Explanatory Notes to Legislation Relating to Income Tax

Issued by
The Honourable Michael H. Wilson
Minister of Finance

June 1988

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 Canada Pension Plan, the Unemployment Insurance Act, 1971, the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 and certain related Acts. 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 Legislation tabled today contains proposed amendments to the Income Tax Act, the Canada Pension Plan, the Unemployment Insurance Act, 1971, the Federal-Provincial Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 and certain related Acts. These amendments are intended to implement the tax reform proposals announced on December 18, 1987 as well as the proposals announced in the February 10, 1988 budget and the proposals originally announced on October 1, 1987 relating to the taxation of trusts and their beneficiaries.

These explanatory notes describe the proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisers.

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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) to (3)

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. Subparagraph (vii) is amended by deleting the requirement therein that a travelling allowance, in order to be considered reasonable, has to be computed by reference to time spent travelling. In addition, subparagraph (vii) is amended to exclude from its ambit allowances for the use of a motor vehicle. Such allowances are now governed by new subparagraph (vii.1) which excludes such an allowance in computing the income of an employee (other than an employee employed in connection with the selling of property or negotiating of contracts) where the allowance is solely for the use of a motor vehicle, is not in excess of a reasonable amount and is received from the employer for travelling in the performance of employment duties. 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 use of the vehicle for performing employment duties, the whole amount of the allowance will be deemed to be in excess of a reasonable amount 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. Subject to new subsection 8(10), this deduction is available to salesmen and to other employees who regularly travel in the course of their employment, are required by their employment to pay for their travelling expenses and are not in receipt of certain non-taxable allowances. New subsection 8(10) provides that the employee must file a prescribed form signed by his employer in order to deduct amounts under paragraph 8(1)(f) or (h).

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

Subclause 1(4)

ITA
6(2) to (2.2)

Subsection 6(2) of the Act provides rules concerning the calculation of a 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 describing the calculation of the standby charge in terms of a formula. In addition, the reduction in the special standby charge that is available for an employee with limited personal use of the automobile is restricted to those situations where the automobile is used all or substantially all (at least 90%, measured by distance travelled) 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 where an employer is engaged solely in the business of selling or leasing used automobiles and accordingly has not acquired any new automobiles for sale or lease in the course of the 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 or lease.

Where an employer pays for gasoline and other operating expenses relating to the personal use of an employer-owned vehicle, these expenses represent a benefit to the employee and are required to be included in computing his employment income. However, subsection 6(2.2) of the Act provides a special election that an employee may use to calculate the benefit received 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 for the purposes of subparagraph 6(1)(e)(i). Subsection 6(2.2) is amended so that this election 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 equal to the lesser of 20% of employment income and $500, is repealed.

Paragraphs 8(1)(k) and (l) of the Act, which provide for the deductions for unemployment insurance premiums and Canada/Quebec 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 who, as a condition of employment, is required to provide a musical instrument. This paragraph permits the deduction (not exceeding the taxpayer's income for the year from employment as a musician) of amounts expended in the year for the maintenance, insurance and rental of the instrument for the period or periods of employment in the year as a musician. 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), (h) or (j) in respect of the use of his automobile, or an automobile leased to him, 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 in the course of earning income 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, including a corporation or a partnership, to include in the cost of land that is held as inventory, amounts that are denied as a deduction under subsection 18(2) to him, to a person with whom he does not deal at arm's length, to a specified shareholder of the corporation, or to a partner whose share of any income or loss of the partnership 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) and (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. This paragraph is amended as a consequence of the amendment to paragraph 20(1)(p) which provides for a deduction in respect of loans or lending assets that have become uncollectable in the 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 three-quarters of bad debts arising in this situation may be deducted under new subsection 20(4.2), only three-quarters of amounts which are subsequently recovered will be required to be included in income under new paragraph 12(1)(i.1). Subsection 20(4.2) allows a deduction only to the extent that the amount received on the disposition of an eligible capital property did not generate a taxable capital gain in respect of which a deduction was taken under section 110.6 of the Act. Accordingly, paragraph 12(1)(i.1) is similarly restricted and requires an income inclusion only in respect of a recovered amount proportional to the subsection 20(4.2) deduction previously claimed. The balance of the recovered amount is deemed to be a taxable capital gain under new subsection 39(11) of the Act. 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 one-half, the portion of the debt which may be deducted under new subsection 20(4.2) is one-half and, accordingly, only one-half 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)(o)(iii)

Paragraph 12(1)(o) of the Act requires that a taxpayer include in his income for a taxation year as income from a business or property certain amounts that may reasonably be regarded as being in relation to the production in Canada of specified resources or the acquisition, development or ownership of Canadian resource properties.

Subparagraph 12(1)(o)(iii) is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever" in reference to corporations, commissions and associations controlled by Her Majesty (or by an agent of Her Majesty) in right of Canada or a province.

This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to *de facto* control -- are not applicable to paragraph 12(1)(o).

Subclause 4(4)

ITA
12(1)(t)

The amount deducted from tax in respect of the investment tax credit reduces the tax basis of the related expenditure - that is, the undepreciated capital cost of depreciable property, the adjusted cost base of certain interests in a partnership or a trust, the amount of deductible scientific research expenditures, or the amount of qualified Canadian exploration expenditures. To the extent that such reductions in tax basis do not take place, paragraph 12(1)(t) of the Act requires the amount of any credit claimed to be included in the taxpayer's income. Because a claim of a tax credit can produce such an income inclusion thereby affecting tax otherwise payable and the amount of investment tax credit which may be claimed in a year, the calculations can very often become circular. Accordingly, paragraph 12(1)(t) is amended to require an income inclusion only for taxation years following that in which the related investment tax credit is claimed. Where a tax credit is carried back to a year preceding that in which it was earned, the required income inclusion will not have to be made until the year following that in which the property was acquired or the expenditure was made. This amendment is applicable for taxation years ending after 1987.

Subclause 4(5)

ITA
12(1)(y)

Subsection 12(1) of the Act is amended by adding new paragraph (y) which imposes a standby charge on an individual who is a member of a partnership or an employee of a member of a partnership and who is entitled to make personal use of an automobile provided by the partnership. Where a partnership makes an automobile available to such an individual or to a person related to the individual, new paragraph (y) includes in the income of the individual an amount equal to the standby charge that would, by reason of paragraph 6(1)(e), be included in that individual's income if the individual 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 a taxpayer is 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 adjustment 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 depreciation recapture in respect of a motor vehicle owned by an individual other than a trust (except where all or substantially all of the distance travelled with the motor vehicle throughout the period that he owned it was for the purpose of earning income) or a passenger vehicle having a cost at the time of acquisition in excess of $20,000 or such other amount as many be prescribed owned by a trust, partnership or corporation is not required to be included in income. However, such excess amount shall be deemed for the purposes of subparagraph 13(21)(f)(ii) to have been included in the taxpayer's income to prevent recapture at a subsequent time of such excess. Capital cost allowance for employees and the self-employed is restricted in respect of these vehicles by the rules set out in new section 67.3 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.

Regulations will create a new class, 10.1, for property that is a motor vehicle owned by an individual (other than a trust) and a passenger vehicle having a cost in excess of $20,000, or such other amount as may be prescribed, owned by a trust, partnership or corporation. A separate class will be prescribed for each vehicle included in class 10.1. The "half year" rule for claiming capital cost allowance will continue to apply in the year of acquisition of such vehicles. However, there will be a new "half year" rule which will permit the taxpayer to claim, in the year of disposition of a vehicle included in class 10.1, one-half of the normal capital cost allowance in respect of the vehicle. This new rule will not apply to a vehicle owned by an individual (other than a trust) where all or substantially all of the distance travelled by the vehicle was for the purpose of earning income.

Subclause 7(3)

ITA
13(5)

Subsection 13(5) of the Act contains the rules for computing the undepreciated capital cost of property of a prescribed class that has been transferred from one class (the former class) to another class (the other class).

This amendment clarifies the methodology of the transfer. Paragraph 13(5)(a) provides that, at the time of the transfer, the transferred property shall be deemed to be depreciable property of the other class and not depreciable property of the former class. This effectively transfers the capital cost of the property. Paragraph 13(5)(b) then adjusts the total depreciation in respect of both the former and the other class. An amount equal to the greater of the amount, if any, by which the capital cost of the transferred property exceeds the undepreciated capital cost of property of the entire former class immediately before the transfer, and the total of all capital cost allowance deducted in respect of the transferred property before the year of the transfer, is included in computing the total depreciation for the other class and not included in computing the total depreciation for the former class. This effectively transfers the capital cost allowance previously claimed in respect of the property.

Subsection 13(5) is a rule of general application, including situations where motor vehicles are required by reason of the amendment of Schedule II of the regulations to be transferred to new class 10.1.

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 the 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. Three amendments are being made to clause 13(7)(b)(ii)(B), two of which relate to the changes in the inclusion rates for capital gains and one which corrects a technical deficiency.

The first amendment to clause 13(7)(b)(ii)(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 second amendment substitutes the reference to the proceeds of disposition of the property at the time of the change in use with the reference to the fair market value of the property at that time and is applicable to property acquired after May 22, 1985 other than property acquired before 1986 pursuant to an agreement in writing entered into before May 23, 1985. The portion of the excess that is added in determining the capital cost of the property to the taxpayer is increased from one-half to two-thirds for changes in use occurring 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 occurring 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 third amendment to clause 13(7)(b)(ii)(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 deals with the calculation of the cost, for capital cost allowance purposes and the calculation of proceeds of disposition, of property used regularly by a taxpayer in part for the purpose of earning income from that property or from a business and in part for some other purpose. 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 simply 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 and capital cost allowance, as described in the commentary concerning 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 increases the portion of the excess of the amount of proceeds of disposition of the property 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 and provides that the proceeds of disposition are to be those determined under subparagraph 45(1)(c)(ii). 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 addition of the reference to subparagraph 45(1)(c)(ii) in subparagraph 13(7)(d)(i) is applicable to property acquired after May 22, 1985 other than property acquired before 1986 pursuant to an agreement in writing entered into before May 23, 1985.

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 capital 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 an acquisition of control after January 15, 1987 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 after June 5, 1987 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 periodic adjustment of the $20,000 limit.

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 at that time shall be deemed to be the least of $20,000 (or such other amount as may be prescribed), its fair market value and its undepreciated capital cost to the transferor 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 certain vehicles acquired or leased 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)

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. Where a tax credit is carried back to a year preceding that in which it was earned, the reduction of the capital cost of the related depreciable property will not have to be made until the year following that in which the property was acquired. This amendment is applicable for taxation years ending after 1987.

Subclause 7(15)

ITA
13(9)

Subsection 13(9) of the Act provides a special rule where there is a change of use of depreciable property owned by a non-resident from producing income from a business wholly carried on in Canada to some other use or vice-versa. This rule modifies the more general change of use rules set out in subsection 13(7) of the Act. The wording of subsection 13(9) is amended strictly as a consequence of the amendments to subsection 13(7) and is applicable to changes in use occurring after April, 1988.

Subclause 7(16)

ITA
13(11)

Subsection 13(11) provides that any deductions made in respect of capital cost allowance of an automobile used in the performance of employment duties by an employee by reason of subparagraph 8(1)(j)(ii) shall be deemed, for purposes of section 13, to have been made under regulations made under paragraph 20(1)(a). This paragraph has been amended to include a reference to new subparagraph 8(1)(p)(ii) which permits an employed musician to deduct capital cost allowance in respect of a musical instrument required to be provided by him under the terms of the employment contract. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 7(17)

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, terminal losses 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 capital cost allowance in respect of certain motor vehicles 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 have been so deducted but for new section 67.3 and amounts deducted under subsection 20(16) in respect of terminal losses 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 certain circumstances to restrict the capital cost allowance and deny any terminal loss in respect of motor vehicles owned by an individual, and certain passenger vehicles having a cost when acquired in excess of $20,000 (or such other amount as may be prescribed) and owned by a corporation, partnership or trust. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 that end after 1987.

Subclause 7(18)

ITA
13(21)(f)(vii)

Paragraph 13(21)(f) of the Act defines the term "undepreciated capital cost" ("UCC") of depreciable property of a prescribed class at any time. Subparagraph (vii) reduces the UCC of the class by the amount of any investment tax credit claimed in respect of a property which was in the class in the year where that credit was claimed subsequent to the disposition of the property. Because an investment tax credit claim reduces the balance of the class and may cause it to become negative, thereby giving rise to an income inclusion for a year which, in turn, may affect the amount of the credit which can be claimed, this calculation can become circular where the credit reduces the UCC in the same year as that in which the credit is claimed. Accordingly, subparagraph 13(21)(f)(vii) is amended to require a reduction of the UCC of the class 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(19)

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 to this rule. The first is strictly consequential on the change in the inclusion rate for eligible capital property from one-half to three-quarters. 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. This also applies where the excess relates to a partnership or trust of which an individual is a member or beneficiary.

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 one-half to three-quarters.

Subsection 14(1) is further amended to provide that, in the case of a taxpayer other than a corporation, a partnership all the members of which are corporations, or a partnership which was not a "Canadian partnership" (as defined in subsection 248(1) of the Act) throughout the year, 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, in the case of an individual, 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(3)

New subsection 14(3) of the Act applies where a taxpayer makes an eligible capital expenditure in respect of the acquisition of an eligible capital property from a non-arm's length vendor. In this case, where the vendor has disposed of an eligible capital property and has claimed the capital gains exemption under section 110.6 of the Act in respect of that disposition, the eligible capital expenditure made by the purchaser is to be reduced to reflect the exemption claimed by the vendor. In the absence of this provision, the purchaser would have an increased tax basis for the purpose of the annual deduction in respect of eligible capital property for an amount that qualified in the hands of the non-arm's length vendor for the special capital gains exemption. The rule provided in new subsection 14(3) corresponds with the existing rule in paragraph 13(7)(e) which applies in respect of non-arm's length transfers of depreciable property. This amendment is applicable in respect of dispositions of property occurring after 1987.

Subclause 8(3)

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 one-half to three-quarters. 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, as a taxable capital gain, a portion of the amount in respect of eligible capital property that would otherwise be included in a taxpayer's income from a business. Accordingly, in the case of a taxpayer other than a corporation, a partnership all the partners of which are corporations, or a partnership which was not a "Canadian partnership" (as defined in subsection 248(1) of the Act) throughout the year, 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).

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(4)

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 immediately after the commencement of its first taxation year commencing after June 30, 1988 and, in any other case, the adjustment time is immediately after the commencement of the taxpayer's first fiscal period commencing after 1987.

Subclause 8(5)

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 one-half to three-quarters 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 three-quarters.

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 (c)) 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.

Paragraph (g) (redesignated paragraph (d)) provides that subsection 15(1) does not apply where an insurance corporation or a bank converts its contributed surplus into paid-up capital in respect of its shares pursuant to paragraph 84(1)(c.1) or (c.2). This paragraph is amended to add a reference to new paragraph 84(1)(c.3), which allows a corporation, other than an insurance corporation or a bank, to convert into the paid-up capital of a class of its shares any contributed surplus that arose on the issuance of shares of that class after March 31, 1977 other than an issuance to which certain special provisions of the Act applied.

These amendments are applicable to benefits conferred after June, 1988, except that the addition of the reference to paragraph 84(1)(c.3) in redesignated paragraph 15(1)(d) is applicable to actions to convert contributed surplus into paid-up capital occurring after 1987.

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 due, 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)(m)(iii)

Paragraph 18(1)(m) of the Act provides that no deduction may be made in computing the income of a taxpayer from a business or property in respect of certain amounts that may reasonably be regarded as being in relation to the production in Canada of specified resources or the acquisition, development or ownership of Canadian resource properties.

Subparagraph 18(1)(m)(iii) is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever" in reference to corporations, commissions or associations controlled by Her Majesty (or by an agent of her Majesty) in right of Canada or a province. This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to de facto control -- are not applicable to paragraph 18(1)(m).

Subclause 11(5)

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 or payable as an allowance for the use by an individual of an automobile to an amount determined in accordance with prescribed rules, unless the amount so paid or payable is required to be included in computing the individual's income. Regulations will provide rules to 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 the course of earning income in a year and 21 cents for each subsequent kilometre in the year. An additional 4 cents for each kilometre travelled in the Yukon and the Northwest Territories will be allowed. This amendment is applicable with respect to allowances paid for the use of automobiles 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(6)

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(7)

ITA
18(2.2) to (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(8)

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(9)

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% or greater interest. This amendment is applicable to taxation years commencing after April, 1988.

Subclauses 11(10) and (11)

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

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(12)

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(13)

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% of the relevant costs incurred in 1988 will be required to be capitalized, 40% for calendar year 1989, 60% for calendar year 1990, 80% for calendar year 1991 and 100% after 1991.

Subclause 11(14)

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(15)

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 amended, is applicable.

Subclause 11(16)

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 for the purpose of earning income from business and be used on a regular and continuous basis for meeting his clients, customers or patients in respect of the business. 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 work space expenses for a particular year, such expenses are treated as work space 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

Advertising Expenses

ITA
19(5)(b)(v)

Section 19 of the Act provides rules restricting the deductibility of expenses of a taxpayer in respect of advertising in non-Canadian newspapers or periodicals where the advertisement is directed primarily to a market in Canada.

Paragraph 19(5)(b) defines "Canadian newspaper or periodical" for the purposes of section 19. Where the publisher of a newspaper or periodical is a corporation, subparagraph (v) of the definition imposes certain restrictions on the ownership of shares of the capital stock of the corporation and any holding corporations which must be met in order for the publication to qualify as Canadian.

In conjunction with the introduction of new subsection 256(5.1) of the Act, the phase "directly or indirectly" in clause (v)(C) of the definition, in reference to corporations controlled by non-Canadians, has been deleted. These words are generally regarded as being unnecessary. The amendment is effective for taxation years commencing after 1988.

Clause 13

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 13(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 13(2)

ITA
20(1)(e) and (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 parent corporation or new corporation, as the case may be, 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 certain 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 13(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 13(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 13(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)(1)(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)(1)(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)(1)(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 general provisions and specific 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. Loans or lending assets in respect of exposures to designated countries that were acquired from persons who did not deal at arm's length with the bank are not to be included in the calculation of the prescribed reserve amount. However, a specific reserve may be claimed in respect of such loans or lending assets. The amortized cost at the end of the year to the taxpayer of indebtedness in each of these pools is then multiplied 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)(1)(ii)(B) -- is the lesser of two amounts in respect of loans or lending assets that were not included in calculating the amount deducted under clause 20(1)(1)(ii)(A). 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 part of 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. That part of the reserve 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.

Paragraph 20(1)(l) is also amended to clarify that the deduction of a reserve under subparagraph (ii) can be for such lesser amount as the taxpayer may claim of the permissible maximum amount determined under that paragraph provided the lesser amount is the aggregate of a percentage of the amount determined under clause (A) and the same percentage of the amount determined under clause (B) of that subparagraph. 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 his business of insurance or the lending of money. 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 13(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 13(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 13(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 13(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 to be a repayment of interest which was included in computing his income for the year or a preceding year. Where the taxpayer is an individual, the amount deductible under this paragraph could not exceed the amount by which the amount of interest included in his income for the year exceeds, in respect of interest from a source in Canada, $1,000. This amendment, which is applicable to the 1988 and subsequent taxation years, 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 13(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 13(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 three-quarters of that amount. To the extent that the deduction in respect of the unrecoverable amount is denied because it relates to a taxable capital gain in respect of which a deduction was taken under section 110.6 of the Act, it shall be deemed to be an allowable capital loss.

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 13(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 13(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 other than a trust (except where all or substantially all - at least 90%, measured by distance travelled - 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 having a cost at the time of acquisition in excess of $20,000 or such other amount as may be prescribed that is owned by a trust, partnership or corporation. 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 67.3 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.

Regulations will create a new class, 10.1, for property that is a motor vehicle owned by an individual (other than a trust) and a passenger vehicle having a cost in excess of $20,000, or such other amount as may be prescribed, owned by a trust, partnership or corporation. A separate class will be prescribed for each vehicle included in class 10.1. The "half year" rule for claiming capital cost allowance will continue to apply in the year of acquisition of an automobile. However, there will be a new "half year" rule which will permit the taxpayer to claim, in the year of disposition of a vehicle included in class 10.1, one-half of the normal capital cost allowance in respect of the vehicle.

Subclause 13(14)

ITA
20(26) and (27)

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.

New subsection 20(27) provides a special rule for the purposes of the deduction of the reserve for doubtful loans or lending assets in paragraph 20(1)(l), the reserve for credit risks under arm's length guarantees or indemnities etc. in paragraph 20(1)(l.1) and the deduction for the uncollectable portion of loans or lending assets in paragraph 20(1)(p). These deductions are only available in respect of loans or lending assets made or acquired or instruments or commitments issued, made or assumed in the ordinary course of a taxpayer's business of insurance or the lending of money. A loan or lending asset or instrument or commitment will be treated as having been acquired, made or assumed by the taxpayer in the ordinary course of his business of insurance or the lending of money where it was acquired by the taxpayer from a non-arm's length person who was an insurer or whose ordinary business included the lending of money and the loan or lending asset was made or acquired or the instrument or commitment was issued, made or assumed in the ordinary course of that person's business of insurance or the lending of money.

Clause 14

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 -- prescribed aggregate reserve -- 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. For the purposes of paragraph 12(1)(i) and section 12.4, paragraph 26(3)(a) treats 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. For the purposes of section 12.4, new paragraph 26(3)(b) of the Act treats 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 15

Farming or Fishing Business

ITA
28

Subsection 28(1) of the Act provides for a method of accounting, known as the cash-basis method, which may be used for computing the income or loss of farmers and fishermen. These amendments modify subsection 28(1) in three respects.

Under existing paragraph 28(1)(b), farmers are allowed to add to their income for a year an elected amount not exceeding the fair market value of their livestock on hand at the end of the year, with a deduction of an equivalent amount required to be made in computing their income for the following year. This is known as the flexible livestock inventory election. The amendment to paragraph 28(1)(b) extends the flexible livestock inventory election to all farm inventory.

New paragraph 28(1)(c) provides for a mandatory inventory adjustment for farmers, in loss years only, in respect of purchased inventory on hand at the end of the year. This adjustment will operate in a manner similar to the existing flexible livestock inventory election except that it will be mandatory, will apply only to purchased inventory (although not just to livestock) and will apply only in loss years. The adjustment will require an addition to income in a loss year of the lesser of the amount of the loss and the value of purchased inventory on hand at the end of the year. As with the existing flexible livestock inventory election, any amount required to be included in income in a year is deducted in the following year -- see new paragraph 28(1)(f).

Lastly, subsection 28(1) has been amended to include references to subsections 13(1), 14(1), 20(16) and 24(1). These changes ensure that the income inclusions for recaptured depreciation and recaptured deductions in respect of eligible capital property, and the income deductions for capital cost allowance (including terminal losses) in respect of depreciable property and the write-off for eligible capital property, are reflected in the calculation of farming or fishing income or loss.

New subsection 28(1.1) defines inventory for the purposes of the mandatory inventory adjustment and the flexible inventory election. This definition is necessary because the definition of inventory in subsection 248(1) would not necessarily include the inventory of a cash-basis taxpayer, and to ensure that livestock is included in inventory. The subsection also excludes from inventory animals included in a taxpayer's basic herd, as a separate regime is provided for these animals under section 29 of the Act.

New subsection 28(1.2) provides rules concerning the manner in which a farmer's inventory is to be valued for the purposes of the mandatory inventory adjustment required by new paragraph 28(1)(c). Generally, inventory will be valued at the lower of its original purchase price and its fair market value. A "specified animal", however, will be valued at its original purchase price less 30% per year on a diminishing balance basis unless the taxpayer chooses to value the animal at a greater amount (not exceeding its original cost). For the purposes of this special rule, all horses are to be regarded as specified animals. A bovine animal registered under the Livestock Pedigree Act may be treated as a specified animal at the option of a taxpayer.

New subsection 28(1.3) applies to the valuation of specified animals in taxation years which are less than 51 weeks, and provides a formula for prorating the allowable 30% inventory value reduction for such animals. Thus, for example, where the taxation year is six months, the value of a specified animal could not be reduced below 85% of its value at the end of the preceding year -- 85% being determined by the formula 100 minus (30 x 183/365).

These amendments are applicable to taxation years commencing after 1988 subject to transitional relief over seven years for existing farm businesses in respect of the mandatory inventory adjustment. Transitional relief has been provided to reduce the impact of including, in the mandatory inventory adjustment, the value of inventory on hand which was purchased in taxation years commencing before 1989. Taxpayers may choose between two alternative methods of transitional relief in each of the first six taxation years of their business which commence after 1988. By the seventh year, the mandatory inventory adjustment will be fully phased in under either method. These alternatives are described below and illustrated in the examples that follow the description.

One of these alternatives is the "fixed-dollar" method of transitional relief as described in the December 1987 discussion paper "Tax Treatment of Farm Losses". This method will apply in any particular transition year unless the taxpayer elects otherwise. Under this method, the mandatory inventory adjustment will be reduced from what it would otherwise be by a fixed dollar amount each year. However, the phase-in period will be two years longer than was originally proposed in the discussion paper, such that the fixed amount will be $15,000 for the first taxation year of the business which commences after 1988, declining by $2,500 for each subsequent year ($12,500, $10,000, $7,500, $5,000 and $2,500 in the second to sixth such taxation years, respectively).

The other alternative form of transitional relief, referred to herein as the "elective method", is based on the value of year-end inventory on hand that was acquired before the end of the last taxation year commencing before 1989. Where a taxpayer so elects in a particular year, a portion of his inventory which was on hand at the beginning of the year in which the new rules first apply will be taken into account for the purposes of the mandatory inventory adjustment over the seven-year transitional period at the rate of 1/7th of the value of that inventory which is still on hand at the end of the first taxation year commencing after 1988, 2/7th of the value of that inventory which is still on hand at the end of the second such taxation year, and so on, until, at the end of the seventh such taxation year, the new mandatory inventory adjustment will be fully phased in. This adjustment will affect only the calculation of losses and is not required in any year for which the taxpayer reports positive net farm income as determined on a cash basis. The amount to be included in the mandatory inventory adjustment will reflect the decline in value of the inventory over the seven years as a result of dispositions, a decline in the fair market value of the inventory below cost, or the 30% declining balance valuation method applicable to specified animals, as defined above.

For the purposes of both transitional rules, a special valuation rule will apply to specified animals which were purchased in taxation years commencing before 1989 (see examples below). A specified animal purchased in the taxation year immediately preceding the first taxation year of the business which commences after 1988 will be valued at the end of a year as though it had been purchased in the first taxation year of the business which commences after 1988. As a consequence, the 30% "depreciation" rule applicable to the valuation of specified animals will begin to apply to the full amount that was paid to acquire those animals, starting with the first taxation year of the business which commences after 1988. A specified animal purchased in the two taxation years prior to that taxation year will be valued at the end of a year as though it had been purchased in the first taxation year of the business which commences after 1988 for one-half of the amount that was paid to acquire it. A specified animal purchased before those years will be valued at the end of a year as though it had been purchased in the first taxation year of the business which commences after 1988 for one-quarter of the amount that was paid to acquire it.

For example, for taxpayers having a calendar year-end, specified animals owned by them on January 1, 1989 will be valued in 1989 and subsequent taxation years as though they had been purchased in 1989 for:

- 100% of original cost if actually purchased in 1988;
- 50% of original cost if actually purchased in 1986 or 1987; and

- 25% of original cost if actually purchased before 1986.

The following examples illustrate the mechanics of the two transitional methods:

Fixed-Dollar Method

Farmer A

Farmer A does not choose to use the elective method and, therefore, the fixed dollar method applies.

. 1989 - Farmer A has a loss under cash accounting of $35,000 before the mandatory inventory adjustment (the "MIA"). He also has $40,000 worth of livestock and supplies on hand at the end of the year which were purchased in the year and in earlier years. He has no specified animals. It is the first year of the new system.

Cash-Basis Loss	($35,000)
Add back MIA: $35,000 (loss) or $40,000 (inventory on hand at the end of the year), whichever is less, minus $15,000 (transitional relief)	20,000
Deductible Farm Loss	($15,000)

. 1990 - Farmer A has a cash-basis loss of $10,000 and has on hand at the end of the year purchased inventory with a value of $10,000.

Cash-Basis Loss	($10,000)
Deduct 1989 MIA:	(20,000)
	($30,000)
Add back 1990 MIA: $30,000 (loss) or $10,000 (inventory on hand at the end of the year), whichever is less, minus $12,500 (transitional relief)	Ø
Deductible Farm Loss	($30,000)

. 1991 - Farmer A has a cash-basis loss of $40,000, and has $35,000 worth of purchased inventory on hand at the end of the year.

Cash-Basis Loss	($40,000)
Deduct 1990 MIA:	Ø
	($40,000)
Add back 1991 MIA: $40,000 (loss) or $35,000 (inventory on hand at the end of the year), whichever is less, minus $10,000 (transitional relief)	25,000
Deductible Farm Loss	($15,000)

Elective Method

Farmer B

Farmer B owns cattle with a value of $210,000 which he purchased before 1989 and which are on hand at the beginning of the new system. None of the cattle is a specified animal. Farmer B values his opening inventory and chooses to use the elective method of transitional relief.

- 1989 - Farmer B has a cash-basis loss of $60,000 in the first year of the new system before the MIA. He neither purchases nor sells any cattle this year and the cattle which he owns do not decline in value below cost.

Cash-Basis Loss	($60,000)
Add back MIA: $60,000 (loss) or $30,000 (1/7 x $210,000) (old system inventory on hand at the end of the year), whichever is less	30,000
Deductible Farm Loss	($30,000)

- 1990 - Farmer B again has a cash-basis loss of $60,000, neither purchases nor sells any cattle this year and the cattle which he owns do not decline in value below cost.

Cash-Basis Loss	($60,000)
Deduct 1989 MIA:	(30,000)
	($90,000)
Add back 1990 MIA: $90,000 (loss) or $60,000 (2/7 x $210,000) (old system inventory on hand at the end of the year), whichever is less	60,000
Deductible Farm Loss	($30,000)

- 1991 - Farmer B has a cash-basis loss of $20,000, sells some of his cattle and the value of the remaining cattle has declined to $140,000.

Cash-Basis Loss	(\$20,000)
Deduct 1990 MIA:	(60,000)
	(\$80,000)
Add back 1991 MIA: \$80,000 (loss) or \$60,000 (3/7 x \$140,000) (old system inventory on hand at the end of the year), whichever is less	60,000
Deductible Farm Loss	(\$20,000)

- 1992 - Farmer B has a cash-basis loss of \$60,000 and purchases more cattle which have a value of \$50,000 at the end of the year. He still has on hand cattle which he had on hand at the beginning of the new system and which now have a value of \$140,000.

Cash-Basis Loss	(\$60,000)
Deduct 1991 MIA:	(\$60,000)
	(\$120,000)
Add back 1992 MIA: lesser of \$120,000 (loss) and \$130,000, being the aggregate of (1) \$80,000 (4/7 x \$140,000) (old system inventory on hand at the end of the year) and (2) \$50,000 (new system inventory on hand at the end of the year)	120,000
Deductible Farm Loss	Ø

It should be noted, however, that the fixed-dollar method of transitional relief applies in any particular year if a taxpayer does not choose to use the elective method. In this year, Farmer B could have chosen the fixed-dollar method with the following result:

Cash-Basis Loss	(\$60,000)
Deduct 1991 MIA:	(60,000)
	(\$120,000)
Add back 1992 MIA: \$120,000 (loss) or \$190,000 (inventory on hand at the end of the year), whichever is less, minus \$7,500 (transitional relief)	112,500
Deductible Farm Loss	(\$7,500)

Farmer C

Farmer C owns two racehorses. Horse A was purchased in 1986 for $40,000. Horse B was purchased in 1988 for $50,000.

- 1989 - Farmer C has a cash-basis loss before the MIA of $20,000. Because a horse is a specified animal, valuation of the horses for the purposes of the MIA in 1989 is as follows:

Horse A:	$20,000 (1/2 of $40,000)	x 70% =	$14,000
Horse B:	$50,000	x 70% =	$35,000
			$49,000

(old system inventory)

Elective Method

Cash-Basis Loss	($20,000)
Add back MIA: $20,000 (loss) or $7,000 (1/7 x $49,000) (old system inventory on hand at the end of the year), whichever is less	7,000
Deductible Farm Loss	($13,000)

Fixed-Dollar Method

Cash-Basis Loss	($20,000)
Add back MIA: $20,000 (loss) or $49,000 (inventory on hand at the end of the year), whichever is less, minus $15,000 (transitional relief)	5,000
Deductible Farm Loss	($15,000)

As a consequence, we will assume, for the purpose of this example, that Farmer C would choose to use the fixed-dollar method this year.

- 1990 - Farmer C has a cash-basis loss of $15,000 and sells Horse A.

Value of Horse B (the remaining horse):
$35,000 (value in 1989) x 70% = $24,500

Elective Method:

Cash-Basis Loss	(\$15,000)
Deduct 1989 MIA:	(5,000)
	(\$20,000)
Add back 1990 MIA: \$20,000 (loss) or \$7,000 (2/7 x \$24,500) (old system inventory on hand at the end of the year), whichever is less	7,000
Deductible Farm Loss	(\$13,000)

Fixed-Dollar Method

Cash-Basis Loss	(\$15,000)
Deduct 1989 MIA:	(5,000)
	(\$20,000)
Add back 1990 MIA: \$20,000 (loss) or \$24,500 (inventory on hand at the end of the year), whichever is less, minus \$12,500 (transitional relief)	7,500
Deductible Farm Loss	(\$12,500)

Farmer C would probably choose to use the elective method this year.

Clause 16

Improving Land for Farming

ITA
30

Section 30 of the Act permits the deduction in computing income from a farming business of certain land improvement costs that would not otherwise be deductible on a current basis by reason of their nature as capital expenditures. The section is amended in two respects.

First, the amendments will allow a taxpayer to claim less than the full cost of such an expenditure in the year in which the expenditure is incurred, and to carry forward the undeducted expenditure for deduction in a subsequent year. Second, this section, which provides a deduction for the cost of laying tile drainage, is amended to clarify that it covers the cost of installing a land drainage system composed of a material other than tile.

These amendments are applicable with respect to amounts paid after 1987.

Clause 17

Restricted Farm Losses

ITA
31

Subsection 31(1) of the Act restricts the farm losses deductible against other sources of income for farmers whose chief source of income is neither farming nor a combination of farming and some other source of income. Currently, the loss limitation under subsection 31(1) is $2,500 plus 1/2 of the next $5,000 of losses in a year. The amendment to subsection 31(1) increases the applicable loss limitation to $2,500 plus 1/2 of the next $12,500 of losses in a year.

This amendment is applicable to taxation years commencing after 1988.

Clause 18

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 19

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 19(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, this requirement is made applicable to 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. As well, at present only payments to approved organizations are subject to the requirement that, where a taxpayer makes a payment for R&D to be conducted on his behalf, the taxpayer must be entitled to exploit the results of the R&D for the payments to qualify under section 37. This requirement is extended to all third party payments.

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 19(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 repaid 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 19(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. Where a tax credit is carried back to a taxation year preceding that in which it was earned, the required reduction of the R&D pool will not have to be made until the year following that in which the expenditure was 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 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 19(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 19(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 19(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 19(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 19(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 all expenditures described in each of those paragraphs are treated as components of a single pool. This amendment is applicable after December 15, 1987.

Subclauses 19(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 19(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 19(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 19(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 exemption 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 deals at arm's length.

Clause 20

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 21

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 21(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 tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 21(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 21(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.

Subclause 21(4)

ITA
39(11)

Subsection 20(4.2) provides that where an amount receivable by a taxpayer as proceeds in respect of a disposition of an eligible capital property proves uncollectible, the taxpayer may deduction three-quarters of that bad debt to the extent that the proceeds did not relate to a taxable capital gain in respect of which a deduction under section 110.6 was taken. The balance of the three-quarters of the bad debt is deemed to be an allowable capital loss. Where a portion of the bad debt is subsequently recovered, paragraph 12(1)(i.1) of the Act requires the taxpayer to include in his income three-quarters of the amount recovered to the extent that it relates to an amount previously deducted under subsection 20(4.2). New subsection 39(11) deems the balance of the three-quarters portion of the recovered amount (i.e. that portion relating to the portion of the bad debt which was deemed to be an allowable capital loss) to be a taxable capital gain. 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 one-half, the applicable portion of the debt or the recovered amount for the purposes of the calculations under each of paragraphs 12(1)(i.1) and subsections 20(4.2) and 39(11) is one-half instead of three-quarters. This amendment is applicable after June 17, 1987.

Clause 22

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 22(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 provide that in the case of an individual (other than a trust) a prescribed form must be filed with the return. 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 22(2)

ITA
40(2)(a)(ii)

Subparagraph 40(2)(a)(ii) of the Act restricts a taxpayer's ability to claim a capital gains reserve in respect of properties disposed of to a corporation that controlled the taxpayer or was controlled by the taxpayer or by a person or group of persons who controlled the taxpayer. In conjunction with the introduction of new subsection 256(5.1), clauses 40(2)(a)(ii)(A), (B) and (C) are amended to refer therein to "controlled directly or indirectly in any manner whatever". As a result, the *de facto* control provisions of subsection 256(5.1) will be relevant, for dispositions after 1988, in determining whether the vendor is entitled to claim a capital gains reserve in computing his gain for a taxation year.

Subclause 22(3)

ITA
40(2)(e)

Paragraph 40(2)(e) of the Act provides that a corporation's loss from the disposition of any property disposed of by it to a person by whom it was controlled, or to another corporation controlled by that person, is nil. In conjunction with the introduction of new subsection 256(5.1), the references in paragraph 40(2)(e) to "controlled" are changed to "controlled, directly or indirectly in any manner whatever". Accordingly, the de facto control provisions of subsection 256(5.1) will be relevant, for dispositions after 1988, in determining the corporation's capital loss.

Subclause 22(4)

ITA
40(2)(h)

Paragraph 40(2)(h) of the Act provides for certain adjustments to a taxpayer's loss otherwise determined from the disposition by the taxpayer of shares of the capital stock of a corporation that was controlled by the taxpayer at any time in the taxation year of the taxpayer in which the disposition occurred. In conjunction with the introduction of new subsection 256(5.1), paragraph 40(2)(h) is amended, to apply to dispositions, after 1988, of shares of the capital stock of a corporation controlled directly or indirectly in any manner whatever by the taxpayer. As a result, the de facto control provisions of subsection 256(5.1) will be relevant in determining whether paragraph 40(2)(h) applies to the disposition.

Subclause 22(5)

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 1985 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 23

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 24

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 1985 and subsequent taxation years, ensures that such losses are taken into account in determining a taxpayer's entitlement to the capital gains exemption.

Clause 25

Exchanges of Property

ITA
44(7)(b)

Section 44 of the Act provides rules applicable to involuntary dispositions of capital properties and to replacement properties.

Paragraph 44(7)(b) restricts a taxpayer from claiming a capital gains reserve under subparagraph 44(1)(e)(iii) where the former property of the taxpayer was disposed of to a corporation that, immediately after the disposition, controlled the taxpayer or was controlled by the taxpayer or by a person or group of persons who controlled the taxpayer. Paragraph 44(7)(b) is amended, in the same manner as paragraph 40(2)(a) -- which applies to capital gains reserves generally -- to refer therein to "controlled, directly or indirectly in any manner whatever". Accordingly, the de facto control provisions of new subsection 256(5.1) will be relevant, for dispositions after 1988, in determining whether the taxpayer is entitled to claim a capital gains reserve in computing his gain for a taxation year.

Clause 26

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 26(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 occurring after April, 1988 to or from any income-producing purpose.

Subclause 26(2)

ITA
45(1)(b)

Paragraph 45(1)(b) provides that, where property is regularly 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 regularly 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 occurring 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 regularly used in part for gaining or producing income from any source and in part for some other purpose.

Subclause 26(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 26(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, which is applicable to changes in use occurring after April, 1988, ensures that the exception is available where the property was used for gaining or producing income from any source.

Subclause 26(5)

ITA
45(4)

An election under subsection 45(3) of the Act allows a taxpayer to defer the recognition of the capital gain on any property which becomes his principal residence after having being used by him for rental or business purposes. Subsection 45(4) provides that the election is not available where the taxpayer, his spouse or a trust of which his spouse is a beneficiary has benefited from capital cost allowance taken in respect of the property for a taxation year ending after 1984.

The amendment to subsection 45(4) makes several changes effective in respect of elections made after 1987. The reference to subsection 104(16) is eliminated as a consequence of the repeal of that subsection. In addition, the subsection 45(3) election will not be available if a trust of which the taxpayer is a beneficiary has taken capital cost allowance in respect of the property. The amendment also ensures that the taking of capital cost allowance after a subsequent change in use of the property will not nullify a prior election made under subsection 45(3).

Clause 27

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 27(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 27(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 28

Options

ITA
49

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

Subclause 28(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 28(2)

ITA
49(4)(a)

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 29

Bad Debts and Shares of Bankrupt Corporation

ITA
50(1)(b)

Paragraph 50(1)(b) of the Act treats a taxpayer as having disposed of a share of the capital stock of a corporation owned at the end of the year in which it becomes bankrupt under the Bankruptcy Act or insolvent under the Winding-up Act and as having reacquired it at a nil cost immediately thereafter. Thus, a shareholder is allowed to recognize a capital loss on the shares of the corporation even though he may not have disposed of them. Amounts subsequently realized on the actual disposition of the shares are taxed as capital gains.

New subparagraph 50(1)(b)(iii) provides that shareholders of a corporation that has ceased to carry on business and is insolvent during the year will be treated as having disposed of their shares at the end of the year where certain conditions are met. These conditions provide that the fair market value of the shares at the end of the year must be nil and that it must be reasonable to expect that the corporation will be dissolved or wound-up and will not commence to carry on business. As well, the corporation must not commence to carry on a business in the year or in the 24 months after the end of the year. Where these conditions are met, new subparagraph 50(1)(b)(iii) will allow shareholders of an insolvent corporation that has not become bankrupt to realize a capital loss on the shares of the corporation. New subparagraph 50(1)(b)(iii) is applicable to the 1988 and subsequent taxation years and, where the taxpayer notifies the Minister of National Revenue in writing, to the 1985, 1986 or 1987 taxation year.

Clause 30

Cost of Right Received
From Trust

ITA
52(6)

Subsection 52(6) of the Act provides that a beneficiary's right to enforce payment of an amount out of the capital gains or income from property of a unit trust for the year in which the beneficiary acquired the right is considered to have a cost equal to such amount. This ensures that the non-taxable portion of a unit trust's capital gains can be distributed to beneficiaries without giving rise to capital gains in their hands on the disposition of the right. This subsection also provides that the beneficiary's cost of the right is reduced by amounts of capital cost allowance and depletion that are allocated by the trust to the beneficiary.

The amendment to subsection 52(6) will extend the application of this provision to beneficiaries under all trusts, for beneficiaries acquiring rights in the 1988 and subsequent taxation years of trusts. In addition, as a consequence of the proposed repeal of the rules permitting a trust to allocate capital cost allowance and depletion to its beneficiaries, the references in subsection 52(6) to subsections 65(1) and 104(16) are being repealed.

Clause 31

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 31(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 include only 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.

Subclause 31(2)

ITA
53(1)(d.2) and (d.3)

New paragraph 53(1)(d.2) of the Act is consequential on the introduction of special rules relating to designations for mutual fund trusts provided under new section 132.1. This paragraph provides for an increase in the adjusted cost base of a taxpayer's unit in a mutual fund trust by any amount required under subsection 132.1(2). It is effective in respect of designations made for the 1988 and subsequent taxation years of mutual fund trusts.

New paragraph 53(1)(d.3) of the Act allows for an addition to the adjusted cost base of a share of the capital stock of a corporation held by a specified shareholder of that corporation in respect of amounts the deduction of which is denied by subsection 18(2) or 18(3.1). This amendment is added consequential to the amendments to paragraph 18(3)(b) and subsection 18(3.2) concerning interest expenses incurred by a taxpayer to finance the acquisition of land or the construction of a building by certain third parties. This amendment is applicable to taxation years ending after 1987.

Subclauses 31(3) and (8)

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 31(4)

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 31(5)

ITA
53(1)(e)(xi)

New subparagraph 53(1)(e)(xi) of the Act allows for an addition to the adjusted cost base of a taxpayer's interest in a partnership in cases where the taxpayer's share of the income or loss of that partnership was 10% or more, in respect of amounts the deduction of which is denied by subsection 18(2) or (3.1). This amendment is consequential to the amendments to paragraph 18(3)(b) and subsection 18(3.2) concerning interest expenses incurred by a taxpayer to finance the acquisition of land or the construction of a building by certain third parties. This amendment is applicable to taxation years ending after 1987.

Subclauses 31(6) and (7)

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.

Paragraph 53(1)(h) is further 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, including a corporation or a partnership, of land of amounts the deduction of which is denied by subsection 18(2) to the taxpayer, to a person with whom he does not deal at arm's length, to a specified shareholder of the corporation, or to a partner whose share of any income or loss of the partnership is 10% or more. This amendment is applicable for taxation years ending after 1987.

Subclause 31(9)

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 31(10)

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 31(11)
ITA
53(2)(h)

Paragraph 53(2)(h) of the Act requires certain amounts to be deducted in computing the adjusted cost base of a unit of a unit trust or of a capital interest in any other trust that was purchased by the taxpayer.

Paragraph 53(2)(h) is being amended in light of the recent change to the definition of capital interest in a trust and in order to provide consistent treatment in respect of all interests in commercial trusts - trusts which are not described in the new definition of "personal trust" in section 248. Paragraph 53(2)(h) will continue to apply in respect of interests in personal trusts acquired for consideration. The amendment also clarifies that the required deduction in computing the adjusted cost base of a trust does not apply to interests in employee trusts, RCA trusts or other special trusts referred to in subparagraphs 108(1)(j)(ii) to (v) of the Act.

Subparagraph 53(2)(h)(i) requires the adjusted cost base of an interest in a trust to be reduced by amounts received from the trust by a beneficiary as a distribution of capital (otherwise than as proceeds of disposition of his interest). The amendment thereto restricts the reduction to amounts that became payable by the trust before 1988. Reductions in the adjusted cost base for amounts becoming payable after 1987 are dealt with in new subparagraph 53(2)(h)(i.1), as discussed below.

New subparagraph 53(2)(h)(i.1) ensures that all distributions by a trust to a beneficiary will reduce the adjusted cost base of the beneficiary's capital interest, unless the amount represents proceeds of disposition of the interest or is included in the beneficiary's income. Thus, for example, distributions to a beneficiary out of a trust's income as determined for trust purposes, in excess of its income for tax purposes, will reduce the adjusted cost base of his capital interest therein. An adjusted cost base reduction will also occur as a consequence of a designation made under subsection 104(13.1) or (13.2) in respect of trust distributions to beneficiaries out of the trust's income for tax purposes, to the extent that such distributions are not fully deducted by the trust as permitted under the new amendment to subsection 104(6).

New subparagraph 53(2)(h)(i.1) includes two exceptions to the general rule described above. First, the non-taxable portion of capital gains realized by a resident trust in a year may be distributed to beneficiaries in that year with no reduction in the adjusted cost base of their capital interests in the trust. For this purpose, the non-taxable portion of the capital gains of a trust is determined by reference to the portion of net taxable capital gains designated by the trust in respect of a beneficiary pursuant to subsection 104(21). In no event can the non-taxable portion exceed 1/2 of the amount so designated for 1988 and 1989 or 1/3 of the amount so designated after 1989. These maximums are based on the capital gains inclusion rates of two-thirds for 1988 and 1989 and three-quarters after 1989. In addition, capital dividends received by a resident trust in a year may be flowed through to its beneficiaries in that year without requiring a reduction in the adjusted cost base of the beneficiary's capital interest in the trust. The amount of capital dividends flowed through to a beneficiary is designated by the trust under amended subsection 104(20).

Subject to a special transitional rule, this new subparagraph will apply with respect to all amounts that become payable by a trust after 1987. However, in the case of a trust that is not a unit trust and that was created before October 2, 1987, it will not apply to amounts that become payable in taxation years of the trust ending before 1990 and that may reasonably be considered to be in respect of capital cost allowance, terminal losses or depletion deducted by the trust for the year. To qualify for this transitional relief, such amounts must be designated by the trust in its return of income for the year in accordance with the coming-into-force provision. This transitional rule will cease to apply if the trust creates any new beneficial interest after October 1, 1987, other than pursuant to the terms of a prospectus, preliminary prospectus, registration statement, offering memorandum or notice filed with a public authority in Canada (where such filing is required before trading can commence) or if there is a substantial increase in the indebtedness of the trust other than as a consequence of an agreement in writing entered into before October 2, 1987.

Subclause 31(12)

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 32

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 32(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 one-half to three-quarters. The amendment is applicable after June 17, 1987.

Subclause 32(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 33

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 34

Artificial Reduction of Capital Gains

ITA
55

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

Subclause 34(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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof. This parallels the coming-into-force of new section 245.

Subclause 34(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 excess of capital losses over allowable capital losses of the corporation for the period from its excess of capital gains over taxable capital gains for that period. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 34(3)

ITA
55(5)(b)(iii)

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 one-half 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 one-half 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 one-half to three-quarters. New subparagraph 55(5)(b)(iii) will operate in essentially the same manner as the existing provision except that the untaxed portion will now be one-quarter of the amounts outlined above, rather than one-half. 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 one-half 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, one-half of that deficit will be included in clause 55(5)(b)(iii)(D).

Reducing this deficit by one-half equates this deficit, which was generated when the inclusion rate for eligible capital property was one-half, with the new one-quarter 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 one-quarter. 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, one-third of this amount is deducted under clause 55(5)(b)(iii)(G) (one-third of three-quarters being equal to one-quarter 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), one-third 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 one-half, these clauses shall be read without reference to the words "1/3 of".

Clause 35

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 35(1)

ITA
56(1)(c.1)

Paragraph 56(1)(c.1) of the Act provides that an amount received by certain common law spouses in the year, pursuant to an order made under the laws of a province, as an allowance payable on a periodic basis for the maintenance of the recipient or the recipient's children must be included in computing the recipient's income for the year. The recipient must also be living separate and apart from the individual required to make payment of the amount at the time the payment was received and throughout the remainder of the year and must be an individual within a prescribed class of persons described in the laws of a province. To date, the only provincial law prescribed for this purpose is the Family Law Reform Act of Ontario.

This amendment removes the requirement that the provincial laws governing the payment of the allowance be set out in the regulations, and provides that such an amount will be included in computing the income of the recipient where the individual required by the order to pay the allowance is an individual of the opposite sex who, before the date of the court order, cohabited with the taxpayer in a conjugal relationship or is the natural parent of a child of the recipient. Corresponding changes are made to paragraph 60(c.1) of the Act which sets out the rules relating to the deductibility of such allowances by the person making the payment.

This amendment is applicable to the 1988 and subsequent years with respect to orders made after February 10, 1988 and with respect to orders made before February 11, 1988, where the recipient and the payor jointly elect in writing to have this paragraph and paragraph 60(c.1) apply. With respect to Ontario court orders, the amendment ensures continuity of the existing treatment and applies to the 1986 and subsequent taxation years.

Subclause 35(2)

ITA
56(1)(u)

Paragraph 56(1)(u) of the Act provides for the inclusion of certain social assistance payments in the income of a taxpayer. While such amounts are effectively not taxable (because of the offsetting deduction in paragraph 110(1)(f)), their inclusion in the taxpayer's income may reduce the amount of certain tax incentives, such as refundable tax credits, to which he would otherwise be entitled.

This amendment provides that the social assistance payments which are to be included in income by a taxpayer are restricted to those made in respect of the taxpayer, a person related to the taxpayer or a person in respect of whom a family allowance is payable under the Family Allowance Act, 1973. Such social assistance payments will be included in the taxpayer's income if they were received by the taxpayer, except in circumstances where the taxpayer is married to and living with his spouse at the time the payments were received and the taxpayer's income is less than his spouse's income for the year. In such cases the payment is included in his spouse's income. The amendments to this paragraph are applicable to the 1982 and subsequent taxation years.

Subclause 35(3)

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 or certain other transactions in respect of which the taxpayer has received from

Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof. This parallels the coming-into-force of new section 245.

Subclause 35(4)

ITA
56(4.1) to (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 are applicable. 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 with respect to loans outstanding after 1988, except that in the case of loans made before 1989, the amendments do not apply to income relating to any period ending before 1989.

Subclause 35(5)

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 months for which the family allowances are paid. For this purpose, new subsection 56(6) deems an individual to have supported a child in a particular month 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 in the particular month 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 particular month 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.

Subclause 35(6)

ITA
56(12)

Paragraphs 56(1)(b), (c) and (c.1) of the Act provide for the inclusion of certain amounts paid as an allowance in respect of alimony or the maintenance of the recipient, children of the recipient or both the recipient and children of the recipient. As a result of the Supreme Court of Canada decision, Gagnon vs. The Minister of National Revenue in which the definition of allowance was modified, payments which the recipient is required by the terms of a decree, order, judgement or written agreement to use to defray specific expenses, must now be included in computing the recipient's income. Certain third party payments must also be included in computing the income of the beneficiary of these payments even where the parties to the court order or separation agreement providing for the payment had not expressly agreed to this treatment.

New subsection 56(12) restores the definition of allowance as it was understood prior to the Gagnon decision. For the purposes of paragraphs 56(1)(b), (c) and (c.1) and 60(b), (c) and (c.1) an "allowance" will not include any amount that is received by a person unless that person has discretion as to the use of the amount. This provision is subject to subsections 56.1(2) and 60.1(2) which, under certain conditions, deem amounts which are not otherwise considered allowances to have been paid and received as an allowance.

This amendment is applicable with respect to decrees, orders, judgements and written agreements made or entered into before March 28, 1986 or after 1987, except that, for the 1986 and 1987 taxation years, the exclusion from an "allowance" of amounts over which the recipient does not have discretion as to their use shall apply only for the purposes of paragraphs 56(1)(b), (c) and (c.1). While the recipient is not required to include such amounts in computing income, the payor of such amounts will, for the 1986 and 1987 taxation years, be permitted to deduct such amounts in accordance with the Gagnon definition of "allowance".

Clause 36

Maintenance

ITA
56.1

Subclause 36(1)

ITA
56.1(1)

Subsection 56.1(1) of the Act provides that, where a periodic payment of an amount pursuant to a court order or written agreement described in paragraph 56(1)(b), (c) or (c.1) is made to the taxpayer or for the benefit of the taxpayer or children in the custody of the taxpayer, the amount shall be deemed, for the purposes of paragraphs 56(1)(b), (c) and (c.1) to have been paid to and received by the taxpayer. The taxpayer must be living apart from the person required to pay the amount at the time of payment and throughout the remainder of the year.

This amendment is similar to that to paragraph 56(1)(c.1) as described above so that the rule applies to amounts paid pursuant to an order made in accordance with the laws of a province and is not restricted to persons within a prescribed class of persons as set out in the Income Tax Regulations. New subparagraph 56.1(1)(a)(ii) provides that, where an amount is paid pursuant to an order made by a competent tribunal after February 10, 1988, by a person of the opposite sex who, before the date of the order, cohabited with the taxpayer in a conjugal relationship or who is the natural parent of a child of the taxpayer and the amount is paid to the taxpayer, or for the benefit of the taxpayer, children in the custody of the taxpayer or both the taxpayer and such children, then, for purposes of paragraphs 56(1)(b), (c) and (c.1) the amount shall be deemed to have been paid to and received by the taxpayer.

This amendment is applicable to the 1988 and subsequent taxation years with respect to orders made after February 10, 1988 except that, with respect to orders made under the laws of Ontario, the amendment is applicable to the 1986 and subsequent taxation years. For Ontario court orders, the reference in new subparagraph 56.1(1)(a)(ii) to "February 10, 1988" shall be read as a reference to "May 6, 1974".

Subclauses 36(2) and (3)

ITA
56.1(2)

Subsection 56.1(2) of the Act provides that certain third party payments made after 1983 pursuant to a court order or written agreement in respect of an expense such as a medical bill, mortgage payment or payment of tuition fees, shall, if certain conditions are met, be deemed to be an amount received by the taxpayer as an allowance payable on a periodic basis and taxable to the taxpayer.

New paragraph 56.1(2)(a) clarifies that an amount paid in respect of a self-contained domestic establishment in which the payor resides is not a qualifying amount. In addition, this paragraph is amended by deleting the reference "owner-occupied home of a taxpayer" and substituting the reference "self-contained domestic establishment in which the taxpayer described in subparagraph (i) or (ii) resides". This particular amendment provides that an amount paid in respect of such an establishment will be taxable to the beneficiary, where the conditions of the subsection apply, even though the payor may have an interest in the property.

New subparagraph 56.1(2)(a)(ii) incorporates the new reference to amounts paid pursuant to an order made by a competent tribunal after February 10, 1988 where the amount is paid for the maintenance of an individual of the opposite sex who, before the date of the order, cohabited with the payor in a conjugal relationship or who is the natural parent of a child of the payor.

This amendment is applicable to the 1988 and subsequent taxation years with respect to orders made after February 10, 1988, except that, with respect to orders made under the laws of Ontario the amendment is applicable to the 1986 and subsequent taxation years.

Subparagraph 56.1(2)(b)(i) is amended by deleting the reference therein to "owner-occupied home of the taxpayer" and substituting the reference "self-contained domestic establishment in which the taxpayer resides". This amendment is similar to that to paragraph 56.1(2)(a) and provides that an amount paid in respect of such an establishment will be taxable to the taxpayer, where the conditions of the subsection apply, even though the payor may have an interest in the property.

Subsection 56.1(4) is repealed as a consequence of the deletion of the reference to "owner-occupied home" in subsections 56.1(2) and 60.1(2).

These amendments are effective upon Royal Assent.

Clause 37

Resource Property Dispositions

ITA
59

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

Subclauses 37(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%; on July 1, 1988, it is reduced to 16 2/3% 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 37(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 37(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% for amounts that became receivable within 60 days after the end of December 1989.

Clause 38

Other Deductions

Subclause 38(1)

ITA
60(c.1)

Paragraph 60(c.1) of the Act mirrors paragraph 56(1)(c.1) and provides a deduction in respect of amounts paid by certain common law spouses which are included in computing a taxpayer's income under paragraph 56(1)(c.1).

Paragraph 60(c.1) provides that an amount paid by a taxpayer in the year, pursuant to an order made under the laws of a province, as an allowance payable on a periodic basis for the maintenance of the recipient, children of the recipient or both the recipient and children of the recipient, be deducted in computing the taxpayer's income for the year. The taxpayer must also be living separate and apart from the recipient of the amount, at the time the payment was made and throughout the remainder of the year and must be an individual within a prescribed class of persons described in the laws of a province. To date, the only provincial law prescribed for this purpose is the Family Law Reform Act of Ontario.

This amendment removes the requirement that the provincial laws be set out in the Regulations and provides that such an amount may be deducted in computing the income of a taxpayer where the taxpayer required by the order to pay the allowance is an individual of the opposite sex who, before the date of the court order, cohabited with the recipient in a conjugal relationship or is the natural parent of a child of the recipient.

This amendment is applicable to the 1988 and subsequent years with respect to orders made after February 10, 1988 and with respect to orders made before February 11, 1988, where the recipient and the payor jointly elect in writing to have this paragraph and paragraph 56(1)(c.1) apply. With respect to Ontario court orders, the amendment also ensures continuity of the existing treatment and applies to the 1986 and subsequent taxation years.

Subclause 38(2)

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 39

Maintenance Payments

ITA
60.1

Subclause 39(1)

ITA
60.1(1)

Subsection 60.1(1) of the Act provides that, where a periodic payment of an amount pursuant to a court order or written agreement described in paragraph 60(b), (c) or (c.1) is made by a taxpayer to or for the benefit of the taxpayer's spouse, former spouse, or children in the custody of such a person, the amount shall be deemed, for the purposes of paragraphs 60(b), (c) and (c.1), to have been paid to and received by that person. The taxpayer must be living apart from the person to whom he is required to pay the amount at the time of payment and throughout the remainder of the year.

This amendment is similar to that to paragraph 60(c.1) so that the rule applies to amounts paid pursuant to an order made in accordance with the laws of a province and is not restricted to persons within a prescribed class of persons as set out in the Income Tax Regulations. New subparagraph 60.1(1)(a)(ii) provides that, where an amount is paid pursuant to an order made by a competent tribunal after February 10, 1988, by the taxpayer to a person of the opposite sex who, before the date of the order, cohabited with the taxpayer in a conjugal relationship or who is the natural parent of a child of the taxpayer and the amount is paid to the person, or for the benefit of the person, children in the custody of the person or both the person and such children, then, for the purposes of paragraphs 60(b), (c) and (c.1), the amount shall be deemed to have been paid to and received by the person.

This amendment is applicable to the 1988 and subsequent years with respect to orders made after February 10, 1988, except that with respect to orders made under the laws of Ontario, the amendment is applicable to the 1986 and subsequent taxation years. For Ontario court orders, the reference in new subparagraph 60.1(1)(a)(ii) to "February 10, 1988" shall be read as a reference to "May 6, 1974".

Subclauses 39(2) and (3)

ITA
60.1(2)

Subsection 60.1(2) of the Act provides that certain third party payments made after 1983 pursuant to a court order or written agreement in respect of an expense such as a medical bill, mortgage payment or payment of tuition fees, shall, if certain conditions are met, be deemed to be an amount paid by the taxpayer as an allowance payable on a periodic basis and therefore deductible under paragraph 60(b), (c) or (c.1) in computing the taxpayer's income.

New paragraph 60.1(2)(a) clarifies that an amount paid in respect of a self-contained domestic establishment in which the payor resides is not a qualifying amount. In addition, this paragraph is amended by deleting the reference "owner-occupied home of a person" and substituting the reference "self-contained domestic establishment in which the person described in subparagraph (i) or (ii) resides". This particular amendment provides that an amount paid in respect of such an establishment will be deductible by the payor, where the conditions of the subsection apply, even though he may have an interest in the property.

New subparagraph 60.1(2)(a)(ii) incorporates the new reference to amounts paid pursuant to an order made by a competent tribunal after February 10, 1988 where the amount is paid for the maintenance of an individual of the opposite sex who, before the date of the order, cohabited with the payor in a conjugal relationship or who is the natural parent of a child of the payor.

This amendment is applicable to the 1988 and subsequent taxation years with respect to orders made after February 10, 1988, except that, with respect to orders made under the laws of Ontario the amendment is applicable to the 1986 and subsequent taxation years.

Subparagraph 60.1(2)(b)(i) is amended by deleting the reference therein to "owner-occupied home of that person" and substituting the reference "self-contained domestic establishment in which that person resides". This amendment is similar to that to paragraph 60.1(2)(a) and provides that an amount paid in respect of such an establishment will be deductible by the payor, where the conditions of the subsection apply, even though he may have an interest in the property.

This amendment is effective upon Royal Assent.

Clause 40

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. These amendments also reflect the February 1988 Budget proposals. All of these amendments are applicable to the 1988 and subsequent taxation years.

Subclause 40(1)

ITA
63(1)

Subsection 63(1) of the Act is amended to provide that child care expenses in respect of an eligible child may only be deducted by a taxpayer in computing his income where the taxpayer files with his return of income a prescribed form containing prescribed information. This amendment is necessary as a result of the new tax form for 1988. Previously, information concerning child care expenses was submitted on a schedule to the T1-General Return. This information will now be furnished by way of a prescribed form.

Subclause 40(2)

ITA
63(1)(e)

Paragraph 63(1)(e) of the Act contains the formula for computing an individual's deduction in respect of child care expenses. Currently, the amount deductible is equal to the least of 2/3 of the taxpayer's earned income for the year, $2,000 multiplied by the number of eligible children for whom care expenses were incurred, and $8,000. This amendment removes the $8,000 family limitation and increases, from $2,000 to $4,000, the amount that may be claimed in respect of severely disabled children and children under 7 years of age at the end of the year.

Subclause 40(3)

ITA
63(2)(b)

Paragraph 63(2)(b) of the Act contains a weekly maximum amount for the child care expense deduction when the income of the taxpayer claiming the deduction exceeds that of a supporting person. This paragraph is amended as a consequence of the increase in the maximum annual deduction from $2,000 to $4,000 in respect of severely disabled children and children under 7 years of age. The maximum weekly deduction in respect of the aforementioned children is accordingly increased from $60 to $120.

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)(iv) is amended to provide that mental or physical infirmity of a person must be certified by a medical doctor, instead of a qualified medical practitioner. Subparagraph 63(2)(b)(vi) is also amended to refer to a person who, by reason of marriage breakdown, is living separate and apart from the taxpayer at the end of the year.

Subclause 40(4)

ITA
63(3)(a)

Paragraph 63(3)(a) of the Act provides a definition of "child care expense" for the purposes of the deduction of such expenses. This definition is amended to refer to the expense incurred in a taxation year for the purpose of providing child care services including services provided at a boarding school or camp. The reference to services provided at a boarding school or camp ensures that all such expenses, not solely expenses relating to lodging at a boarding school, will fall within the weekly dollar limits provided in subparagraph 63(3)(a)(iii).

Subclause 40(5)

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

Clause 63(3)(a)(ii)(C) of the Act currently denies the deduction for child care services provided by a person in respect to whom the taxpayer or a supporting person has claimed a personal exemption. This clause 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 40(6)

ITA
63(3)(a)(iii) and (iv)

Paragraph 63(3)(a)(iii) of the Act is also amended consequential on the increase in the maximum weekly deduction in respect of children who are severely disabled or are under 7 years of age. The exclusion of expenses in excess of $60 per week incurred for a child's board and lodging at a boarding school or camp, from the definition of child care expenses, is amended to exclude amounts in excess of $120 per week paid in the year for a child's attendance at a boarding school or camp.

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

Subclause 40(7)

ITA
63(3)(c)

Paragraph 63(3)(c) of the Act defines an eligible child for the purposes of the child care expense deduction 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. The definition is also amended to refer to a child with a mental or physical infirmity who is dependent on either the taxpayer or the taxpayer's spouse.

Subclause 40(8)

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 the new personal tax credit in respect of a dependent child.

Clause 41

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 42

Flow-Through Shares

ITA
66

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

Subclause 42(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.

New 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 42(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) allows for the late filing of documents referred to in subsections 66(12.68), (12.69) and (12.7). Late-filed documents 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 one-quarter 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 before July, 1988, shall be treated as having been filed on or before the day on or before which they were required to be filed.

Subclause 42(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 43

Canadian Exploration Expense

ITA
66.1

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

Subclause 43(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% 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 six months after the end of the taxation year of the particular taxpayer 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 taxation year of the particular taxpayer in which the drilling of the well to which the certificate relates was commenced.

Subclause 43(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 43(3)

ITA
66.1(6)(b)(xi)

Paragraph 66.1(6)(b) of the Act provides the definition of "cumulative Canadian exploration expense" (CCEE). Subparagraph (xi) reduces a taxpayer's CCEE pool by any investment tax credit claimed by him in respect of his qualified Canadian exploration expenditure. Because a claim of a credit affects CCEE, which in turn affects tax payable and the amount of investment tax credit which may be claimed in a year, the calculations very often become circular where the credit reduces CCEE in the same year in which the credit is claimed. Accordingly, subparagraph 66.1(6)(b)(xi) is amended to require a reduction of the CCEE only for taxation years following that in which a related credit is claimed. Where a tax credit is carried back to a year preceding that in which it was earned, the required reduction of the CCEE will not have to be made until the year following that in which the expenditure was made. This amendment is applicable for taxation years ending after 1987.

Subclause 43(4)

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.

Clause 44

Canadian Development Expenses

ITA
66.2

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

Subclause 44(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% 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% capital cost allowance.

Subclause 44(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 45

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 46

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 changes to 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 is broadened to include 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 47

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 the human consumption of food or beverages or the enjoyment of entertainment expenses to 80% of the expense.

Subsection 67.1(1) of the Act provides that costs 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 provided for, or in the expectation of, compensation in the ordinary course of his business of providing food, beverages or entertainment for compensation 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 a taxpayer's product is a food, beverage or entertainment, promotional samples will also be excluded from the limitation. The exemption is only in respect of amounts expended on food, beverages and entertainment which form part of the product. Accordingly, where employees of a brewery or food company, for example, take clients or customers for a business meal, the cost of that meal is subject to the 80% limitation.

- 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 (including amounts which form part of a taxpayer's inventory and research and development expenditure) 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, such as coffee and muffins, made available during the course of meetings or receptions) 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 subsection 67.1(4) provides that no amount paid or payable for travel on an airplane, train or bus shall be considered to be in respect of food, beverages or entertainment. Accordingly, meals which may be served on such vehicles while travelling are not subject to the 80% limitation. This section also clarifies that "entertainment" includes amusement and recreation.

New section 67.2 of the Act contains restrictions on the amount that may be deducted in respect of interest expense relating to the acquisition of a passenger vehicle. A "passenger vehicle" is defined in subsection 248(1) of the Act to be certain vehicles acquired or leased after June 17, 1987.

New section 67.2 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.

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 restrictions on the total amount of motor vehicle expenses and capital cost allowance that may be deducted by an individual in respect of a motor vehicle owned or leased by him which is used for both earning income and personal use where the total number of kilometres travelled in the vehicle in a year for income earning 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 income earning 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 earning income. The proration is based on the proportion of the number of income earning kilometres to the total number of kilometres travelled by the vehicle. Where income earning 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 income earning 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 income earning 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 income earning use increases and is fully prorated where such use exceeds 24,000 km in a year. Where the vehicle is used solely for earning income the individual may deduct all of the otherwise allowable expenses in respect of the vehicle. Parking expenses in respect of a vehicle used for earning income continue to be fully deductible.

The following examples illustrate how the new proration works for various amounts of business use. The vehicle is assumed to be owned or leased and to be used throughout the year for purposes of earning income. Operating expenses (gas, oil and repairs) are calculated at 8¢ per kilometre. Fixed expenses include capital cost allowance, lease costs, interest, insurance and licensing fees, and are assumed, in these examples, to be $6,500.

Example A

Business Kilometres	15,000
Total Kilometres	20,000
Fixed Expenses	\$6,500
Operating Expenses	\$1,600

Permitted Deduction

$$\frac{15,000}{20,000} \times (\$1,600 + \frac{15,000}{20,000} \times \$6,500)$$

= $4,856.25

Example B

Business Kilometres	25,000
Total Kilometres	30,000
Fixed Expenses	\$6,500
Operating Expenses	\$2,400

Permitted Deduction

$$\frac{25,000}{30,000} \times (\$2,400 + \frac{24,000}{24,000} \times \$6,500)$$

= $7,416.67

Example C

Business Kilometres	12,000
Total Kilometres	12,000
Fixed Expenses	\$6,500
Operating Expenses	\$960

Permitted Deduction

$$\frac{12,000}{12,000} \times (\$960 + \frac{12,000}{12,000} \times \$6,500)$$

$= \$7,460.00$

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 before the end of the year during which the vehicle is leased, and deducting from that amount certain further sums, where applicable: the total of all amounts deducted in preceding taxation years in respect of the lease of the vehicle, and an amount in respect of interest that would be earned on that part of the aggregate of refundable amounts paid in respect of the lease that exceeds $1,000 and the aggregate of all reimbursements receivable in respect of the lease of the vehicle during the year. The interest is computed as the amount that would be payable on the refundable amounts at the prescribed rate if such amounts were amounts payable under the Act, for the period in the year during which the refundable amounts are 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 all refundable amounts paid in respect of the lease and all reimbursements receivable in respect of the lease of the vehicle, as outlined above. The effect of this second formula is to place a restriction on the deductible cost of leased passenger vehicles similar to that placed on the depreciable capital cost of purchased passenger vehicles.

Example A

In this example, the employer leases a vehicle for a three-year term at a cost of $550 per month. The manufacturer's list price for the vehicle plus the applicable sales tax is under $20,000. The employee reimburses the employer $150 per month (or $1,800 per year) in respect of the vehicle. We assume that the deduction is for the first year.

The maximum deductible lease payment in this example will be the lesser of

(1) $(600 \times \frac{365}{30}) - 1{,}800$

$= 600 \times 12.17 - 1{,}800$

$= \$5{,}502$

and

(2) $(550 \times \frac{365}{30}) \times \frac{20{,}000}{.85 \times 23{,}529} - 1{,}800$

$= 6{,}693.50 \times \frac{20{,}000}{20{,}000} - 1{,}800$

$= \$4{,}893.50$

Thus, in this example, the maximum deduction in respect of the lease costs of the vehicle will be $4,893.50.

Example B

In this example the employer leases a vehicle for a two year term at a cost of $800 per month. The manufacturer's list price for the vehicle plus the applicable sales tax is $35,000. We assume that the deduction is for the first year.

The maximum deductible lease payment in this example will be the lesser of

(1) $600 \times \frac{365}{30}$

$= 600 \times 12.17$

$= \$7{,}302$

and

(2) $(800 \times 12.17) \times \dfrac{20{,}000}{.85 \times 35{,}000}$

$= 9{,}736 \times .67$

$= \$6{,}523.12$

Thus, in this example, the maximum deduction in respect of the lease costs of the vehicle will be $6,523.12.

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 paragraphs 13(7)(g) and (h) and 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 maximum deduction to which each individual may be entitled in respect of capital cost allowance, interest or leasing costs is that proportion of the amount otherwise deductible had the vehicle been owned or leased by only one person that the fair market value of the person's interest in the vehicle is of the fair market value of the interests in the vehicle of all joint owners or lessors.

Clause 48

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 person to whom those services are rendered.

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 49

Acquisition and
Disposition of Property

ITA
69

Section 69 of the Act provides a series of rules dealing primarily with transactions entered into for inadequate or unreasonable consideration.

Subclause 49(1)

ITA
69(6)(c)

Subsection 69(6) of the Act treats a taxpayer who disposes of his production from an oil or gas well or mineral resource in Canada to the Crown at less than fair market value as having disposed of that production for its fair market value. Paragraph 69(6)(c) is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever" in reference to corporations, commissions or associations controlled by Her Majesty (or by an agent of Her Majesty) in right of Canada or a province. This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to de facto control -- are not applicable to paragraph 69(6)(c).

Subclause 49(2)

ITA
69(7)(c)

Subsection 69(7) of the Act treats a taxpayer who acquires any production from his oil or gas well or mineral resource from the Crown for an amount in excess of its fair market value as having acquired that production for its fair market value. Paragraph 69(7)(c) is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever" in reference to corporations, commissions or associations controlled by Her Majesty (or by an agent of Her Majesty) in right of Canada or a province. This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to de facto control -- are not applicable to paragraph 69(7)(c).

Subclause 49(3)

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 one-half to three- quarters, 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 50

Death of a Taxpayer

ITA
70

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

Subclause 50(1)

ITA
70(1)

Subsection 70(1) of the Act provides certain rules for calculating the income of a taxpayer in his year of death. This subsection is amended strictly at a consequence of other amendments to paragraph 12(1)(t) and other provisions of the Act relating to the investment tax credit (ITC). These other amendments provide that where a taxpayer claims this credit in a taxation year, the resulting reduction in the cost of the property to which it relates or the resulting income inclusion under paragraph 12(1)(t) will not occur until the following taxation year. However, this rule is not appropriate where the credit is claimed in the year in which the taxpayer died. Accordingly, subsection 70(1) is amended to require that, in the year of the taxpayer's death, the amount of the investment tax credit claimed which would otherwise impact his following taxation year shall be taken into account in the year of death. This amendment is applicable after 1987.

Subclause 50(2)

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 50(3)

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 one-half to three-quarters. 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 four-thirds 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 50(4)

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 51

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 52

Inter Vivos Transfer of
Eligible Capital Property

ITA
73(3)

These amendments are described in the commentary concerning the amendments to section 70 of the Act.

Clause 53

Attribution - Capital Gains

ITA
74.2(2)

Section 74.2 of the Act attributes to an individual taxable capital gains and 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 1985 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 54

Transfers and Loans to Corporations

ITA
74.4

Sections 74.1 to 74.5 of the Act provide attribution rules in respect of property transferred by an individual to a spouse or to another individual under the age of 18 years with whom he does not deal at arm's length. These rules are intended to prevent a taxpayer from splitting income among family members and thereby reducing the total amount of tax payable on that income. Section 74.4 of the Act sets out the rules which apply where an individual loans or transfers property to a corporation, other than a small business corporation, for the benefit of a designated person - namely, the individual's spouse or a minor with whom he does not deal at arm's length. Where section 74.4 applies in respect of such a loan or transfer to a corporation, subsection 74.4(2) considers the individual to have received an amount as interest income during any taxation year which includes a period throughout which a designated person in respect of the individual is a "specified shareholder" of the corporation, the individual was resident in Canada and the corporation was not a small business corporation. A "specified shareholder" is defined in subsection 248(1) as a shareholder who owns 10 per cent or more of the shares of the corporation, either directly or through a trust or a partnership.

The amount which is considered to have been received by the individual as interest income is the amount that would have been received if interest had been charged at the prescribed rate on the outstanding amount of the loan or transfer, less any interest and the "grossed-up" amount of any dividends actually received in the year on indebtedness or shares received in exchange for the property loaned or transferred. Consequential to the changes made to the dividend gross-up and credit, the reference to "4/3" of such dividends is amended to refer to "5/4" of such dividends. This amendment is applicable in respect of taxable dividends received in taxation years ending after 1987.

Clause 55

Taxable Dividends

ITA
82

Section 82 of the Act deals with the tax treatment of dividends received from corporations resident in Canada.

Subclause 55(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 one-third 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, which is applicable to dividends received in the 1988 and subsequent taxation years, provides that the amount by which an individual is required to gross-up the actual amount of taxable dividends received is one-quarter of such dividends.

Subclause 55(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 the purposes of section 82 (relating to the inclusion of dividends in income), section 112 (relating to the inter-corporate dividend deduction) and section 121 (relating to the dividend tax credit). The amendment to subsection 82(2) adds the reference to new subsection 56(4.1) to the list of attributions rules with respect to which this rule applies. It also makes this rule applicable for all purposes of the Act. It will thus apply for the purposes of section 113 (relating to dividends from foreign affiliates) and section 258 (the special rules relating to income bonds and debentures and certain dividends from corporations not resident in Canada). This amendment will also have the effect of extending the application of subsection 82(2) for the purposes of the Part IV tax and the special tax imposed under new Part IV.1 on certain dividends received on taxable preferred shares and taxable RFI shares.

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

Subclause 55(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 56

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 57

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 57(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 57(2)

ITA
84(4.2) and (4.3)

Subsections 84(1) to (4.1) of the Act provide that share redemptions and certain other transactions relating to shares of the capital stock of a corporation result in a deemed dividend. New subsections 84(4.2) and (4.3) extend that treatment to certain transactions involving term preferred shares and guaranteed shares to which subsection 112(2.2) applies.

New subsection 84(4.2) replaces existing subsection 258(1) which is consequently repealed. Subsection 258(1) is applicable with respect to an amount received on the reduction of the paid-up capital of a term preferred share and, therefore, parallels the tax treatment under subsection 84(4.1) of an amount received on the reduction of the paid-up capital of a share of a public corporation. For that reason, section 84 is the more logical location in the Act for this provision.

New subsection 84(4.3) of the Act has a similar effect but is applicable to a guaranteed share to which subsection 112(2.2) would apply to deny a deduction under subsection 112(1) or (2) or 138(6) of a dividend received on the share. This subsection applies where the paid-up capital of such a share of the capital stock of a corporation that is not a public corporation is reduced otherwise than by a transaction that results in a disposition of the share and the share is held by a corporation. In these circumstances, the total amount received by the shareholder on the reduction of the paid-up capital of any such share (rather than only that part of the amount that exceeds its paid-up capital) will be treated as a dividend received on the share.

New subsections 84(4.2) and (4.3) are applicable with respect to reductions of paid-up capital after 1987.

Subclause 57(3)

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. However, it is argued that in certain circumstances 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 58

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 58(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, 1971 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 58(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 59

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 59(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 59(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 59(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 one-half to three-quarters. 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 59(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 59(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 capital cost ceiling of $20,000, or such other amount as may be prescribed, for passenger vehicles acquired after June 17, 1987 from being circumvented. New paragraph 85(1)(e.4) will apply where a passenger vehicle having a cost to the shareholder in excess of $20,000, or such other amount as may be prescribed, is transferred to a corporation which does not deal at arm's length with the shareholder, and deems the elected amount to be an amount equal to the undepreciated capital cost to the shareholder of the vehicle immediately before the disposition.

However, for purposes of subsection 6(2) - the calculation of the standby charge - the cost to the corporation of the vehicle shall be deemed to be the fair market value of the vehicle immediately before the disposition. This amendment is applicable to taxation years and fiscal periods commencing after June 17, 1987 and ending after 1987.

Subclause 59(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 59(7)

ITA
85(2)(a)

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 59(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 a capital property or 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 persons 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 one-half to three-quarters. 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 60

Share for Share Exchange

ITA
85.1(2)(b)(i)

Section 85.1 of the Act provides a rollover to a taxpayer (the "vendor") who has disposed of shares of the capital stock of a corporation in exchange for shares of the capital stock of a Canadian corporation that acquired those shares. Subparagraph 85.1(2)(b)(i) provides that the rollover provisions of subsection 85.1(1) will not apply where the vendor, or persons with whom he did not deal at arm's length, controlled the purchaser. Subparagraph 85.1(2)(b)(i) is amended, applicable to share-for-share exchanges occurring after 1988, to delete therefrom the words "directly or indirectly in any manner whatever". This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to *de facto* control -- are not applicable to paragraph 85.1(2)(b).

Clause 61

Amalgamations

ITA
87

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

Subclause 61(1)

ITA
87(2)(d)

Paragraph 87(2)(d) sets certain rules applying on the transfer of depreciable property from a predecessor corporation to the new corporation. The rules presume that each such property will remain in the same prescribed class for the new corporation as they were for the predecessor corporation. However, following the tax reform changes to the capital cost allowance provisions, in some cases depreciable property will change classes upon the transfer to the new corporation. In fact, in some cases property in the same prescribed class for the predecessor will be placed in two different classes for the new corporation. Accordingly, the rules in paragraph 87(2)(d) are amended to operate on a property-by-property basis, rather than an class-by-class basis. This amendment is applicable to amalgamations occurring after 1987.

Subclause 61(2)

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 61(3)

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 61(4)

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 61(5)

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 insurance or the lending of money 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 61(6)

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 and other related provisions. This amendment is applicable to amalgamations occurring after 1987.

Subclause 61(7)

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 61(8)

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 to 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 61(9)

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 61(10)

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 61(11)

ITA
87(2)(aa)

Paragraph 87(2)(aa) of the Act provides for the transfer of the refundable dividend tax on hand (RDTOH) of a predecessor corporation to the new amalgamated corporation on an amalgamation.

The amendment to paragraph 87(2)(aa), applicable to amalgamations occurring after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, provides the circumstances in which the RDTOH of a predecessor corporation will not be transferred on an amalgamation. The RDTOH will not be transferred in any case where, had a dividend been paid by the predecessor corporation immediately before the amalgamation, new subsection 129(1.2) would have applied to treat the dividend as not being a taxable dividend.

Subclause 61(12)

ITA
87(2)(kk)

Paragraph 87(2)(kk) provides rules applicable for the purposes of paragraph 40(2)(h) -- dealing with a taxpayer's loss on the disposition of shares of the capital stock of a corporation controlled by the taxpayer -- where a corporation controlled, or was controlled by, a predecessor corporation immediately before an amalgamation and controlled, or was controlled by, the new corporation immediately after the amalgamation. In conjunction with the introduction of new subsection 256(5.1), paragraph 87(2)(kk) is amended, effective for taxation years commencing after 1988, to refer therein to "controlled, directly or indirectly in any manner whatever". Accordingly, the <u>de facto</u> control provisions of new subsection 256(5.1) will be relevant in determining whether paragraph 87(2)(kk) is applicable to a disposition of shares to which paragraph 40(2)(h) applies.

Subclause 61(13)

ITA
87(2)(rr) and (ss)

New paragraphs 87(2)(rr) and (ss) of the Act are consequential on the introduction of subsection 112(2.9) and the special taxes in Parts IV.1 and VI.1.

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

Subsection 112(2.9) prevents corporations from becoming related for the purpose of avoiding the denial of the inter-corporate dividend deduction provided for in subsection 112(2.4) for dividends received from corporations other than related corporations. The reference in new paragraph 87(2)(rr) to subsection 112(2.9) ensures that, for the purpose of that subsection, an amalgamated corporation will be considered not to be related to another corporation where a predecessor corporation became related to that other corporation for the purpose of avoiding the application of subsection 112(2.4).

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

New paragraphs 87(2)(rr) and (ss) apply with respect to amalgamations after June 18, 1987.

Subclause 61(14)

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.

Subclause 61(15)

ITA
87(4.2) and (4.3)

New subsection 87(4.2) of the Act is consequential on the introduction of new rules relating to the tax treatment of preferred shares. The status of certain preferred shares depends on their date of issue or acquisition. The purpose of this new subsection is to treat preferred shares issued on an amalgamation in exchange for substantially similar shares issued by a predecessor as having been issued when they were issued by the predecessor and under the same circumstances. This subsection treats these shares as having been acquired by the shareholder at the same time he acquired the exchanged shares. Thus, for example, where a share of a predecessor would have been a taxable preferred share but for the fact that it was issued before June 18, 1987, a new share issued on an amalgamation in exchange for that share will not be a taxable preferred share where it has substantially similar terms and conditions.

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

This subsection applies with respect to amalgamations after November 27, 1986.

Under paragraph (d) of the new definition of "grandfathered share" in subsection 248(1) of the Act, a share issued after 8:00 p.m. EDT, June 18, 1987 upon the exercise of a right issued before that time and listed on a prescribed stock exchange where the right to the exchange and the terms of the share were established before 8:00 p.m. EDT, June 18, 1987 will be considered to be a grandfathered share. In circumstances where there has been an amalgamation or merger of two or more corporations, new subsection 87(4.3) will deem a new right to acquire a share of a new corporation acquired in exchange for a right described in paragraph (d) of the definition of "grandfathered share" to acquire a share of a predecessor corporation to be the same right provided that the terms and conditions of both the rights and the shares are the same or substantially the same.

This subsection applies with respect to amalgamations occurring after June 18, 1987.

Clause 62

Winding-up of a Corporation

ITA
88

Section 88 of the Act deals with the tax consequences arising in respect of the winding-up of a corporation.

Subclause 62(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 62(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 62(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), (z.2) and (rr) 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. The reference to new paragraph 87(2)(rr) will result in the parent corporation being deemed to be a continuation of its subsidiary for the purposes of subsections 112(2.9), 191(4) and 191.1(2) and (4) of the Act. The addition of the reference to new paragraph 87(2)(rr) in paragraph 88(1)(e.2) is applicable to windings-up ending after June 18, 1987.

Subclause 62(4)

ITA
88(1)(e.5)

Paragraph 88(1)(e.5) of the Act provides for the transfer of the refundable dividend tax on hand (RDTOH) of a subsidiary corporation to a parent corporation on a winding-up of the subsidiary.

The amendment to paragraph 88(1)(e.5), applicable to windings-up occurring after 4 p.m. Eastern Daylight Saving Time on September 25, 1987, provides the circumstances in which the RDTOH of a subsidiary corporation will not be transferred on the winding-up. The RDTOH will not be transferred in any case where, had a dividend been paid by the subsidiary corporation immediately before the winding-up, new subsection 129(1.2) would have applied to treat the dividend as not being a taxable dividend.

Subclause 62(5)

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 62(6)

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 62(7)

ITA
88(1.1)(e)

Existing paragraph 88(1.1)(e) of the Act provides that where control of a parent or subsidiary corporation has been acquired special rules apply to restrict the ability of the parent following the winding-up of the subsidiary to deduct any non-capital losses or farm losses incurred by the subsidiary before the acquisition of control. In these circumstances the only losses of the subsidiary that will be available to the parent corporation will be the subsidiary's farm losses or non-capital losses that may reasonably be regarded as its losses from carrying on a business.

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

Subclause 62(8)

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.

This subsection is also amended, applicable to taxation years ending after May 23, 1985, to add a reference to paragraph 88(1)(e.3) dealing with the calculation of the parent corporation's investment tax credit. Also, a reference to paragraph 88(1)(e.4) dealing with the calculation of the corporation's employment tax credit is added, applicable to taxation years ending after May 23, 1985 and before 1989.

Subclause 62(9)

ITA
88(2)(a)

Subsection 88(2) of the Act applies to a winding-up of a Canadian corporation to which subsection 88(1) does not apply. This subsection is amended as a result of the amendments to paragraph 12(1)(t) and other provisions of the Act relating to the investment tax credit (ITC). These amendments provide that where a taxpayer claims this credit in a taxation year, the resulting reduction in the cost of the property to which it relates or the resulting income inclusion under paragraph 12(1)(t) will not occur until the following taxation year. However, this rule is not appropriate where the credit is claimed in the year in which a corporation has been wound-up. Accordingly, paragraph 88(2)(a) is amended to require that, in the year of the winding-up of the corporation, the amount of the investment tax credit claimed shall be taken into account in the year of winding-up. This amendment is applicable after 1987.

Clause 63

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 63(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 in taxation years of a corporation ending 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 63(2)

ITA
89(1)(b)(iii)

As noted earlier in the commentary regarding subsections 83(2.1) to (2.4), 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 one-half 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 one-half 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 one-half to three-quarters. 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 one-quarter of the amounts outlined above, rather than one-half. 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, one-half of that deficit will be included in clause 89(1)(b)(iii)(F). Reducing this deficit by one-half equates this deficit, which was generated when the inclusion rate for eligible capital property was one-half, with the new one-quarter rate for the untaxed 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 one-quarter. 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, one-third of this amount is deducted under clause 89(1)(b)(iii)(G) -- one-third of three-quarters being equal to one-quarter 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), one-third 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 one-half, these clauses shall be read without reference to the words "1/3 of".

Subclause 63(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 63(4)

ITA
89(1)(f)

Paragraph 89(1)(f) sets out the definition of "private corporation". Under this definition, a corporation controlled, directly or indirectly in any manner whatever, by one or more public corporations will not be a private corporation. This definition is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever". The amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to de facto control -- are not applicable in determining whether a corporation is a private corporation.

Subclause 63(5)

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 applies in computing the corporation's capital dividend account at as well as after the time of the change in status.

Subclause 63(6)

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 immediately after 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 64

Adjusted Cost Base of Share
in Foreign Affiliate

ITA
92(1)

Subsection 92(1) of the Act provides for adjustments to be made to the adjusted cost base of a share in a foreign affiliate with respect to certain amounts included or deducted in computing the income of the owner of the share. For that purpose, amounts excluded from the computation of income by virtue of the attribution rules in sections 74 and 75 are also taken into account. The amendment to subsection 92(1), which is applicable to the 1989 and subsequent taxation years, extends that treatment to amounts excluded from the computation of income by virtue of new subsection 56(4.1). Reference should be made to the commentary on that provision.

Clause 65

Adjusted Cost Base of Capital
Interest in Trust

ITA
94(5)

Subsection 94(5) of the Act provides for adjustments to be made to the adjusted cost base of a capital interest in a non-resident trust to which paragraph 94(1)(d) applies with respect to certain amounts included or deducted in computing the income of the holder of that interest. For that purpose, amounts excluded from the computation of income by virtue of the attribution rules in sections 74 and 75 are also taken into account. The amendment to subsection 94(5), which is applicable to the 1989 and subsequent taxation years, extends that treatment to amounts excluded from the computation of income by virtue of new subsection 56(4.1). Reference should be made to the commentary on that provision.

Clause 66

Definitions

ITA
95

Section 95 of the Act defines a number of terms applicable for the purposes of subdivision i of Division B of the Act, which sets out rules applicable to shareholders of non-resident corporations.

Paragraph 95(1)(a) defines "controlled foreign affiliate" as a foreign affiliate of the taxpayer that was controlled, directly or indirectly in any manner whatever, by the taxpayer or the taxpayer and certain other persons. Paragraph 95(1)(a) is amended, effective for taxation years commencing after 1988, to delete therefrom the phrase "directly or indirectly in any manner whatever". This amendment is consequential to the introduction of new subsection 256(5.1) and ensures that the provisions of that subsection -- relating to de facto control -- are not applicable in determining whether a corporation is a controlled foreign affiliate.

Clause 67

Partnerships

ITA
96

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

Subclauses 67(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 business similar to that carried on 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 67(3)

ITA
96(1.7) and (1.8)

New subsection 96(1.7) 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(1.7) is enacted as a consequence of the changes to the inclusion rates for capital gains and losses.

New subsection 96(1.7) 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(1.7) 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 member's income will be the inclusion rate of the member 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. That part of the taxable capital gain that can be attributed to an amount that is treated by new subsection 14(1) of the Act to be a taxable capital gain is not subject to adjustment under new subsection 96(1.7). Subsection 14(1) of the Act, as proposed, treats a portion of the negative balance in the cumulative eligible capital of a taxpayer at the end of a taxation year as a taxable capital gain. The operation of the rule in new subsection 96(1.7) is best illustrated by way of examples.

Example 1 - 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(1.7), 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.

<u>Example 2</u> 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(1.7) 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.

New subsection 96(1.8) applies for the purposes of the attribution rules in section 74.1 and 74.3 and the new anti-avoidance rule in subsection 56(4.1). By reason of subsection 96(1.8), where a taxpayer is a specified member of a partnership (as defined in section 248) at any time in the fiscal period of the partnership, the taxpayer's share of the partnership income or loss for the period shall be deemed to be income or loss from property for the purposes of these rules, rather than income or loss from carrying on a business. Accordingly, any income of the specified member from the partnership will be subject to the attribution rules in section 74.1 and 74.3 and to the new anti-avoidance rule in subsection 56(4.1).

This amendment is applicable to the 1989 and subsequent taxation years except with respect to income of a partnership that may reasonably be considered to relate to a period before 1989.

Subclause 67(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 amendments 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 67(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 68

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 1985 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 69

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 70

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 one-half 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 71

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 71(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 71(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 72

Trusts

ITA
104

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

Subclause 72(1)

ITA
104(3)

While a trust is treated as an individual for tax purposes, subsection 104(3) of the Act denies any deduction to a trust in respect of personal exemptions. That subsection is repealed (and replaced by new subsection 122(1.1)) as a consequence of the repeal of section 109, which is itself repealed as a consequence of the conversion of such exemptions to credits.

Subclause 72(2)

ITA
104(6)

Subsection 104(6) of the Act provides that a trust may deduct, in computing its income, amounts that become payable or are paid out of the trust income to or for the benefit of beneficiaries. Under the existing rules, the maximum amount that may be deducted under subsection 104(6) is the trust income determined under Part I, before deducting distributions to beneficiaries and allocations to preferred beneficiaries. However, a deduction is not allowed to permit a spousal trust to reduce its income below the amount included in its income by reason of the deemed disposition of certain properties pursuant to subsections 104(4) and (5). This rule does not similarly restrict the deduction in respect of income arising on the deemed disposition of resource properties.

The amendment to paragraph 104(6)(b) corrects this deficiency in relation to resource properties by adding a reference to subsection 104(5.2). This reference is strictly consequential on the introduction of that provision in 1985.

In addition, paragraph 104(6)(b) is amended to permit the deduction, at the discretion of the trust, of an amount that is less than the amount of its income distributions. To the extent such distributions are not deducted by the trust, they will not be taxable in hands of the beneficiaries provided the requirements of new subsection 104(13.1) or (13.2) are met. This change will enable trusts to utilize in a particular year losses from prior years without affecting the ability of the trust to distribute its income currently. Also, testamentary trusts will also be able to choose to be taxed at the trust level rather than at the beneficiary level by using subsection 104(13.1). Distributions of income in excess of the amount deducted by the trust will, however, reduce the adjusted cost base of the beneficiary's capital interest in the trust unless the interest is in a personal trust (as newly defined in subsection 248(1)) and was acquired for no consideration. (See comments on the amendments to paragraph 53(2)(h).)

Amended paragraph 104(6)(b) is applicable for taxation years of trusts commencing after 1987.

Subclause 72(3)

ITA
104(7) and (7.1)

Subsection 104(7) of the Act currently denies the deduction under subsection 104(6) to a trust of income distributions to non-resident beneficiaries unless the trust is resident in Canada.

Under the proposed changes, subsection 104(7) will require that a trust be resident in Canada throughout the year in order to obtain subsection 104(6) deductions in respect of its income distributions to designated beneficiaries. As amended, subsection 104(7) will also apply to deny the deduction by a non-resident trust of income distributions, not only to non-residents, but also to other persons that were "designated beneficiaries" of the trust (within the meaning of the definition for the purposes of section 210.3).

Amended subsection 104(7) is applicable for taxation years of trusts commencing after 1987.

Subsection 104(7.1) of the Act is an anti-avoidance measure intended to prevent the streaming by commercial trusts of income and capital to different beneficiaries depending on their taxable status. The amendment, strictly consequential on the proposed new definition of "personal trust" in subsection 248(1), has the effect of applying the rule to trusts other than "personal trusts". The amendment is of a relieving nature and comes into force generally for the 1986 and subsequent taxation years.

Subclause 72(4)

ITA
104(8)

Subsection 104(8) of the Act provides a special rule to deny the deduction under subsection 104(6) of trust income distributions to designated beneficiaries - non-resident persons, non-resident-owned investment corporations and certain trusts - out of the income of the trust from carrying on business in Canada, from Canadian real estate, resource properties and timber limits and from dispositions of taxable Canadian property. The purpose of this special rule is to ensure that these types of income are taxable to non-resident and other designated beneficiaries at the full personal tax rates rather than at the 25% (15% in most treaty circumstances) non-resident withholding tax rate. Subsection 104(8) is to be repealed effective for the 1988 and subsequent taxation years of trusts as a consequence of the introduction of new Part XII.2, which is described below.

Subclause 72(5)

ITA
104(13) to (13.2)

Existing subsection 104(13) of the Act requires the inclusion of trust income distributions in the income of the beneficiaries who are entitled to receive such distributions. This inclusion corresponds to the deduction provided to the trust in respect of such distributions under subsection 104(6), except that where the trust has itself deducted amounts in respect of capital cost allowance or terminal loss in computing its income for tax purposes, the amount included in a beneficiary's income is the amount of the distribution out of the trust's income computed before any deduction for capital cost allowance or terminal loss. Under the existing provisions, while the gross amount is included in the beneficiary's income, the trust may allocate to its beneficiaries the capital cost allowance deductions to which it would otherwise have been entitled in accordance with the rules in subsections 104(16), (17.1) and (17.2), and these amounts are deductible by the beneficiary.

Two changes to subsection 104(13) are proposed. First, the special treatment which allows capital cost allowance and terminal losses to be flowed out to beneficiaries will no longer apply. Capital cost allowance will be deductible only by the trust, and the income of the trust, determined in accordance with Part I of the Act after deducting capital cost allowance, is the maximum amount that will be taxed in the beneficiaries' hands under subsection 104(13), 104(14) or paragraph 212(1)(c). As a consequence, subsections 104(16), (17.1) and (17.2), which provide for the flow-through to beneficiaries of capital cost allowance, are repealed.

The second change reflected in paragraph 104(13)(c) provides that all amounts that become payable to a beneficiary by a non-resident trust will be included in the beneficiary's income. However, such amounts will not include proceeds arising on the disposition of all or part of an interest in the trust or, where the trust is a personal trust, distributions of capital.

The changes are applicable with respect to amounts that become payable in taxation years of trusts commencing after 1987.

New subsections 104(13.1) and (13.2) are consequential on the change to subsection 104(6) which permits a trust to deduct less than the full amount of its income distributions. By reason of these new provisions, a Canadian resident trust (other than a trust exempt from tax under subsection 149(1)) may also choose to have distributed income taxed at the trust level rather than the beneficiary level.

Subsection 104(13.1) provides the mechanism for a trust to designate to its beneficiaries their respective shares of that portion of the trust's actual income distributions which has not been deducted in computing its income for the year. Such designated amounts are deemed not to have been paid or payable in the year by the trust for the purposes of subsections 104(13) and 105(2), with the result that such amounts will neither be deductible to the trust nor taxable in the hands of the beneficiaries. Under revised paragraph 53(2)(h), however, such amounts will reduce the adjusted cost base to the beneficiaries of their capital interest in the trust unless that interest was acquired for no consideration in a personal trust. (See comments on the amendments to paragraph 53(2)(h).)

Subsection 104(13.2) contemplates the situation where a trust has a non-capital loss carryforward from a prior taxation year and current taxable capital gains. In such circumstances, the trust may choose not to deduct the full amount to which it is entitled under subsection 104(6) in order to allow the non-capital loss carryforward to absorb the current taxable capital gain. The designation in subsection 104(13.2) allows the trust to designate to its capital beneficiaries their respective shares of the portion of the potential deduction under subsection 104(6) which has not actually been deducted under subsection 104(6) or used in the designation under subsection 104(13.1). Such amount designated under subsection 104(13.2) reduces the amount of taxable capital gains otherwise included in the beneficiary's income pursuant to subsection 104(21). However, such amounts will reduce the adjusted cost base to the beneficiaries of their capital interest in the trust unless that interest was acquired for no consideration where the trust was a personal trust.

The amount designated under subsection 104(13.2) will not affect the amount designated under subsection 104(21) for the purposes of subsection 104(21.1) or (21.2) or paragraph 53(2)(h). Notwithstanding the subsection 104(13.2) designation, the non-taxable portion of a capital gain will be able to be flowed through to a beneficiary without reducing the adjusted cost base of a trust interest in accordance with clause 53(2)(h)(i.1)(B).

Subsections 104(13.1) and (13.2) apply for taxation years of trusts commencing after 1987.

Subclause 72(6)

ITA
104(16) to (17.2)

Subsections 104(16), (17), (17.1) and (17.2) of the Act currently permit a trust to allocate to its beneficiaries amounts of capital cost allowance, terminal loss and depletion allowance which the trust would otherwise be entitled to deduct in the year. These subsections are being repealed, consequential on the change to subsection 104(13), described above, which provide that these deductions are to be claimed only at the trust level rather than by the beneficiaries. Effective for taxation years of trusts commencing after 1987, only the amount of income computed after the deduction of capital cost allowance, terminal losses and depletion will be included in the beneficiaries' income.

Subclause 72(7)

ITA
104(18)

Subsection 104(18) of the Act provides for such parts of the income of a trust as are held in trust for a minor in a year to be considered to have been payable to the minor in the year, resulting in a flow through of trust income to the minor. The amendment to subsection 104(18), applicable to taxation years of trusts commencing after 1987, makes reference to amounts which "become" payable in order to make subsection 104(18) consistent with amended subsections 104(6) and (13).

Subclauses 72(8) to (10), (13) and (17)

ITA
104(19) to (21), (22) and (27)

These amendments clarify that the provisions which permit certain categories of income to retain their character on a distribution in a year to beneficiaries apply only to those trusts which are resident in

Canada throughout the year, effective for taxation years of trusts commencing after 1987. Under these changes, the entitlement to flow through those sources of income which benefit from preferential treatment under Part I of the Act -- such as capital gains and taxable dividends -- will be limited to trusts which are taxable under Part I on their world income. The provisions affected are:

1. subsection 104(19) in respect of dividends from taxable Canadian corporations,

2. subsection 104(20) in respect of capital dividends from corporations resident in Canada,

3. subsection 104(21) in respect of net taxable capital gains,

4. subsection 104(22) in respect of foreign source income and foreign taxes paid in respect thereof, and

5. subsection 104(27) in respect of pension benefits.

Subsection 104(19) of the Act permits a trust to designate dividends received by it in a taxation year on shares of a taxable Canadian corporation to be taxable dividends received by a beneficiary of the trust in the year from the corporation. New subsection 104(19) is introduced for the 1988 and subsequent taxation years to clarify that any dividend so designated by a trust shall be considered to have been received by the beneficiary on the share of the capital stock of the corporation on which the dividend was received by the trust. This measure thus ensures that where a dividend is received on a taxable preferred share or a taxable RFI share a beneficiary of a trust will be equally subject to tax under new Part IV.1 whether the dividend is received directly by the beneficiary or received by the trust and allocated to the beneficiary.

Subsection 104(20) of the Act ensures that the amount of capital dividends received by a trust in a year and flowed out to a beneficiary in that year will not be taxed when received by its beneficiaries. But for such a provision, it might be argued that such amounts received by the beneficiary were included in the beneficiary's income as a benefit under subsection 105(1). As a result of changes to subsection 105(1), it is no longer necessary to specifically exclude such amounts in computing income of a beneficiary. However, in order to allow such amounts to flow out to beneficiaries without a reduction in the adjusted cost base of their trust interests and to preserve the "stop-loss" rules found in subsections 112(3.2) and (4.3) in respect of shares held by trusts, amended subsection 104(20) provides that a resident trust must make a designation in respect of the capital dividends received and flowed out in a year to its beneficiaries.

Amended subsection 104(20) is applicable for taxation years of trusts commencing after 1987.

Subclause 72(11)

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. Beneficiaries who are 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 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 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. That part of the taxable capital gain that can be attributed to an amount that is treated by new subsection 14(1) of the Act to be a taxable capital gain is not subject to adjustment under new subsection 104(21.1). New subsection 14(1) treats a portion of the negative balance in the cumulative eligible property of a taxpayer at the end of a taxation year as a taxable capital gain. 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	
Trust's 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 72(12)

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.

In order to ensure that such gains are eligible for the capital gains exemption, paragraph 104(21.2)(b) is amended, applicable to the 1985 and subsequent taxation years, to treat the beneficiary as having disposed of a capital property in the year in respect of the designated amounts. Paragraphs 104(21.2)(a) and (b) are also amended, applicable to the 1988 and subsequent taxation years, to ensure that a beneficiary of a personal trust 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, for the purposes of section 110.6, 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 designated amounts bears to the total of such amounts.

Subclause 72(14)

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 118.7 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 72(15)

ITA
104(24), (25) and (25.1)

The definition of "amount payable" in subsection 104(24) of the Act is relevant for the purpose of determining amounts that are deductible by a trust and included in the income of beneficiaries. This subsection is amended to make the definition applicable also for the purposes of new rules in subparagraph 53(2)(h)(i.1) relating to the computation of the adjusted cost base of a capital interest in a trust. In addition, the references to subsections 104(8), (25) and 212(11.1) are deleted as a consequence of the repeal of those subsections.

Amended subsection 104(24) is applicable for taxation years of trusts commencing after 1987.

Subsections 104(25) and (25.1) of the Act provide rules to ensure that the same income will not be taxed both in the trust and in the hands of its beneficiaries. These provisions are no longer required as a consequence of the repeal of subsection 104(8), the change described above to subsection 104(13) and new subsections 104(13.1) and (13.2), which ensure that only those amounts deductible in computing a trust's income are included in the income of beneficiaries. The repeal is effective with respect to taxation years of trusts commencing after 1987.

Subclause 72(16)

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 72(18)

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.

Subclause 72(19)

ITA
104(29) to (31)

Subsection 104(29) of the Act is amended for taxation years commencing in 1988 in two respects. The special treatment provided by subsection 104(29) for "phantom income" of a trust -- the amount of the non-deductible resource royalties of the trust -- is restricted to trusts resident in Canada throughout a taxation year. In addition, the amendment to subsection 104(29) makes reference to amounts which "become" payable in order to make the provision consistent with amended subsections 104(6) and (13).

Payment of a special tax by trusts under new Part XII.2 for taxation years commencing after 1987 is provided as part of the mechanism to replace the existing designated income rules in subsection 104(8). New subsection 104(30) provides a deduction for this special tax in computing a trust's income for a year. Accordingly, the tax paid under new Part XII.2 is treated in the same manner as the income distributions to which it applies. (See the examples provided in the commentary on new Part XII.2.)

Under new Part XII.2, certain resident beneficiaries under a trust will be entitled to a tax credit under Part I for their share of the special Part XII.2 tax payable by the trust. New subsection 104(31) requires such beneficiaries to include in their income the amount of the credit to which they are entitled. The purpose of including the special tax in the income of such beneficiaries is to allow them to be taxed under Part I on their share of the trust's income that would, in the absence of new Part XII.2, have been distributed directly to them by the trust. This new rule applies with respect to taxation years of trusts commencing after 1987.

Clause 73

Benefits Under Trust

ITA
105(1)

Subsection 105(1) of the Act provides that the value of all benefits received or enjoyed by a taxpayer from or under a trust - other than capital distributions - are to be included in the taxpayer's income. The subsection is amended to ensure that trust distributions which would ordinarily reduce the adjusted cost base of a beneficiary's capital interest in a trust in accordance with the amendments proposed to paragraph 53(2)(h) and discussed above are excluded from the scope of subsection 105(1). This amendment is effective with respect to benefits received from trusts in their taxation years that commence after 1987.

Clause 74

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 75

Trust Interests

ITA
107

Section 107 of the Act provides certain rules relating to the acquisition and disposition of interests in, and the property of, trusts.

Subclause 75(1)

ITA
107(1)

Subsection 107(1) of the Act contains special rules applicable on the disposition of a capital interest in a trust. Paragraph 107(1)(a) ensures that such a disposition will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount of the interest. The amendment to subsection 107(1) restricts this special rule to personal trusts, as defined in subsection 248(1).

The amendment to 107(1) applies to dispositions after 1987 other than dispositions before 1991 (or such earlier time after October 1, 1987 as the trust issues a beneficial interest in the trust) of units of trusts that are listed on a prescribed stock exchange on October 1, 1987.

Subclause 75(2)

ITA
107(2)

Subsection 107(2) of the Act provides a rollover on the distribution of trust property to beneficiaries on the termination of their interests. Thus, where trust property is distributed to a beneficiary in satisfaction of all or any part of his capital interest in the trust, subject to certain other provisions, the trust is not taxable on the distribution. In addition, the beneficiary is deemed to have acquired the property at its cost amount to the trust and to have received that amount as proceeds of disposition for his interest.

Subsection 107(2) is amended to limit its application to personal trusts (as defined in subsection 248(1)) and prescribed trusts. The corresponding rules for distributions by other trusts are set out in new subsection 107(2.1). It is contemplated that a trust maintained principally to secure a debt owing by a beneficiary, to consolidate voting rights for shares of which the trust is the registered owner or to provide an intermediary through which to hold shares in the capital stock of an employer for the benefit of employees will be a prescribed trust for the purposes of subsection 107(2).

The amendment to subsection 107(2) applies with respect to distributions of properties by trusts after 1987, other than distributions before 1991 (or such earlier time after October 1, 1987 as the trust issues a beneficial interest under the trust) by trusts, the units of which were listed on a prescribed stock exchange on October 1, 1987.

Subclause 75(3)

ITA
107(2.1)

As a consequence of the change to subsection 107(2) described above, the special rollover provided in that subsection will only apply to distributions of trust property in satisfaction of a beneficiary's capital interest in a personal trust or in a prescribed trust. New subsection 107(2.1) provides rules where property is so distributed by any other type of trust. In addition, subsection 107(2.1) applies where property is distributed by a trust in satisfaction of a right described in subsection 52(6). These new rules apply in taxation years commencing after 1987.

Where property is distributed by a trust to a beneficiary at any time in the circumstances described in subsection 107(2.1), the trust is deemed to have disposed of the property for proceeds equal to the fair market value of the property at that time and the beneficiary is deemed to have acquired the property at a cost equal to that fair market value. The beneficiary is also deemed to have disposed of his interest in the trust, or the right described in subsection 52(6), for proceeds equal to that fair market value. The reference to subsection 52(6) is intended to ensure that the rules in subsection 107(2.1) will not result in double taxation where a right described in subsection 52(6) is satisfied by a distribution to which subsection 107(2.1) applies. By its express terms, subsection 107(2.1) overrides any other provision (such as paragraph 54(c)(v)) which might otherwise apply in circumstances described in subsection 107(2.1).

Subclause 75(4)

ITA
107(4.1)

A reversionary trust is a trust that has been established under which property of the trust may revert to the settlor or pass to persons who will be determined by the settlor in the future. If the property appreciates in value, there would generally be no immediate tax consequences as the property would generally be transferred to beneficiaries on a tax-free basis under the rules provided in subsection 107(2). If the settlor had held such appreciating property directly, the transfer of the property would generally have been a taxable transaction.

The purpose of new subsection 107(4.1) is to remove the tax advantage from establishing a trust which is merely an intermediary through which the settlor holds appreciating property for a period during which the property could revert to him or he retains a right to determine who should receive the trust property. After 1988, a rollover under subsection 107(2) will not be allowed in respect of any distribution of property by a trust where subsection 75(2) has been applicable to any property of the trust. In this case, the rules in paragraph 107(4)(d) to (f) will apply for the purpose of determining the proceeds of disposition of the trust property and the tax consequences to the beneficiary to whom the property was transferred. However, the new rule will not apply to a disposition of property after the death of the settlor or where the property was transferred to the settlor. The new rule will also not apply (and the rollover under subsection 107(2) will thus continue to be available) where the property was transferred to the spouse of the settlor or another individual entitled to receive property from the settlor on a rollover basis under subsection 73(1).

Subclause 75(5)

ITA
107(5)

Subsection 107(5) of the Act provides that where trust property is distributed by a personal trust or a prescribed trust to a non-resident beneficiary in satisfaction of his capital interest in the trust, the rollover provisions of subsection 107(2) are not applicable unless the property is taxable Canadian property (as defined in paragraph 115(1)(b)). Rollover treatment is appropriate in the case of taxable Canadian property since any gain arising on the subsequent disposition of such property by the non-resident beneficiary will be taxable at the full personal or corporate tax rate under Part I of the Act.

The amendment to subsection 107(5) extends the rollover under subsection 107(2) to distributions after 1987 of Canadian resource properties to non-resident beneficiaries. Any income arising from such properties (including any income on the subsequent disposition of such properties) will ordinarily be subject to tax under Part I of the Act.

Subsection 107(5) is also amended to deny the rollover where capital property of a trust is distributed after 1987 to a partnership, other than a Canadian partnership. The expression "Canadian partnership" is defined in section 102 as one in which all members are resident in Canada.

Clause 76

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 76(1)

ITA
108(1)(a)

"accumulating income"

The definition of "accumulating income" in paragraph 108(1)(a) of the Act is relevant for the purposes of the preferred beneficiary election provided in subsection 104(14). The amendment adds a reference to subsection 104(5.2), which is strictly consequential on the addition in 1985 of that subsection. The amendments are effective for taxation years of trusts commencing after 1987.

Subclause 76(2)

ITA
108(1)(c)

"capital interest"

The definition of "capital interest" in a trust in paragraph 108(1)(c) of the Act ensures that beneficiaries cannot offset any portion of their cost of a capital interest in a trust by amortizing the cost of their trust interest under section 106. The amendment to the definition is strictly consequential on the proposed new definition of "personal trust" in subsection 248(1). Any interest in a trust other than in a personal trust or a prescribed trust will be a capital interest in a trust. In the application of the definition to subsection 107(2), a trust prescribed under subsection 107(2) will also be prescribed for the purposes of the definition. The amendment is of a relieving nature and comes into force generally in respect of interests created after January 31, 1987 and acquired after February 6, 1987.

Subclause 76(3)

ITA
108(1)(d)

"cost amount"

Subsections 107(1) and (2) of the Act contain special rules that apply on the disposition of a capital interest in a trust. Paragraph 107(1)(a) ensures that such a disposition by a taxpayer will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount to him of the interest. Subsection 107(2) allows trust property to be distributed to a beneficiary in satisfaction of his capital interest for his cost amount of the interest. The cost amount of a capital interest is defined for these purposes as the proportion of the cost amounts of the net assets of the trust attributable to the particular capital interest.

The amendments to subsections 107(1) and (2) generally restrict the application of these special rules after 1987 to personal trusts, as defined in subsection 248(1). The amendment to the definition of "cost amount" in section 108 ensures that after 1987 such definition overrides the definition of "cost amount" in subsection 248(1).

Subclause 76(4)

ITA
108(1)(d.1)

"designated income"

The definition of designated income in paragraph 108(1)(d.1) of the Act is repealed effective after 1987 as a consequence of the changes proposed in the rules relating to certain trusts with non-resident beneficiaries, as described in the notes on new Part XII.2.

Subclause 76(5)

ITA
108(1)(e)

"income interest"

The definition of "income interest" in paragraph 108(1)(e) of the Act is no longer relevant in respect of commercial trusts since each interest in such a trust will fall within the definition of "capital interest", as described above. The amendment, strictly consequential on the proposed new definition of "personal trust" in subsection 248(1), has the effect of limiting an "income interest" to an interest in a "personal trust". The amendment is of a relieving nature and comes into force generally in respect of interests created after January 31, 1987 and acquired after February 6, 1987.

Subclause 76(6)

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

"qualified farm property"

"qualified small business corporation share"

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 76(7)

ITA
108(1)(j)

"trust"

The definition of "trust" in paragraph 108(1)(j) of the Act excludes certain types of trusts from the application of the 21-year deemed realization rule, the preferred beneficiary election rules and the special rules in sections 105, 106 and 107. The definition is amended so that unit trusts are subject to the rules in sections 105 to 107. The definition is also amended to exclude the special trusts described in subparagraphs 108(1)(j)(ii) to (iv) from the special rules for designating certain distributions that will not be taxable in the hands of beneficiaries under new subsections 104(13.1) and (13.2), and to exclude those trusts from the special rule in subsection 104(5.2) relating to resource properties which was added in 1985. The amendments to the definition are applicable for taxation years of trusts commencing after 1987.

Subclause 76(8)

ITA
108(3)

"income" of a trust

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 76(9)

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 77

Personal Exemptions

ITA
109

Section 109 of the Act provides for the deduction of 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 78

Other Deductions

ITA
110

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

Subclauses 78(1), (6) and (8)

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 78(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 78(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 78(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 78(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 78(7)

ITA
110(1)(f)(iii)

Subparagraph 110(1)(f)(iii) of the Act currently provides a deduction from income in respect of social assistance payments to the extent that they have been included in the taxpayer's income for the year. This amendment provides that the deduction may be claimed in respect of a social assistance payment only where the payment is received by the individual in respect of whom the social assistance was provided or by a person who resided with the individual at the time the payment was made. This amendment is applicable to the 1982 and subsequent taxation years.

Subclause 78(9)

ITA
110(1)(k)

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

This amendment is applicable to the 1988 and subsequent taxation years. In the case of taxation years ending before July 1988, however, the deduction allowed to a corporation under paragraph 110(1)(k) will be equal to 2 times, rather than 2 1/2 times, the tax payable for the year under Part VI.1. This adjustment takes into account the higher rate of corporate tax applicable to taxation years ending before July 1, 1988.

Subclause 78(10)

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 78(11)

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 79

Deduction for Gifts

ITA
110.1

As a result of the elimination of the investment income deduction for the 1988 and subsequent taxation years, section 110.1 of the Act, which provided for a deduction of up to $1,000 in respect of Canadian investment income, is repealed.

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 that 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 capital property.

New subsection 110.1(4) incorporates the provisions of former subsection 110(5), under which the character of gifts made by a partnership was flowed through to its members. 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 80

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 such deductions to tax credits. This amendment is generally applicable to the 1988 and subsequent taxation years.

For the 1986 and 1987 taxation years, there is a special relieving measure which provides that those individuals under 60 years of age will not be prohibited from taking the deduction merely because of a transfer to a registered retirement savings plan or registered pension plan under paragraph 60(j) of a refund of undeducted past service additional voluntary contributions from a registered pension plan. Additional voluntary contributions are those contributions to a registered pension plan used to provide benefits under a money purchase provision of the plan and which are not required as a condition of membership in the plan. There is a parallel relieving measure with respect to the new pension income credit for the 1988 taxation year.

Clause 81

Forward Averaging

ITA
110.4

Subclause 81(1)

ITA
110.4(1)

Subsection 110.4(1) of the Act, which contains the forward averaging election, is repealed for taxation years ending after 1987.

Subclause 81(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.

Subclauses 81(3) to (6)

ITA
110.4(3) to (8)

The amendments contained in subclauses 81(3) to (5) are strictly consequential on the repeal of subsection 110.4(1) of the Act. Subclause 81(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 82

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 82(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 (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 (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 or 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. 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 personal trust (as defined in subsection 248(1) of the Act and explained in the commentary concerning that subsection) 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 personal 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 personal 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 allow real property used by, for example, the owner's grandchildren to be treated as qualified farm property.

Where real property is owned by a personal 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. 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 constitute qualified farm property only 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 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, family farm partnership, or a personal trust from which the individual acquired the property, 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) or by a personal trust from which the person acquired the property. 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" has been added to section 110.6 effective for the 1988 and subsequent taxation years. A capital gain realized on a disposition of such an interest by an individual is eligible for the $500,000 exemption for qualified farm property. An interest in a partnership owned by an individual, other than a trust that is not a personal trust, will qualify provided that, at the time of the disposition of the interest, all or substantially all of the property of the partnership was property that was used, throughout a period of at least 24 months before that time, by the partnership or certain eligible persons in the business of farming carried on in Canada in which any such person who is an individual was actively engaged on a regular and continuous basis. An eligible person includes the individual, where the individual is a personal trust as defined in subsection 248(1), a beneficiary of the trust, or a spouse, parent or child of the individual or the beneficiary or a family farm corporation of any such individual. This definition will ensure that interests in partnerships that have ceased to carry on a business of farming in Canada because of the retirement of its partners will be included as qualified farm property of an individual provided that all or substantially all of the property of the partnership meets the 24 month use test.

"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 means a limited partner or 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 50% 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 and renounced by a corporation under subsection 66(12.6), (12.62) or (12.64) or incurred 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 or a multiple unit residential building.

Subject to a special transitional provision applicable to certified productions, 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 relevant time (referred to as the "determination time"), 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. The definition of a small business corporation in subsection 248(1) of the Act is being amended, applicable after Royal Assent, to require a fair market value asset test to be applied to a corporation for the purposes of the determination under that definition. For this purpose, a small business corporation is defined as a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which is attributable to assets 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, in order to qualify as a qualified small business corporation share, 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 the determination 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. Paragraph 110.6(14)(f) provides a special rule that will require shares issued from treasury to be held for the full 24 month holding period unless the shares are issued as consideration for other shares or on a transfer of all or substantially all of the assets used in an active business or on a transfer of certain active partnership interests. 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 all or substantially all of the fair market value of 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 24 months immediately preceding the determination time 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 Canadian-controlled private corporation's assets must have been attributable to assets 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 qualify as active business assets of the corporation only 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 24 month period immediately preceding the determination time that 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 immediately preceding the determination time 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 fair market value of the corporation's assets was not attributable to assets used in an active business.

Paragraph (d) of the definition provides that, where for any period of time all or substantially all of the fair market value of a corporation's assets is not attributable to assets that are 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, for that period of time, use all or substantially all of the fair market value of their assets in an active business. As a result, where paragraph (d) applies at any time, the shares and debt of connected corporations held by the corporation will qualify as active business assets only where the connected corporations are, at that time, 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, for any period of time, a parent does not use substantially all of the fair market value of its assets in an active business, a subsidiary must, for that period of time, 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 immediately preceding the determination time, 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 preceding the determination time 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 preceding the determination time that ends at the time of 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" has been added to section 110.6 effective for the 1988 and subsequent taxation years. A capital gain realized on a disposition of such a share by an individual is eligible for the $500,000 exemption for qualified farm property. A share owned by an individual, other than a trust that is not a personal trust, will qualify provided that at the time of disposition of the share all or substantially all of the property of the corporation was property that was used, throughout a period of at least 24 months before that time, by the corporation or certain other eligible individuals or partnerships in the business of farming carried on in Canada in which any such individual was actively engaged on a regular and continuous basis. An eligible person includes the individual, where the individual is a personal trust as defined in subsection 248(1), a beneficiary of the trust or a spouse, parent or child of the individual or the beneficiary of the trust or a family farm partnership of any such individual. This definition will ensure that shares of corporations that have ceased to carry on a business of farming in Canada because of the retirement of their shareholder managers will be included as qualified farm property of an individual provided that all or substantially all of the property of such a corporation meets the 24 month use test.

Subclause 82(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 certain transitional rules, the amendments to subsection 110.6(2) are applicable to the 1988 and subsequent taxation years.

Subclause 82(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 certain transitional rules, new subsection 110.6(2.1) is applicable to the 1988 and subsequent taxation years.

Subclause 82(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 permissible 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 permissible 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 82(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 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 82(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 82(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, where, as part of a series of transactions or events, a corporation or partnership acquires property for consideration that does not approximate 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 1985 and subsequent taxation years, therefore, this paragraph is amended to apply only in situations where a corporation or partnership acquires property for consideration that is significantly less than its fair market value at the time of acquisition.

Subclause 82(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 82(14)

ITA
110.6(11)

Subsection 110.6(11) of the Act is an anti-avoidance rule that prevents individuals from claiming disproportionate amounts received from or allocated by a partnership or certain investment intermediaries, including commercial trusts, as being eligible for the special lifetime capital gains exemption under section 110.6. The relieving amendment to this subsection, strictly consequential on the proposed new definition of "personal trust" in subsection 248(1), has the effect of applying the rule in respect of interests in trusts other than "personal trusts". This amendment is applicable to the 1985 and subsequent taxation years.

Subclause 82(15)

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 82(16)

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, a right referred to in paragraph 251(5)(b) will not include a right 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 ("CCPC") as of the date of the agreement. Such an agreement would therefore not result in the loss of CCPC and 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 personal 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 personal 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 personal 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 where all or substantially all of the consideration received by a shareholder from the corporation in respect of the acquisition was common shares of the corporation. 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.

New paragraph 110.6(14)(f) applies for the purposes of the definition of "qualified small business corporation share" and treats shares issued by a corporation to a particular person or partnership except in certain circumstances, as having been owned, immediately before their issue to the particular person or partnership by a person who was not related to the person or partnership. Subparagraph (i) provides that shares issued as consideration for other shares will not be subject to this rule. In addition, subparagraph (ii) provides that shares issued as part of a transaction or series of transactions in which the person or partnership disposed of all or substantially all of the assets used in an active business carried on by that person or the members of the partnership or disposed of an interest in a partnership where all or substantially all of the partnership's assets were used in an active business carried on by the members of that partnership are not subject to this rule. The effect of the rule in paragraph 110.6(14)(f) is to require shares issued in circumstances, other than those provided for in the exceptions in subparagraphs (i) and (ii), to be owned for the full 24 month holding period by the taxpayer or persons or partnerships related to him in order to qualify for the increased exemption. This rule ensures that the holding period requirement in the "qualified small business corporation share" definition cannot be circumvented through the issue of shares of a corporation from treasury. For example, a sole shareholder of a small business corporation wishing to sell his shares which were acquired from an unrelated person within the 24 month period preceding the expected date of sale could have his corporation issue shares from treasury immediately before the sale. In the absence of the rule in paragraph 110.6(14)(f), the shares issued from treasury would meet the holding period requirement for the purposes of the increased exemption.

The exception in subparagraph 110.6(14)(f)(ii) is consistent with the rule in new section 54.2 which provides that shares received in similar circumstances will be capital property.

An amendment to the definition to "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 come within the exception in subparagraph 110.6(14)(ii).

Clause 83

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 84

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.

Subclause 84(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 84(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 an individual 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), and
- 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, and

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)], and
- 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)], and

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 84(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	$3,000
(Amount of net capital losses claimed under paragraph 111(1)(b) to offset the 3(b) gains is $2,000[(1)], and	
(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 84(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.

Subclauses 84(5) and (6)

ITA
111(5)(a) and (b)

The amendments to paragraphs 111(5)(a) and (b) of the Act are consequential on the inclusion in non-capital losses of amounts deductible under new paragraph 110(1)(k). Without these changes and the change to paragraph 88(1.1)(e) which is discussed in the commentary concerning the amendment to that provision, the amounts included in a corporation's non-capital loss resulting from a deduction under new paragraph 110(1)(k) would cease to qualify for carry-forward or carry-back after an acquisition of control of the corporation. The amendment to paragraph 111(5)(a) will ensure that, where there has been an acquisition of its control, a corporation will be allowed in a subsequent taxation year to deduct that portion of its non-capital loss that may reasonably be regarded as being in respect of a deduction under new paragraph 110(1)(k), but only if a business carried on by the corporation in the year in which the deduction arose is carried on throughout the subsequent year and only to the extent of its income for the subsequent year from that business or from a similar business. The amendment to paragraph 111(5)(b) provides a similar rule with regard to the carry-back of a non-capital loss realized after an acquisition of control. The amendments to these paragraphs are applicable with respect to non-capital losses and farm losses for the 1988 and subsequent taxation years.

Subclause 84(7)

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 one-half to three-quarters. 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 84(8)

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.

A further amendment to clause 111(8)(b)(i)(A) of the Act ensures that the unused part of the amount deductible under paragraph 110(1)(k) by a corporation (2 1/2 times its Part VI.1 taxes payable) will be included in the computation of its non-capital loss that is available for carryover to the preceding three and subsequent seven taxation years. The amount by which the non-capital loss will be increased is the unused portion of the paragraph 110(1)(k) deduction -- that is, the portion that did not reduce the corporation's taxable income for the year in which it was deductible. This amendment is applicable to the 1988 and subsequent taxation years, except that in situations where a corporation's non-capital loss for a taxation year ending after July 30, 1988 is carried back to a taxation year ending on or before that date, a provision applies to reduce this non-capital loss in order to account for the fact that the deduction allowed to a corporation under paragraph 110(1)(k) for such a taxation year ending before that date is equal to 2, rather than 2 1/2, times its tax payable under Part VI.1. This reduction is one-fifth of the lesser of the deduction under paragraph 110(1)(k) and the non-capital loss otherwise computed. However, for the purposes of determining under subsection 111(3) of the Act which part of that non-capital loss has been so deducted in a taxation year ending before July 1, 1988, the amount of the non-capital loss that has been deducted in that year is to be computed without taking this reduction into account.

In the same way, when a corporation's non-capital loss for a taxation year ending before July 1, 1988 is carried forward to a taxation year ending on or after that date, a corresponding increase in the part of that non-capital loss that is attributable to a deduction under paragraph 110(1)(k) of the Act is appropriate.

Subclause 84(9)

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 85

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 and subsequent taxation years, 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 deduction.

Clause 86

Taxable Dividends

ITA
112

Section 112 of the Act is one of the principal provisions dealing with the treatment of dividends received by a corporation resident in Canada from another corporation. Subsection 112(1) permits a corporation to deduct taxable dividends received in computing its taxable income.

Subclause 86(1)

ITA
112(2.1)

Subsection 112(2.1) of the Act prevents a specified financial institution from deducting taxable dividends received on most term preferred shares in computing its taxable income. This subsection is amended as a consequence of the introduction of a definition of "specified financial institution" in subsection 248(1). It is also amended to provide that a dividend received by a restricted financial institution on a share of a mutual fund corporation or an investment corporation after that corporation has elected under new subsection 131(10) of the Act not to be treated as a restricted financial institution will be considered to have been received on a term preferred share acquired in the ordinary course of business. This amendment is applicable with respect to dividends received after June 18, 1987.

Subclause 86(2)

ITA
112(2.2)

Subsection 112(2.2) of the Act denies the intercorporate dividend deduction for dividends on certain shares that are guaranteed by a specified financial institution. This subsection, as amended, generally applies to dividends received on shares issued, or deemed to have been issued, after 8:00 p.m. EDT, June 18, 1987. It is applicable where a specified financial institution or a specified person in relation to any such institution has undertaken to protect a corporate shareholder with respect to the value or yield of a share. The amendments to paragraphs 112(2.2)(a) and (b) ensure that the intercorporate dividend deduction will not apply where a specified financial institution has provided a guarantee to the shareholder or a specified person in relation to the shareholder with respect to the share or dividend.

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

Paragraph (c) provides that subsection 112(2.2) does not apply to a dividend received on a share that is not a term preferred share because it has been issued by a corporation in financial difficulty. Under new paragraph (d), amended subsection 112(2.2) will not apply with respect to dividends received on a prescribed share, a taxable preferred share issued before December 16, 1987 or a grandfathered share. However subsection 112(2.2), as it read before June 18, 1987, may apply to dividends received on a grandfathered share.

New paragraph (e) continues the exception provided by existing paragraph 112(2.2)(d) from the application of subsection 112(2.2) for publicly listed shares issued by a specified financial institution where all guarantee agreements in respect of these shares are given by the issuer or persons related thereto unless the shareholder and persons with whom the shareholder does not deal at arm's length (otherwise than by reason of a right referred to paragraph 251(5)(b)) receive dividends in respect of more than 10% of the guaranteed shares.

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

New paragraph 112(2.2)(g) provides that for the purposes of subsection 112(2.2) the expression "specified person" in relation to a specified financial institution or to a corporate shareholder has the same meaning as provided in the definition of taxable preferred share in subsection 248(1) of the Act.

Subclause 86(3)

ITA
112(2.3)

Subsection 112(2.3) of the Act denies a deduction under subsection 112(1) or (2) to a corporation in respect of a dividend received by it on a short-term preferred share. This subsection is repealed with respect to dividends on short-term preferred shares issued after 8:00 p.m. EDT, June 18, 1987. Dividends paid on short-term preferred shares issued after December 15, 1987 are now subject to a 66 2/3% special tax under new Part VI.1. This tax is payable by the dividend-paying corporation but may be offset through the deduction provided by new subsection 110(1)(k) against the Part I tax liability of that corporation. Reference may be made to the commentary on section 191.1(1).

Subclause 86(4)

ITA
112(2.9)

Subsection 112(2.9) of the Act prevents corporations from becoming related for the purpose of avoiding the application of subsection 112(2.4) which denies the deduction of dividends on so-called collateralized preferred shares. This amendment clarifies the application of that anti-avoidance provision.

Clause 87

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 throughout which he was resident, employed or carrying on business, in Canada. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 88

Deductions in Separate Returns

ITA
114.2

Section 114.2 of the Act, which governs the total amount of certain 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 89

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 89(1)

ITA
115(1)

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

Subclause 89(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 90

Dispositions by Non-Residents

ITA
116

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

Subclauses 90(1) to (3)

ITA
116(2)(a), (4)(a) and (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 91

Personal Tax Rates

ITA
117

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

Subclause 91(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 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 91(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 91(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 91(4)

ITA
117(6) and (7)

Subsection 117(6) of the Act provides the authority for the use of a tax table to assist individuals to determine their tax and surtax payable. As a result of the conversion of personal exemptions into tax credits, this subsection is amended for the 1988 and subsequent taxation years, to enable individuals to compute their federal tax liability before claiming personal credits and other credits to which they may be entitled.

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 such a case, the individual is required to add to his tax otherwise payable an 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 92

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 equivalent-to-married 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 thresholds 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 $388, $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, the $200 supplementary child tax credit and the $24,090 family income threshold for the purposes of that credit,
- the $1,500 threshold for the purposes of the medical expense credit, and
- the prepayment of the refundable child tax credit.

These amounts will be indexed annually for each taxation year after 1988, except for the $200 supplementary child tax credit which will be indexed annually for each taxation year after 1989. 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 consecutive 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 this figure.

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 93

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, in 1988 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 for 1988 with respect to the spouse will be 17% of $5,000, or $850.

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, available to a person who is not entitled to a married credit (for reasons other than the spouse's income) 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 $388 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 $388 will be read as $776 for each such additional dependant. The balance of the formula remains the same. This will double the deduction for such additional 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 two such dependants and $130 for each such additional 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 in 1988 $550 from tax payable -- that is, the appropriate percentage (17% in 1988) of $3,236.

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, he may deduct from tax payable the appropriate percentage of the lesser of $1,000 and his qualified pension income for the year. The pension credit is, however, not available for an individual under 60 years of age who has 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 except where the transfer is made in the 1988 taxation year in the circumstances described in the commentary concerning the repeal of section 110.2.

New subsection 118(4) of the Act provides several rules governing the tax credit available under subsection 118(1). Paragraph 118(4)(a) provides that an individual may claim the tax credit for the married or equivalent-to-married status 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 credit for the same person or the same self-contained domestic establishment. Where two or more individuals may otherwise be entitled to a credit 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 credit 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 by reason of paragraph 118(1)(d).

New paragraph 118(4)(d) of the Act provides that no amount may be claimed as a tax credit in respect of a dependant by reason of 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 by reason of 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 in 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) to be 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 each 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

New 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)(b.1), 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 for 1988 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.

No amount in respect of gifts made before 1984 shall be included in an individual's "total charitable gifts", "total Crown gifts" or "total cultural gifts" where the individual deducted in the 1983 taxation year the standard $100 permitted by paragraph 110(1)(d) as it then read.

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)(c)(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 severe and prolonged 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 an equivalent-to-married credit by reason of paragraph 118(1)(b) if the individual were not married and, where the person is the individual's parent, grandparent, child or grandchild, that person 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 be the dependent person's tax payable for the year determined before claiming any deductions under Part I other than the tax credits under section 118 and the unemployment insurance and Canada/Quebec Pension Plan credit under section 118.7.

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 severe and prolonged impairment for the purposes of the child care expense deduction and 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 to a qualified institution where the total of such fees paid in the year to that 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 in 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 throughout 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.

For purposes of calculating the tuition fees tax credit for 1988, an individual may elect to have that part of an amount paid in 1987 in respect of tuition fees for a course taken in 1988 deemed to have been paid in 1988. An amount paid or deemed to have been paid in 1988 shall not be included in computing the tuition fees tax credit to the extent that it was deducted in computing the individual's income for the 1987 taxation year.

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 of "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/Quebec 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 an individual from that person's 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 deductions under subdivision a of Division E other than the personal credits under subsection 118(1) and the unemployment insurance and Canada/Quebec Pension Plan credit under section 118.7.

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 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 the tuition fee and education credits over the student's tax payable determined before claiming any tax credits under subdivision a of Division E, other than the personal credits under section 118, the unemployment insurance and Canada/Quebec Pension Plan credits under section 118.7 and the disability credits under section 118.3. An individual claiming a credit under this section is required to file with the Minister a prescribed form containing prescribed information.

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 similar 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 periods throughout which he was resident, employed or carrying on business 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 such periods.

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
- the medical expenses credit
- the charitable donations credit

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 supporting person (but not to a spouse) 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 an individual who at no time in a taxation year is resident in Canada 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 age credit, the pension credit, medical expenses, deemed medical expenses, tuition fees, education, U.I. and C.P.P./Q.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 94

Block Averaging

ITA
119

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

Subclause 94(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 94(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 95

Forward Averaging

ITA
120.1

Section 120.1 of the Act is amended as a result of the phasing out 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. 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 averaged 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 96

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 97

Trusts

ITA
122

Subsection 122(1) of the Act currently provides that the rate of federal tax payable by an <u>inter vivos</u> trust is 34%, being the top marginal tax rate for individuals. This subsection is amended, as a consequence of the lowering of the top marginal tax rate for individuals, to provide that <u>inter vivos</u> trusts will be taxable at the 29% rate.

New subsection 122(1.1) clarifies that 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 98

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 98(1)

ITA
122.2(1)(a)

Paragraph 122.2(1)(a) of the Act provides the maximum amount of the refundable child 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 and subsequent taxation years to increase the maximum amount per eligible child to $559 from $524.

This paragraph is further amended to provide an additional amount in respect of certain children in new subparagraph 122.2(1)(a)(ii). The refundable child tax credit will be increased by $200 (in 1989 and indexed thereafter) in respect of each eligible child of the individual under 7 years of age at the end of the year. This amount will be reduced by 25% of the amount of child care expenses in respect of the child for the year. The amendments to this paragraph are applicable to 1988 and subsequent taxation years except that, for the 1988 taxation year, the reference to "$200" in new subparagraph 122.2(1)(a)(ii) shall be read as a reference to "$100".

Subclause 98(2)

ITA
122.2(1)(b)(ii)

Subparagraph 122.2(1)(b)(ii) of the Act contains the threshold amount of family income beyond which the amount of refundable child tax credit is reduced. This is solely a technical amendment which inserts a reference to $24,090 instead of $23,500, as a result of the annual adjustment of that threshold amount, computed by reference to the increase in excess of 3% in the Consumer Price Index. The figure of $24,090 will continue to be indexed annually.

Subclause 98(3)

ITA
122.2(2)(a)

Paragraph 122.2(2)(a) of the Act defines an eligible child for the purposes of the refundable child 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 and to include a child who either dies or attains the age of 18 in the year provided that family allowances were payable in respect of the child for the month in which he died or had his eighteenth birthday.

Subclause 98(4)

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 99

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 100

Refundable Federal
Sales Tax Credit

ITA
122.4

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

Subclauses 100(1) and (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 100(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 100(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 101

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 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)) 696.17	NIL	
Tax payable under subsection 123(1)	$45,596.71	$40,784.70

Clause 102

Corporation Surtax

ITA
123.2

Section 123.2 of the Act levies a surtax of 3% 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 103

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 103(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 103(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 103(3)

ITA
125(6) to (6.3)

Subsection 125(6) is an anti-avoidance provision designed to prevent multiple access to the small business deduction where a business is carried on through two or more partnerships of which a corporation or a corporation associated with it is a member. Where it applies, it reduces the amount of the partnership income that can qualify for the small business deduction in the hands of a corporate partner. The amendments to this subsection do not alter its substance. The condition contained in existing paragraph 125(6)(a) has been repealed as it is effectively subsumed by the condition contained in existing paragraph 125(6)(b) which is substantially re-enacted.

New subsection 125(6.1) provides that, for purposes of the provisions in section 125 relating to the small business deduction, a corporation that is a member of a partnership which in turn is a member of another partnership shall be deemed to be a member of the second partnership and its share of income therefrom shall be deemed to be the amount to which it is directly or indirectly entitled through those partnerships of which it is a member. This new provision is intended to effectively "look through" tiers of partnerships.

New subsection 125(6.2) provides that the income of a partnership that is controlled, directly or indirectly in any manner whatever, by any combination of non-resident persons or public corporations cannot qualify for the small business deduction. The purpose of this rule is to ensure that the income of such a partnership is treated in the same way as if the business were carried on by a corporation, in which case the corporation would not qualify for the small business deduction because it would not qualify as a "Canadian-controlled private corporation".

With the exception of new subsection 125(6.3), precise rules as to when a partnership will be considered to be controlled, directly or indirectly in any manner whatever, are not proposed. Rather, it is expected that factual determinations will be made in individual cases depending upon the relevant facts and circumstances. Under new subsection 125(6.3) a partnership will be treated as being controlled by one or more persons whenever their share of the income of the partnership from any source exceeds 50%.

New subsections 125(6) and (6.1) will be effective with respect to fiscal periods of partnerships commencing after February 10, 1988 and new subsections 125(6.2) and (6.3) will be effective with respect to fiscal periods of partnerships commencing after 1988.

Subclause 103(4)

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 104

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 104(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 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 104(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 104(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 105

Part VI 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 seven preceding and three 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 carry-over. 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 106

Foreign Tax Credit

ITA
126

Section 126 of the Act provides rules under 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 106(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.

Subclause 106(4)

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% 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 107

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 of a taxpayer's investment tax credit ("ITC") from his tax otherwise payable under Part I of the Act.

Subclause 107(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. 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. As well, in order to allow a taxpayer to carry back ITCs which cannot be used in the year because the taxpayer is subject to minimum tax in the year, a further limit prohibiting the taxpayer from claiming an ITC to reduce his Part I tax liability below his minimum tax liability is introduced. This amendment is applicable to the 1988 and subsequent taxation years, except that the relieving amendment with respect to minimum tax liability is applicable to the 1986 and subsequent taxation years.

Subclause 107(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 business similar 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 107(3)

"certified property"

The definition of "certified property" in subsection 127(9) of the Act, 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 107(4) to (9)

"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 107(4) to (9) 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 107(10) to (13)

"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 107(14)

ITA
127(9)

"annual investment tax credit limit"

Subsection 127(9) 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 three-quarters of the remainder of its tax otherwise payable under that Part. The new provision defines the limit as three-quarters 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 three-quarters 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% (one-quarter 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 107(15)

ITA
127(11.2) and (13) to (16)

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.

Subsections 127(13) to (16) of the Act, relating to the employment tax credit, are repealed. This credit, and more specifically its carry-over, is no longer available after 1988.

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

Subclause 107(16)

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 108

Refundable Investment
Tax Credit

ITA
127.1

Section 127.1 of the Act provides for the refundability of certain investment tax credits.

Subclause 108(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 108(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 109

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 110

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 111

National Labour-Sponsored Venture Capital Corporations

ITA
127.4

Section 127.4 of the Act provides a federal tax credit of the lesser of 20 % of the cost of the shares or $700, where an individual is the first purchaser of shares of the capital stock of a prescribed labour-sponsored venture capital corporation and a province also provides a tax credit of at least 20%, in respect of those shares.

Subsections 127.4(3) and (4) are amended to permit a federal labour-sponsored funds tax credit of 20% in respect of the acquisition of an approved share in circumstances where no provincial tax credit is provided. The 20% credit will be available with respect to approved shares of a national labour-sponsored venture capital corporation. These amendments are applicable to the 1988 and subsequent taxation years.

Clause 112

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 113

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 113(1)

ITA
127.52(1)(d)

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". As a consequence of the changes to the inclusion rate for capital gains and losses of individuals, paragraph 127.52(1)(d) is being amended to require sections 38 and 41 to be read without reference to the fractions set out therein. That paragraph is also amended to ensure that the exempt portion of capital gains realized on foreclosures is not included in the minimum tax base.

The amendments to paragraph 127.52(1)(d) are applicable to the 1986 and subsequent taxation years.

Subclause 113(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 one-third of such net taxable capital gains in its 1990 and subsequent taxation years.

Subclause 113(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.

Subclause 113(4)

This amendment to subsection 127.52(3) of the Act ensures that the minimum tax continues to apply to capital cost allowance claimed in respect of certified film productions.

Clause 114

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 115

Application of Minimum Tax

ITA
127.55

Section 127.55 of the Act, which exempts individuals in certain limited circumstances from the application of minimum tax, 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 be 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 116

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 and 118.9. This amendment is applicable to the 1988 and subsequent years.

Clause 117

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 117(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 117(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 the subsequent distribution of that income.

Subclause 117(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 117(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 to 30% the assumed rate of federal corporate tax for the purposes of clause 129(3)(a)(ii)(B), 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 117(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 117(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 four-fifths 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 five-fourths 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 117(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 117(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 one-quarter 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,
- one-third 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 118

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.

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, a 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 119

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 119(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 119(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 is 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 119(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 1985 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 120

Mutual Fund Corporations

ITA
131

Section 131 of the Act contains special rules relating to the taxation of mutual fund corporations.

Subclause 120(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 1985 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 120(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 120(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 require 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 120(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 established by 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 120(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 120(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.

Subclause 120(7)

ITA
131(10)

New subsection 131(10) of the Act permits a mutual fund corporation or an investment corporation to elect not to be treated as a restricted financial institution within the meaning of that expression as defined in amended subsection 248(1) of Act. Dividends paid on shares of the mutual fund corporation or the investment corporation to a shareholder that is a restricted financial institution after this election has been made will be treated as having been paid on a term preferred share acquired in the ordinary course of business for the purposes of new subsection 112(2.1) of the Act.

This amendment is applicable after December 15, 1987, except that an election will be deemed to have been filed on time if it is filed within 6 months of the date on which the implementing legislation receives Royal Assent.

Clause 121

Mutual Fund Trusts

ITA
132

Section 132 of the Act contains special rules relating to the taxation of mutual fund trusts.

Subclause 121(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 inter vivos 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 at 19 1/3% to reflect the effective personal tax rate applying to capital gains realized in 1988 and 1989.

Subclause 121(2)

ITA
132(3)

Subsection 132(3) of the Act restricts the flow out by a mutual fund trust of dividends under subsection 104(20) to capital dividends. The amendment to subsection 132(3) is strictly consequential on the proposed amendments to subsection 104(20) and does not alter the existing restriction.

Subclause 121(3)

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 that is established by 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 121(4)

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 122

Designation by Mutual Fund Trust

ITA
132.1

Mutual fund trusts owning depreciable property may be subject to potential tax liabilities arising from the recapture of capital cost allowance that had been claimed before 1988 at the beneficiary level under subsection 104(16) and capital cost allowance claimed after 1987 at the trust level. Under the present tax rules governing mutual fund trusts, there is no mechanism by which the tax liability on depreciation recapture may be assigned to beneficiaries who received the benefit of the subsection 104(16) deduction. As a result, even where the redemption price of trust units is discounted to reflect future tax liabilities, unitholders surrendering their units before the recapture may face a different effective tax burden than those surrendering their units after the recapture is realized, simply because of the timing of the surrender.

The same potential disparities continue under the new rules. In addition, after 1987, tax-free cash distributions will reduce the adjusted cost base to a unitholder in a mutual fund trust under paragraph 53(2)(h). If a trust is unable to distribute income representing recaptured depreciation, the trust will face tax at the trust level on the recapture and the after-tax amount may also give rise to a capital gain because of the reduction in the previous years of the adjusted cost base of a trust interest under paragraph 53(2)(h) related to the distribution of the portion of the cash flow to unitholders that was sheltered by capital cost allowance taken at the trust level.

Section 132.1 provides a mechanism by which a mutual fund trust may address both of the problems described above. In addition, the section effectively allows a mutual fund trust to treat a tax-free cash distribution from the trust after 1987 as income to a unitholder in a year following the year in which the distribution was made. It is anticipated that the new section will only be of advantage to open-ended mutual fund trusts in which the units are not ordinarily traded in order that the taxpayers who receive the benefit of a tax-free cash distribution from a trust also generally bear the consequences of a designation by the trust.

Subsection 132.1(1) provides that a mutual fund trust may designate an amount for its taxation year in respect of a trust unit, generally resulting in a deduction of the amount designated for the trust and a corresponding inclusion of income for the taxpayer owning the unit during the year. If the taxpayer is a non-resident, the trust would be required to remit withholding tax by reason of new paragraph 214(3)(f.1) in respect of the amount designated. Where more than one taxpayer owned the unit during the year, the trust may allocate the income inclusion resulting from the designation among such taxpayers. However, it is anticipated that the entire amount would generally be allocated to the taxpayer last owning the unit in the year.

If a trust is attempting to address the problems relating to depreciation recapture, the amount designated for a taxation year by the trust in respect of a unit owned by a taxpayer would represent the taxpayer's proportionate share of such portion of the trust's estimated future depreciation recapture which arises as a result of capital cost allowance claimed in previous years. In many cases, a trust might only make a designation in respect of a unit surrendered to the trust. However, the trust may also wish to designate an amount under the new section in a year in which significant depreciation recapture arises in order to avoid the tax that would otherwise be imposed at the trust level if the recapture is reinvested by the trust rather than distributed to beneficiaries.

Subsection 132.1(1) provides that the amount designated in respect of a unit owned by a taxpayer at any time in a taxation year will be the aggregate of two amounts determined in respect of the unit. The first amount in respect of the unit, determined under paragraph 132.1(1)(a) for the year, is limited to the amount by which capital cost allowance designated to taxpayers under subsection 104(16) for years prior to 1988 exceeds all other amounts determined under paragraph 132.1(1)(a) for the year and previous years, other than the amount determined under paragraph 132.1(1)(a) for the year in respect of the particular unit. The second amount, determined under paragraph 132.1(1)(b) for a year, is limited to the amount by which the aggregate of the adjusted cost base reductions under paragraph 53(2)(h)(i.1) in previous years exceeds other amounts determined under paragraph 132.1(1)(b) for the year and previous years other than the amount determined under paragraph 132.1(1)(b) for the year in respect of the particular unit. The amount designated will generally be deductible in computing the trust's income, be included in computing the unitholder's income and, to the extent determined under paragraph 132.1(1)(b), increase the adjusted cost base to the unitholder of his interest in the trust. The increase in the adjusted cost base of the unit is provided under subsection 132.1(2).

There is a considerable range within which a trust may designate an amount in respect of a particular unit. However, as trust units of a taxpayer are treated as identical property by section 47, the trust would likely determine each amount designated under section 132.1 in respect of a unit of a particular taxpayer on an identical basis. The discretion of the trust is, however, limited by the rule found in subsection 132.1(5).

Subsection 132.1(3) provides that the trust cannot use the subsection 132.1(1) designations to create a loss. Amounts which are not deductible in computing a trust's income because of subsection 132.1(3) may be carried forward to the following year by reason of subsection 132.1(4).

Subsection 132.1(5) provides for a denial, in certain circumstances, of a deduction under 132.1(1)(c) in respect of a trust unit for a taxation year in which a tax-exempt beneficiary owned the unit. If the amounts determined under paragraphs 132.1(a), (b) or (d) in respect of the unit differs from the amount that would have been so determined if the owner of the unit were a taxable beneficiary, the amount designated for the year in respect of the unit will not result in a deduction for the trust.

The following example, summarized in Table 1 below, illustrates the application of section 132.1:

<u>Example</u>

> A and B each purchase one unit in a trust at the end of 1986 for $200 per unit as specified in Table 1. For the purposes of this example, the trust shall be assumed to be a mutual fund trust. The resulting proceeds of $400 are used to purchase rental property of that value. The value of the rental property is assumed to remain constant in value throughout this example. In 1987, the trust flows through rental receipts of $25 to each of A and B and is also able to flow out sufficient capital cost allowance under subsection 104(16) to shelter the resulting income fully in the hands of A and B.
>
> In 1988, the trust is required to take capital cost allowance at the trust level and fully shelters its 1988 rental income of $40 in this manner. The trust distributes cash-flow of $20 to each of A and B. This results in the reduction in the adjusted cost base for each unit of $20. At the beginning of 1989, A surrenders his unit to the trust for $200. At the same time, C is issued a unit for $200.
>
> In 1989, the tenant of the rental property vacates and the property produces no rental income. The trust sells the property early in 1990. Before the end of 1990, all the outstanding units are surrendered to the trust.

Application of Section 132.1

In 1989, the trust may designate $45 in respect of A's unit which has been surrendered in 1989 ($25 by reason of paragraph 132.1(1)(a) and $20 by reason of paragraph 132.1(1)(b)). As a result, A will be deemed to have $45 of income under paragraph 132.1(1)(d). But for the designation, the adjusted cost base of the surrendered unit would have been $180 because there would be a $20 reduction per unit under paragraph 53(2)(h). Under subsection 132.1(2), the adjusted cost base is increased by $20. As a result, A does not have a capital gain or loss on the surrender of the unit. A is generally in the same position in respect of the unit that he would have been in had he owned an interest in the rental property directly rather than through the trust.

In 1990, the trust may designate $45 in respect of B's unit which is surrendered in 1990, resulting in an income inclusion of $45 for B. As is the case for A's unit, there would be an increase in the adjusted cost base of $20 for B's unit. The trust would not designate an amount with respect to the unit of C.

In 1990, the trust will have income from recaptured capital cost allowance totalling $90 ($50 + $40 = $90), before taking into account section 132.1. As a result of using designations under section 132.1 to the maximum extent, the trust is able to deduct $90 in computing its income in 1990. (The deduction of $45 in respect of A's unit redeemed in 1989 was denied in 1989 under subsection 132.1(3) because the trust did not have any income against which the deduction could be applied, but the deduction may be carried forward to 1990.) The trust therefore has no tax liability and is able to redeem each outstanding unit for $200 each. This results in no realization of capital gains for B and C.

Table 1

	1987 Number of Units	1987 104(16) Flow-out	1988 Adjusted Cost Base Reduction	1989 Number of Units Acquired (Surrendered)	1990 Number of Units Acquired (Surrendered)	Income of Unitholders after s.132.1 Designation, 1989 and 1990
A	1	25	20	(1)	0	$45 (1989)
B	1	25	20	0	(1)	$45 (1990)
C	0	0	0	1	(1)	$0
Total		$50	$40			$90

Clause 123

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, which is that the full amount of the gain or loss is, in effect, taken into account in computing the corporation's income.

Clause 124

Credit Unions

ITA
137

Section 137 of the Act contains special rules relating to the taxation of credit unions.

Subclause 124(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 124(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 members' 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 124(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 commencing 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 taxation year commencing after June, 1988.

Clause 125

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 125(1) to (3) and (5)

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.

Subclause 125(4)

ITA
137.1(5)(c)(ii)

In order for a corporation to qualify as a "deposit insurance corporation" under section 137.1 of the Act, at least 50% of its property must constitute "investment property". For this purpose subparagraph 137.1(5)(c)(ii) of the Act defines "investment property" to include deposits or guaranteed investment certificates with a bank or trust company. This subparagraph is amended to provide that such investments in a credit union or central that is a member of the Canadian Payments Association will also constitute investment property for the purposes of section 137.1.

Subclause 125(6)

ITA
137.1(9)

Subsection 137.1(9) of the Act provides a special tax rate for deposit insurance corporations other than those incorporated under the Canada Deposit Insurance Corporation Act. This amendment reduces the rate of tax payable under subsection 137.1(9) from 25% to 22% effective for taxation years ending after June, 1988. For corporations with taxation years commencing before July, 1988 but ending after June, 1988, a transitional provision applies to maintain a 25% tax rate in respect of the period in the year that falls before July, 1988.

Subclause 125(7)

ITA
137.1(11)

Subsection 137.1(11) of the existing Act permits a member institution of a deposit insurance corporation to deduct in computing its income for a taxation year premiums or assessments paid or payable to the deposit insurance corporation in the year. This subsection is amended to provide that a deduction in computing income for a taxation year will also be available for repayments of amounts of assistance received by a member institution or its members or depositors from a deposit insurance corporation in a preceding year. This deduction will be permitted only where the member institution has not chosen to exclude the repaid assistance from its income for the year in which the assistance was received by filing an amended return for that year under subsection 137.1(2) of the Act.

Clause 126

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 126(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 126(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 or a preceding taxation 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 December 31st 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 126(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 three 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 126(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 126(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 year 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 126(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 126(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 126(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 126(9)

ITA
138(6)

Subsection 138(6) of the Act provides that, in computing the taxable income of a life insurer, taxable dividends received from taxable Canadian corporations (other than dividends on certain term preferred shares) may be deducted. Subsections 112(2.2) and (2.4), however, deny any deduction under subsection 138(6) with respect to certain dividends on so-called collateralized preferred shares and on shares the value or yield of which is guaranteed. The amendment to subsection 138(6) clarifies that no deduction may be made under subsection 138(6) where subsection 112(2.2) or (2.4) applies. This amendment is applicable with respect to dividends received after 8:00 p.m. EDT, June 18, 1987.

Subclause 126(10)

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 are 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 126(11)

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 126(12)

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 126(13)

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 126(14)

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 126(15)

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)(1.1) 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 126(16)

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)(1) and (1.1), 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 assumed the obligations of the business or line of business in respect of which a reserve may be claimed under paragraph 20(7)(c) or subparagraph 138(3)(a)(i) or (ii) of the Act.

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, amounts paid or payable by the vendor or 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 amount paid and include in income the 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 amount received and deduct from income the 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 126(17)

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 126(18)

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 126(19)

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 126(20)

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 126(21)

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 127

Segregated Funds

ITA
138.1(1)(f)

Subsection 138 of the Act requires life insurance segregated funds to be treated as trusts for income tax purposes. For the 1988 and subsequent taxation years, amended paragraph 138.1(1)(f) makes reference to amounts which "become" payable in order to make that provision consistent with subsections 104(6) and (13).

Clause 128

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 to the policyholder or applied in discharge of a premium liability of the policyholder 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 129

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 130

Employees Profit Sharing Plan

ITA
144

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 and paragraph (f) thereof is amended 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 amended for the same reason. These amendments are applicable to the 1988 and subsequent years.

Clause 131

Registered Retirement Savings Plans

ITA
146

Section 146 of the Act deals with registered retirement savings plans (RRSPs).

Subclause 131(1)

ITA
146(1)(c)(iv)

Paragraph 146(1)(c) of the Act defines "earned income" for the purposes of the rules applicable to RRSPs. 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 131(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 131(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 132

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 133

Registered Retirement Income Funds

ITA
146.3

Section 146.3 of the Act deals with registered retirement income funds (RRIFs). 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 134

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 134(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 134(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 the commentary regarding new subsections 149(4.1) and (4.2) of the Act.

Subclause 134(3)

ITA
149(3)

Paragraph 149(1)(1) 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 134(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 134(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.

Subclause 134(6)

ITA
149(10)

Subsection 149(10) of the Act provides special rules where a corporation becomes exempt or ceases to be exempt from tax under Part I of the Act. Where a corporation becomes exempt from Part I tax, the subsection ensures that any gain or loss that accrued before the corporation becomes tax-exempt will be recognized before the corporation becomes tax-exempt. Likewise, where a corporation ceases to be exempt from Part I tax, the subsection ensures that any gain or loss subsequently realized by the corporation when it is taxable does not include any gain or loss that accrued when the corporation was tax-exempt.

The opening words of subsection 149(10) are amended to exclude an insurance corporation that insures farming and fishing property and that is described in paragraph 149(1)(t). As a result of this exclusion, such an insurance corporation will not be subject to the deemed realization provisions of subsection 149(10) where it ceases to be exempt or becomes exempt from Part I tax on all part of its taxable income. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 135

Charities

ITA
149.1

Section 149.1 of the Act contains definitions and rules governing charitable organizations.

Subclause 135(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 135(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 135(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 135(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 135(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 135(6)

ITA
149.1(9)

Subsection 149.1(9) of the Act applies in respect of certain property accumulated by a registered charity for a particular purpose that is not used for that purpose. 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 135(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 136

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's 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 137

Assessments

ITA
152

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

Subclause 137(1)
ITA
152(1)(b)

Subsection 152(1) of the Act lists certain refunds and deemed payments of tax that are to be determined by the Minister in the course of assessing a taxpayer's return of income. Paragraph 152(1)(b) refers to specific provisions of the Act under which tax is paid on account of a taxpayer. The amendment to paragraph 152(1)(b) adds a reference to tax deemed to be paid by a trust beneficiary under subsections 210.2(3) and (4) as a consequence of the proposed changes in Part XII.2 of the Act relating to trusts and their beneficiaries.

In addition, paragraph 152(1)(b) is amended to delete an inappropriate reference to tax paid pursuant to subsection 164(6), as a result of the amendments to that subsection applicable to the 1985 and subsequent taxation years. Those amendments require an amended return to be filed for a deceased taxpayer where his legal representative elects to treat certain capital losses and terminal losses of the estate for its first taxation year to be capital losses of the deceased taxpayer for the year in which he died. Formerly, the legal representative was considered to have paid on account of the estate's tax any tax reduction of the deceased taxpayer that related to such losses.

The amendments to paragraph 152(1)(b) are applicable to the 1988 and subsequent taxation years.

Subclause 137(2)

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). In the absence of such a 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 137(3)

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 137(4)

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 six-year limit applies to cases relating to retrospective claims under subsection 152(6). In all other cases, a three-year limit applies. The amendment to paragraph 152(4)(b) adds two more cases where the six-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 six years from such adjustment in the foreign country's taxes. The amendment also clarifies that the six-year limit applies only 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 137(5)

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 137(6)

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 three-year carry-back 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 carry-back of unused Part VI tax credits.

Clause 138

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 139

Instalment Requirements
for Corporations

ITA
157

Section 157 relates to the payment of a corporation's tax liability arising under Part I of the Act.

Subclauses 139(1) and (2)

ITA
157(1)(a) and (b)

Subparagraph 157(1)(a)(i) of the Act requires corporations to pay monthly tax instalments. This subparagraph is amended, applicable to the 1989 and subsequent taxation years, 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 to subparagraph 157(1)(a)(i) also integrates the instalment requirements for tax payable under Part I and new Part VI.1. This change is necessary because new Part VI.1 tax payable on dividends for a year may offset Part I tax payable on income for that year. The amendment will ensure that a corporation's Part I tax instalments for a year are not inappropriately reduced where Part VI.1 tax is payable for the year. Absent this change, in the first year Part VI.1 tax was payable by a corporation, it could estimate its Part I tax payable for the year after claiming a deduction under paragraph 110(1)(k) in computing its taxable income of 2 1/2 times its Part VI.1 tax payable for the year. As a result, the corporation's Part I tax instalments for the year might be reduced while its Part VI.1 tax instalments would be nil since it had no Part VI.1 payable for the preceding year.

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

The amendments to paragraphs 157(1)(a) and (b) apply to the 1988 and subsequent taxation years, except that for taxation years ending before 1989, subparagraph 157(1)(a)(i) is to be read without reference to new paragraph 125.2(1)(a).

Subclause 139(3)

ITA
157(2)

Subsection 157(2) of the Act is amended, effective for 1988 and subsequent taxation years, to provide that the relief from the instalment obligations for a year of a credit union with taxable income not exceeding $10,000 will apply only where it has no Part VI.1 tax payable for the year or the preceding year.

Subclause 139(4)

ITA
157(2.1)

Subsection 157(2.1) of the Act is amended to provide that the relief from the instalment provisions for a corporation with Part I tax payable or a first instalment base not exceeding $1,000 for a year be amended to add a reference to the corporation's Part VI.1 tax for the year. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 140

Interest on Excess Refunds

ITA
160.1(1)

Subsection 160.1(1) of the Act provides for the recovery of certain amounts refunded to a taxpayer under certain provisions of the Act in excess of the amount to which he was entitled. The amendment to subsection 160.1(1) deletes the references to specific provisions of the Act so that the subsection will apply where the excess amount is refunded under any provision of the Act. This amendment is applicable to the 1988 and subsequent taxation years.

Clause 141

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 141(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% penalty for late or deficient instalments provided in section 163.1. This amendment is applicable to the 1989 and subsequent taxation years.

Subclause 141(2)

ITA
161(3)

Subsection 161(3) of the Act imposes an additional 3% interest charge on a credit union which, pursuant to subsection 157(2), did not pay instalments for a taxation year where the taxable income of the credit union for the year exceeds $10,000.

The amendment to subsection 161(3) is consequential on the amendment to subsection 157(2). By virtue of this amendment, the additional amount of 3% of tax payable will also be payable where a credit union has relied on subsection 157(2) in order not to pay instalments and the credit union is liable to pay tax under new Part VI.1 for the year. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 141(3)

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% 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 to paragraph 161(4.1)(a) also adds a reference to the Part VI.1 tax payable by the corporation for the year. This change is consequential on the amendments to section 157 that integrate the instalment requirements for the taxes payable under Part I and new Part VI.1.

The amendment to paragraph 161(4.1)(a) is effective for the 1988 and subsequent taxation years. However, where the 1988 taxation year commences in 1987, interest on late or deficient instalments will be determined as if Part VI.1 tax were not payable by the corporation for the year. In addition, for such year, the effect of the deduction under new paragraph 110(1)(k) on the computation of a corporation's Part I tax instalments is ignored. Finally, the reference to new section 125.2 of the Act in paragraph 161(4.1)(a) is to apply only for taxation years ending after 1988.

Subclause 141(4)

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 carry-back 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 141(5)

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 carry-back 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 carry-back 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 arise 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 three-year carry-back 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 carry-back 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 141(6)

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) provides that interest on the new penalty for late or deficient tax instalments is to be computed from the date on which the balance of tax is due to the date of payment. Other amendments are made that are 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 142

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% of the unpaid tax as of the return due date plus 1% of such unpaid tax per month of default not exceeding 12 months. Subsection 163(1) of the Act imposes a penalty of 50% of the tax sought to be evaded for willful 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) is, except for grammatical changes, the same as existing subsection 162(1). New subsection 162(2) provides that on a second or further occurrence the penalty will be the sum of 10% of the unpaid tax plus 2% 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 willful 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 15 days of the request and the Number is subsequently provided within 15 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 Act or the regulations or to comply with any duty imposed thereunder, except where, in the case of a duty or obligation, another provision of the Act sets out a penalty in respect of the failure. 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 penalty under new subsection 162(7) has been assessed for that period, a demand for the return for that period has been made under section 233, and 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 $100 per member of the partnership for each month or part of a month, not exceeding 24, during which the failure continues. The new penalty is applicable to failures to make an information return occurring after the implementation of the new partnership information return requirement.

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 misleading information and to any person acting as a principal or an agent in respect of the sale, issuance or acceptance of a contribution towards the acquisition of interests in a tax shelter before obtaining an identification number. The new penalty is the greater of $500 and 3% of the aggregate of the costs to all persons who acquire interests in the tax shelter before the correct 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, where a corporation served with a demand for the information does not comply with the demand within 90 days of service. 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 for each month or part of a month, not exceeding 24, during which such failure continues. 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 143

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 by a person to report amounts required to be included in computing his income. 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 amount. This penalty will typically apply to the suppression of amounts that are included in determining net income, but will not normally apply to understatements of income attributable to errors in the characterization of income or in its computation if all amounts required to be included in computing income are reported.

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. This subsection is amended to increase this penalty from 25% to the greater of $100 and 50% 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 144

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% of the interest payable in respect of such instalments under subsection 161(2) of the Act. The penalty applies only to net instalment interest after any offset of interest payable to the taxpayer under subsection 161(2.2) and does not apply in respect of the first $1,000 of interest or in respect of the interest on up to 25% of the tax payable by instalments, whichever is greater. This new section is applicable to instalments of tax payable for taxation years commencing after a day to be fixed by order of the Governor in Council.

Clause 145

Refunds

Section 164 of the Act deals with the refund of a taxpayer's overpayment of taxes for a taxation year.

Subclause 145(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 145(2)

ITA
164(1.2) to (1.31)

Subsection 164(1.1) of the Act provides that where 120 days have passed since the service of a notice of objection to an assessment and the Minister has not confirmed or varied the assessment or issued a reassessment in respect of the objection, or where the taxpayer has appealed from an assessment either to the Tax Court of Canada or directly to the Federal Court of Canada, the Minister must with all due dispatch refund an amount paid or surrender a security obtained where the taxpayer so requests in writing. Subsection 164(1.2) provides that the Minister may direct that such payment of money or surrender of security not be made where it may reasonably be considered that collection of all or any part of the amount assessed would be jeopardized by the repayment of the amount or the surrender of the security to the taxpayer under subsection (1.1). Subsections 164(1.1) to (1.3) are being amended to coincide with the amendments to section 225.2, which set out a prior judicial authorization procedure in respect of immediate collections measures to be taken by the Minister. The amended subsections set out a procedure under which the Minister must apply to a judge to be exempted from the obligation to repay an amount or surrender a security found in subsection 164(1.1).

Subsection 164(1.1) is being amended to provide that the Minister's obligation to repay an amount or surrender a security applies only where an authorization under subsection 225.2(2) has not been granted in respect of the amount assessed. Under subsection 164(1.2) as amended a judge shall, on application made within 45 days of the taxpayer's written request for a refund, permit that the repayment of the amount assessed or a part thereof not be made or that a security or part thereof not be surrendered where he is satisfied that there are reasonable grounds to believe that collection of all or any part of an amount assessed would be jeopardized by the repayment of the amount assessed or the surrender of the security. Instead of making an order of non-repayment or non-surrender, a judge may make such other order as he considers reasonable in the circumstances. For example, he may, in appropriate circumstances, permit that a security be modified or that adequate security be accepted instead of money, in accordance with subsection 220(4.1).

New subsection 164(1.3) provides that a notice of six clear days must be given by the Minister of National Revenue to a taxpayer in respect of whom an application is made under subsection 164(1.2).

New subsection 164(1.31) provides that the rules relating to applications in subsections 225.2(4), (10), (12) and (13) will apply to an application under 164(1.2) with such modifications as the circumstances require. Subsection 225.2(13) provides that there is to be no appeal from the decision of the Court on the application.

Subsections 164(1.1) to (1.31), as amended, will become effective upon Royal Assent.

Subclause 145(3)

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 carry-back 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 145(4)

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 carry-back 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 carry-back of unused share-purchase tax credits and unused scientific research and experimental development tax credits, respectively. As these tax credits may no longer arise 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 three-year carry-back 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 carry-back 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 145(5)

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 145(6) and (8)

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 145(7)

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 146

Prepayment of Child Tax Credit

ITA
164.1

Section 164.1 of the Act permits the Minister to prepay $300 or such greater amount as may be prescribed in respect of the refundable child tax credit. Subsection 164.1(1) is amended to delete the reference to $300 and provide that the total amount which may be prepaid in respect of each eligible child cannot exceed two-thirds of a particular amount. For eligible children over six years of age at the end of the year of the prepayment or in respect of whom child care expenses have been claimed for the preceding year, the particular amount will be the maximum amount of the credit for the year. In any other case, the particular amount will, except for 1988, be the total of the maximum amount of the credit for the year and $200, both amounts being indexed. For 1988, in the first situation, the amount of the prepayment will therefore approximate two-thirds of $559 whereas in the latter case it will be increased by an additional $100.

Paragraph 164.1(1)(b) of the Act currently provides that the prepayment of this credit will be made only to those individuals whose family income for the preceding taxation year does not exceed $15,000. New paragraph 164.1(1)(d) now provides that the income level beyond which no prepayment will be issued is set at two-thirds of $24,090, the family income threshold for the basic refundable child tax credit. Accordingly, individuals with net family income not in excess of $16,090 in 1987 will receive a prepayment of the credit in 1988. Since the $24,090 threshold is indexed, this means that the family income level for the purposes of the prepayment will also increase proportionately.

Clause 147

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 148

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 149

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 150

Tax on Corporate Distributions

ITA
Part II.1

Part II.1 of the Act contains provisions intended to prevent the avoidance of normal tax on corporate distributions where a corporation effects a distribution of corporate surplus that would otherwise be taxable, directly or indirectly, to its shareholders in the form of proceeds of disposition that result in an exempt capital gain in the hands of individual shareholders. The measure takes the form of a special tax to be paid by the corporation that is intended to approximate the shareholder tax that would have been paid had the distribution been received as a dividend. Part II.1 is being substantially revised as a result of the introduction of the general anti-avoidance rule in section 245 of the Act. The scope of the general anti-avoidance rule is broad enough to apply to many of the transactions to which Part II.1 was intended to apply.

In particular, in transactions involving closely-held corporations section 245 can be applied, where the conditions for its application have been met, at the shareholder level to yield a more appropriate tax result than a tax at the corporate level. It is only in the case of widely-held companies that significant difficulties arise in identifying and assessing a large number of shareholders and that a tax at the corporate level remains appropriate. Part II.1 is therefore being amended to apply only to transactions involving public corporations or other corporations whose shares are publicly traded. Transactions involving other corporations will be subject to review under section 245. In addition, the type of transaction at which Part II.1 is targeted is being restricted to transactions where amounts that may reasonably be regarded as dividends have been paid as proceeds of disposition of property. Transactions that involve the conversion of corporate surplus other than dividends into capital gains, for example, where salary or bonus are converted into a capital gain, would normally occur only in closely-held corporations and therefore will be subject to review under section 245.

Subsection 183.1(1) provides that Part II.1 is only applicable to corporations which at any time in a taxation year are public corporations or corporations resident in Canada which have a class of shares that are purchased and sold in the manner in which such shares are normally purchased and sold by any member of the public in the open market. This latter reference is intended to include corporations whose shares, although not listed on a prescribed stock exchange, are publicly traded through over the counter trading systems. The exception in subsection 183.1(6) ensures that Part II.1 only applies to a corporation described in subsection (1) in respect of those classes of shares that are listed on a prescribed stock exchange or are traded in the open market.

Subsection 183.1(2) provides that the tax will only apply where it may reasonably be considered, having regard to all the circumstances, that proceeds of disposition have been paid by a corporation or a person with whom it does not deal at arm's length as a substitute for dividends that would otherwise have been paid in the normal course by the corporation. The test in subsection 183.1(2) is an objective one to be determined by reviewing all of the relevant circumstances. Some of the relevant circumstances in making this determination could include the corporation's past dividend policy, the amount, if any, of dividends paid for the current year and any objective evidence of the corporation's intention to pay amounts instead of dividends. The purpose of the transaction, while not relevant under subsection (2) in determining whether Part II.1 applies, will be relevant in determining whether the exception in subsection (6) applies. The tax will also only apply where the dividends would have otherwise been paid in the "normal course" by the corporation. These words are intended to exclude dividends that would have arisen in special or unusual circumstances such as on a redemption by the corporation of its shares or a corporate reorganization.

An example of a transaction to which subsection (2) could apply is a pro rata purchase of a corporation's shares in the open market by the corporation or by a non-arm's length person, but only where the purchase may reasonably be regarded as having been made instead of paying dividends in the normal course. Another example of a transaction to which subsection (2) may apply is an acquisition of shares for an amount that reflects a future dividend payment. For example, a share may be issued for $90 and be redeemable for $100. Just before the redemption date, the share could be purchased for the $100 amount in the open market by the issuing corporation or a non-arm's length person so that the shareholder realizes a capital gain rather than a deemed dividend.

Where subsection 183.1(2) is applicable, the amount of tax to be paid by the corporation is 45% of the amount or the portion of the amount paid as proceeds of disposition of property that can reasonably be considered to be a substitute for dividends. This rate approximates the 29% maximum rate of tax payable on dividend income by individual shareholders.

Subsection 183.1(3) provides a special rule for the purposes of subsection (2) in the case of shares received as stock dividends where, as part of the same transaction or series of transactions or events, the share or another share of the corporation is purchased, directly or indirectly, by the corporation or a person with whom it was not dealing at arm's length for an amount in excess of the share's paid-up capital. In such a case, the excess of the purchase price over the paid-up capital of the share purchased will be treated as a substitute for dividends that would have otherwise been paid in the normal course by the corporation. The effect of this rule is to tax such excess under subsection (2) where the payment of the stock dividend and the repurchase of the shares can be established to be part of the same transaction or series unless the exception in subsection (6) applies. In the absence of this rule, it could be argued that, since a stock dividend is a dividend, any proceeds of disposition paid on the repurchase of a share issued as a stock dividend cannot be reasonably regarded as a <u>substitute</u> for dividends that would have otherwise been paid.

Subsection 183.1(4) provides a special rule for the purposes of subsection (2) to deal with a purchase of shares of a corporation, directly or indirectly, by the corporation or a person with whom it does not deal at arm's length where a dividend has been declared on those shares but has not been paid at the date of purchase. Where it is reasonable to consider that any portion of the purchase price of the share was consideration for a dividend that has been declared but not paid, that portion shall be treated as a substitute for dividends that would have otherwise been paid in the normal course by the corporation notwithstanding the fact that the dividend was paid after the date of purchase. As a result, where the purchase price is received by the vendor as proceeds of disposition, subsection (2) will apply to tax the portion that is treated as a substitute for dividends unless the exception in subsection (6) applies. In the absence of this rule a shareholder could sell his shares cum-dividend to a corporation that does not deal at arm's length with the issuer of the share at a premium in order to realize the declared dividend as a capital gain. The corporation that purchased the share could then claim the intercorporate dividend deduction on the dividend subsequently paid to it.

Subsection 183.1(5) provides a special rule for the purposes of subsection (2) to deal with transactions where a corporation indirectly pays an amount to a person through an intermediary.
Subsection 183.1(5) applies where a person receives a payment from a corporation or a person with whom the corporation was not dealing at arm's length in consideration for paying an amount to any other person as proceeds of disposition of any property. The effect of this subsection is to treat any such payment as having been paid indirectly by the corporation to that other person.

Subsection 183.1(6) provides an exception from the rule in subsection (2). The exception applies where it can be established that none of the purposes of a transaction or a series of transactions or events may reasonably be considered to have been to enable shareholders of a corporation who are individuals or non-resident persons to receive an amount as proceeds of disposition of property instead of as a dividend on shares of a class listed on a stock exchange or traded in the open market. This subsection will override subsection (2) even where on an objective basis the proceeds of disposition are received as a substitute for dividends. For example, where none of the shareholders is an individual or where the shares are not of a class listed on a prescribed stock exchange or traded in the open market, subsection (6) would apply. It will also override the deeming provisions of subsections (3), (4) and (5). Therefore, proceeds of disposition received on the issue and repurchase of a stock dividend share as part of the same transaction or series would be exempt if none of the purposes was to give a shareholder dividends as proceeds of disposition of property. Similarly, a purchase of a share cum-dividend would be exempt where the test in subsection (6) could be satisfied. This could occur, for example, where a corporation, having declared a dividend, purchases its shares on the open market for commercial reasons and none of the reasons for the purchase was to enable its shareholders to realize dividends as proceeds of disposition of property.

Subsection 183.1(7) ensures that subsection 110.6(8) will not apply to deny the capital gains exemption with respect to a capital gain realized on a share where section 183.1 has applied to a portion of the proceeds of disposition that were used in calculating the capital gain.

The amendments to Part II.1 are applicable 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 151

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 152

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% 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 152(1)

ITA
186(1)

Due to 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% to 25% for dividends received after 1987 to reflect the reduction in the rate of tax payable by individuals on such dividends.

Subclause 152(2)

ITA
186(1)(b)

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

Subsection 112(2.4) and new subsection 112(2.2) of the Act apply in certain circumstances to deny the intercorporate dividend deduction in respect of dividends received by a corporation. Where this occurs Part IV tax should not apply since the corporation is fully taxed on these dividends under Part I of the Act. The amendment to paragraph 186(1)(b) excludes taxable dividends received from a connected corporation from the base on which Part IV tax is calculated in those circumstances where the dividend is not deductible under subsection 112(1) of the Act. A similar exclusion is provided in existing paragraph 186(1)(a) for non-deductible dividends received from a non-connected corporation. This amendment to paragraph 186(1)(b) is applicable to dividends received after June 18, 1987.

Subclause 152(3)

ITA
186(1)(b)(i)

An amendment to subsection 129(1) of the Act provides that the dividend refund rate on dividends paid after 1987 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% 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 152(4)

ITA
186(1.1)

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

Subclause 152(5)

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.

Subclause 152(6)

ITA
186(6)

New subsection 186(6) of the Act sets out rules that clarify, for purposes of Part IV, the tax treatment of dividends received by partnerships for fiscal periods ending after June 18, 1987. These rules provide for the flow-through to partners of dividends received by a partnership. For the purposes of the Part IV tax, each partner is considered to own a proportion of the shares that were owned by the partnership in a fiscal period based on the proportion of the dividends received by the partnership on such shares in the period that is included in the partner's income. This amendment is applicable with respect to fiscal periods ending after June 18, 1987.

Clause 153

Part IV.1

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

Subclause 153(1)

ITA
187.1 and 187.2

New section 187.2 of the Act imposes a special 10% tax on dividends, other than excepted dividends (as defined in new section 187.1), received by a corporation on a taxable preferred share other than a share of a class subject to the special election provided in subsection 191.2(1). This tax applies with respect to dividends received after 1987, or deemed by the coming into force provision for new Part IV.1 to have been received after 1987, and must be paid by the corporation on or before the last day of the second month following the end of its taxation year. A taxable preferred share is defined in subsection 248(1) to include most preferred shares issued after 8:00 p.m. EDT, June 18, 1987.

The special 10% tax is payable on dividends on taxable preferred shares in respect of which the recipient corporation may claim an intercorporate dividend deduction under section 112 or 113 or under subsection 138(6) in computing its taxable income, other than dividends on taxable preferred shares where the corporation paying the dividends has made the special election in respect of the relevant class of shares under new subsection 191.2(1). Reference may be made to the commentary on that provision.

This special tax does not apply to excepted dividends. An excepted dividend is defined in new section 187.1 as any dividend that comes within one or more of the following categories:

- a dividend received by a corporation on a share of a foreign affiliate where the share was not acquired in the ordinary course of its business,

- a dividend received by a corporation on a share of another corporation in which it has (or would have, if that other corporation were a taxable Canadian corporation) a substantial interest at the time the dividend was paid, unless the other corporation is described in paragraphs (a) to (f) of the definition "financial intermediary corporation" in subsection 191(1),

- a dividend received by a corporation at a time when it was a private corporation,

- a dividend received by a corporation at a time when it was a financial intermediary corporation (this expression is defined in subsection 191(1) and reference may be made to the commentary on that provision),

- a dividend received on a short-term preferred share (as defined in amended subsection 248(1) of the Act), except where the dividend is an "excluded dividend" described in paragraph (b) or (c) of the definition of that term in subsection 191(1), and

- a dividend received on a share of a mutual fund corporation provided that the share of the mutual fund corporation would not be a "taxable preferred share" if the definition of that term in subsection 248(1) were read without reference to paragraph (a) thereof.

For the purpose of this definition new subsection 191(2) applies to determine whether a corporation has a substantial interest in another corporation. Generally, a corporation is considered to have a substantial interest in another corporation if it is related to the other corporation or if it owns 25% or more, in terms of votes and value, of the shares of the other corporation, as well as 25% or more, in terms of value, of the shares of the other corporation that are not taxable preferred shares.

Tax on dividends on taxable RFI shares

ITA
187.3

New subsection 187.3(1) of the Act levies a special 10% tax on dividends, other than excepted dividends, received by a restricted financial institution on a taxable RFI share that is acquired after 8:00 p.m. EDT, June 18, 1987. The tax applies to dividends received after 1987, or deemed by the coming into force provision for new Part IV.1 to have been received after 1987, in respect of which the institution may claim an intercorporate dividend deduction under section 112 or 113 or subsection 138(6) in computing its taxable income for the year. The tax payable under this subsection by an institution for a taxation year must be paid on or before the last day of the second month following the end of that year.

This special tax applies only to restricted financial institutions. The definition in subsection 248(1) of "restricted financial institution" includes a bank, trust company, credit union, insurance corporation, a corporation whose principal business is the lending of money to persons with whom the corporation is dealing at arm's length or a corporation controlled by one or more such corporations. A taxable RFI share is defined in subsection 248(1) to include most preferred shares that were issued before 8:00 p.m. EDT, June 18, 1987 that are not term preferred shares. However, an important exception in the taxable RFI share definition will permit a restricted financial institution to be exempted from the 10% tax on dividends received on shares acquired after June 18, 1987 that would otherwise be taxable RFI shares provided it does not acquire shares in excess of certain threshold amounts. Reference may be made to the commentary under the definition of taxable RFI share.

The 10% tax is not payable by a restricted financial institution on an excepted dividend as that expression is defined in section 187.1. Reference may be made to the commentary on that provision.

New subsection 187.3(2) of the Act contains a number of transitional provisions with respect to the acquisition of taxable RFI shares after 8:00 p.m. EDT, June 18, 1987. This subsection treats a share that is acquired by a person or partnership after 8:00 p.m. EDT, June 18, 1987 as having been acquired before that time and thus not subject to the new tax under section 187.3, where

- the share was acquired pursuant to an agreement in writing entered into before that time;

- the share was acquired as part of a distribution to the public made in accordance with the terms of certain documents filed with a public authority before that time;

- the share was acquired on the conversion of a share or debt obligation issued before that time and its terms and conditions were established in writing before that time;

- the share is a share of a Canadian corporation listed on a stock exchange in Canada and was acquired on the exercise of a right, such as a warrant, that was similarly listed and the terms and conditions of the share were established in writing before that time; or

- the share was acquired from a related restricted financial institution in the circumstances outlined in new paragraph 187.3(2)(e) or by reason of an amalgamation of two or more corporations described in any of paragraphs (a) to (d) of the definition "restricted financial institution" in the circumstances outlined in new paragraph 187.3(2)(f).

Partnerships

ITA
187.4

New section 187.4 of the Act sets out rules that clarify for the purposes of new Part IV.1 the tax treatment of dividends received by partnerships after 1987. These rules provide for the flow-through to partners of dividends received by a partnership. Each partner is considered to own a proportion of the shares that were owned by the partnership in a fiscal period based on the proportion of the dividends received by the partnership on such shares in the period that is included in computing the partner's income. They also provide that a reference to a person in Part IV.1 includes a partnership.

Information return

ITA
187.5

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

Provisions applicable to Part

ITA
187.6

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

Subclause 153(2)

This subclause provides that the new Part IV.1 tax is applicable with respect to dividends received after 1987. For this purpose, dividends received after December 15, 1987 and before 1988 will be treated as having been received on January 1, 1988 where it may reasonably be considered that these dividends were paid at that time to avoid or limit the application of the new Part IV.1. In addition, a dividend received on a short-term preferred share (including a share issued after June 18, 1987 that would have been a short-term preferred share if it were issued after December 15, 1987) issued before April 22, 1988 or after April 21, 1988 pursuant to certain arrangements made before April 21, 1988, will generally be excluded from the application of section 187.2.

Clause 154

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 155

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% of its taxable capital. This amendment increases the rate of tax to 1 1/4% 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 one-fifth of capital in excess of $200 million. Thus, tax will effectively be levied at a rate of 1% on capital between $200 million and $300 million and at a rate of 1 1/4% on capital in excess of $300 million.

Clause 156

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 are 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 157

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 one-fifth 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 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 158

Artificial Reduction of Part VI Tax

ITA
190.19

Section 190.19 of the Act is an anti-avoidance provision aimed at a transaction or series of transactions one of the main purposes of which is to reduce unduly or artificially the tax payable under Part VI by a financial institution.

Section 190.19 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 section 190.19 was intended to apply, that section is no longer necessary.

Section 190.19 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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof. This parallels the coming-into-force of new section 245.

Clause 159

Instalments

ITA
190.21

Section 190.21 provides that Part VI 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 160

Part VI.1

New Part VI.1 of the Act provides for a special tax to be paid with respect to dividends, other than excluded dividends, paid by corporations after 1987 on taxable preferred shares. The purpose of this tax is to make the tax system more neutral as between debt and preferred share financing. The Part VI.1 tax may be offset against tax payable under Part I of the Act by way of a deduction provided by new paragraph 110(1)(k) so that the overall tax liability for those corporations with Part I tax payable will remain largely unaffected by the Part VI.1 tax. As explained below, a $500,000 annual dividend allowance will exempt from the tax dividends on preferred shares paid by most small corporations.

Definitions

ITA
191(1)

New subsection 191(1) defines certain expressions used in new Part VI.1.

Excluded dividends on taxable preferred shares are not subject to the Part VI.1 tax. The term "excluded dividend" means:

- a dividend paid to a shareholder who had a substantial interest in the payer corporation when the dividend was paid;
- a dividend paid by a corporation that was a financial intermediary corporation or a private holding corporation when the dividend was paid;
- a dividend paid by a corporation that would, under certain conditions, have been a financial intermediary corporation;
- a dividend paid by a mortgage investment corporation; or
- a capital gains dividend (within the meaning assigned by subsection 131(1) of the Act) paid by a mutual fund corporation.

Dividends paid by a financial intermediary corporation are not subject to Part VI.1 tax. The expression "financial intermediary corporation", also used in new Part IV.1, includes:

- a corporation licensed to issue investment contracts, as described in clause 146(1)(j)(ii)(B);

- an investment corporation;
- a mortgage investment corporation;
- a mutual fund corporation;
- a prescribed venture capital corporation, or
- a prescribed labour-sponsored venture capital corporation.

Such a corporation will not be a financial intermediary corporation, however, if it is a prescribed corporation, or

- a corporation that is controlled by or for the benefit of one or more corporations that are not financial intermediary corporations or private holding corporations, except where such controlling corporations do not own more than 10%, in value, of all the issued and outstanding shares of the corporation, or
- any corporation in which another corporation other than a financial intermediary corporation or a private holding corporation has a substantial interest unless the other corporation and specified persons in relation thereto do not own more than 10%, in value, of all the issued and outstanding shares of the corporation.

Part VI.1 also does not apply to dividends paid by a private holding corporation. The expression "private holding corporation" is defined as a corporation that does not own shares of another corporation (except another private holding corporation) in which it has a substantial interest and the only undertaking of which is the investment of its funds. Such a corporation will not be a private holding corporation, however, if it is a specified financial institution (as defined in subsection 248(1)) or a corporation that is controlled by or for the benefit of one or more corporations other than private holding corporations, or in which a corporate shareholder other than a private holding corporation has a substantial interest.

Substantial interest

ITA
191(2) and (3)

New subsection 191(2) of the Act describes the circumstances in which a shareholder will be treated as having a substantial interest in a corporation. A shareholder has a substantial interest in a corporation if the corporation is a taxable Canadian corporation and either the shareholder is related to the corporation (otherwise than by reason of a right referred to in paragraph 251(5)(b)) or where the shareholder owns shares of that corporation representing, in terms of votes and value, 25% or more of its issued shares and, as well, either common shares representing at least 25% of the fair market value of all common shares or 25% or more, in terms of value, of each class of shares. For the purpose of subsection 191(2), shares owned by persons related to a shareholder are considered to be owned by the shareholder.

New paragraphs 191(3)(a), (c) and (d) deem a person not to have a substantial interest in a corporation where

- it is reasonable to consider that the principal purpose for acquiring the interest in the corporation was to avoid or limit the application of Part IV.1 or VI.1,

- the person is a corporation described in paragraphs (a) to (f) of the definition of "financial intermediary corporation" in subsection 191(1) and is not related to the other corporation, or

- the person is a partnership or trust other than a partnership all the members of which are related, a trust that has only one beneficiary or a trust in which all the beneficiaries are related to each other (for this purpose any beneficiary and his or her descendants are considered to be related to the beneficiary's aunt, uncle, niece or nephew and any of their descendants).

New paragraph 191(3)(b) provides that, where a person with a substantial interest in a corporation has acquired a share of the corporation from a shareholder who does not have a substantial interest in order to avoid tax under Part IV.1 or VI.1, the acquiror will be deemed not to have a substantial interest in the corporation with respect to any dividend paid on the share.

In addition, new paragraph 191(3)(e) provides that where a person holds a share of a corporation to which either paragraph (g) of the definition "taxable preferred share" or paragraph (e) of the definition "taxable RFI share" is applicable, the person shall be deemed not to have a substantial interest in the corporation.

Reorganizations

ITA
191(4)

New subsection 191(4) of the Act provides that the Part VI.1 tax and the Part IV.1 tax payable under section 187.2 do not apply with respect to certain dividends deemed to have been paid under subsection 84(2) or (3), and that such dividends will not be denied the intercorporate dividend deduction by reason of subsection 112(2.1) or 138(6).

Subsection 84(3) of the Act provides that where a corporation resident in Canada has paid an amount on the redemption, acquisition or cancellation of a share of its capital stock, a dividend equal to the excess of the amount paid over the paid-up capital of the share is deemed to have been paid by the corporation and received by the shareholder. Subsection 84(2) provides a similar rule with respect to amounts distributed or otherwise appropriated on the winding-up, discontinuance or reorganization of the business of a corporation.

New subsection 191(4) applies with respect to a deemed dividend arising under subsections 84(2) and (3) of the Act on the redemption, acquisition or cancellation of a share where

- the share was newly issued or the terms and conditions of an existing share were changed or an agreement in respect of an existing share was changed or entered into and it was specified that the share is to be redeemed, acquired or cancelled for an amount not greater than the value of the consideration for which the share was issued in the case of a newly issued share and, in respect of an existing share, for an amount not greater than the fair market value of the share immediately before its terms or conditions were changed or the agreement in respect of the share was changed or entered into;

- with respect to a share that is or became a term preferred share, the share was not issued to raise capital or for consideration that included a term preferred share in the case of a newly issued share or, in the case of an existing share, the share was not, immediately before its terms were changed or the agreement in respect of the share was entered into or changed, a term preferred share; and

- with respect to a share that is or became a taxable preferred share, the share was not issued for consideration that included a taxable preferred share in the case of a newly issued share or, in the case of an existing share, the share was not, immediately before its terms were changed or the agreement in respect of the share was entered into or changed, a taxable preferred share.

In these circumstances the Part VI.1 tax and the tax payable under section 187.2 will not apply to the dividend deemed to have been paid under subsection 84(2) or (3). New subsection 191(5) will limit the application of subsection 191(4) to the extent that the total of the amount paid on the redemption, acquisition or cancellation of the share and all amounts paid upon a reduction in the paid-up capital of the share (other than an amount deemed to be a dividend under subsection 84(4)) exceeds the specified amount referred to in subsection (4).

Tax payable

ITA
191.1(1)

New subsection 191.1(1) of the Act provides for a tax to be paid by a corporation that has paid taxable dividends on taxable preferred shares. This tax applies to dividends, other than excluded dividends, paid after 1987, or deemed to have been paid after 1987. The tax is payable by way of monthly instalments, as provided by amended subparagraph 157(1)(a)(i). Reference may be made to the commentary on that provision.

The tax to be paid pursuant to paragraph 191.1(1)(a) is equal to 66 2/3% of the amount by which the taxable dividends (other than excluded dividends) paid by the corporation in the year on short-term preferred shares exceed the corporation's dividend allowance for the year. As discussed in the commentary on the definition of short-term preferred share in subsection 248(1), short-term preferred shares are shares which are retractable or could be required to be redeemed within 5 years of issue. The rate of 66 2/3% is intended to approximate the amount of tax that would be paid on an equivalent amount of interest assuming a 40% rate of corporate tax.

Where taxable dividends are paid by a corporation on its taxable preferred shares (defined in subsection 248(1) to include most preferred shares issued after June 18, 1987), other than short-term preferred shares, and in respect of which no election has been made under section 191.2, the tax to be paid is equal to 25% of the amount by which these taxable dividends exceed the corporation's dividend allowance for the year.

Where the corporation has made an election under section 191.2 in respect of a class of its taxable preferred shares, the rate of this tax will be 40%. Reference may be made to the commentary on section 191.2 relating to this election.

Under new section 191.3 two corporations may agree that one of them may transfer its liability for Part VI.1 tax to the other. The purpose of this provision is described in the commentary on that section. Where such an agreement is made, the agreed amount will be added to the Part VI.1 tax payable by the transferee and will reduce the Part VI.1 tax payable by the transferor.

New Part VI.1 tax is not payable in respect of excluded dividends as defined in subsection 191(1). These include dividends paid to a shareholder who had a substantial interest in the payer corporation when the dividend was paid, dividends paid by a corporation that was a financial intermediary corporation or a private holding corporation when the dividend was paid, dividends paid to certain shareholders by a corporation that would, under certain conditions, have been a financial intermediary corporation, dividends paid by a mortgage investment corporation and capital gains dividends.

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

Dividend allowance

ITA
191.1(2) to (6)

A corporation will generally pay tax under Part VI.1 only on dividends on taxable preferred shares (other than excluded dividends) paid by it in excess of its dividend allowance. New subsections 191.1(2) to (6) of the Act set out the rules applicable for the computation of a corporation's dividend allowance. These rules parallel the rules used in determining a corporation's business limit for the purposes of the small business deduction under section 125.

New subsection 191.1(2) determines a corporation's dividend allowance for a taxation year to be $500,000 where the corporation is not associated with another corporation in the year. This amount, however, is reduced on a dollar-for-dollar basis by the amount of non-excluded dividends in excess of $1,000,000 paid in the preceding calendar year by the corporation on its taxable preferred shares or shares that would have been taxable preferred shares if they had been issued after June 18, 1987.

New subsections 191.1(3), (4) and (5) of the Act apply for the purpose of determining the dividend allowance of associated corporations. A total dividend allowance is first determined for a group of associated taxable Canadian corporations. Under subsection 191.1(4), this total dividend allowance is $500,000 less the excess over $1,000,000 of non-excluded dividends paid in the preceding calendar year by the corporations in that group on taxable preferred shares or shares that would have been taxable preferred shares if they had been issued after June 18, 1987. These corporations may then allocate the total dividend allowance among the group by filing a prescribed agreement under new subsection 191.1(3) of the Act. If such agreement is not filed by any corporation in the group that has paid dividends on taxable preferred shares in the year, the Minister of National Revenue may make the allocation under new subsection 191.1(5).

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

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

Election

ITA
191.2

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

An election may be made by a taxable Canadian corporation in respect of a class of its taxable preferred shares only if the terms and conditions of the shares require that this election be made. According to new section 191.2, the election is to be made by filing a prescribed form with the Minister of National Revenue not later than the date on which a tax return must be filed by the corporation under Part I for the taxation year in which shares of that particular class of shares are first issued or first become taxable preferred shares or within the six month period following the mailing of a notice of assessment or confirmation or variation thereof or the disposition by a court of an appeal from an assessment. A special transitional rule is provided to allow elections to be filed at any time within six months from the date on which the implementing legislation receives Royal Assent.

Agreement respecting liability for tax

ITA
191.3

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

An agreement to transfer tax otherwise payable under Part VI.1 by a transferor corporation for a particular taxation year will be valid only if the transferee corporation was related to the transferor throughout that particular taxation year and also throughout the last taxation year of the transferee corporation ending on or before the end of the particular year.

Under new subsection 191.3(2) an agreement or amended agreement must be filed by the transferor corporation and the transferee corporation with the Minister of National Revenue in prescribed form no later than the day on which the transferor corporation's tax return under Part I is required to be filed for its taxation year in which Part VI.1 tax would otherwise be payable by it. An agreement or amended agreement may also be filed within 90 days of the day of mailing of a notice of assessment (or notification that no tax is payable) to the transferor corporation or the transferee corporation for the taxation year in respect of which the agreement is filed. Subsection 191.3(2) also requires the agreement to be accompanied by a certified copy of a resolution of the directors (or the persons legally entitled to administer the affairs of the corporation) of both the transferor and transferee corporation authorizing the agreement.

New subsection 191.3(3) imposes on the Minister of National Revenue the duty to assess the transferor and transferee corporations according to an agreement or amended agreement even where the three-year limit provided by subsections 152(4) and (5) might otherwise apply.

New subsection 191.3(4) is an anti-avoidance provision that prevents a corporation from becoming related to another corporation in order to transfer its Part VI.1 tax liability to the related corporation through a subsection 191.3(1) election. Absent such a rule, this election would allow the corporation effectively to avoid the payment of the Part VI.1 tax since the deduction allowed by subsection 110(1)(k) would allow the related corporation to offset the Part VI.1 tax so transferred against its Part I tax payable.

The amount of tax specified in the agreement filed in accordance with section 191.3 will be included in the Part VI.1 tax payable by the transferee corporation and will be deducted from the amount of Part VI.1 tax otherwise payable by the transferor corporation. Both corporations remain jointly and severally liable to pay the tax and any interest and penalties in respect thereof. Therefore, new subsection 191.3(5) permits the Minister to assess the transferor corporation in respect of the agreed amount of tax and provides that certain provisions of Part I relating to assessments, penalties, objections and appeals are then applicable.

New subsection 191.3(6) provides that where payment is made by the transferor corporation on account of this joint liability, the joint liability is reduced accordingly. However, any payment by the transferee corporation will reduce the transferor corporation's liability only to the extent of the excess, if any, of the amount paid over the transferee corporation's remaining liability under the Act after the payment. In effect, this treats a tax payment by the transferee corporation as applying first against its other tax liabilities under the Act.

Information return

ITA
191.4

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

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

Subclauses 160(2) to (4)

The Part VI.1 tax is applicable to the 1988 and subsequent taxation years but only with respect to dividends paid after 1987. For that purpose, dividends paid after December 15, 1987, but before 1988, are treated as having been paid on January 1, 1988 where it may reasonably be considered that these dividends were paid to avoid or limit the application of new Part VI.1.

A special provision applies with respect to elections under new subsection 191.2 of the Act. Since, in some cases, such elections may be required to be filed before the enactment of new subsection 191.2, an election will be deemed to have been filed on time if it is filed within 6 months of the date on which the implementing legislation receives Royal Assent.

Clause 161

Tax on Designated Income of Certain Trusts

ITA
Part XII.2

New Part XII.2 introduces a special tax on the designated income of certain trusts as part of the mechanism to replace the existing designated income rules of subsection 104(8). Under the existing provisions, the income distributions of a trust resident in Canada are not deductible in computing the trust's income where the beneficiary is a designated beneficiary -- a non-resident person, non-resident-owned investment corporation and certain trusts -- and the distribution is out of the trust's designated income -- income from carrying on business in Canada, from Canadian real estate, resource properties and timber resource properties and from dispositions of taxable Canadian property. These provisions were intended to ensure that such designated income earned by trusts for the benefit of non-residents would be subjected to tax at full personal tax rates under Part I rather than at the lower non-resident withholding tax rates under Part XIII.

Under the existing designated income rules, where a trust has resident as well as non-resident beneficiaries, the tax under Part I resulting from the application of these rules -- which is computed by reference to the distributions to non-residents -- may, depending on the terms of the trust, be borne by all of the beneficiaries of the trust. Resident beneficiaries who indirectly bear a portion of the tax are not entitled to any credit for such tax and must report the full amount of their share of the trust income distributions. To correct this deficiency, the tax under new Part XII.2 will be determined by reference to all income distributions out of the designated income of a trust that makes income distributions, with a proportionate tax credit available for resident beneficiaries (other than designated beneficiaries) and non-resident beneficiaries taxable under Part I.

New section 210 contains the definition of "designated beneficiary" for the purposes of new Part XII.2. This definition has substantially the same meaning as presently, except that the new definition includes an exempt person who acquires an interest in the trust unless the interest was owned continuously by an exempt person since the later of October 1, 1987 or the date on which the interest was created. The new definition will also exclude trusts governed by registered retirement savings plans and registered retirement income funds which acquire trust interests from their beneficiaries or beneficiaries' spouses (or former spouses).

New section 210.1 is the application section and provides that the special Part XII.2 tax does not apply to testamentary trusts, mutual fund trusts, non-resident trusts, trusts described in subparagraphs 108(1)(ii) and (iv) or to trusts (such as pension fund trusts or trust that are registered charities) that are exempt from Part I tax under subsection 149(1). Part XII.2 tax also does not apply to segregated funds in respect of life insurance policies because such arrangements are deemed by section 138.1 to be trusts only for the purposes of Part I and Part XIII.

New subsection 210.2(1) provides that the special Part XII.2 tax for a year is generally equal to 36% of the designated income of a trust for the year, unless the amount of income distributed by the trust to its beneficiaries in the year (and deducted under paragraph 104(6)(b) in computing its income for the year) is less than 64% of the designated income of the trust for the year. In such cases, the tax is equal to 36% of the amount determined by grossing-up the amount deducted under paragraph 104(6)(b) to a before-tax amount, in recognition of the deduction in computing the trust's income under new subsection 104(30) for tax paid by it under new Part XII.2. The "designated income" of a trust is determined under rules in subsection 210.2(2) which are consistent with the existing rules for determining "designated income".

New subsection 210.2(3) provides the mechanism which permits a pro rata portion of the Part X11.2 tax payable by a trust to be refunded to its taxable resident beneficiaries -- those beneficiaries who are not designated beneficiaries. In addition, where trust income is included in computing a non-resident beneficiary's tax liability under Part I and no exemption from that inclusion is provided by a tax treaty, the beneficiary will be entitled to a pro rata refund of Part XII.2 tax.

New subsection 210.2(4) provides a special rule that permits a Canadian partnership that is a beneficiary of a trust to flow out the credit for the Part XII.2 tax to its partners.

New subsections 210.2(5) to (7) contain provisions relating to the payment, assessment, appeal and other administrative procedures applicable to Part XII.2.

New section 210.3 provides that the Part XII.2 tax is not payable by a trust where the trustee certifies that none of the income distributions of the trust was made to designated beneficiaries. For the purposes of this section and subsection 104(7), a "designated beneficiary" does not include a non-resident beneficiary that would be entitled to a full pro rata refund in respect of the Part XII.2 tax for the year had Part XII.2 tax been paid by the trust.

The following examples illustrate the application of new Part XII.2.

Example 1

> Assume: an inter vivos trust resident in Canada with two beneficiaries - Mr. A (a resident in Canada) and Mr. B (a non-resident) - each of whom is entitled to receive an equal share of the trust income; the income of the trust for 1988 is $1,400 - $1,000 of business income and $400 of interest income. The trust intends to distribute all of its income after Part XII.2 tax.

For the trust in this example, the tax under Part XII.2 in respect of distributions out of its designated income ($1,000 of business income) is determined under paragraph 210.2(1)(a). Therefore, the Part XII.2 tax payable by the trust would be $360 (36% of $1,000). (The amount of tax determined under paragraph 210.2(1)(c) would be less than the amount determined under paragraph 210.2(1)(a) only where the trust distributed to its beneficiaries less than $640 -- that is, 64% of its designated income).

After determining its Part XII.2 tax liability, the trust would distribute its after-tax income of $1,040 ($1,400 - $360) to its beneficiaries. One half of this amount, $520, would be paid to Mr. A, the resident beneficiary, and the trustee would also designate $180 of its tax to Mr. A under the formula provided in subsection 210.2(2) -- $360 x 520/1,040 = $180.

Mr. A is required to include in income $520 under subsection 104(13) and a further $180 under new subsection 104(31). Thus, Mr. A will include in his income a total of $700 -- one-half of the trust income -- and will be deemed to have paid tax of $180 under Part I for his taxation year in which the trust year ends.

Mr. B will also receive $520 from the trust. He will not receive any credit for the Part XII.2 tax paid by the trust. In addition, the non-resident withholding tax under Part XIII of the Act will be deducted from the $520 payment at 25% or such lower rate as may be provided in a tax treaty between Canada and the country in which the taxpayer resides.

Example 2

> Assume: same facts in example 1, except that the trust wants to distribute 25% of its income (25% of $1,400 = $350) before Part XII.2 tax. However, the trust also wishes to withhold sufficient amounts from the distributions to satisfy the Part XII.2 tax liability.

In this example, the amount of Part XII.2 tax may be determined as the least of:

1. 36% of the designated income of the trust (.36 x $1,000 = $360)

2. 36% of the income of the trust before Part XII.2 tax and distributions (.36 x $1,400 = $504), and

3. 36% of the amount ($350) which would have been distributed by trust but for Part XII.2 tax (.36 x $350 = $126).

The Part XII.2 tax is equal to $126. The trust therefore has an amount of $224 ($350 - 126 = $224) as a subsection 104(6) deduction and to distribute to beneficiaries. Note that the Part XII.2 tax payable is in accordance with the amount determined under paragraph 210.2(1)(c) (.36 x 100/64 x 224 = $126).

One-half of the amount distributed would be paid to Mr. A and Mr. B. The trust would designate $63 of its Part XII.2 tax to Mr. A under the formula provided in subsection 210.2(2) -- $126 x 112/224 = $63.

Mr. A is required to include in his income $112 under subsection 104(13) and a further $63 under new subsection 104(31) for a total of $175. The total is equal to one-half of trust income which would have been distributed to Mr. A in the absence of Part XII.2 tax (.5 x .25 x $1,400 = $175). Mr. A will also be deemed to have paid tax of $63 under Part I for his taxation years in which the trust year ends.

Mr. B's distribution of $112 would be taxed as described in example 1.

Tax on Investment Income of Life Insurers

ITA
Part XII.3

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% 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", "policy loan" and "segregated fund" will have the meanings assigned by subsection 138(12).

"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)(1) 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, particularly since 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, benefits payable under life insurance policies (including amounts payable in respect of such benefits under reinsurance arrangements), expenses related to the segregated funds of the insurer and amounts deducted under subsection 138(3) of the Act. Such expenses must be reduced by expense allowances under reinsurance arrangements which have been included in computing the insurer's income from such business under Part I for the year. Amounts deducted under subsection 20(26) and paragraphs 20(1)(1) and (1.1) 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 (determined as described under A) are included, and

(d) the maximum amounts allowable in computing the insurer's income in respect of policy reserves, unpaid claims reserves and policy 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 Part XII.3 tax base.

"D" The description of D represents the aggregate of amounts of investment income accumulating under the insurer's reserves for annuity contracts, registered life insurance policies and registered pension funds or plans, as well as prescribed arrangements. Effectively, these lines of business are excluded from the new Part XII.3 tax. It is intended that prescribed arrangements will include certain group term life insurance policies and certain reinsurance arrangements. 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 represents the aggregate of

(a) the term insurance component in respect of all of the insurer's non-segregated life insurance policies in Canada (other than annuity contracts, registered life insurance policies and prescribed arrangements), 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, registered life insurance policies and prescribed arrangements).

The amount determined under E is added in computing the new Part XII.3 tax base to offset amounts deducted under B and C. The amount 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 amount 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 represents 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, registered life insurance policies and prescribed arrangements. The definition of guaranteed interest will be contained in the regulations.

"G" The description of G represents the prescribed portion of amounts which policyholders 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. The prescribed portion of such amounts is intended to reflect the portions of such income amounts which have been subject to the new Part XII.3 tax in prior years. The detailed rules for determining the prescribed portion 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 lesser of the tax payable for the immediately preceding year and the current year's tax payable under this Part.

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 162

Non-Resident Withholding Tax

Section 212 is the principal provision of the Act dealing with the withholding tax imposed in respect of payments made to non-residents.

Subclause 162(1)

ITA
212(1)(b)(ii)(C)

Clause 212(1)(b)(ii)(C) of the Act provides an exemption from non-resident withholding tax for interest paid on certain government and government-guaranteed debt obligations. This exemption is scheduled to expire for interest on debt obligations issued after 1988. The amendment to this clause extends the exemption to interest paid on such debt obligations issued after 1988.

Subclause 162(2)

ITA
212(1)(b)(vi)

Subparagraph 212(1)(b)(vi) of the Act provides an exemption from non-resident withholding tax for interest paid to residents of prescribed countries on certain government and government-guaranteed debt obligations issued after 1988. As a consequence of the amendment to clause 212(1)(b)(ii)(C), which extends the existing exemption for interest paid on government debt obligations to such obligations issued after 1988, subparagraph 212(1)(b)(vi) becomes redundant and is therefore repealed.

Subclause 162(3)

ITA
212(1)(b)(vii)

Subparagraph 212(1)(b)(vii) of the Act provides an exemption from non-resident withholding tax for interest paid to arm's length parties on certain long-term corporate indebtedness. This exemption is scheduled to expire for interest on debt obligations issued after 1988. The amendment to this subparagraph extends the exemption to interest paid on such debt obligations issued after 1988.

Subclauses 162(4) and (6)

ITA
212(1)(c) and (11.1) and (11.2)

Under paragraph 212(1)(c) and subsection 212(11) of the Act, distributions, other than capital distributions, by a resident trust to non-resident beneficiaries are subject to a 25% non-resident withholding tax under Part XIII of the Act. These provisions are modified by subsections 212(11.1) and (11.2), which permit the designated income of a trust to be paid free of any Part XIII tax since, under the existing rules, such income will already have borne tax in the hands of the trust under Part I.

Paragraph 212(1)(c) is revised, effective for distributions in the 1988 and subsequent taxation years of a trust. As amended, a non-resident beneficiary is subject to the Part XIII tax only on amounts that would be taxable under Part I if he were a person resident in Canada to whom Part I were applicable. Thus, for example, if the designated income of a trust is $75 after deducting $25 of capital cost allowance and, after determining its Part XII.2 tax of $27 (36% of $75), the trust distributes $73 ($100-$27) to the non-resident beneficiary, only $48 ($75 - $27) would attract the non-resident withholding tax. As a consequence of the changes to paragraph 212(1)(c), subsections 212(11.1) and (11.2) are repealed with respect to amounts distributed by a trust in its 1988 and subsequent taxation years.

Subclause 162(5)

ITA
212(5)

Subsection 212(5) of the Act provides that a withholding tax is payable in respect of payments for the use in Canada of motion picture films and for film and video tape used in connection with television. The amendment to paragraph 212(5)(b) provides a withholding tax exemption in respect of payments made after 1985 for film or videotape used solely in connection with and as part of a news program produced in Canada and also extends, effective for payments made after 1988, the withholding tax obligation under paragraph 212(5)(b) to other means of reproduction for use in connection with television.

Subclause 162(7)

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 163

Non-Arm's Length Sales of
Shares by Non-Residents

ITA
212.1

Section 212.1 of the Act contains special provisions applying to a non-resident who disposes of shares to another Canadian corporation with which the non-resident does not deal at arm's length.

Subclause 163(1)

ITA
212.1(1)

Subsection 212.1(1) of the Act is intended to prevent the conversion of a corporation's surplus -- which would be subject to Canadian tax upon distribution to its non-resident shareholder -- into proceeds from the disposition of the corporation's shares -- which may give rise to a capital gain that is not subject to tax in Canada. Where a non-resident disposes of his shares to a Canadian corporation with which he does not deal at arm's length, subsection 212.1(1) treats a dividend as having been paid to the non-resident to the extent that any non-share consideration, including debt, received on the disposition exceeds the paid-up capital of the shares.

This amendment extends the application of section 212.1 to situations in which shares of a Canadian corporation are disposed of after February 9, 1988 by a non-resident-owned investment corporation to a Canadian corporation with which it does not deal at arm's length. This amendment also provides that any dividend arising under subsection 212.1(1) is deemed to have been both paid to and received by the vendor of the shares, so that, in the case of a vendor that is a non-resident-owned investment corporation, the dividend will be subject to tax under Part I of the Act.

Subclause 163(2)

ITA
212.1(2)(a)(i)

Where section 212.1 of the Act applies to an acquisition of shares, any increase in the paid-up capital of the acquiror corporation that would otherwise result is reduced to match the paid-up capital of the acquired shares minus the value of any non-share consideration received by the vendor. This reduction may be offset under subsection 212.1(2) by an add-back to paid-up capital to the extent that the original reduction later has the effect of increasing the amount of any dividends deemed to have been paid by the acquiror corporation under subsection 84(3), (4) or (4.1) on a redemption, acquisition, cancellation or reduction of capital of its shares.

Dividends deemed to have been paid to corporations resident in Canada are disregarded for the purpose of the paragraph 212.1(2)(a)(i) addition to paid-up capital, since such corporations are generally entitled to deduct dividends in computing their income. In the case of a non-resident-owned investment corporation, however, Part I tax is exigible in respect of dividend income which it receives and this amendment to paragraph 212.1(2)(a)(i) provides that dividends deemed to have been received by such corporations under subsection 84(3), (4) or (4.1) will be included in computing the amount, if any, added to the paid-up capital of the corporation's shares.

Clause 164

Rules Relating to Non-Resident Withholding Tax

Section 214 of the Act contains special rules applicable to non-resident withholding tax.

Subclause 164(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 paragraph 16(1)(b) would, if Part I were applicable, result in part of an amount being included in a non-resident's income, that part will be deemed to have been paid or credited to the non-resident in respect of income from property, services or otherwise depending on the nature of that part of the amount. Thus, depending on the nature of the income portion of the amount, Part XIII may apply to it. 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 164(2)

ITA
214(3)(f.1)

Under new subsection 132.1, a trust may designate an amount in respect of a unit of the trust owned by a taxpayer. Where the taxpayer is a non-resident person, the amount so designated is deemed to be paid or credited to the non-resident. As a consequence, after 1988 the trust will be required to remit 25% (15% in most treaty circumstances) of the amount so designated as tax under Part XIII forthwith after the time at which the amount is designated.

Subclause 164(3)

ITA
214(3)(h)

Under subsection 214(3) of the Act, certain amounts that would, if a non-resident person were resident in Canada, be required to be included in his income are treated 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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof.

Clause 165

Income of Non-Residents

Section 216 of the Act provides certain rules relating to non-residents who elect to be taxed under Part I of the Act in respect of certain rental and timber royalty income rather than under Part XIII of the Act which would normally apply in such circumstances.

Subclauses 165(1) and (2)

ITA
216(1) and (5)

Where an election is made under subsection 216(1) of the Act, 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.

Subclause 165(3)

ITA
216(8)

Section 216 allows a non-resident person to elect to be taxed under Part I on his net income from Canadian real property and timber royalties rather than pay Part XIII tax on the gross amount of such payments. The amendment to section 216 clarifies that the amount of Part I tax that the non-resident elects to pay must be determined without regard to deductions which are not available to non-residents. For example, a non-resident person would be denied a deduction in respect of distributions to a non-resident beneficiary under subsection 104(7) and the foreign tax credit under section 126. In addition, the non-resident beneficiary would be denied those deductions expressly referred to in subsections 216(1) and (5). This amendment is effective on Royal Assent.

Clause 166

Election Respecting Certain Payments

ITA
217

Section 217 of the Act provides that a non-resident may elect, within six months after the end of the taxation year, to pay tax on certain amounts under Part I of the Act 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 as 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 167

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% 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% 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 167(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 167(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% 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% under Part XIII of the Act. New subsection 219(5.3) is applicable after December 15, 1987.

Subclause 167(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 corporation of which the insurer is a subsidiary wholly-owned corporation, 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 168

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 169

Certificates for Unpaid Amounts

ITA
223

Section 223 of the Act allows Revenue Canada, Taxation to register with the Federal Court a certificate specifying an amount payable by a taxpayer under the Act. When registered, the certificate has the same effect as if it were a judgment of the Court for the amount specified plus interest. There are a number of amendments to this section.

ITA
223(1) to (3)

Existing subsection 223(1) of the Act provides for the issuance of certificates by Revenue Canada, Taxation and existing subsection 223(2) provides for the registration of the certificates in the Federal Court. These subsections are renumbered as subsections 223(2) and (3) and are amended to provide that for the purposes of any proceedings taken to collect an amount certified, such a certificate shall be considered to be a judgment of the Court. The purpose of these amendments, together with new subsections 223(5), (6) and (7) is to confirm that provincial enforcement of judgment and land registry legislation applies to such certificates and to thereby ensure that the certificates can be used to effectively bind land owned by a tax debtor.

New subsection 223(1) provides that the amounts for which Revenue Canada, Taxation may issue a certificate under new subsection 223(2) are amounts payable under the Act, the Unemployment Insurance Act, 1971, the Canada Pension Plan, and the provincial income tax laws that are administered by Revenue Canada, Taxation under tax collection agreements.

These amendments are applicable to certificates made by Revenue Canada, Taxation after 1971 and to documents evidencing such certificates issued by the Federal Court after 1977. The amendments do not apply, however, with respect to certificates that were the subject of court decisions given on or before February 10, 1988 or actions pending before a court on that date.

ITA
223(4)

Existing subsection 223(3) of the Act provides that the costs of registration of a certificate may be recovered in the same way as they could have been if they had been included in the amount certified.

This subsection is renumbered as subsection 223(4) and extended to apply similarly to the recovery of the costs of any proceedings taken to collect the amount certified. The costs recoverable under this provision would be similar to those that would normally be recoverable by a judgment creditor for proceedings to enforce a judgment.

The effective date for this amendment is the same as the effective date for new subsections 223(1) to (3), as explained in the commentary on those subsections.

ITA
223(5) to (8)

New subsections 223(5) to (8) of the Act set out the details of the rules that, together with new subsections 223(2) and (3), confirm that provincial enforcement of judgment and land registry legislation applies to certificates made under section 223.

New subsection 223(5) provides that a "memorial" of such a certificate issued by the Federal Court may be filed, registered or otherwise recorded under a province's enforcement of judgment and land registry legislation in the same way as it could if it were a document evidencing a judgment of the superior court of the province. New subsection 223(6) provides that the memorial binds the land of the tax debtor under that provincial legislation in the same way as it would if the memorial were such a document.

New subsection 223(7) of the Act provides that where a memorial of a certificate has been filed, registered or otherwise recorded under new subsection 223(5), certain proceedings may be taken as if the memorial were a document evidencing a superior court judgment. Those proceedings include proceedings to enforce payment of the amount certified (together with interest and costs), to renew the filing, registration or other recording of the memorial, to cancel the memorial wholly or in part, or to postpone the effectiveness of the memorial. Where provincial law would require an order, consent or ruling of a superior court judge or official before any such proceeding may be taken, that order, consent or ruling may be made or given by a judge or official of the Federal Court.

New subsection 223(8) of the Act provides that where a memorial of a certificate is presented to an officer of a superior court of a province or an official in the land registry system of a province for filing, registration or other recording under subsection 223(5), it shall be accepted by the officer or official for filing, registration or other recording as provided under subsection 223(5). Where provincial law would require an affidavit or declaration to accompany the memorial, subsection 223(8) provides that, for the purposes of the proceedings described in subsection 223(7), the memorial shall be treated as though the affidavit or declaration did accompany the memorial.

The effective date for new subsections 223(5) to (8) is the same as the effective date for new subsections 223(1) to (3), as explained in the commentary on those subsections.

ITA
223(9) to (11)

New subsection 223(9) of the Act provides that where a document evidencing a certificate is filed, registered or otherwise recorded under provincial enforcement of judgment and land registry legislation, a sheriff shall not sell any property of the tax debtor to enforce the certificate without the written consent of the Minister of National Revenue. The document evidencing the certificate shall nevertheless continue to bind the property of the tax debtor in the same way that it would have if the Minister had consented to such a sale. Where the consent is given and the property is sold, new subsection 223(10) of the Act provides that the requirements of the provincial law regarding the documentation for the sale shall be considered to have been met where they have been followed as closely as possible. Where a sheriff complying with subsections 223(9) and (10) is unable, because of those subsections, to comply with any law or any rule of court, subsection 223(11) of the Act provides for the sheriff to be bound by by such order as may be made by a judge of the Federal Court on an _ex parte_ application by the Minister.

New subsections 223(9) to (11) are applicable with respect to certificates made after Royal Assent.

ITA
223(12)

New subsection 223(12) of the Act provides that it is adequate for a certificate to set out one total amount as the amount owing by the debtor without setting out the separate amounts (such as federal tax, provincial tax or unemployment insurance premiums) making up that total amount. Subsection 223(12) also provides that the certificate may refer to the interest rate to be charged on the amount certified as the prescribed rate of interest applicable under the Act, without specifying the exact rates that apply from time to time. The effective date for new subsection 223(12) is the same as the effective date for new subsections 223(1) to (3), as explained in the commentary on those subsections.

Clause 170

Collection Restrictions

ITA
225.1(1)(b)

Section 225.1 of the Act restricts the collection of unpaid amounts for which a taxpayer has been assessed under the Act where the taxpayer objects to or appeals from the assessment in question. Paragraph 225.1(1)(b) provides that one collection procedure that is restricted is the certification of an unpaid amount under subsection 223(1) of the Act. The amendment to paragraph 225.1(1)(b) changes the reference in that paragraph to "subsection 223(1)" to a reference to "section 223" as a consequence of the renumbering of the subsections of section 223. This amendment is retroactive to the date of the introduction of section 225.1, which is applicable with respect to notices of assessment mailed after 1984.

Clause 171

Collection in Jeopardy

ITA
225.2

Existing section 225.2 of the ITA enables the Minister to direct immediate payment and collection of an amount assessed where there are reasonable grounds to believe that a delay in the collection of such an amount would jeopardize its collection. This represents an exception to the rule in section 225.1 which provides that amounts assessed may not be collected until the expiration of the 90 day period a taxpayer has to object to an assessment or to appeal a confirmation or variation of an assessment, or, where the taxpayer files an appeal to the Tax Court of Canada or directly to the Federal Court of Canada, until the court has rendered a judgment. A taxpayer has the right to apply to a judge for a determination as to whether the direction was justified in the circumstances. Section 225.2 is amended to provide that the Minister must obtain judicial approval before he may proceed with immediate collection. This amendment will ensure that adequate safeguards are applied before collection action is taken. A judge hearing an application will decide whether the application is justified on the basis of essentially the same criteria found in existing section 225.2, -- namely, that there are reasonable grounds to believe that the collection of an amount assessed would be jeopardized by a delay in the collection of the amount.

New subsection 225.1(1) defines a judge to whom applications may be made as a judge or a local judge of a superior court of a province or a judge of the Federal Court of Canada.

New subsection 225.2(2) provides that a judge shall, upon being satisfied that there are reasonable grounds to believe that the collection of all or part of an amount assessed would be jeopardized by a delay in the collection thereof, authorize the Minister to take forthwith any of the collection actions described in paragraphs 225.1(1)(a) to (g).

New subsection 225.2(3) provides that an authorization relating to an amount assessed may be granted under subsection (2) even where no notice of assessment has been sent to the taxpayer, provided that the judge hearing the application is satisfied that the receipt by the taxpayer of the notice would likely further jeopardize the collection of the amount. That subsection also provides that an amount in respect of which the authorization is granted will be deemed payable for the purposes of specified sections which set out particular collection measures which may be taken by the Minister.

Under new subsection 225.2(4), statements contained in an affidavit filed in connection with an application under new section 225.2 may be based on belief provided the grounds on which the affiant relies are stated in the affidavit.

In order to ensure that a taxpayer in respect of whom an authorization is issued may ask for a review of the authorization in a timely manner, the Minister is, under new subsection 225.2(5), required to serve a copy of the authorization on the taxpayer within 72 hours of the granting of the authorization, except where a judge orders otherwise. In situations where a notice of assessment has not been sent to the taxpayer at or before the time of the application, the notice of assessment must be served at the same time as the authorization.

New subsection 225.2(6) sets out that service on a taxpayer of an authorization and, where applicable, of a notice of assessment, is to be effected by personal service or in accordance with the direction, if any, of a judge.

Such a direction may be given at the time the authorization is granted, but may also be given pursuant to new subsection 225.2(7) at a later time where service cannot otherwise reasonably be effected as required, in which case the Minister may apply as soon as practicable to a judge for further direction.

Under new subsection 225.2(8), a taxpayer may, upon 6 clear days notice to the Deputy Attorney General of Canada, apply to a judge of the court which granted the authorization for review of that authorization.

New subsection 225.2(9) provides that an application for review must be made within 30 days from the day on which the authorization was served in accordance with the section. The taxpayer may, however, obtain an extension of that time period from a judge upon satisfying him that the application was made as soon as practicable.

By virtue of new subsection 225.2(10), the application for review may, where warranted and upon application of the taxpayer, be heard *in camera*.

New subsection 225.2(11) provides that the judge hearing the application shall determine the question summarily and may confirm, set aside or vary the authorization and make such other order as he considers appropriate.

New subsection 225.2(12) provides that a judge may give whatever direction he considers appropriate where any question arises as to the course to be followed in connection with anything done under section 225.2.

New subsection 225.2(13) provides that no appeal lies from an order of a judge made pursuant to the application for review.

Unlike existing section 225.2, no reference is made in new section 225.2 to the burden of proof on the application or to costs, and the normal rules concerning motions or applications are to be applied. Accordingly, for example, the burden on a review application will lie upon the applicant as is normally the case.

New section 225.2 will become effective upon Royal Assent.

Clause 172

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 172(1)

ITA
227(5)

Subsection 227(4) of the Act provides that amounts withheld from payments made by a payor in respect of taxes payable by the recipient are deemed to be held in trust. Subsection 227(5) of the Act provides that in the event of the liquidation, assignment, receivership or bankruptcy of or by a person, such amounts held in trust are deemed not to form part of the estate of that person notwithstanding the provisions of the Bankruptcy Act. This rule, however, only applies with respect to the portion of taxes withheld that represents federal taxes. The amendment to subsection 227(5), effective after Royal Assent to the enacting legislation, extends that rule to the portion of taxes withheld that represents provincial taxes that the federal government collects in the name of a province under a tax collection agreement.

Subclause 172(2)

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% of the amount not deducted or withheld and a second or further occurrence penalty will be 20% of that amount. The 20% 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), which 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 172(3)

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 15th 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 the Act 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 172(4)

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% 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% of the amount not remitted or paid and a second or further occurrence penalty will be 20% of that amount. The 20% 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 172(5)

ITA
227(9.2) to (9.4)

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.

New subsection 227(9.4) of the Act provides that a person who fails to remit an amount as and when required under the Act or regulations is liable to pay that amount as tax under this Act on behalf of the payee. Subsection 227(9.4) restates the obligations to remit an amount deducted or withheld as provided in subsections 153(1) and 215(1) of the Act. This subsection, in conjunction with subsection 227(10.1), enables the Minister to assess the unremitted source deductions against the person who fails to remit, together with interest and penalties in respect thereof.

Subclauses 172(6) and (7)

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), (9.3) and (9.4), empower the Minister to assess amounts imposed under those provisions. These amendments are applicable to assessments issued after Royal Assent.

Subclause 172(8)

ITA
227(14)

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

Clause 173

Liability of Directors

ITA
227.1(2)(a)

Under section 227.1 of the Act, a director of a corporation becomes liable to pay an amount owing by the corporation if certain conditions are satisfied. Such an amount would generally be in respect of source deductions or non-resident withholding tax that the corporation failed to deduct or withhold or failed to remit as required under the Act. The conditions that trigger the director's liability are set out in subsection 227.1(2) of the Act. The first condition, which is set out in paragraph 227.1(2)(a), is that a certificate for the amount has been made by Revenue Canada, Taxation and has been registered in the Federal Court of Canada under subsection 223(2) of the Act, and execution for the amount has been returned unsatisfied in whole or in part. The amendment to paragraph 227.1(2)(a) changes the reference in that paragraph to "subsection 223(2)" to a reference to "section 223" as a consequence of the renumbering of the subsections of section 223. This amendment is retroactive to the date of the introduction of section 227.1, which is applicable with respect to amounts required to be deducted and remitted, or withheld and remitted, after November 12, 1981.

Clause 174

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 175

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 176

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 or 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 substantially all information or documents 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 10 documents required, that person may be prohibited from introducing into evidence any of the 10 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. It is not as much the quality of the documents supplied as their relevance that should be taken into account in assessing whether there has been substantial compliance. This determination will be made at the proceeding during which the person served with the notice wishes to introduce the documents.

New section 231.6 is applicable upon Royal Assent.

Clause 177

Information Return

ITA
233 and 233.1

Section 233 of the Act enables the Minister of National Revenue to demand the production of any prescribed information return. Because of the introduction of the new foreign-based information reporting obligation under section 233.1 of the Act, it is necessary to amend section 233 so that it can apply to information required under the Act as well as the regulations. This amendment is applicable upon Royal Assent.

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 six 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 whom the corporation did not deal at arm's length at any time in the year. This section is applicable to taxation years ending after Royal Assent.

Clause 178

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 179

Penalty for Failure
to Make Returns

ITA
235

Section 235 of the Act 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 repealed effective upon Royal Assent. This penalty is now provided in subsection 162(7) of the Act and is increased to the greater of $100 and $25 per day of default up to a maximum of 100 days.

Clause 180

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 to every individual (other than a trust) who was resident or employed in Canada at any time in a taxation year and who files a return of income under Part I of the Act, and requires the individual to provide that number for all information reporting purposes established by regulation. 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 written consent of the holder thereof.

These amendments are applicable to the 1988 and subsequent taxation years and to the 1987 taxation year in respect of an individual who files a return of income with a prescribed form under section 122.2 or 122.4 in which he claims either the refundable child tax credit or refundable sales tax credit.

Clause 181

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 calculation 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 a person can sell, issue or accept a contribution towards the acquisition of interests in a tax shelter. The prohibition applies both to persons who sell or issue interests as agents or principals. Preliminary promotions would not offend 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 is 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.

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 who sold, issued or accepted contributions for the acquisition of interests in the tax shelter, whether acting as principal or agent, in respect of all interests acquired from him or for which he accepted contributions in a calendar year. 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 both the agent and his principal are responsible for reporting the same acquisition, a report by one discharges the other.

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 apply to interests acquired after a future day to be fixed well in advance by order of the Governor in Council.

Clause 182

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 subject to penalties under 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, or both the fine and imprisonment for up to 12 months.

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 183

Offences

ITA
239

Section 239 of the Act establishes various offences involving wilful contraventions and other contraventions that are considered serious.

Subclause 183(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% 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% of the amount of tax sought to be evaded. This amendment is applicable to offences committed after Royal Assent.

Subclause 183(2)

ITA
239(2) to (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, in addition to any penalty otherwise provided, 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% and a maximum of 200% of the amount of tax sought to be evaded and to imprisonment for a term not exceeding five years. 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% and not more than 200% 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 provide penalties in respect of 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 184

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 184(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 184(2)

ITA
241(4)(h.1) and (h.2)

New paragraph 241(4)(h.1) 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)(h.2) 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 184(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 185

Procedure and Evidence

ITA
244

Section 244 of the Act provides certain procedural and evidentiary rules relating to the enforcement of the Act.

Subclause 185(1)

ITA
244(4)

Subsection 244(4) of the Act currently provides that an information or complaint under the provision of the Criminal Code relating to summary convictions, in respect of an offence under the Income Tax Act, may be laid on or before the later of a day 5 years from the time when the matter of the information or complaint arose or within one year from the day on which evidence sufficient in the opinion of the Minister to justify a prosecution for the offence came to his knowledge. Existing subsection 244(4) also provides that a certificate made by the Minister as to the day on which such evidence came to his knowledge is conclusive evidence thereof. Subsection 244(4) as amended eliminates the unlimited extension of the limitation period which is linked to the Minister's knowledge, and substitutes an eight years limitation period which commences on the day on which the matter of the information or complaint arose.

Subsection 244(4) as amended will become effective on Royal Assent.

Subclause 185(2)

ITA
244(14)

Subsection 244(14) 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. This subsection 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 186

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, that 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 having regard to 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 having regard to the provisions 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 of concern in relation to gifts of property only where the transfer is to a spouse or child under 18 years of age. The attribution rules are not intended to apply to 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).

Section 245 of the Act is applicable 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 or certain transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation as to the tax consequences thereof.

Clause 187

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, at any time, 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 in the taxation year in which the benefit has been conferred or, if the taxpayer is a non-resident, shall be deemed for the purposes of Part XIII to be a payment made to the taxpayer at that time in respect of property, services or otherwise depending on the nature of the benefit. Thus, Part XIII withholding tax may apply depending on that nature.

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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof. This parallels the coming-into-force of new section 245.

Clause 188

Dividend Stripping and Associated Corporations

ITA
247

Section 247 relates to transactions undertaken to reduce or eliminate tax otherwise payable under the Act.

Subclause 188(1)

ITA
247(1)

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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation or opinion as to the tax consequences thereof. This parallels the coming-into-force of new section 245.

Subclause 188(2)

ITA
247(2) and (3)

Subsection 247(2) of the Act sets out an anti-avoidance rule that treats two or more corporations as being associated corporations where one of the main reasons for their separate existence was for tax purposes.

The repeal of subsections 247(2) and (3) is merely consequential as subsection 247(2) is substantially re-enacted in section 256 -- the section of the Act in which the other rules are located for determining the circumstances in which corporations will be regarded as associated.

For the purposes of determining whether two or more corporations are associated with each other, the repeal will be effective for taxation years commencing after 1988 where the taxation years of all such corporations commenced after 1988. It will be effective also for the 1989 taxation years of such corporations where at least one of the corporations was incorporated or formed as a result of an amalgamation after February 10, 1988 or acquired after February 10, 1988 from a person with whom it was not dealing at arm's length all or substantially all of the assets used by it in its business. It will also be effective for the 1989 taxation years of such corporations where the 1989 taxation year of at least one of the corporations does not end on approximately the same calendar date in 1989 as the calendar date in 1987 on which a 1987 taxation year, if any, of that corporation ended.

Clause 189

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 189(1)

ITA
248(1)

Subclause 189(1) amends several definitions currently contained in subsection 248(1).

"amount"

The amendment to the definition of "amount" in subsection 248(1) of the Act is consequential on the addition of new Parts IV.1 and VI.1 to the Act relating to taxable preferred shares. The amendment adds to this definition a reference to sections 187.2, 187.3 and 191.1 and subsections 258(3) and (5) for the purpose of determining the amount of a stock dividend. Thus, for the purposes of the Act, where the new Part IV.1 taxes or the special rules that deny the intercorporate dividend deduction in respect of certain shares apply with respect to a stock dividend paid by a corporation, the amount of the stock dividend will be the greater of the amount of the resultant increase in the corporation's paid-up capital and the fair market value of the shares paid as a stock dividend at the time of payment. However, where the new Part VI.1 tax provided by section 191.1 applies with respect to a stock dividend, the same rule will apply only for the purposes of Part VI.1. This amendment is applicable with respect to dividends paid after June 18, 1987.

"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 and new paragraph 110.6(14)(f) 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. New paragraph 110.6(14)(f) provides a similar rule for the purposes of the holding period requirement in the definition "qualified small business corporation share" in section 110.6 of the Act. Paragraph 110.6(14)(f) requires shares issued from treasury to a person or partnership to be held for a full 24 month period unless the shares were issued as consideration for other shares, in exchange for all or substantially all of the assets used in an active business or in exchange for interests in active business partnerships.

"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 or certain other transactions in respect of which the taxpayer has received from Revenue Canada, before April 13, 1988, a written confirmation as to the tax consequences thereof. 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.

"short-term preferred share"

The definition of "short-term preferred share" is to be amended with respect to shares issued after December 15, 1987.

Under existing subsection 112(2.3) of the Act dividends received by a corporation on a short-term preferred share are not deductible in computing its taxable income unless the corporation does not deal at arm's length with the dividend-paying corporation. In general, a share which was issued in lieu of commercial paper or short-term debt and that may be retracted within 18 months of its issue falls within the existing definition of short-term preferred share.

Subsection 112(2.3) is repealed with respect to dividends paid on short-term preferred shares issued after 8:00 p.m. EDT, June 18, 1987. Dividends paid on short-term preferred shares (other than grandfathered shares) issued after December 15, 1987 will be subject to a 66 2/3% tax provided under new Part VI.1.

The amended definition of short-term preferred share generally applies to shares issued after December 15, 1987. The condition that the share be issued in lieu of commercial paper or short-term debt is no longer included in the definition. In addition, under paragraph (a), the 18-month retraction period is extended so that a share will be a short-term preferred share if the issuing corporation or a specified person in relation to the issuer may under the terms of the share or an agreement in respect of the share be required to redeem, acquire or cancel the share or to reduce its paid-up capital within 5 years of the date of issue. A share will not be a short-term preferred share by reason only of paragraph (a) if the requirement to redeem, acquire or cancel the share arises solely in the event of the death of the shareholder or a shareholder of the shareholder or on a conversion or exchange of the share. An agreement to acquire a share for an amount that does not exceed its fair market value at the time of the acquisition will not in itself cause a share to be a short-term preferred share.

Paragraph (b) of the new definition provides that a short-term preferred share also includes a share that is convertible or exchangeable within 5 years from the date of its issue except in those circumstances where the share of a corporation is convertible or exchangeable only into a share of the issuing corporation or a related corporation that if issued would not be a short-term preferred share, or into a right or warrant to acquire such a share that is not a short-term preferred share, and all the consideration receivable upon the conversion or exchange is the share, right, warrant or a combination thereof.

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

The amended definition of short-term preferred share applies only to shares issued after December 15, 1987. However, where the terms or conditions of a share (or any agreement in respect of that share) relating to any matter referred to in any of paragraphs (a), (b), (f) and (h), are established or changed after that time, paragraph (c) will treat the share as having been issued at that later time.

Paragraph (d) is similar to paragraph (h) of the existing short-term preferred share definition. This paragraph anticipates the possibility that a share may be issued in combination with a debt obligation or another short-term preferred share in order to circumvent the new Part VI.1 tax. Where one of the main purposes of the issue of the share or modification of its terms and conditions is to avoid or limit the taxes payable under new Part VI.1, this paragraph treats the share as a short-term preferred share.

Paragraph (e) treats a share as a short-term preferred share if, after December 15, 1987, the terms of the share are established or modified or any agreement in respect of the share has been changed or entered into so that it is reasonable to expect that the share will be redeemed within 5 years of its date of issue. This might apply, for example, in the case of a redeemable share issued for an indefinite term but on which the rate of dividends or redemption premium is scheduled to increase sharply at some time within 5 years from its date of issue. In this case the share could reasonably be expected to be redeemed before any such increase would take effect. In circumstances where the reasonable expectation ceases to exist, for example, where the term providing for an increase in the rate of dividends is deleted, this paragraph ceases to treat the share as a short-term preferred share.

Paragraph (f) treats a share issued after December 15, 1987 as a short-term preferred share in circumstances where there is an arrangement under which the issuing corporation will dissolve or wind-up within 5 years from the date on which the share was issued unless the share is a grandfathered share and the arrangement is a written arrangement entered into before December 16, 1987.

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

Paragraph (h) of the definition will treat a share as a short-term preferred share where any person (other than the issuing corporation or an individual) is obligated by the terms or conditions of the share or by an agreement to which the issuing corporation or a specified person in relation thereto is a party to effect any undertaking within five years of the issue of the share which guarantees all or part of the shareholder's investment against any loss that he may suffer in respect of the share. For the purpose of this rule, the share is treated as having been issued at the time the guarantee agreement is given.

Paragraph (i) excludes from the definition of short-term preferred share a prescribed share and a share issued by a corporation in financial difficulty (described in paragraph (e) of the definition "term preferred share").

Paragraph (j) provides that the expression "specified person" has the meaning assigned to it by paragraph (h) of the definition of taxable preferred share and means, in relation to a corporation, any other person with whom the corporation does not deal at arm's length or any partnership or trust of which the corporation or any such other person is a member or beneficiary.

The new definition of short-term preferred share applies with respect to shares issued or deemed to have been issued after December 15, 1987.

Subclause 189(2)

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.

Subclauses 189(3) and (4)

"income bond"

The changes to subparagraph (c)(iii) of the definition of "income bond" clarify that where a corporation issues an income bond in exchange for a debt obligation, all or substantially all of the income bond proceeds must be used to repay the debt obligation.

The changes to subparagraphs (e)(iv) and (v) of the definition are consequential upon the introduction of a definition of "specified financial institution" in subsection 248(1).

Subclause 189(5)

ITA
248(1)

"mineral resource"

The definition of "mineral resource" is amended to include a deposit of kaolin provided that kaolin is the principal mineral extracted from the deposit. Thus, expenditures incurred in exploring or developing such a deposit will generally be eligible for the same tax treatment as expenditures incurred in exploring or developing a base or precious metal deposit. For example, such expenditures may be eligible for flow-through share treatment. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 189(6)

ITA
248(1)

"small business corporation"

The definition of "small business corporation" in subsection 248(1) of the Act is amended, applicable after Royal Assent, to provide for a fair market value of asset use test. Therefore a corporation will qualify as a small business corporation if all or substantially all of the fair market value of the assets can be attributed to assets set out in that definition.

Subclauses 189(7) to (13)

"term preferred share"

Subparagraph (a)(iv) of the definition of "term preferred share" provides that a share will be considered a term preferred share where it is convertible into debt or another term preferred share. This conversion provision has been changed to correspond to similar conversion provisions in the definitions of "short-term preferred share" and "taxable preferred share". Under new subparagraph (a)(iv), a share will be considered to be a term preferred share if it is convertible or exchangeable unless the share is convertible or exchangeable only into a share of the corporation or a related corporation that if issued would not be a term preferred share or a right or warrant to acquire such a share, and all the consideration receivable upon the conversion or exchange is the share, right, warrant or combination thereof. The changes to subparagraphs (a)(i) and (ii) of this definition are consequential upon the amendment to subparagraph (a)(iv).

The amendments to paragraph (b) of the definition "term preferred share" are consequential upon the introduction of the definition of "specified financial institution" in subsection 248(1).

Paragraph (e) of the definition of "term preferred share" in subsection 248(1) of the Act excludes shares issued by a corporation in financial difficulty. The amendment to subparagraph (e)(iii) of the definition, applicable to shares issued after 8:00 p.m. EDT, June 18, 1987, clarifies that if a corporation is, or is expected to be, in default on a debt obligation and a share is issued in exchange for the obligation, the share will be excluded from the definition only if all or substantially all of the share issue proceeds are used to repay all or part of the debt.

New paragraph (f.1) will exclude from this definition a taxable preferred share acquired before December 16, 1987 if the share was issued between June 18, 1987 and December 16, 1987 (other than a share deemed to have been issued after December 15, 1987 by reason of a change of its terms or conditions or by reason of an agreement being changed or entered into). The draft legislation released on June 18, 1987 excluded taxable preferred shares from the definition of term preferred share. Taxable preferred shares issued after December 15, 1987 are not excluded from the definition term preferred share unless they were acquired by the shareholder before December 15, 1987 or after December 15, 1987 and before 1989 pursuant to an agreement in writing entered into before December 16, 1987. This amendment is applicable after June 18, 1987.

Section 6201 of the draft regulations released on April 21, 1988 would prescribe the shares for the purpose of the exclusion in paragraph (f) of this definition. Under that regulation a publicly-listed share issued after 8:00 p.m. EDT, June 18, 1987 will not be a term preferred share where the corporate recipient of a dividend on the share and persons with whom that corporation does not deal at arm's length (referred to herein as the group) receive dividends in respect of not more than 10% of the issued and outstanding shares of the class, other than shares held by a securities dealer that are prescribed under subsection 6201(5) as described below.

Where, however, a dividend is received by a restricted financial institution on a share that is not a taxable preferred share and any of the shares of that class owned by the restricted financial institution and other restricted financial institutions with which it does not deal at arm's length were acquired after December 15, 1987, that share will be a prescribed share only if the total holding of the group of restricted financial institutions at the time does not exceed 5% of the shares of that class, other than shares held by a securities dealer that are prescribed under subsection 6201(5) as described below.

In addition, a special provision applies for shares acquired as inventory of a business ordinarily carried on by a corporation that is a specified financial institution or a restricted financial institution and that is registered or licenced under the laws of a province to trade in securities. A share will be a prescribed share with respect to such a corporation for the purposes of paragraph (f) of the definition of "term preferred share" in subsection 248(1) of the Act where it is acquired for the purpose of a primary distribution to the public or, where the shares are not acquired as part of a primary distribution, dividends are not received by the corporation or the corporation and corporations controlled by it in excess of the prescribed limits.

Subsection 6201(8) of the draft regulations provides transitional rules applicable to determine whether shares are to be considered as having been acquired before December 16, 1987. These rules are described in the commentary on the definition of "taxable RFI share" in subsection 248(1) of the Act.

The changes to subparagraphs (h)(iv) to (vi) of the definition "term preferred share" are consequential upon the introduction of the definition of "specified financial institution" in subsection 248(1).

Paragraph (i.1) is an anti-avoidance provision that applies where it may reasonably be considered that the dividends on a particular share other than a prescribed share or a share described in paragraph (e) of this definition are derived primarily from dividends received on term preferred shares of another corporation and that the share was issued or acquired in order to avoid or limit the application of subsection 112(2.1) or 138(6) of the Act. Where this is the case, the particular share will be treated as a term preferred share acquired in the ordinary course of business.

As noted above, the definition of term preferred share will not apply with respect to a taxable preferred share issued before December 16, 1987. Where the terms or conditions of a share issued before that time are changed or an agreement in respect of that share is changed or entered into so as to affect any of the matters referred to subparagraphs (a)(i) to (iv) of this definition, new paragraph (i.2) will treat the share as having been issued at the time of the change. This amendment is applicable after June 18, 1987.

The further amendment to the definition of term preferred share deletes the rule relating to interests in trusts. This change is strictly consequential on the addition of new subsection 248(13) dealing with interests in trusts and partnerships. This amendment is applicable to shares issued after 8:00 p.m. EDT, June 18, 1987.

Subclause 189(14)

ITA
248(1)

Subclause 185(13) 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 taxpayers' 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 nine people (including the driver) and a motor vehicle that is a station wagon or van if it is equipped to carry more than the driver and two passengers but not more than the driver and eight passengers. A van or pick-up truck acquired primarily for the purpose of transporting goods or equipment in the course of earning income is excluded from the definition. Vehicles such as an ambulance, a motor vehicle acquired for use as a taxi or in connection with funerals, and (other than for purposes of paragraph 6(1)(e) - the standby charge) motor vehicles acquired for the purpose of selling, renting or leasing such vehicles are also 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.

"grandfathered share"

This amendment adds the definition of "grandfathered share" to subsection 248(1) of the Act. Grandfathered shares are expressly excluded from the application of new subsection 112(2.2) and from the definitions of short-term preferred share and taxable preferred share in subsection 248(1). Under this definition a share is a grandfathered share if it is issued after 8:00 p.m. EDT, June 18, 1987 and it

- was issued pursuant to an agreement in writing entered into before that time;

- was issued as part of a distribution to the public made in accordance with certain documents filed with a public authority before that time;

- was issued on the conversion of a grandfathered share or of a share or debt obligation issued before that time where the terms and conditions of that share were established in writing before that time; or

- is a share of a class of the capital stock of a Canadian corporation that is listed on a stock exchange in Canada and was issued on the exercise of a right or warrant that was similarly listed where the terms and conditions of the share were established in writing before that time.

However, a share ceases to be a grandfathered share if it is deemed to have been issued at any time after June 18, 1987 under subsection 112(2.2) or under the definition of "short-term preferred share", "taxable preferred share" or "term preferred share".

"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 may reasonably be considered to be and 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) and an automobile leased under a lease entered into, extended or renewed in writing after June 17, 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.

"personal trust"

The new definition of "personal trust" is relevant for the new rules relating to trusts and particularly for the purposes of paragraph 53(2)(h), subsections 104(7.1) and (13), 107(1) and (2), paragraph 108(1)(c) and subsection 110.6(11). A personal trust is either a testamentary trust or an inter vivos trust in which no beneficial interest was acquired for consideration payable to the trust or a person who has made a contribution to the trust. However, the mere retention of an interest in an inter vivos trust by the individual or related individuals who settled the trust will not result in the trust not qualifying as a personal trust. This amendment is applicable after 1984.

"restricted financial institution"

This amendment adds the definition of "restricted financial institution" to subsection 248(1) of the Act. This definition is used for the purpose of the new Part IV.1 tax on taxable RFI shares. A restricted financial institution includes a bank, trust company, credit union, insurance corporation, a corporation whose principal business is the lending of money to persons with whom the corporation deals at arm's length or a corporation controlled by one or more such corporations. Unlike the definition of "specified financial institution", this definition does not include a corporation which is related to, but not controlled by, one or more of the financial institutions listed above.

"specified financial institution"

This amendment adds the definition of "specified financial institution" to subsection 248(1) of the Act. The status of a taxpayer as a specified financial institution is relevant for the purposes of subsections 112(2.1) and (2.2), new Parts IV.1 and VI.1 and certain other provisions of the Act. A specified financial institution includes a bank, trust company, credit union, insurance corporation, a corporation whose principal business is the lending of money to persons with whom the corporation deals at arm's length or a corporation controlled by or related to one or more such corporations. This definition is different in two respects from that provided under existing subsection 112(2.1) of the Act. A corporation serving as an internal financing vehicle to a group of related corporations will not, in most circumstances, be considered to be a specified financial institution. In addition, the associated corporation rule has been replaced with a related corporation test in paragraph (g) of the definition.

"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 subsections 96(1) and (1.8) relating to partnership income and 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.

"taxable preferred share"

The definition of "taxable preferred share" is relevant for the purposes of the taxes imposed under new Parts IV.1 and VI.1 of the Act.

This definition includes a share that is a short-term preferred share issued after December 15, 1987. It also includes any share (other than a grandfathered share) that is issued after 8:00 p.m. EDT, June 18, 1987 where:

- it may reasonably be considered that the amount of any dividend on the share is fixed, limited to a maximum or established to be not less than a minimum;
- it may reasonably be considered that the amount that a shareholder is entitled to receive for the share upon the dissolution, liquidation or winding-up of the issuing corporation, or on the redemption, acquisition or cancellation of the share, or on a reduction of the paid-up capital in respect of the share is fixed, limited to a maximum or established to be not less than a minimum;
- the share is convertible or exchangeable except in those circumstances where the share is convertible or exchangeable only into a share of the corporation or a related corporation that if issued would not be a taxable preferred share or a right or warrant to acquire such a share, and all the consideration receivable upon the conversion or exchange is the share, right, warrant or combination thereof; or

- any person, other than the issuing corporation, has undertaken (in an agreement with the issuing corporation or a person related to it) to guarantee the shareholder's investment in the share (for the purpose of this condition where such a guarantee agreement is given after 8:00 p.m. EDT, June 18, 1987 in respect of a share, the share is deemed to have been issued at that time).

Excluded from this definition are prescribed shares or shares issued by a corporation in financial difficulty (described in paragraph (e) of the definition "term preferred share").

Paragraphs (c) to (h) of the definition provide a number of supplementary rules.

Paragraphs (c) and (d) of the definition treat a shareholder's entitlement to dividends or an amount on liquidation of the issuing corporation as not being fixed, limited to a maximum or established not to be less than a minimum where such entitlement is determined by reference to the entitlement of another share of the corporation or of another corporation that controls the corporation, provided the other share would not be a taxable preferred share if this definition were read without reference to paragraph (f), the other share were issued after June 18, 1987, and the other share were not a grandfathered share, a prescribed share or a share issued by a corporation in financial difficulty.

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

Paragraph (f) is a relieving provision that provides that the liquidation entitlement of a shareholder shall not be considered to be fixed, limited to a maximum or established to be not less than a minimum, solely as a result of an agreement to which the corporation or a specified person with respect to the corporation is a party, such as a shareholders' agreement, under which a purchaser agrees to acquire the share for an amount that is not greater than its fair market value at the time of the acquisition.

Paragraph (g) is an anti-avoidance rule that prevents the use of holding corporations to avoid the new Part IV.1 and VI.1 taxes. This rule deems a share to be a taxable preferred share where:

- the share is not a prescribed share or a share described in paragraph (e) of the definition "term preferred share" and has been issued after December 15, 1987 or acquired after June 15, 1988;

- the dividends on the share may reasonably be considered to be derived primarily from dividends on taxable preferred shares of a corporation; and

- the share was issued or acquired to avoid the application of new Parts IV.1 and VI.1.

Paragraph (h) provides that the expression "specified person" used throughout the definition means any person with whom the corporation does not deal at arm's length or any partnership or trust of which the corporation or the other person is a member or beneficiary.

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

"taxable RFI share"

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

A taxable RFI share is a share issued before 8:00 p.m. EDT, June 18, 1987 or a grandfathered share where

- it may reasonably be considered that the amount of any dividend on that share is either fixed, limited to a maximum or established to be not less than a minimum; or

- it may reasonably be considered that the amount that a shareholder is entitled to receive for the share upon the dissolution, liquidation or winding-up of the issuing corporation is fixed, limited to a maximum or established to be not less than a minimum.

Excluded from the definition are shares which are prescribed shares, taxable preferred shares, term preferred shares or shares issued by a corporation in financial difficulty as described in paragraph (e) of the definition "term preferred share".

Paragraphs (c) and (d) of the definition treat a shareholder's entitlement to dividends or an amount on liquidation of the issuing corporation as not being fixed, limited to a maximum or established to be not less than a minimum where such entitlement is determined by reference to the entitlement of another share of the corporation or of another corporation that controls the corporation provided the other share would not be a taxable preferred share if that definition were read without reference to paragraph (f), the share were issued after June 18, 1987, and the share were not a grandfathered share, a prescribed share or a share issued by a corporation in financial difficulty.

Paragraph (e) of the definition is an anti-avoidance provision that applies where it may be reasonably be considered that the dividends on a particular share other than a prescribed share or a share described in paragraph (e) of the definition "term preferred share" are derived primarily from dividends received on taxable RFI shares of another corporation and that the particular share was issued or acquired in order to avoid or limit the application of new Part IV.1. Where this is the case, the particular share will be treated as a taxable RFI share.

Since taxable RFI shares cannot by definition be term preferred shares, restricted financial institutions holding such shares are generally entitled to the intercorporate dividend deduction under subsection 112(1) for dividends received on such shares. Subsection 187.3(1) imposes a 10% tax on dividends received after 1987 on taxable RFI shares acquired after 8:00 p.m. EDT, June 18, 1987 other than shares deemed to have been acquired before that date under subsection 187.3(2) (see commentary on that provision).

The definition of taxable RFI shares provides an exclusion for prescribed shares. For this purpose Subsection 6201(4) of the draft regulations released on April 21, 1988 provides that certain publicly listed shares would not be taxable RFI shares. Under that regulation a share of a class of the capital stock of a corporation will be a prescribed share at the time a dividend is received with respect to a corporation holding the share if the aggregate holdings of the corporation and restricted financial institutions with which the corporation does not deal at arm's length (referred to herein as the group) do not exceed certain limits.

If, at the time a dividend is received by a corporation with respect to shares of a class, none of the shares of the class owned by any member of the group (other than those acquired from another member of the group) were acquired after December 15, 1987 those shares will be prescribed shares only if the total group holding at the time does not exceed 10% of the shares of that class, other than shares held by a securities dealer that are prescribed under subsection 6201(5) as described below.

If, at the time a dividend is received by a corporation with respect to shares of a class, any of the shares of the class owned by the corporation and any other member of the group (other than those acquired from another member of the group) were acquired after December 15, 1987, those shares will be prescribed shares only if the total group holding does not exceed 5% of the shares of the class at that time, other than shares held by a securities dealer that are prescribed under subsection 6201(5) as described below.

In addition, a special provision applies for shares acquired as inventory of a business ordinarily carried on by a corporation that is a restricted financial institution or a specified financial institution and that is registered or licenced under the laws of a province to trade in securities. A share will be a prescribed share with respect to such a corporation for the purposes of the definition of "taxable RF1 share" in subsection 248(1) of the Act where it is acquired for the purpose of a primary distribution to the public or, where the shares are not acquired as part of a primary distribution, dividends are not received by the corporation or corporations controlled by it in excess of the prescribed limits.

The rule in Regulation 6201(6) provides that shares disposed of will be considered to be disposed of on a last-in, first-out basis.

Draft regulation 6201(8) provides rules applicable to determine whether shares may be deemed to be acquired before December 16, 1987 in the following circumstances:

- shares acquired after December 15, 1987 pursuant to an agreement in writing entered into before December 16, 1987 or as part of a public distribution made pursuant to documentation filed before December 16, 1987;

- shares acquired after December 15, 1987 by a restricted financial institution from a related restricted financial institution; and

- shares acquired after December 15, 1987 by reason of an amalgamation of two or more corporations described in any of paragraphs (a) to (d) of the definition "restricted financial institution".

The definition of taxable RFI share is applicable after June 18, 1987.

"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 189(15)

ITA
248(6)

Subsection 248(6) of the Act extends all references to a class of shares to a series of the class of shares. The amendment to that subsection clarifies that this rule also applies where a single series of a class of shares has been issued.

Subclause 189(16)

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 189(17)

ITA
248(12) to (14)

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.

New subsection 248(13) of the Act treats a person having a direct or indirect interest in a trust or partnership as being a beneficiary or member, as the case may be, of that trust or partnership for the purposes of a number of definitions and rules in the Act.

Subsections 112(2.1) and (2.2) of the Act deny the inter-corporate dividend deduction under subsections 112(1) and (2) with respect to certain dividends received on term preferred shares by specified financial institutions and certain dividends received by any corporation on shares guaranteed by specified financial institutions. The term "specified financial institution" is defined in amended subsection 248(1) of the Act to include financial institutions and any corporation related to a financial institution. New subsection 248(14) of the Act is an anti-avoidance rule intended to treat two or more corporations as being related for the purposes of the definition "specified financial institution" where the corporations are not otherwise related but one of the main reasons for the separate existence of the corporations may reasonably be considered to limit or avoid the application of subsection 112(2.1) or (2.2) or 138(6).

Clause 190

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 190(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 dependent child tax credit. This amendment is applicable to the 1988 and subsequent taxation years.

Subclause 190(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 191

Related Persons

ITA
251

Section 251 of the Act deals with the concept of arm's length and defines the circumstances in which persons, including corporations, will be regarded as related for tax purposes.

Subclause 191(1)

ITA
251(5)

Subsection 251(5) sets out three special rules that are relevant for the purposes of determining control of a corporation.

Three amendments have been made to subsection 251(5). The first is merely consequential and effectively provides, by deleting the reference to section 256, that the special rules in subsection 251(5) do not apply for the purposes of the associated corporation rules because similar special rules for the purposes of the associated corporation provisions are set out in new subsections 256(1.2), (1.4) and (1.5) and are discussed in the commentary on those provisions.

The second amendment expands the scope of paragraph 251(5)(b). That paragraph currently applies in certain circumstances to treat a person who has a right to acquire shares in a corporation or control the voting rights of shares in a corporation as being in the same position in relation to the control of the corporation as if he owned the shares. New subparagraph 251(5)(b)(ii) applies a similar rule to a person who has a right to cause a corporation to redeem, acquire or cancel shares of its capital stock owned by other shareholders of the corporation. In such a case, that person will be treated as being in the same position in relation to the control of the corporation as if the shares were redeemed, cancelled or acquired by the corporation.

The third amendment restricts the scope of paragraph 251(5)(b). An exception is provided in paragraph 251(5)(b) where the contract provides that the right to acquire the shares or control the voting rights of the shares is not exercisable until the death of an individual designated therein. This exception has been broadened, in both of the subparagraphs, to apply also where the right is not exercisable until the bankruptcy or permanent disability of an individual designated in the contract. This amendment is of a relieving nature and is intended to accommodate provisions frequently found in shareholders' agreements governing the purchase and sale of shares.

These amendments will be effective for taxation years commencing after 1988. They will also be applicable to the 1989 taxation year commencing in 1988 of a corporation in any case where it was incorporated or formed as a result of an amalgamation after February 10, 1988, where it acquired after February 10, 1988 from a person with whom it did not deal at arm's length all or substantially all of the assets used by it in its business, or where its 1989 taxation year did not end on approximately the same calendar date in 1989 as the calendar date in 1987 on which a 1987 taxation year, if any, of the corporation ended.

Subclause 191(2)

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 192

Interpretation

ITA
252

Section 252 provides an extended meaning of the terms "child", "parent", "spouse" and "former spouse" for the purposes of the Act.

Subclause 192(1)

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.

Subclause 192(2)

ITA
252(3)

This amendment is strictly consequential on the new definition of "designated beneficiary" in section 210. The amendment provides for an extended meaning of "spouse" and "former spouse" for these purposes and is effective after 1987.

Clause 193

Associated Corporations

ITA
256

Section 256 of the Act establishes certain rules for determining whether corporations are considered to be associated, as well for determining whether control of a corporation has been acquired for the purposes of the Act.

Subclause 193(1)

ITA
256(1) to (2.1)

Subsection 256(1) contains the basic rules for determining the circumstances under which two corporations are considered to be associated with each other for purposes of the Act.

Under subsection 256(1), the essential test which determines association relies on control. The new rules extend the use of the concept of control to control <u>directly or indirectly in any matter whatever</u>. Under the existing rules, control of a corporation generally exists by reason of the ability to elect a majority of the directors of the corporation. Under the new rules, in addition to being able to exercise control in such manner, it is intended that corporations will be associated when control can be exercised in any manner whatever, including circumstances where control in fact exists by reason of a person having any direct or indirect influence, as provided for under new subsection 256(5.1). Such manner of control is sometimes referred to as <u>de facto</u> or actual control, and is discussed in the commentary concerning new subsection 256(5.1).

Paragraphs 256(1)(c), (d) and (e) have been further amended in several respects. First, the references therein to ownership "directly or indirectly" have been deleted in light of the explicit rules relating to indirect ownership as set out in new paragraphs 256(1.2)(d), (e) and (f) and new subsections 256(1.3) and (1.4). Second, the cross-ownership threshold for the purposes of the special rules applicable to ownership of shares by related persons has been increased from 10% to 25% of the shares of any class. Third, specified classes of shares, as defined in new subsection 256(1.1), will be exempted from the cross-ownership test. A class of shares will be a specified class for this purpose if

(1) the shares are neither convertible nor exchangeable,

(2) the shares are non-voting,

(3) dividends payable on the shares are fixed in amount or rate,

(4) the annual rate of the dividend on the shares, expressed as a percentage of the fair market value of the consideration for which the shares were issued, does not exceed the prescribed rate of interest at the time the shares were issued, and

(5) the amount that a holder of the shares is entitled to receive on their redemption, cancellation or acquisition by the corporation or a person with whom the corporation does not deal at arm's length does not exceed the fair market value of the consideration for which the shares were issued plus any unpaid dividends.

These changes will permit a person to invest funds in a corporation controlled by a related person -- such as a spouse or child -- without subjecting his own corporation to a reduced small business deduction, provided that the investment takes the form of fixed-rate, non-voting, preferred shares or constitutes less than 25% of the issued shares of any class.

Paragraph 256(1)(d) is applicable in the case where a person who controls a corporation is related to each member of a group of persons who control a second corporation. Under the existing law, the cross-ownership test is applied where the person owns shares of the corporation controlled by the group or where the group owns shares of the corporation controlled by the person. As a result of the amendments to paragraph 256(1)(e) and the introduction of new paragraphs 256(1.2)(a) and (b), the latter situation -- where the group owns shares of the corporation controlled by the person -- is accommodated in paragraph 256(1)(e) and has therefore been removed from the operation of paragraph 256(1)(d).

Paragraph 256(1)(e), applicable to corporations controlled by related groups, is further amended to provide that the cross-ownership test will be met where " ...one or more persons who were members of both related groups, either alone or together, owned..." not less than 25% of the issued shares of any class of the capital stock of each corporation (other than shares of a specified class). This change from the existing law, which requires that "...either of the related groups owned...", clarifies that the two corporations would be associated where, for example, ownership of 25% of the shares of a class of the capital stock of each corporation rests with one person who is a member of both related groups.

New subsection 256(1.2) contains special rules for the purposes of determining whether a corporation will be considered to be controlled for purposes of the new associated corporation rules.

New paragraph (1.2)(a) provides that in determining whether a corporation is controlled by a group of persons, a group, in respect of that corporation, means any two or more persons each of whom owns shares of the capital stock of the corporation.

New paragraph (1.2)(b) provides that a corporation can be considered to be controlled by a person or particular group of persons notwithstanding that the corporation is also controlled by another person or group of persons. As a consequence, under this paragraph, a corporation can be considered to be controlled at the same time by several persons or groups of persons. Paragraph (1.2)(b) also provides that where a group of persons owns shares of the capital stock of a corporation, the fact that an individual member of the group owns, by himself, enough shares to control the corporation will not alter the fact that the group also controls the corporation.

New paragraph (1.2)(c) represents a substantial change from the existing rules and provides that a person or group of persons will be treated as controlling a corporation where the person or group owns shares representing more than 50% of the fair market value of all the issued and outstanding shares of the corporation, or common shares representing more than 50% of the fair market value of all the issued and outstanding common shares of the corporation. For purposes of making this valuation, paragraph 256(1.2)(g) and new subsection 256(1.6), described below, provide that voting rights and shares that qualify under paragraph (e) of the definition "term preferred share" (financial difficulty shares) or under new subsection (1.1) (specified shares) are to be disregarded.

New paragraph (1.2)(d) provides a "look through" or attribution rule where shares are held by one corporation in another corporation. It treats a shareholder of a corporation that holds shares of another corporation as owning such of those shares as is proportionate to the value of his holdings in the holding corporation. For purpose of determining that proportion, voting rights, financial difficulty shares and specified shares are to be disregarded.

New paragraph (1.2)(e) provides a similar "look-through" rule for shares that are property of a partnership. It treats a member of a partnership that holds shares of a corporation as owning such of those shares as is proportionate to his income interest in the partnership. Where both the income and loss of a partnership in a fiscal period are nil, so that a member's income interest is not determinable, paragraph (1.2)(e) provides that this proportion is to be determined as if the partnership had income of $1,000,000 in that period.

New paragraph (1.2)(f) provides a similar "look-through" rule where shares are held by a trust. It treats shares of a corporation held by a trust to be owned by its beneficiaries and, in one case, by the person from whom trust property was received. In the case of a testamentary trust under which some beneficiaries are entitled to all income of the trust prior to the death of one or all of them and no other person is entitled to any capital of the trust before that time, the shares are deemed to be owned by such beneficiaries before that time. In the case of a discretionary trust, all discretionary beneficiaries are deemed to own the shares. In any other case, each beneficiary is deemed to own a proportion of the shares based on the fair market value of his interest in the trust. In addition, where a trust is one referred to in subsection 75(2) of the Act -- such as a "reversionary" trust -- the person from whom property of the trust was received is also deemed to own the shares. The result of the application of these provisions may be that more than one person can be deemed to own the same shares at the same time. In addition, of course, the shares are actually held by the trustees of the trust and the new rules do not negate this fact.

New paragraph (1.2)(g) provides that the various fair market valuations that may be required to be made under the new "look-through" or attribution rules are to be made without regard to the voting attributes of all shares of the capital stock of a corporation. Particularly in the case of closely held private corporations, assigning a value to such voting rights could be very difficult and result in inappropriate consequences.

New subsection 256(1.3) is an attribution rule which provides that shares of a corporation owned by a child, or treated as being owned by a child under one of the other provisions of the section, shall be treated as being owned by a parent of the child for the purposes of determining whether the corporation is associated with any other corporation controlled by that parent. Where the parent is a member of a group of persons which controls a corporation, shares of the corporation owned by the child shall be treated as being owned by the group for the purposes of determining whether the two corporations are associated. An exception to this provision is provided where the child manages the business and affairs of the corporation without a significant degree of influence by the parent.

New subsection 256(1.4) incorporates into the provisions relating to associated corporations, the special rules in paragraph 251(5)(b) of the Act, as amended, dealing with rights to acquire shares. Subsection 256(1.4) provides, in paragraph (a), that anyone having an option or right to acquire shares, or to control the voting rights of shares, shall be treated as owning those shares, except where the option or right is not exercisable until the death, bankruptcy or permanent disability of an individual. As is the case for the amendment to paragraph 251(5)(b), which provides the exception for rights exercisable on the bankruptcy or permanent disability of an individual, these changes are of a relieving nature and are intended to accommodate provisions frequently found in shareholders' agreements governing the purchase and sale of shares. New paragraph 256(1.4)(b) applies a similar rule to a person who has a right to cause a corporation to redeem, acquire or cancel shares of its capital stock owned by other shareholders of the corporation. In such a case, that person will be treated as being in the same position in relation to control of the corporation and ownership of its shares as if the shares were redeemed, acquired or cancelled by the corporation.

New subsection 256(1.5) will re-enact, for the purposes of subsections 256(1) to (5.1), existing paragraph 251(5)(c) of the Act. This subsection treats a person as being related to himself in his capacity as shareholder of two or more corporations.

New subsection 256(1.6) provides that shares described in paragraph (e) of the definition "term preferred share" in subsection 248(1) of the Act (financial difficulty shares) and shares of a specified class within the meaning of new subsection (1.1) are to be disregarded for purposes of making the fair market valuations required in subsection 256(1.2). An amount equal to the greater of the paid-up capital of such shares and their redemption value will be treated as a liability of the corporation.

New subsection 256(2) is similar to the existing rule that treats two otherwise unassociated corporations as being associated with each other if they are both associated with the same third corporation. However, the new rule provides an exception, for the purposes of the small business deduction, where the third corporation does not claim a small business deduction, either because it explicitly elects not to qualify for that deduction or because it in fact does not qualify for the small business deduction because it is not a "Canadian-controlled private corporation".

New subsection 256(2.1) is substantially similar to existing subsection 247(2). The existing procedure requiring Ministerial direction is unnecessarily cumbersome and has been repealed. In addition, the business purpose test for the separate existence of corporations contained in existing paragraph 247(2)(a) has been repealed as it is effectively subsumed by the condition contained in existing paragraph 247(2)(b) which will be substantially re-enacted. This anti-avoidance rule is intended to apply where two or more corporations are not otherwise associated but one of the main reasons for their separate existences may reasonably be considered to be to duplicate the small business deduction or increase their refundable investment tax credits. This provision would apply, for example, where two parts of what could reasonably be considered to be one business, such as the manufacturing and sales activities of a single business, were carried on by two corporations each of which was controlled by different persons. In such a case, where it is reasonable to conclude that the separate existence of the corporations was mainly tax motivated, the corporations will be treated as associated with each other. As a result, only one small business deduction will be allowed in respect of the income generated by the business.

For the purposes of determining whether two or more corporations are associated with each other, the new rules will be effective for taxation years commencing after 1988 where the taxation years of all such corporations commenced after 1988, except in circumstances where existing corporations change their established year-ends or transfer their businesses to new corporations in order to extend the period that they are subject to the existing rules. Accordingly, the new rules will also be applicable to the 1989 taxation years of such corporations where at least one of the corporations was incorporated or formed as a result of an amalgamation after February 10, 1988, or acquired after February 10, 1988 from a person with whom it did not deal at arm's length all or substantially all of the assets used by it in its business. The new rules will also be applicable where the 1989 taxation year of at least one of such corporations does not end on approximately the same calendar date in 1989 as the calendar date in 1987 on which a 1987 taxation year, if any, of that corporation ended. This provision will therefore not be triggered where a Canadian-controlled private corporation had two taxation years ending in 1987 (as a result of the special election available to CCPC's to elect a December 31, 1987 year-end), provided that the corporation subsequently returns to its normal year-end or continues to use a December 31 year-end. The provision also accommodates those corporations whose year-end is not determined by a calendar date -- for example, a corporation whose normal year-end is the last Friday of January.

Subclause 193(2)

ITA
256(3)(b)

Subsection 256(3) of the Act is a saving provision which treats associated corporations as not being associated if it is established to the satisfaction of the Minister that certain conditions set out therein are met. One of these conditions -- set out in paragraph (b) -- is that the chief purpose for the control relationship which triggers the associated status is to safeguard the "controller's" rights in respect of a loan made by it to the controlled corporation or in respect of shares of the controlled corporation owned by it that are to be redeemed by the controlled corporation or purchased by persons dealing at arm's length with the controller.

Two amendments have been made to paragraph 256(3)(b). First, the "chief purpose" test has been narrowed so that for the saving provision to apply, the sole purpose for the control relationship must be to safeguard the controller's rights as described in paragraph (b). This change is consistent with amendments made in 1985 to paragraph 256(6)(b), a similar saving provision. Second, the reference to "any loan made by the controller" in subparagraph 256(3)(b)(i) has been replaced by a reference to "any indebtedness owing to the controller" to broaden the application of the subsection to include indebtedness other than by way of loan.

These changes are applicable to taxation years commencing after 1988.

Subclause 193(3)

ITA
256(5.1)

New subsection 256(5.1) of the Act provides that, for the purposes of the Act, a corporation shall be considered to be controlled, directly or indirectly in any manner whatever, by another corporation, a person or a group of persons (the "controller") where the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation. An exception is provided where the corporation and the controller are dealing at arm's length and the controller's influence is derived from an agreement or arrangement -- such as a franchise, licence, lease, distribution, supply or management agreement -- the main purpose of which is to govern the relationship between the parties regarding the manner in which a business carried on by the corporation is to be conducted.

New subsection 256(5.1) expands the concept of control for certain provisions of the Act to include what is often referred to as de facto control. Under the existing rules, control of a corporation generally exists by reason of the ability to elect a majority of the directors of the corporation -- de jure control. An example of de facto control might be a situation where a person held 49% of the voting control of a corporation and the balance was widely dispersed among many employees of the corporation or was held by persons who could reasonably be considered to act in respect of the corporation in accordance with his wishes. Whether a person can be said to be in actual control of a corporation, notwithstanding that he does not legally control more than 50% of its voting shares, will depend in each case on all of the circumstances.

The exception in subsection 256(5.1) distinguishes between control of the corporation and control over the business carried on by the corporation and clarifies that the de facto control test provided for therein will not be applicable in arm's length situations where the controller's influence derives only from an agreement or arrangement the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is conducted. Thus, for example, a franchise agreement or lease which provides to the franchisor or lessor a measure of control over the products sold by the corporation or the hours during which it conducts its business, would not in itself result in the franchisor or lessor having control over the corporation.

New subsection 256(5.1) applies, effective for taxation years commencing after 1988, to those provisions of the Act which refer to corporations controlled "directly or indirectly in any manner whatever". These provisions include

- subsection 24(2), which provides rules applicable where an individual ceases to carry on a business which is thereafter carried on by a corporation controlled by the individual

- amended paragraphs 40(2)(a), (e) and (h), 44(7)(b) and 87(2)(kk), in respect of capital gains reserves or capital losses

- paragraph 54(i), which defines "superficial loss"

- new subsections 83(2.2) and (2.4) and amended paragraph 89(1)(b) and subsection 89(1.1), which provide rules applicable to the payment of capital dividends

- subsections 85(4) and (5.1), which provide rules applicable to dispositions of property to controlled corporations

- paragraph 95(6)(b), an anti-avoidance provision applicable to foreign affiliates and controlled non-resident corporations

- paragraph 125(7)(b), which defines "Canadian-controlled private corporation"

- the definition of "excluded corporation" in subsection 127.1(2), applicable for purposes of the refundable investment tax credit

- new paragraph 241(4)(j), regarding communication of information and

- amended subsection 256(1) and new subsections 256(1.3) and (1.4), regarding associated corporations.

Several provisions of the Act have been amended, as a consequence of the introduction of subsection 256(5.1), to delete therefrom the words "directly or indirectly in any manner whatever," thus ensuring that de facto control is not applicable in the case of corporations referred to in these provisions. Additionally, the words "directly or indirectly" have been deleted from several provisions which utilize the phrase "controlled directly or indirectly". Those words are generally regarded as being unnecessary. These provisions include

- paragraphs 12(1)(o) and 18(1)(m) and subsections 69(6) and 69(7), in respect of corporations controlled by Her Majesty in right of Canada or a province
- subparagraph 85.1(2)(b)(i), in respect of share for share exchanges
- paragraph 89(1)(f) defining "private corporation"
- paragraph 95(1)(a) defining "controlled foreign affiliate"
- subsection 186(1), in respect of corporations liable for Part IV tax
- paragraph (b) of the definition "term preferred share" in subsection 248(1).

Subclause 193(4)

ITA
256(6)(b)(i)

Subsection 256(6) of the Act is a saving provision which treats a controlled corporation as not being so controlled if the Minister is satisfied that certain conditions set out therein are met. One of the requirements of the subsection is that the purpose for which the controlled corporation was so controlled was to safeguard the "controller's" rights in respect of indebtedness of the controller or certain shares of the capital stock of the controlled corporation owned by the controller.

Subparagraph 256(6)(b)(i) is amended, applicable to taxation years commencing after 1988, by substituting the words "any indebtedness owing to the controller" for "any indebtedness of the controller" to remove any possible ambiguity.

Subclause 193(5)

ITA
256(7)

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 194

Dividends on certain shares

ITA
258

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

Subclause 194(1)

ITA
258(1)

Subsection 258(1) of the Act provides special rules for deemed dividends on term preferred shares. This provision is repealed as a consequence of the introduction of new subsection 84(4.2) to which these rules have been transferred (see commentary on that provision). This amendment is applicable with respect to reductions of paid-up capital after 1987.

Subclause 194(2)

ITA
258(3)

Subsection 258(3) of the Act treats certain dividends received on shares of non-resident corporations as interest. The amendment to paragraph 258(3)(b) simply clarifies the type of shares to which paragraph 258(3)(b) is intended to apply. A further amendment to this subsection restricts its application to corporations resident in Canada. These amendments are applicable to dividends received or deemed under the Act to have been received on shares acquired after 8:00 p.m. EDT, June 18, 1987.

Subclause 194(3)

ITA
258(5)

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

Clause 195

Private Corporation Year-End Election

This clause 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 196

Tax on Financial Institutions

ITA

Part VI

This clause 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 197

ITAR
21(1)

Subsection 21(1) of the Income Tax Application Rules, 1971 currently applies in respect of eligible capital property that is a "government right". This subsection is amended to correspond with the changes to paragraph 14(5)(a) of the Income Tax Act which will 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 amendment is applicable for dispositions after June 17, 1987.

Clause 198

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 199

S.C.1986, c.6, subs.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 200

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 201

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 103.

Clause 202

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 the subject of amendment. This amendment to subsection 46(3) is intended to reflect these amendments to subsection 125.1(1).

Clause 203

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 118 are applicable.

Clause 204

S.C. 1986, c.55, section 76

Section 76 of S.C. 1986, c. 55

Section 238 of the Income Tax Act sets out various offences for failing to comply with specified provisions of the Act. Subsection 238(1) was amended by section 76 of S.C. 1986, c.55 to make it an offence to fail to provide information described in paragraph 221(1)(d.1) of the Act. Section 76 was to come into force on a day to be fixed by proclamation, but no such day has been proclaimed. As a consequence of amendments to paragraph 221(1)(d.1) and subsection 238(1) of the Act, and the addition of a penalty under new subsection 162(6) of the Act to deal with failures to comply with regulations made under paragraph 221(1)(d.1), the reference to paragraph 221(1)(d.1) in subsection 238(1) is unnecessary. Section 76 of S.C. 1986, c.55 is therefore repealed as of December 19, 1986, which was the date of Royal Assent to that Act.

Clause 205

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% 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% rather than 10%. New subsections 22(6) and (7) are applicable upon Royal Assent.

Clause 206

Unemployment Insurance Act, 1971

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% 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% rather than 10%. New subsections 68(6) and (7) are applicable upon Royal Assent.

Clause 207

Certificates for Unpaid Amounts

UI
79

Section 79 of the Unemployment Insurance Act, 1971 allows Revenue Canada, Taxation to register with the Federal Court a certificate specifying an amount payable by an employer under Part IV of the Act. When registered, the certificate has the same effect as if it were a judgment of the Court for the amount specified plus interest. This procedure is similar to the procedure provided under section 223 of the Income Tax Act for unpaid amounts under that Act. A number of amendments are being made to section 223 of the Income Tax Act. The amendment to section 79 of the Unemployment Insurance Act, 1971 adopts the certificate procedure provided for in the amended section 223 of the Income Tax Act, with such modifications as the circumstances require. This amendment is applicable to certificates made by Revenue Canada, Taxation after January 1, 1972 and to documents evidencing such certificates issued by the Federal Court after 1977. The amendments do not apply, however, with respect to certificates that were the subject of court decisions given on or before February 10, 1988 or actions pending before a Court on that date.

Clause 208

Unemployment Insurance Act, 1971

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.

Clause 209

Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977

Section 9 of the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 provides that the Minister of Finance may pay to a province a provincial personal income tax revenue guarantee payment where, in the opinion of the Minister, amendments to the Income Tax Act introduced in the House of Commons during the first taxation year to which they apply would result in a reduction of a province's personal income tax revenue greater than 1% of basic federal tax in the province. New section 9.1 provides that, for the purpose of section 9, an amendment to the Income Tax Act which gives effect to a measure referred to in a Notice of Ways and Means Motion tabled in the House of Commons shall be considered to have been introduced in the House of Commons when the first Notice of Ways and Means Motion in which the measure was referred to was tabled. New section 9.1 is applicable to fiscal years ending after 1987.

Clause 210

Transfer Payments With
Respect to Taxes Under
Parts IV.1 and VI.1 of
the Income Tax Act

New Part V of the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 permits the Minister of Finance to pay to a province a proportion of the taxes levied under new Part IV.1 and VI.1 of the Income Tax Act.

Subclause 210(1)

New subsection 13(1) of the Act provides that the Minister of Finance may pay to a province for a fiscal year 35 per cent of the taxes payable by a corporation under Part IV.1 and VI.1 of the Income Tax Act for a taxation year ending in the fiscal period. Where part of the corporation's taxable income is not earned in that province the amount of the payment will be prorated on the basis of the proportion of its taxable income earned in the province.

New subsection 13(2) of the Act provides a special rule for the calculation of a province's share of the new Part IV.1 and VI.1 taxes in circumstances where a particular corporation's taxable income for a year is nil and the corporation has either Part IV.1 or VI.1 taxes payable. In this case the proportion of the payment which may be made to the province under new subsection 13(1) will be determined as if the corporation's taxable income were $100.

New section 14 of the Act provides rules which determine a province's eligibility for a payment made pursuant to Part V. Under new subsection 14(1), no payment may be made to a province under this Part unless the province has entered into a tax collection agreement which authorizes the federal government to collect provincial corporate taxes or, alternatively, the province provides for a deduction in computing a corporation's taxable income under a provincial act of at least 5/2 of the taxes payable under Part VI.1 of the Income Tax Act by the corporation.

New subsection 14(2) provides that no payment will be made to a province under Part V where, in the opinion of the Minister of Finance, the province imposes a tax under a provincial act which is identical or similar to the taxes imposed under Part IV.1 or VI.1 of the Income Tax Act.

New section 15 of the Act requires a corporation to furnish to the Minister of National Revenue any information required to determine the amount payable to a province under Part V.

Subclause 210(2)

Subclause 210(2) provides that Part V of the Act is applicable to fiscal years ending after 1987. In addition this subclause provides that, for taxation years ending before July, 1988, a province that is not party to a corporate tax collection agreement need provide a deduction of only 2 times, rather the 5/2 of, the tax payable under Part VI.1 of the Income Tax Act, in order to qualify for receipt of a payment made pursuant to section 13 of the Act.