance business in the immediately preceding taxation year. The aggregate value for the year of such property required to be designated need not but may exceed the amount, if any, by which the insurer's mean Canadian reserve liabilities for the year in respect of the particular insurance business exceed the total of:

- the aggregate value for the year of investment property designated by the insurer under paragraph (a) in respect of the particular insurance business for the year,

- where the particular business is a life insurance business, the mean policy loans of the insurer in respect of that business for the year, and

- where the particular insurance business is a property and casualty insurance business, 1/2 of the aggregate of the year-end balances of deferred acquisition costs and premiums receivable (to the extent that those premiums are included in Canadian reserve liabilities) in respect of that business at the end of the year and the immediately preceding taxation year.

Paragraph 2400(1)(c) requires an insurer to designate in respect of the particular insurance business such investment property owned by it at any time in the year as has not been designated under paragraph (a) or (b), except that the value for the year of such property required to be designated need not but may exceed the amount of any short fall determined after the required designation of property is made under paragraph (b).

Paragraph 2400(1)(d) requires an insurer to designate investment property with a value for the year in total at least equal to its Canadian investment fund for the year. Where the aggregate value for the year of all investment property designated by the insurer under paragraph (a), (b) or (c) with respect to all insurance businesses in Canada is less than the insurer's Canadian investment fund for the year, further investment property with an aggregate value for the year at least equal to the short fall must be designated. The additional property required to be designated pursuant to paragraph (d) can be designated in respect of any insurance business carried on in Canada by the insurer in the year. Therefore, the insurer can choose to designate property in respect of one or all of its insurance businesses carried on in Canada in the year. The insurer can also choose to designate property in excess of that required under paragraph (d).

Paragraph 2400(1)(e) requires the insurer to designate such non-segregated property or a portion thereof, other than investment property, owned by the insurer at any time in the year as was actually used or held by it in the year in the course of carrying on an insurance business in Canada.

Paragraph 2400(1)(f) permits the Minister of National Revenue to designate property in accordance with paragraphs 2400(1)(a) to (e) where the insurer has failed to do so. The Minister is not restricted by new subsection 2400(5) and is therefore entitled to designate any property of the insurer including that used or held by it in the year in a foreign insurance business. The property designated by the Minister pursuant to paragraph 2400(1)(f) is treated as having been designated by the insurer for the purposes of paragraphs 2400(1)(a) to (e).

Subsection 2400(2) sets out a number of special rules. Paragraph 2400(2)(a) provides that designations of property under paragraphs 2400(1)(a) to (c) must be made first in respect of an insurer's other than life insurance businesses in Canada and then in respect of its life insurance businesses in Canada. Paragraph 2400(2)(b) provides that a property cannot be designated in respect of more than one insurance business in Canada for the year. Paragraph 2400(2)(c) provides that investment property designated pursuant to paragraph 2400(1)(d) or (f) shall be designated in respect of the insurance business in Canada specified by the insurer in the case of property designated under paragraph 2400(1)(d) or by the Minister in the case of property designated under paragraph 2400(1)(f).

Subsection 2400(3) provides that property received in certain exchanges in the year for property that was insurance property in respect of the preceding year in respect of a particular insurance business shall be deemed to be insurance property in respect of that particular business in that preceding year. This subsection is similar to existing subsection 2400(3) but has been expanded to include property received on a winding-up of a corporation to which subsection 88(1) of the Act applied.

Subsection 2400(4) provides that the aggregate value of Canadian equity property that may be designated in respect of all the insurer's insurance businesses in Canada for a taxation year cannot exceed the insurer's equity limit for the year. This subsection overrides the rules for designating insurance property under subsection 2400(1) and the ordering rule in respect of designations under subsection 2400(6).

Subsection 2400(5), which is simply a refinement of the rule in existing subsection 2400(5), prevents a designation of property in respect of an insurance business carried on in Canada by the insurer for a taxation year where, throughout a period in the year the insurer owned the property, it was used or held in a foreign insurance business.

Subsection 2400(6) sets out an ordering rule in respect of the designation of investment property for the purposes of subsection 2400(1). An insurer must designate the following types of investment property in respect of its insurance businesses in Canada in the following order to the extent of such property and to the extent required to be designated:

- investment property owned by the insurer at any time in the year that was designated in the immediately preceding taxation year,

- other investment property owned by the insurer at any time in the year that was Canadian investment property except that such property is to be designated in the following order:

  - land and depreciable property situated in Canada,
  - mortgages, hypothecs, agreements of sale and any other form of indebtedness in respect of land and depreciable property situated in Canada,
  - other property,

- other non-Canadian investment property owned by the insurer at any time in the year.

Subsection 2400(7) permits a designation of part of an investment property under paragraph 2400(1)(b), (c), (d) or (f) where a designation of the whole property would result in an excess designation under those paragraphs.

Clause 6

REG 2405(3)

Subsection 2405(3) of the Regulations defines several terms for the purposes of Part XXIV.

Subclause 6(1)

The definitions of "Canadian equity property", "Canadian investment fund for the year", "designated corporation", "equity limit for the year", "equity property" and "gross Canadian life investment income" in subsection 2405(3) of the Regulations are amended, and the definition of "property of the insurer in the course of development" in that subsection is revoked, applicable to taxation years commencing after June 17, 1987 that end after 1987. These changes are consequential to the amendments to the Income Tax Act to implement the June 18, 1987 tax reform proposals for insurance corporations. The definition "Canadian reserve liabilities" is amended applicable to the 1987 and subsequent taxation years.

The amended definition of "Canadian equity property" expands the existing definition to include a small business development bond or a small business bond issued by a person (other than a designated corporation) or partnership resident in Canada. The amended definition also includes a proportion of shares of a designated corporation or an interest in a partnership or a trust based on the amount of equity property owned by such corporation, partnership or trust.

The amended definition of "Canadian investment fund for the year" for a taxation year in respect of a life insurer resident in Canada and a non-resident insurer refers to the amount determined in this regard under new section 2412 of the Regulations.

The amended definition of "Canadian reserve liabilities" expands the existing definition to mean, in cases where the relevant authority has not required the determination of this amount, the amount of the insurer's liabilities and reserves in respect of its insurance policies in Canada that would be determined at the end of the year if the relevant authority had required such a determination.

The amended definition of "designated corporation" refers to a corporation in respect of which an insurer, or an insurer and persons or partnerships that do not deal at arm's length with the insurer, held shares in a taxation year that represented 30 per cent or more of the outstanding common shares of the corporation.

The amended definition of "equity limit for the year" for a taxation year is provided in respect of a life insurer resident in Canada, a non-resident other than life insurer and a non-resident life insurer. For a life insurer resident in Canada, "equity limit for the year" means the greater of two amounts -- the first being 8 per cent of the insurer's Canadian investment fund for the year, and the second being the proportion of the aggregate value for the year of the insurer's equity property that the amount by which the insurer's mean Canadian reserve liabilities exceed its mean policy loans for the year is of the amount by which the insurer's mean total reserve liabilities exceed its mean policy loans and foreign policy loans for the year.

For a non-resident other than life insurer, "equity limit for the year" means 1/4 of the aggregate of the amount by which the insurer's mean Canadian reserve liabilities exceed the aggregate of its mean deferred acquisition expenses and premiums receivable for the year and the immediately preceding year and its property and casualty surplus for the year.

For a non-resident life insurer, "equity limit for the year" means the aggregate of the insurer's life equity limit for the year and 1/4 of the aggregate of the amount by which the insurer's mean Canadian reserve liabilities exceed its mean deferred acquisition expenses and premiums receivable for the year and the immediately preceding year and its property and casualty surplus for the year.

The amended definition of "equity property" expands the existing definition to include a small business development bond or a small business bond issued by a person (other than a designated corporation) or partnership. The amended definition also includes a proportion of shares of a designated corporation or an interest in a partnership or a trust based on the amount of equity property owned by such corporation, partnership or trust.

The amended definition of "gross Canadian life investment income" of a life insurer for a taxation year refers to the amount by which the aggregate of certain income inclusions exceeds the aggregate of certain income deductions. The inclusions aggregated for this purpose are described in paragraphs (a) to (e) of the definition as follows:

- the insurer's gross investment revenue for the year from non-segregated property used or held in its life insurance business in Canada,

- the additional amount included in income under paragraph 138(9)(b) of the Income Tax Act in cases where the net investment revenue derived from the insurer's designated property is less than the required amount,

- the amounts included in income for the year under paragraphs 138(4)(b) and (c) of the Act in respect of the gain derived from a disposition of a Canada security by the insurer in the year and the excess of the principal amount of a Canada security owned by the insurer at the end of the year over its acquisition cost to the insurer,

- the amount included in income for the year under paragraph 12(1)(d) of the Act in respect of a Canada security for which the insurer deducted a reserve in the preceding year, and

- the amount deducted from income in the preceding year under paragraph 138(3)(c) of the Act as an investment reserve.

Paragraphs (f) and (g) of the definition describe the deductions which are to be aggregated and netted against the aggregate of the amounts described above. These deductions are as follows:

- the amounts deducted from income for the year under paragraphs 138(3)(b) and (d) of the Income Tax Act in respect of the loss derived from a disposition of a Canada security by the insurer in the year and the excess of the acquisition cost to the insurer of a Canada security over its principal amount, and

- the amounts deducted from income for the year under paragraph 20(1)(l) of the Act as a reserve for doubtful debts in respect of a Canada security.

Subclause 6(2)

Several new definitions are added to subsection 2405(3) of the Regulations applicable to taxation years commencing after June 17, 1987 that end after 1987. These definitions are consequential to the amendments to the Act to implement the June 18, 1987 tax reform proposals for insurance corporations.

The definition of "Canadian investment property" of an insurer for a taxation year refers to an investment property that is real property in Canada, Canadian equity property, a mortgage, hypothec, agreement of sale or any other form of indebtedness in respect of real property in Canada, or a bond or debenture denominated in Canadian currency and issued by a person or partnership resident in Canada or a government of Canada or any province or territory of Canada. This definition excludes such investment property that is established by a non-resident insurer not to be effectively connected with its Canadian insurance businesses.

The definition of "foreign policy loan" refers to an amount advanced by an insurer to a policyholder under the terms of a life insurance policy other than a life insurance policy in Canada.

The definition of "mean policy loans" is provided in respect of an insurer for a taxation year and refers to 1/2 of the aggregate of the insurer's policy loans at the end of the year and at the end of the immediately preceding year.

The definition of "mean policy loans and foreign policy loans" is provided in respect of an insurer for a taxation year and refers to 1/2 of the aggregate of the insurer's policy loans and foreign policy loans at the end of the year and at the end of the immediately preceding year.

Subclause 6(3)

Paragraph (a) of the definition of "Canadian investment fund" in subsection 2405(3) of the Regulations provides the meaning of this term in respect of a life insurer resident in Canada. The amendment to paragraph (a) sets out a formula by which a positive amount is determined as the Canadian investment fund of a life insurer resident in Canada as at the end of a taxation year. This formula may be expressed as follows:

$$\left[\frac{A}{B} (C - D) \right] - E$$

where:

A is the amount of the insurer's Canadian reserve liabilities at the end of the year;

B is the amount of the insurer's total reserve liabilities at the end of the year;

C is the total at the end of the year of the aggregate policy loans and foreign policy loans and the valuation of investment property, money and positive bank or similar account balances of the insurer;

D is the total of the aggregate debt owing by the insurer at the end of the year in respect of borrowed money and the aggregate cheques drawn by the insurer before the end of the year on its accounts; and

E is the aggregate policy loans of the insurer at the end of the year.

The Canadian investment fund of an insurer resident in Canada determined by this formula differs from the existing definition in that it takes into account the policy loans, foreign policy loans and positive bank or similar account balances of an insurer and it treats outstanding cheques similar to debt. The amendment to paragraph (a) of the definition of "Canadian investment fund" is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 6(4)

Paragraph (b) of the definition of "Canadian investment fund" in subsection 2405(3) of the Regulations provides the meaning of this term in respect of a non-resident insurer. Subparagraph (iii) of this definition refers to the amount described in clause 138(3)(a)(iv)(A) of the Income Tax Act that is a reserve in respect of policy dividends payable by an insurer. This subparagraph is amended as a consequence of the amendments to subparagraph 138(3)(a)(iv) of the Act and to accommodate short fiscal periods. Amended subparagraph (iii) refers to the amount of policy dividends as at the end of the year that will become payable, according to the annual report for the year filed by the insurer with the relevant authority or, where the insurer was subject to the supervision of the relevant authority but was not required to file an annual report for the year, according to its financial statements for the year, by the insurer in the immediately following year under its participating life insurance policies. This amendment is applicable to the 1987 and subsequent taxation years.

Subclause 6(5)

Paragraph (b) of the definition of "Canadian investment fund" in subsection 2405(3) of the Regulations provides the meaning of this term in respect of a non-resident insurer. Subparagraph (vii) of this definition refers to the aggregate valuation of all property under paragraph 2400(1)(e) of the Regulations that is non-segregated property owned by an insurer and used or held by it in carrying on an insurance business in Canada. This subparagraph is amended to correct the reference to paragraph 2400(1)(e) by a reference to new paragraph 2400(1)(f) of the Regulations and to provide that such non-segregated property does not include a share of or a debt owing to the insurer by a designated corporation unless the share or debt is established by the insurer to be effectively connected with its Canadian insurance businesses. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclauses 6(6)

Paragraphs (a) to (d) of the definition of "investment property" in subsection 2405(3) of the Regulations set out the various types of non-segregated property that are considered to be investment property of an insurer for a year. Paragraph (c) of this definition refers to a portion of property of the insurer that is land, depreciable property or property considered to be depreciable property used to earn gross investment income. This paragraph is amended to include a portion of such property not used to earn gross investment income to the extent that the property is held for resale or development or is expected to be used in a subsequent year to earn gross investment revenue. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 6(7)

Paragraph (c) of the definition of "life equity limit" in subsection 2405(3) of the Regulations provides that, where paragraph (a) or (b) of the definition is not applicable, the life equity limit of a non-resident life insurer for a taxation year is of the amount by which 8 per cent the insurer's Canadian investment fund for the year exceeds the aggregate value for the year of all Canadian equity property of the insurer included in paragraphs 2400(1)(b) and (c) of the Regulations. This paragraph is amended to provide in this case that the life equity limit is 8 per cent of the amount of the insurer's Canadian investment fund for the year. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 6(8)

Subclause (a)(i)(B)(I) of the definition of "life surplus factor" in subsection 2405(3) of the Regulations, refers to certain amounts described in the definition of "Canadian investment fund" in subsection 2405(3) in respect of a non-resident insurer. This subclause is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to correct these cross-references.

Subclause 6(9)

Paragraph (a) of the definition of "value for the year" in subsection 2405(a) of the Regulations provides the value for the year in respect of property of an insurer, designated corporation, partnership or trust that is a mortgage, hypothec, agreement of sale or an investment property that is a positive bank or similar account balance is the gross investment revenue for the year from the property divided by the average interest rate earned during the year from the property. The amendment to this paragraph provides that the value for the year of such property is the amount by which the gross investment revenue for the year from the property divided by the average interest rate earned on the amortized cost of the property exceeds the interest paid or payable on a debt incurred to acquire the property divided by the average interest rate paid or payable on the debt. This amendment is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 6(10)

Paragraphs (a) to (h) of the definition of "valuation" in subsection 2405(3) of the Regulations set out the valuation of various types of property of an insurer, designated corporation, partnership or trust. This definition is amended by adding new paragraph (e.1) which provides that the valuation of a bank or similar account balance is the amount of that balance standing to the insurer's credit. Paragraph (e.1) is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 6(11)

This sets out the effective date for the amendments to subsection 2405(3) of the Regulations.

Clause 7

REG 2409

Section 2409 of the Regulations sets out certain transitional rules for the purposes of Part XXIV.

New subsection 2409(4) of the Regulations, applicable to taxation years commencing after June 17, 1987 that end after 1987, provides that, where the expression "immediately preceding taxation year" refers to the 1987 taxation year, the definitions in Part XXIV of the Regulations are to be read as if they applied to the insurer's 1987 taxation year.

Clause 8

REG 2410, 2411 and 2412

New sections 2410, 2411 and 2412 of the Regulations implement the June 18, 1987 tax reform proposals to ensure that an appropriate amount of investment revenue and gains and losses of an insurer is subject to taxation in Canada. Section 2410 sets out the basis for determining the prescribed amount to be included in the income of a life insurer under subsection 138(4.4) of the Income Tax Act in respect of vacant real property or real property under development owned by the insurer. Section 2411 sets out the basis for determining the prescribed amount to be included in the income of an insurer under paragraph 138(9)(b) of the Income Tax Act where the amount of net investment revenue derived from property designated by the insurer is less than a required minimum amount. Section 2412 defines the "Canadian investment fund for the year" in respect of an insurer in a manner that takes into account the growth of that fund throughout the year.

REG 2410

New section 2410 sets out the basis for determining the prescribed amount for the purposes of new subsection 138(4.4) of the Income Tax Act applicable to taxation years commencing after June 17, 1987 that end after 1987. This subsection provides that, where a life insurer owned vacant real property or real property under development for a period of time in a taxation year and the property was used or held by it in the year in the course of carrying on an insurance business in Canada, a prescribed amount shall be included in computing the income of the insurer in respect of the cost or capital cost of the property and in computing the cost or the capital cost to the insurer of the property. The provisions of subsection 138(4.4) also apply, pursuant to new subsection 138(4.5) of the Act, where a life insurer has transferred or loaned a property referred to in subsection (4.4) to a designated corporation or to a non-arm's length person or partnership.

Subsection 2410(1) provides that the prescribed amount is determined as the specified percentage for the year of the aggregate of all amounts determined for the year in respect of property owned by the insurer in the year under the formula set out therein. Calculations under this formula are made in respect of property for the period in the year referred to in subsection 138(4.4) of the Act. The specified percentage for the year is defined in subsection 2410(2).

The formula under subsection 2410(1) may be expressed as follows:

$$\left[(A \times B) \times \frac{C}{D} \times \frac{E}{365} \right] - F$$

where:

A is the average annual rate of interest determined by reference to the interest rates prescribed in section 4301 of the Regulations for the months or portion thereof in the period;

B is the amount by which the average cost or average capital cost of the property for the period exceeds the average amount of debt relating to the acquisition of the property outstanding during the period that bears a fair market interest rate;

C is the amount by which the Canadian reserve liabilities of the insurer at the end of the year that includes the period exceed the aggregate policy loans and premiums receivable of the insurer at the end of the year;

D is, where the insurer does not carry on an insurance business outside Canada, the amount by which the valuation of investment property, money or positive bank or similar account balances of the insurer at the end of the year that includes the period exceeds the aggregate of debts outstanding at the end of the year in respect of money borrowed by the insurer and cheques drawn before the end of the year on bank or similar accounts of the insurer, or, where the insurer carries on an insurance business outside Canada, is the amount of the insurer's Canadian investment fund at the end of the year that includes the period;

E is the number of days in the period; and

F is the amount of the insurer's net income for the year derived from the property.

This formula deals with the portion of the cost of the property that is assumed to be financed out of Canadian reserve liabilities, as opposed to surplus, and that is net of related debt of the insurer bearing a fair market value interest rate. This portion is determined by multiplying the average cost of the property net of the average debt for the period by the ratio of net Canadian reserve liabilities to the net valuation amount of investment-type property or, if the insurer is a multinational insurer, by the ratio of net Canadian reserve liabilities to the Canadian investment fund of the insurer, as at the end of the year. An annual imputation amount is determined by multiplying the appropriate portion of the net average cost of the property for the period by an average annual rate of interest for the period. Where the period is less than 365 days, only a portion of the annual imputation amount is included in income based on the proportion that the number of days in the period is of 365 days. The amount to be included in income for the year is reduced by net income earned on the property for the year.

Subsection 2410(2) provides for the phasing-in of the amounts to be included in the income of the insurer in respect of real property as determined under subsection (1) for a taxation year. Each amount is included on the basis of a "specified percentage for a taxation year" that is 20 per cent, 40 per cent, 60 per cent, 80 per cent and 100 per cent of the amount determined under subsection (1) for the 1988, 1989, 1990, 1991 and 1992 and subsequent calendar years respectively. These percentages are prorated where taxation years straddle calendar years.

New section 2410 is applicable to taxation years commencing after June 17, 1987 that end after 1987.

REG 2411

New section 2411 sets out the basis for determining the prescribed amount for the purpose of paragraph 138(9)(b) of the Act. Subsection 138(9) requires a resident multinational life insurer and a non-resident insurer to include in computing income for a year from a Canadian insurance business the gross investment revenue that is derived from property used or held by the insurer in that insurance business. This subsection is amended, applicable to taxation years commencing after June 17, 1987 that end after 1987, to require the insurer to include under paragraph (b) a prescribed amount in computing income. In essence, the prescribed amount ensures that an insurer is taxed on a minimum amount of net investment revenue or is required to reduce an excess amount of net investment losses derived from its property used or held in its Canadian insurance business.

Subsection 2411(1) provides a formula for determining the prescribed amount in respect of an insurer for a taxation year. This formula may be expressed as follows:

$$A - (B + C)$$

where:

A is the positive or negative amount determined under subsection (3) as the required minimum net investment revenue or allowable maximum net investment loss of the insurer for the year;

B is the positive or negative amount determined under subsection (4) as the actual net investment revenue or actual net investment loss of the insurer for the year in respect of investment property designated by the insurer under subsection 2400(1) of the Regulations as property used or held by it in the year in carrying on its Canadian insurance businesses; and

C is the amount claimed by the insurer for the year in respect of its cumulative excess account determined under subsection (6) at the end of the year.

This formula may yield a prescribed amount to be included in computing the income of an insurer for a year where the insurer's actual net investment revenue from designated property is less than the required minimum net investment revenue and where the insurer's actual net investment loss from designated property is greater than the maximum allowable net investment loss.

Subsection 2411(2) provides that the amount determined as the prescribed amount under the formula in subsection (1) cannot be less than nil.

Subsection 2411(3) provides a formula for calculating the required minimum net investment revenue or the maximum allowable net investment loss from property of the insurer for a taxation year which is defined as "A" in the calculation under subsection (1). This formula may be expressed as follows:

$$\left(\frac{A}{B} \times C\right) + \left(\frac{D}{E} \times F\right) + \left(\frac{G}{H} \times J\right)$$

where:

A is the positive or negative amount determined under subsection (4) in respect of Canadian investment property (other than Canadian equity property) owned by the insurer in the year;

B is the total value for the year of property referred to in A;

C is the total value for the year of property referred to in A that is designated by the insurer under subsection 2400(1) as property used or held by it in the year in its Canadian insurance businesses;

D is the positive or negative amount determined under subsection (4) in respect of Canadian investment property that is Canadian equity property owned by the insurer in the year;

E is the total value for the year of property referred to in D;

F is the total value for the year of property referred to in D that is designated by the insurer under subsection 2400(1) as property used or held by it in the year in its Canadian insurance businesses;

G is the positive or negative amount determined under subsection (4) in respect of foreign investment property owned by the insurer in the year;

H is the total value for the year of property referred to in G; and

J is the total value for the year of property referred to in G that is designated by the insurer under subsection 2400(1) as property used or held by it in the year in its Canadian insurance businesses.

This formula deals with Canadian investment property, Canadian equity property and foreign investment property of an insurer. For each type of property of the insurer, the required minimum net investment revenue or the allowable maximum net investment loss in respect of that property is based on the net investment revenue or loss from the total value for the year of such property. An example of the calculations made under the formula in subsection (3) is provided below.

Subsection (3) also provides that, where the value for the year of foreign investment property designated by an insurer under subsection 2400(1) for the year is not greater than 5 per cent of the amount of the Canadian investment fund for the year of the insurer, the insurer may elect to use the following formula:

$$\left[\frac{A}{B} \times (C + J) \right] + \left(\frac{D}{E} \times F \right)$$

where A, B, C, D, E, F and J have the meanings given above.

Subsection 2411(4) provides a formula for calculating the net investment revenue or loss of the insurer for the year derived from property for the purposes of subsections (1) and (3). This formula is used to determine the required minimum net investment revenue or maximum allowable net investment loss of the insurer for the year and the actual net investment revenue or loss of the insurer for the year derived from property used or held by it in the year in the course of carrying on an insurance business in Canada. This formula may be expressed as follows:

A - B

where:

A is the aggregate of certain revenue and income amounts that are determined in respect of the property for the year or that would be so determined if the property were designated by the insurer under subsection 2400(1) as property used or held by it in the year in its Canadian insurance business; and

B is the aggregate of certain loss and expense amounts that are determined in respect of the property for the year or that would be so determined if the property were designated by the insurer under subsection 2400(1).

Subsection 2411(5) provides an assumption with respect to the use of property that has not been designated by an insurer under subsection 2400(1) as property used or held by it in the year in its Canadian insurance business. Such property is treated as property used or held by the insurer in the year in a Canadian insurance business in respect of which the property was reported by the insurer in its annual report for the year to the relevant authority, or would have so been reported if an annual report had been required, for the purpose of determining under subsection (4) the net investment revenue or loss of an insurer for the year derived from that property.

Subsection 2411(6) sets out the basis for calculating the balance of an insurer's cumulative excess account as at the end of the year which is defined as "C" in the calculation under subsection (1) and can be used by the insurer to reduce the amount that is included in its income for the year under paragraph 138(9)(b) of the Act. The balance of an insurer's cumulative excess account for a year is determined as the amount by which the aggregate of the excess of the actual net investment revenue of the insurer derived from property (the amount "B" under subsection (1)) over the required minimum net investment revenue in respect of that property (the amount "A" under subsection (1)) for each of 7 preceding years exceeds the aggregate of the amounts of the cumulative excess account claimed by the insurer under subsection (1) for those preceding years. An example of this calculation is provided below.

Subsection 2411(7) defines the term "foreign investment property of an insurer" for the purposes of section 2411.

The following example shows the mechanics of subsections 2411(1) to (6):

Table 1: Subsection 2411(1) of the Regulations

Year	Required Minimum Net Investment Revenue (or Maximum Loss) A 2411(2)	Actual Net Investment Revenue (or Loss) B	Amount Claimed from Balance in Cumulative Excess Account C 2411(1)	Additional Amount A-(B+C)
1	400	500	0	0
2	400	300	100	0
3	500	450	0	50

Table 2: Subsection 2411(6) of the Regulations

Year	Cumulative B-A	Cumulative Claims	Balance in Cumulative Excess Account
1	100	0	100
2	100	100	0
3	100	100	0

Table 3: Subsection 138(9) of the Act

Year	138(9)(a)	138(9)(b)	138(9)
1	500	0	500
2	300	0	300
3	450	50	500

Note: Paragraph 138(9)(a) of the Act requires an insurer to include in computing its income for a year its gross investment revenue, rather than net investment revenue, derived from property used or held by it in the year in carrying on an insurance business in Canada.

Table 4: Subsection 2411(3) of the Regulations

The figures used in this table correspond to year 3 of the previous tables.

Canadian equity property (E)	$ 2,300
Canadian other investment property (B)	7,000
Foreign investment property (H)	2,700
Total investment property	$12,000
Canadian equity property revenue (D)	$ 115
Canadian other investment property revenue (A)	$ 700
Canadian investment fund for the year	$ 6,000
Canadian equity property designated (F)	2,000
Canadian other investment property designated (C)	4,000
Foreign investment property designated (J)	0
Total designated property	$ 6,000
D/E	5%
A/B	10%

The total minimum net investment revenue for the taxation year is $500 and is calculated as follows:

$$\left[\frac{A}{B} \times (C + J) \right] + \left(\frac{D}{E} \times F \right)$$

$$(0.10 \times (4{,}000 + 0)) + (0.05 \times 2{,}000) = 500$$

New section 2411 is applicable to taxation years commencing after June 17, 1987 that end after 1987.

REG 2412

New section 2412 is consequential to the amendments to subsection 2405(3) of the Regulations which set out the definition of the term "Canadian investment fund for the year" in respect of a resident life insurer and a non-resident insurer.

Subsection 2412(1) provides a formula for determining the "Canadian investment fund for the year" for a taxation year in respect of an insurer. This formula may be expressed as follows:

$A + B$

where:

A is the mean Canadian investment fund for the year, as defined under subsection (5), of the insurer for the taxation year; and

B is the amount determined under subsection (2) in respect of the insurer for the taxation year.

The Canadian investment fund for the year under subsection (1) includes the amount "A" based on a definition of "mean Canadian investment fund for the year" in subsection (5) which is the same as the current definition of "Canadian investment fund for the year" in subsection 2405(3) of the Regulations. It also includes the amount "B", as determined under subsections (2) to (4), which reflects the Canadian cash flow of the insurer and the fact that the Canadian investment fund may not grow at a uniform rate throughout a taxation year since investment property may be acquired at varying rates at various times in the year.

The amount "B" is determined under subsections 2412(2) to (4). Subsection 2412(4) provides a formula for determining the amount of the Canadian cash flow of an insurer for a 3-month period in a taxation year. This amount is used in the calculations under subsection (2). This formula may be expressed as follows:

$A - B$

where:

A is the aggregate of amounts received by the insurer in the period in respect of premiums, interest on policy loans or reinsurance; and

B is the aggregate of amounts paid by the insurer in the period in respect of claims or benefits, premiums, policy loans or reinsurance.

Subsection 2412(2) provides a formula for determining the amount in respect of an insurer for the taxation year that is the amount "B" under subsection (1). This formula uses the Canadian cash flow amount determined under subsection (4) and may be expressed as follows:

$$\frac{1}{2}\left[A - \frac{(B + 3C + 5D + 7E)}{F} \right]$$

where:

A is the aggregate of B, C, D and E;

B is the amount of the Canadian cash-flow determined for the first 3-month period in the taxation year;

C is the amount of the Canadian cash-flow determined for the second 3-month period;

D is the amount of the Canadian cash-flow determined for the third 3-month period;

E is the amount of the Canadian cash-flow determined for the fourth 3-month period; and

F is the number obtained when the number of calendar months in the taxation year is divided by 3.

Subsection 2412(3) provides that the amount determined under subsection (2) is nil where the taxation year is less than 3 months. In this event, the "Canadian investment fund for the year" as determined under subsection (1) would be equal to the "mean Canadian investment for the year as defined in subsection (5).

Subsection 2412(5) defines the term "mean Canadian investment fund for the year" in respect of a resident life insurer and in respect of a non-resident insurer for the purposes of section 2412.

The following example shows the mechanics of subsections 2412(1) to (4). This example assumes that the taxpayer is a multinational life insurer resident in Canada. The amount of the insurer's Canadian investment fund is $2,500 as at the end of the year and $1,000 as at the end of the preceding year. The Canadian cashflow of the insurer, as determined under subsection (4) and used in subsection (2), is $1,500 in the first quarter ("B"), $300 in the second and third quarters ("C" and "D"), and negative $900 in the fourth quarter ("E") for a total net Canadian cash-flow for the year of $1,200 ("A").

The amount "A" in the formula under subsection (1) is defined under subsection (5) and is calculated as follows:

$$\frac{1}{2}(1{,}000 + 2{,}500) = 1{,}750$$

The amount "B" in the formula under subsection (1) is calculated under subsection (2) as follows:

$$\frac{1}{2}\left[A - \frac{(B + 3C + 5D + 7E)}{F}\right]$$

$$\frac{1}{2}\left[1{,}200 - \frac{(1{,}500 + (3 \times 300) + (5 \times 300) + (7 \times -900)}{4}\right] = 900$$

The Canadian investment fund for the year is calculated under subsection (1) as follows:

A + B
1,750 + 900 = 2,650

Under the existing Regulations, the Canadian investment fund for the year would be equal to $1,750. In this example under the new regulations, $900 is added to the mean Canadian investment fund for the year to reflect the rapid growth of the fund in the first quarter and the significant drop in the fourth quarter.

Section 2412 is applicable to taxation years commencing after June 17, 1987 that end after 1987.

Subclause 8(2)

This sets out the effective date for new sections 2410 to 2412 of the Regulations.

Appendix C

Draft Income Tax Regulations: Motor Vehicles Explanatory Notes

APPENDIX C

DRAFT INCOME TAX REGULATIONS - MOTOR VEHICLES

EXPLANATORY NOTES

Paragraph 1100(1)(a)

Paragraph 1100(1)(a) of the Regulations is amended by the insertion of new subparagraph (x.1) which creates new class 10.1 and provides a rate of 30 per cent for calculating the deduction in respect of capital cost allowance for property of that class.

Section 1101

Section 1101 of the Regulations is amended by the insertion of new subsection (1af) which prescribes a separate class for each motor vehicle included in class 10.1 of Schedule II.

Schedule II

Schedule II contains details of the various classes for capital cost allowance purposes. New class 10.1 is created for property that is a motor vehicle owned by an individual (other than a trust) and a passenger vehicle owned by any other taxpayer.

These amendments implement the separate class requirement for passenger vehicles of all taxpayers and motor vehicles owned by individuals which is mandated by the restrictions on capital cost allowance for these vehicles.

New section 7305 of the Income Tax Regulations contains the rules for determining the amount per kilometre that may be deducted in respect of payments made to an employee or other individual for the use of an automobile in a calendar year. These rules also apply to an individual who, pursuant to new subsection 8(11) of the Act, deducts a prescribed amount instead of claiming actual automobile expenses otherwise deductible under paragraph 8(1)(f) or (h) of the Act. Where the automobile expenses would have been deductible under paragraph 8(1)(f), the restriction found in that paragraph whereby expenses are limited to the amount of commissions received will apply in the same manner to the amount deductible under new subsection 8(11).

The deductible amount is 27 cents per kilometre for the first 5,000 kilometres driven by the individual in a calendar year, 21 cents for each kilometre in excess of 5,000 driven by the individual in the year and an additional 4 cents per kilometre for each kilometre driven by the individual in the Yukon Territory and the Northwest Territories.