Explanatory Notes to Legislation Relating to Income Tax

Issued by
The Honourable Michael H. Wilson
Minister of Finance

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Canada

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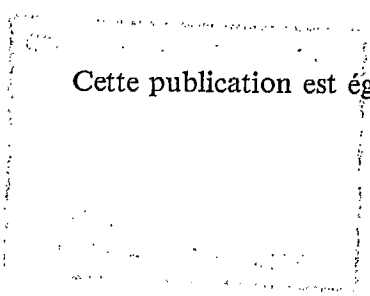
Department of Finance Canada
Ministère des Finances Canada

These explanatory notes are provided to assist in an understanding of the amendments proposed to be made to the *Income Tax Act*, the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act*, the *Old Age Security Act*, the *Public Utilities Income Tax Transfer Act* and a related Act. These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.



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Preface

The legislation tabled today contains proposed amendments to the *Income Tax Act*, the *Federal-Provincial Fiscal Arrangements and Federal Post-Secondary and Health Contributions Act*, the *Old Age Security Act*, the *Public Utilities Income Tax Transfer Act* and a related Act. These amendments are intended to implement the proposals announced in the April 1989 budget.

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

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Clause 1

Income from Office or Employment

Subclause 1(1)

ITA
6(1)(a)

Paragraph 6(1)(a) of the Income Tax Act provides for the inclusion in computing the income of a taxpayer from an office or employment of the value of board, lodging and any other benefits, received or enjoyed by the taxpayer in respect of or in the course of employment, apart from certain exceptions that are set out therein. Paragraph 6(1)(a) is amended to provide that any benefit from counselling services paid for or provided by an employer in respect of:

- the mental or physical health of the taxpayer or a person related to the taxpayer, or
- the re-employment or retirement of the taxpayer

will not be required to be included in computing the employee's income by virtue of that paragraph.

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

Subclause 1(2)

ITA
6(1)(j)

New paragraph 6(1)(j) of the Act requires a taxpayer to include in income any award or reimbursement received by the taxpayer in respect of amounts deductible under subsection 8(1), to the extent that the award or reimbursement is not otherwise included in computing the income of the taxpayer or is not taken into account in computing the amount claimed by the taxpayer under subsection 8(1). Paragraph 6(1)(j) is intended primarily to be relevant to awards and reimbursements of legal expenses incurred to collect salary and wages for which a deduction is available under paragraph 8(1)(j) of the Act. Paragraph 6(1)(j) is consistent in this regard with new paragraph 56(1)(l.1) under which awards and reimbursements in respect of legal expenses to collect retiring allowances and pension benefits are included in income.

This amendment is applicable in respect of amounts received after 1989.

Clause 2

Legal Expenses

ITA
8(1)(b)

Paragraph 8(1)(b) of the Act provides for a deduction to a taxpayer in respect of legal expenses incurred by the taxpayer to collect salary or wages. Paragraph 8(1)(b) is amended to conform with the language in new paragraph 60(o.1) of the Act (which provides for the deduction of legal expenses to collect retiring allowances and pension benefits) and, as a consequence, to ensure that deductible legal expenses include those incurred to establish a right to salary or wages owed to the taxpayer. Awards or reimbursements in respect of such legal expenses would be included in income under new paragraph 6(1)(j).

This amendment is applicable in respect of amounts paid after 1989.

Clause 3

"Taxation Year"

ITA
11(2)

Subsection 11(2) of the Act provides that the references in subdivision b of Division B of Part I of the Act to a "taxation year" are to be read as references to a "fiscal period" ending in the year with respect to businesses with fiscal periods that do not coincide with the calendar year. Subsection 11(2) is amended to apply to all of Division B. Thus subsection 11(2) will apply to section 80.3 of the Act, which provides for a deferral to a subsequent taxation year of income received in a year in respect of the forced destruction of livestock or drought-induced sales of breeding livestock herds.

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

Clause 4

Amounts to be Included 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(4) to (8)

Subsection 12(4) of the Act provides for the inclusion in income by individuals of accrued interest income on certain debt obligations at least every three years. The amendments to this subsection provide that interest accrued on an investment contract up to each anniversary date of the investment contract must be included in income in the taxation year in which the anniversary falls. The term "investment contract" is defined in paragraph 12(11)(a) of the Act to include any debt obligation other than a salary deferral arrangement, an income bond or debenture, a small business development bond or a small business bond. Subsections 12(5) and (6), which apply with respect to debt obligations acquired before October 29, 1980, and subsection 12(7), which applies to the 1978 taxation year of certain corporations, are repealed consequential upon the amendments to subsection 12(4). Subsection 12(8), which provides for an election to report certain accrued interest income on an annual basis, is repealed consequential upon the amendments to subsection 12(4) which require such income to be reported annually for investment contracts acquired after 1989.

These amendments are applicable with respect to investment contracts acquired or materially altered after 1989 and, accordingly, no change is effected to the application of subsections 12(5) to (7) of the Act.

Subclause 4(2)

ITA
12(9)

Subsection 12(9) of the Act, which provides rules for calculating accrued interest on certain debt obligations, is amended to delete the references therein to subsections 12(8) and (11) effective with respect to investment contracts acquired or materially altered after 1989. This amendment is consequential upon the repeal of subsection 12(8) and a previous amendment to subsection 12(11).

Subclause 4(3)

ITA
12(10)

Subsection 12(10) of the Act, which provides transitional relief for investment contracts acquired before November 13, 1981, is repealed consequential upon the amendments to subsection 12(4), which are effective for investment contracts acquired after 1989. Accordingly, no change is effected to the application of subsection 12(10).

Subclause 4(4)

ITA
12(11)(a)

Paragraph 12(11)(a) of the Act defines the term "investment contract" for the purposes of the rules requiring the periodic reporting of accrued investment income in subsection 12(4). This paragraph is amended to ensure that the new annual reporting rules will not apply to debt obligations in respect of which investment income is otherwise included in income at least annually. While this amendment is applicable for debt obligations acquired after 1989, a similar amendment is introduced to ensure that the existing three-year accrual rules will not apply for investment contracts acquired before 1990 where the investment income thereon is otherwise included in income at periodic intervals of less than three years.

Subclause 4(5)

ITA
12(11)(b)

Paragraph 12(11)(b) of the Act defines the "third anniversary" of an investment contract for the purposes of the three-year accrual rules. As a result of the amendments to subsection 12(4) introducing an annual reporting requirement for accrued investment income, paragraph 12(11)(b) is amended to define the "anniversary day" of an investment contract, effective with respect to investment contracts acquired after 1989.

Clause 5

Amounts Included in Income

ITA
12.2

Section 12.2 of the Act provides for the inclusion in income of income accrued on certain life insurance policies and annuity contracts.

Subclause 5(1)

ITA
12.2(2) to (4.1)

Subsection 12.2(2) of the Act, which provides transitional rules for annuity contracts acquired before December 20, 1980 and not disposed of before 1985, is repealed. Subsection 12.2(3) of the Act provides for the inclusion in income by individuals, of accrued investment income from certain life insurance policies and annuity contracts, at least

every three years. This subsection is amended to provide that investment income accrued on these contracts up to the annual anniversary date of the contracts must be included in income in the taxation year in which the anniversary falls. Subsections 12.2(4) and (4.1) of the Act provide for a mechanism under which individuals may elect to report accrued investment income on certain life insurance and annuity contracts annually. As a result of the change providing mandatory annual accrual under new subsection 12.2(3), subsections 12.2(4) and (4.1) are repealed. These amendments are applicable with respect to policies acquired or materially altered after 1989 and, accordingly, the transitional rules previously provided in subsection 12.2(2) will continue to apply to contracts last acquired before December 20, 1980.

Subclause 5(2)

ITA
12.2(5) to (7)

Subsection 12.2(5) of the Act, which provides for the inclusion in income at least every three years of income accrued in respect of certain life insurance policies, is amended consequential upon the amendments to subsection 12.2(3), and provides the method for calculating the required annual income inclusion for such policies acquired or materially altered after 1989.

Subsection 12.2(6) of the Act, which provides transitional relief from the application of subsection 12.2(1) to annuity contracts last acquired before December 20, 1980, is repealed as this provision cannot apply to policies acquired after 1989.

Subsection 12.2(7) of the Act, which provides transitional relief from the income accrual rules in respect of policies last acquired before December 2, 1982, is repealed as a consequence of the changes to subsection 12.2(3) which introduce annual accrual reporting requirements for policies acquired after 1989. Subsection 12.2(7) will, therefore, continue to apply to policies last acquired before December 2, 1982.

Subclause 5(3)

ITA
12.2(8)

Subsection 12.2(8) of the Act provides that an annuity contract acquired before December 2, 1982, and which would otherwise be exempt from the existing accrual rules, will be subject to accrual to the extent of any premiums that were not fixed on that date. The unfixed portion of such premiums are treated as having been paid on a new contract on which accrual is required. Subsection 12.2(8) is amended to refer to premiums paid after 1989 consequential upon the amendments to subsection 12.2(3) introducing annual accrual reporting requirements. These amendments are applicable in respect of premiums paid after 1989.

Subclause 5(4)

ITA
12.2(9)

Subsection 12.2(9) of the Act, which provides for the situation where a policy is materially changed after December 1, 1982, is repealed effective after 1989, reflecting the changes to subsection 12.2(3) which introduce annual accrual reporting requirements in respect of policies acquired after 1989. This subsection will continue to apply in respect of policies acquired before 1990 (other than those materially altered after 1989.)

Subclause 5(5)

ITA
12.2(10)

Subsection 12.2(10) of the Act, which provides that certain riders to life insurance policies are to be treated as separate life insurance policies, refers to riders added to policies after December 1, 1982. The amendments to subsection 12.2(10) take into account riders added after 1989 consequential upon the amendments to subsection 12.2(3) introducing annual accrual reporting requirements in respect of policies acquired after 1989. The amendments to subsection 12.2(10) are generally effective after 1989.

Subclause 5(6)

ITA
12.2(11)(b)

Paragraph 12.2(11)(b) of the Act defines the "third anniversary" of an insurance policy for the purpose of the three-year accrual rules. As a result of the amendments to subsection 12.2(3) introducing annual reporting requirements, paragraph 12.2(11)(b) is amended to define the "anniversary day" of an insurance policy. This amendment is generally effective with respect to policies acquired after 1989.

Clause 6

Recapture of Depreciation

Subclause 6(1)

ITA
13(2)

Subsection 13(2) of the Act provides that depreciation recapture in respect of a vehicle is not required to be included in income if it is a motor vehicle owned by an individual (except where all or substantially all of the distance travelled with the motor vehicle throughout the period that the individual owned it was for the purpose of earning income) or a passenger vehicle owned by a trust, partnership or corporation having a cost at the time of acquisition in excess of $20,000, or such other amount as may be prescribed.

As amended, subsection 13(2) provides that only depreciation recapture in respect of a passenger vehicle with a cost in excess of $20,000 or such other amount as may be prescribed, owned by any taxpayer, is not required to be included in income. The 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.

Subclause 6(2)

ITA
13(3)(a)

Paragraph 13(3)(a) of the Act (which is subject to subsection 13(8) of the Act described below) provides that, where an individual has income from a business the fiscal period of which does not coincide with the calendar year, the reference in subsections 13(1) and 20(16) (concerning recaptured depreciation and terminal losses) to "taxation year" shall be read as a reference to "fiscal period". This paragraph is amended to include a reference to new subsections 13(2) and 20(16.1) relating to recaptured depreciation and terminal losses arising in respect of certain passenger vehicles.

Subclause 6(3)

ITA
13(8)

Subsection 13(8) of the Act provides that, notwithstanding subsection 13(3), the reference in subsections 13(1) or 20(16) to a "taxation year" shall not be read as a reference to a fiscal period where a taxpayer has, after ceasing to carry on business,

disposed of depreciable property used in that business. This subsection is amended to include a reference to new subsections 13(2) and 20(16.1) relating to recaptured depreciation and terminal losses arising in respect of certain passenger vehicles.

Clause 7

Leasing Properties

ITA
16.1(1)

New subsection 16.1(1) of the Act provides special rules which may apply in computing the income of a lessee of property, other than prescribed property, leased for a term of more than one year from an arm's length person who is resident in Canada or who carries on business in Canada through a permanent establishment. These special rules apply only where the lessor and lessee jointly elect in a prescribed form that is filed by the lessee with his tax return for the year in which the lease was entered into. Both the lessor and the lessee are required to be parties to the election in order that the fair market value of the leased property, which is indicated in the election, is agreed upon. Where no election is filed, the lessee's tax position is unaffected by these new rules and the lessee will continue to be entitled to deduct in a year those rental payments that relate to the use of the property in the year in accordance with the existing rules of the Act.

If the election is filed, these new rules will treat the lessee as though he had borrowed an amount equal to the fair market value of the leased property and acquired the property directly. For tax purposes, the rental payments made under the lease will be treated not as rent but as blended payments of principal and interest on the loan. Interest will be calculated in accordance with the prescribed rate in effect at the time the lease is entered into, determined under new section 4302 of the Income Tax Regulations or, where a taxpayer elects in respect of a floating rate lease, at the prescribed rate in effect from time to time. To the extent that the property is used to earn income, the lessee will be able to claim capital cost allowance (CCA) in respect of the property and deduct the interest portion of each rental payment under the rules generally applicable under the Act.

The lessor's tax position is not in any way affected by this election. The rental payments will continue to be included in the lessor's income as rent, but the lessor may be limited in the amount of capital cost allowance that may be claimed in respect of the leased property in accordance with new subsection 1100(1.1) of the Regulations to the Act.

EXAMPLE

Taxpayer A leases an asset having a fair market value of $10,000 from another person for a period of 5 years. The prescribed rate in effect at the time of the commencement of the lease is 10 per cent. The annual rent is $1,314 and the CCA rate that is applicable in respect of the property is 25 per cent, on a diminishing balance basis, subject to the half-year convention. A jointly elects with the lessor to treat the lease as a loan and purchase for the lease term and deducts interest expense and CCA as follows:

Year	Lease Payment	Principal	Interest	CCA	UCC
					10,000
1	1,314	314	1,000	1,250	8,750
2	1,314	345	969	2,188	6,562
3	1,314	380	934	1,641	4,921
4	1,314	418	896	1,230	3,691
5	1,314	460	854	923	2,768
TOTAL	**6,570**	**1,917**	**4,653**	**7,232**	

At the time of the expiration, cancellation, assignment or sublease of a lease in respect of which an election has been made under this subsection, the lessee is effectively treated as having disposed of the leased property for proceeds equal to the remaining principal amount of the loan plus or minus any amounts actually received or paid by the lessee in respect of the cancellation, assignment or sublease. The normal rules relating to recapture and terminal losses will apply at that time.

EXAMPLE

At the end of the 5 year lease described in the above example, A will be deemed to have disposed of the property for the remaining principal amount of the deemed loan – $8,083 ($10,000 original principal less $1,917 repayments of principal). If the property were the only property in that Class A would be subject to recapture of CCA of $5,315 ($8,083 deemed proceeds of disposition less $2,768 undepreciated capital cost). The total deductions allowed to A with respect to the property over the term of the lease would be $6,570 (interest of $4,653 and CCA of $7,232 less recapture of $5,315).

New paragraph 16.1(1)(g) ensures that all amounts paid or payable by a taxpayer in respect of a property for which an election has been made under subsection 16.1(1), are considered to be amounts deducted by the taxpayer in respect of payments made for the use of or the right to use the property, for the purposes of the rules in subsections 13(5.2) and (5.3) relating to lease payments.

New paragraph 16.1(1)(h) provides that any amount paid by a lessee in consideration for the granting or assignment of a lease or sublease of property will not be treated as an amount paid in respect of the capital cost of a leasehold interest. Such amounts will be allocated proportionately over the term of the lease (see examples below concerning assignments of leases).

New paragraph 16.1(1)(i) provides that a lease in respect of which an election has been made by a lessee, assignee or sublessee of property is deemed, for the purposes of subsection (1), to have been cancelled at any time when the owner of the property is not resident in Canada (other than an owner who carries on business through a permanent establishment in Canada).

ITA
16.1(2)

New subsection 16.1(2) of the Act provides rules which apply where a lessee who has made an election to have the special leasing rules apply with respect to a leased property subsequently assigns the lease or subleases the leased property to another person ("the assignee"). This subsection provides that the special leasing rules will cease to apply to the lessee at the time of the assignment or sublease. In this case, except where the rules in subsection 16.1(4) apply, the lessee will be treated as having disposed of the property and the rules in paragraph 16.1(1)(f) will apply to determine the amount of any resulting recapture or terminal loss. In addition, any further payments that may be made by the original lessee after that time will be treated as ordinary rent.

In the case of an assignment or sublease, the assignee may, by filing the joint election, take advantage of the special leasing rules provided under subsection 16.1(1), provided that the assignee deals at arm's length with the original lessor and the owner of the property is resident in Canada or carries on business through a permanent establishment in Canada. Thus, at the time of the assignment or sublease, the assignee may elect to be treated as having acquired the property at a capital cost equal to its fair market value at that time for the purposes of claiming capital cost allowance and to have borrowed money in a principal amount equal to the fair market value of the property at that time for the purpose of determining the portion of each rental payment that may be deducted as interest.

It should be noted that subsection 16.1(2) is modified by the rules described below in new subsections 16.1(3) and (4) which apply in the context of assignments or subleases to non-arm's length parties.

EXAMPLE: ARM'S LENGTH SUBLEASE

Immediately after the third year of the lease described in the previous example, A enters into a sublease of the property to taxpayer B, a person with whom he deals at arm's length. The annual lease payment from B to A will be $1,314 and B pays A $500 in consideration for the sublease. At the time of the sublease, the property has a fair market value of $8,000 and the prescribed rate in effect is 11 per cent.

A has deemed proceeds of disposition calculated as follows:

(i)	(A) Original Principal:	$10,000
	Plus	
	(B) Amount received for sublease:	500
	Minus	
(ii)	Amount paid as principal:	(1,039)
	Proceeds	$9,461

A will be subject to recapture on the amount of $4,540 ($9,461 deemed proceeds of disposition less $4,921 undepreciated capital cost). As a result, the total deductions allowed to A with respect to the property will be $3,442 (interest of $2,903 and CCA of $5,079 less recapture of $4,540).

B jointly elects with A to treat the lease as a loan and purchase for the lease term. For this purpose, the amount of the loan will be deemed to be $8,000 (the fair market value of the property at that time) and the applicable interest rate will be the rate in effect at that time, in this case 11 per cent. Similarly, the capital cost of the property to B will be $8,000. The $500 paid to A in consideration for the sublease is deemed to be a payment for the use of, or right to use, the property for the remaining two years of the lease and is, therefore, apportioned between the lease payments for those years. B is entitled to deduct interest expense and CCA for the remaining two years of the original five year term of the lease as follows:

Year	Lease Payment	Loan Amount	Principal	Interest	CCA	UCC
		8,000				8,000
4	1,564(1,314+250)		684	880	1,000	7,000
5	1,564(1,314+250)		759	805	1,750	5,250
	3,128		1,443	1,685	2,750	

At the end of the sublease, B is deemed to have disposed of the property for the remaining principal amount of the deemed loan – $6,557 ($8,000 original principal less $1,443 repayments of principal). As a result, B will be subject to recapture of CCA of

$1,307 ($6,557 deemed proceeds of disposition less $5,250 undepreciated capital cost). The total deductions allowed to B with respect to the property will be $3,128 (interest of $1,685 and CCA of $2,750 less recapture of $1,307).

ITA
16.1(3)

New subsection 16.1(3) of the Act provides a special rule where an assignment or sublease of a lease in respect of which an election has been made under new subsection 16.1(1) has been made to another person with whom the lessee is not dealing at arm's length (the special case of a transfer of a lease as a consequence of an amalgamation or winding-up is dealt with in subsection 16.1(4)). In non-arm's length circumstances, for the purposes of computing the income of the person to whom the lease is transferred (the transferee), the transferee is deemed to be the same person as, and a continuation of, the original lessee. Consequently, for the purposes of determining the unpaid principal amount of the loan and the applicable interest rate to the transferee, the transferee will be considered to have borrowed money at the time that the property was leased by the original lessee. However, for the purposes of determining the capital cost allowance available to the transferee in respect of the leased property, the transferee is treated as having acquired the property at a cost equal to the unpaid principal amount of the original lessee's loan rather than at the fair market value of the property at the time of the original lease.

EXAMPLE: NON-ARM'S LENGTH SUBLEASE

Assume that A and B in the example described above were not dealing at arm's length at the time of the sublease. The tax treatment of A would remain the same. For the purposes of calculating B's income, the amount of the loan would be $8,961 (the principal amount outstanding on the original lessee's loan at the time of the sublease) and the applicable interest rate would be the rate in effect at the time of the original lease (10 per cent). Similarly, the capital cost of the property to B would be $8,961. The half-year convention will not apply to B because A and B are not dealing at arm's length. B would thus be able to deduct interest expense and CCA for the remaining two years of the original five-year term of the lease as follows:

Year	Lease Payment	Loan Amount	Principal	Interest	CCA	UCC
		8,961				8,961
4	1,564(1,314+250)		668	896	2,240	6,721
5	1,564(1,314+250)		735	829	1,680	5,041
	3,128		1,403	1,725	3,920	

At the end of the sublease, B would be deemed to have disposed of the property for the remaining principal amount of the loan – $7,558 ($8,961 original principal less $1,403 repayments of principal). As a result, B would be subject to recapture of CCA of $2,517 ($7,558 deemed proceeds of disposition less $5,041 undepreciated capital cost). The total deductions allowed to B with respect to the property would be $3,128 (interest of $1,725 and CCA of $3,920 less recapture of $2,517).

ITA
16.1(4)

New subsection 16.1(4) of the Act provides a rollover where a lease in respect of which an election has been made under new subsection 16.1(1), as described above, is transferred by a corporation to another corporation with which it is not dealing at arm's length in the course of certain amalgamations or windings-up of corporations. In such a case, in computing its income, the corporation to which the lease has been transferred is treated as the same person as, and a continuation of, the lessee. Consequently, for the purposes of determining the principal amount of the loan and the applicable interest rate, the transferee is deemed to have borrowed money and acquired the property at the time that the property was originally leased by the lessee. Unlike all other assignments and subleases to which this section applies, however, the transferee will also be deemed to have acquired the property at a cost equal to the fair market value of the property at the time of the original lease and be treated as having claimed any capital cost allowance claimed by the predecessor corporation. In essence, the surviving corporation will step into the same position as the predecessor corporation with respect to the lease.

Subject to certain transitional provisions, these amendments to the Income Tax Act are generally applicable in respect of leases and subleases entered into after 10:00 p.m. Eastern Daylight Savings Time April 26, 1989.

Clause 8

General Limitations

ITA
18(1)(t)

Section 18 of the Act prohibits the deduction of certain outlays and expenses in computing a taxpayer's income from a business or property. This amendment, which is applicable to the 1989 and subsequent taxation years, adds new paragraph 18(1)(t) and denies a deduction in respect of any amount – including taxes, interest and penalties – payable under the Act.

Clause 9

Deductions in Computing Income from Business or Property

ITA
20

Section 20 of the Act expressly permits the deduction of certain outlays and expenses in computing the income of a taxpayer for a taxation year from a business or property.

Subclause 9(1)

ITA
20(1)(c)(iv)

Subparagraph 20(1)(c)(iv) of the Act allows the deduction of interest expenses on money borrowed to acquire an annuity contract to which the income accrual rules apply. This provision is amended to delete the reference therein to the "third anniversary" of an annuity contract as a consequence of the amendments to section 12.2 of the Act. This amendment is effective with respect to contracts acquired or materially altered after 1989.

Subclause 9(2)

ITA
20(16.1)

Subsection 20(16.1) of the Act provides that, where a terminal loss is determined under subsection 20(16), the loss may not be deducted in computing a taxpayer's income if it is in respect of a motor vehicle owned by an individual (except where all or substantially all of the use, measured by distance travelled, of the motor vehicle throughout the period that the individual owned it was for the purpose of earning income) or a passenger vehicle owned by a trust, partnership or corporation where the cost at the time of acquisition was in excess of $20,000 or such other amount as may be prescribed.

As amended, subsection 20(16.1) provides that a terminal loss may not be deducted in computing a taxpayer's income only where it relates to a passenger vehicle with a cost in excess of $20,000 or such other amount as may be prescribed.

Clause 10

Farming or Fishing Business

ITA
28(1)

Subsection 28(1) of the Act provides for a method of accounting, known as the cash-basis method, that may be used for computing income or loss from the business of farming or fishing. The amendments to this subsection add references to new subsections 80.3(2) to (5) of the Act, so that the income tax deferral provided under section 80.3 where there has been a forced destruction of livestock or a drought-induced sale of a breeding livestock herd will be available to a farmer who computes income from farming using cash-basis accounting.

The amendments to section 28 also provide consistency with previous amendments to section 30 of the Act to ensure that an amount paid in a year for land improvement costs, such as installing land drainage systems, may be deducted in the year in which the costs are incurred or in a subsequent year by taxpayers using cash-basis accounting.

These amendments are applicable to fiscal periods commencing after 1988.

Clause 11

Amounts Included in Income

Subclauses 11(1) and (2)

ITA
56(1)(d) and (d.1)

Paragraphs 56(1)(d) and (d.1) of the Act require certain amounts received in respect of annuity payments to be included in the income of a taxpayer for a taxation year. Paragraph 56(1)(d) is amended to delete the reference therein to the "third anniversary" of an investment contract and paragraph 56(1)(d.1) is repealed. These amendments are consequential upon the amendments to section 12.2 and are effective for contracts acquired or materially altered after 1989.

Subclause 11(3)

ITA
56(1)(l.1)

New paragraph 56(1)(l.1) of the Act requires a taxpayer to include in computing income amounts received as an award or reimbursement of legal expenses paid to collect or

establish a right to a retiring allowance or benefits under a pension fund or plan in respect of employment. This inclusion arises only to the extent that the legal expenses to which it relates are deductible under new paragraph 60(o.1) of the Act.

New paragraph 56(1)(l.1) is applicable to amounts received after 1985, other than amounts received as an award or reimbursement in relation to legal expenses paid before 1986 for which no offsetting deduction would be available under paragraph 60(o.1).

Subclause 11(4)

ITA
56(4.2)(a)(i)

Subsection 56(4.1) of the Act provides, subject to specific exceptions, that where property is loaned between individuals who do not deal at arm's length with each other and one of the main reasons for the loan is to reduce or avoid tax on income from the property or from property substituted for that property, the income is considered to be income of the individual that made the loan and not of the other individual. Subsection 56(4.2) provides an exemption from the rule in subsection 56(4.1) for loans that bear a rate of interest that is 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 loan was made. Subparagraph 56(4.2)(a)(i) is amended to refer to a prescribed rate of interest, rather than the rate of interest prescribed for the purposes of subsection 161(1) of the Act (i.e. 2% above the rate prescribed by formula). This amendment is applicable with respect to interest to be calculated in respect of periods that are after September 1989.

Subclause 11(5)

ITA
56(9)

Section 56 of the Act lists certain sources of income that are required to be included in computing the income of a taxpayer for a taxation year. Family allowances, along with social assistance payments and certain grants, received by a married person are required to be included in the income of the spouse having the higher income. Subsection 56(9) defines for that purpose the "income for the year" of a person. Subsection 56(9) is amended to clarify the rules governing the computation of each spouse's income as a consequence of the new measure dealing with the repayment of federal family allowances and old age security benefits. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 12

Deductions in Computing Income

Subclause 12(1)

ITA
60(o.1)

New paragraph 60(o.1) of the Act provides new rules for the deduction of legal expenses by taxpayers in respect of retiring allowances and pension benefits.

Paragraph 60(o.1) provides for the deductibility of eligible legal expenses paid after 1985 to collect or establish a right to a retiring allowance or pension benefits. Eligible legal expenses do not include legal expenses relating to a division or settlement of property arising from marriage or other conjugal relationship or to Canada Pension Plan or Quebec Pension Plan benefits. In the case of the Canada Pension Plan and the Quebec Pension Plan, a deduction for legal expenses is provided under paragraph 60(o) of the Act.

Eligible legal expenses may be deducted in a taxation year to the extent they do not exceed the retiring allowance or pension benefits to which such expenses relate. The non-deductible portion of such expenses may be carried forward and deducted in any of the seven subsequent taxation years, to the extent further related income arises.

The income against which eligible legal expenses may be deducted may, however, be reduced by virtue of a transfer to a registered retirement saving plan or registered pension plan under paragraph 60(j) or (j.1). Where an individual has effectively transferred all or a portion of his or her retiring allowance or pension benefits on a tax-free basis under either of those paragraphs, the income against which related legal expenses may be deductible is correspondingly reduced.

New paragraph 60(o.1) is applicable to the 1986 and subsequent taxation years.

Subclause 12(2)

ITA
60(w)

New paragraph 60(w) of the Act provides for the deduction in computing the income of a taxpayer for a taxation year of an amount equal to the federal family allowances and old age security benefits that the taxpayer is required to repay for the year as tax under Part I.2 of the Act. This deduction is claimed after all other allowable amounts have been deducted in computing the taxpayer's income. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 13

Child Care Expenses

ITA
63(2) and (2.1)

Section 63 of the Act provides rules governing the deductibility of child care expenses. Subsection 63(2) contains a weekly maximum amount that may be claimed in respect of the child care expenses where the income of the taxpayer claiming the deduction exceeds that of a supporting person. Subsection 63(2.1) provides that, where the income of the taxpayer equals that of the supporting person, no child care expense deduction is allowed unless both individuals agree to treat the income of one as exceeding the income of the other. These two subsections are amended to provide that, for the purposes of the child care expense deduction, the income of an individual must be determined before deducting child care expenses and any amount under new paragraph 60(w) in respect of a repayment of federal family allowances and old age security benefits. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 14

Attendant Care Expenses

ITA
64

New section 64 permits the deduction, in computing the income of an individual who has a severe and prolonged mental or physical impairment, of expenses paid to an unrelated attendant over 18 years of age that are incurred to enable the individual to work. Such an individual will be entitled to deduct the least of the three following amounts:

- the actual amount of expenses for attendant care provided in Canada,
- $5,000, and
- 2/3 of the individual's earned income for the year.

For this purpose, "earned income" means income from business, gross employment income, net research grants, training allowances paid under the *National Training Act*, and the taxable portion of scholarships, fellowships, bursaries and similar awards. This amendment is applicable to the 1989 and subsequent taxation years.

Deemed Residents

ITA
64.1

Section 63.1 of the Act is being renumbered as section 64.1. The existing section provides a special rule for individuals who are deemed by reason of section 250 of the Act to be residents in Canada with respect to their deductible child care and moving expenses. In the case of deemed residents, amounts paid for child care services outside Canada and expenses incurred to move to or from a location outside Canada are deductible. This amendment extends the exception to individuals who, while no longer physically present in Canada, continue nevertheless to be resident in Canada for tax purposes. The amendment also extends the application of this special rule to section 64 which is the new provision that enables a disabled individual to deduct attendant care expenses. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 15

Restrictions on Expenses

ITA
67.3(c) and (d)

Section 67.3 of the Act contains restrictions on the amount of lease payments that may be deducted by a taxpayer in respect of a leased passenger vehicle. The maximum deduction is determined by a formula in which one of the terms is an amount of interest determined by reference to the prescribed rate of interest that would be applicable to amounts payable under the Act. Paragraphs 67.3(c) and (d) are amended to refer instead simply to a prescribed rate of interest (i.e. the actual prescribed rate and not the rate that is two per cent per annum higher than the rate determined by formula). These amendments are applicable with respect to interest to be calculated in respect of periods that are after September 1989.

Clause 16

Attribution Rules

ITA
74.5(1) and (2)

Subsections 74.5(1) and (2) of the Act provide for the attribution of certain types of income arising in respect of loaned or transferred property. These subsections are amended to refer simply to interest at a prescribed rate and are consequential to the amendments to subsection 161(1).

Clause 17

Income Deferral from Destruction of Livestock
or Drought-Induced Sales of Breeding Animals

ITA
80.3

Section 80.3 of the Act, which provides a deferral of the recognition of income received in a year as a result of the forced destruction of livestock, has been restructured as an income inclusion with an offsetting deduction. This change is in consequence of the expansion of section 80.3 to include new rules providing a deferral in respect of the proceeds of sale of breeding animals in prescribed drought areas.

ITA
80.3(1)

New subsection 80.3(1) of the Act defines the terms "breeding animals" and "breeding herd" for the purposes of new subsection 80.3(4). Generally, a breeding herd at any time is defined as the number of cattle, bison, goats and sheep owned by a taxpayer at that time that are over 12 months of age and that are held for the purposes of breeding. The formula for calculating the size of a farmer's breeding herd, however, includes a requirement that, with respect to cattle, the number of heifers included in the herd does not exceed 50% of the number of cows included in the herd. Horses kept for breeding purposes in the commercial production of pregnant mares' urine may also qualify as breeding animals for the purposes of the deferral in respect of the proceeds of drought-induced sales.

ITA
80.3(2) and (3)

New subsections 80.3(2) and (3) of the Act retain a one-year deferral for amounts received as a result of the forced destruction of livestock under statutory authority. However, unlike the existing scheme of section 80.3 of the Act, which deems the amount not to be income for the year in which it is received but, rather, to be income for the following year, the new rules provide that the proceeds eligible for the deferral are to be included in income for the year received, subject to an offsetting deduction for the year up to the amount included in income. Any amount deducted under this provision is deemed to be income of the taxpayer from the business for the following year.

ITA
80.3(4) and (5)

New subsection 80.3(4) of the Act provides a deduction of a portion of the proceeds of the sale of breeding animals by a taxpayer who carries on the business of farming in a prescribed drought region and whose breeding herd has been reduced by at least 15 per cent in a drought year. New subsection 80.3(5) of the Act provides that the amount deducted under this provision for a year is deemed to be income of the taxpayer from the business for the year following the drought year, or for the year immediately following a series of consecutive drought years.

The portion of such proceeds which may be deducted is 30 per cent if the taxpayer's breeding herd has been reduced by at least 15 per cent, but less than 30 per cent, in the year, and 90% if the breeding herd has been reduced by 30 per cent or more in the year. The proceeds of sale of breeding animals to which the formula applies is net of amounts paid to acquire breeding animals in the year and does not include any amount which has been deducted under paragraph 20(1)(n) of the Act as a reserve for proceeds of sale not due until a later year.

ITA
80.3(6)

New subsection 80.3(6) of the Act provides that the deferral of income in respect of a farming business provided by subsections 80.3(2) and (4) does not apply for a year in which a taxpayer dies or for a year at the end of which the taxpayer is a non-resident unless the taxpayer carried on the business throughout the year in Canada.

These amendments are effective for fiscal periods and taxation years ending after 1987. Draft Part LXXIII of the Income Tax Regulations released by the Department of Finance with information release 88-155 dated December 12, 1988 prescribes the provinces of Alberta, Saskatchewan and Manitoba as prescribed drought regions for the 1988 calendar year. Subsequent releases of Agriculture Canada dated January 27 and February 22, 1989, indicated that certain regions of British Columbia and Ontario, respectively, would also be prescribed as drought areas for the 1988 calendar year.

Clause 18

Dividend Gross-Up

ITA
82(1)

Section 82 of the Act provides rules regarding the treatment of taxable dividends received by a taxpayer from a corporation resident in Canada. Currently, paragraph 82(1)(a) requires taxpayers to include all such amounts in computing their income for a taxation year. Under new paragraph 82(1)(a) of the Act, in computing income for a

taxation year, an individual will be required to include taxable dividends received from taxable corporations resident in Canada only to the extent they exceed any payments made by the individual during the year that were deemed to have been received by another person as a taxable dividend by reason of new subsection 260(5). This change is consequential to the introduction of the rules governing securities lending in new section 260.

In addition, where an individual receives a taxable dividend from a taxable Canadian corporation, paragraph 82(1)(b) of the Act requires him to gross-up the amount included in his income by an additional amount equal to 1/4 of the actual dividend received. Paragraph 82(1)(b) is effectively amended to exempt from this gross-up requirement any dividends received after April 30, 1989 as part of a "dividend rental arrangement". The expression "dividend rental arrangement" is defined in amended subsection 248(1) of the Act. This change to paragraph 82(1)(b) also has the effect of denying individuals the dividend tax credit under section 121, which is calculated as 2/3 of the amount of the gross-up included in income by paragraph 82(1)(b). This amendment parallels the amendment to section 112 of the Act which denies the inter-corporate dividend deduction in respect of any dividends received by a corporation as part of a dividend rental arrangement.

Clause 19

Amalgamations

Subclause 19(1)

ITA
87(2)(j.9)

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

Paragraph 87(2)(j.9) of the Act currently provides that a new corporation formed on an amalgamation is treated as a continuation of its predecessor corporations for the purposes of determining the new corporation's claim under section 125.2 of the Act in respect of the carryforward of the predecessors' unused Part VI tax credits.

Paragraph 87(2)(j.9) is amended as a consequence of the introduction of the Part I.3 tax credit in new section 125.3. New section 125.3 provides that a corporation may deduct in computing its tax payable under Part I of the Act for a taxation year the amount of tax payable under Part I.3 by it for the year, to the extent that such tax does not exceed the corporation's "Canadian surtax payable" for the year. The corporation may also deduct, subject to the same limitation, any Part I.3 taxes payable by it for the seven preceding and three following taxation years. The amendment to paragraph 87(2)(j.9) is intended to provide an amalgamated corporation with a carryforward of "unused Part I.3 tax

credits" of its predecessors similar to that currently available for unused Part VI tax credits following an amalgamation. In addition, pursuant to paragraph 88(1)(e.2) of the Act, amended paragraph 87(2)(j.9) will allow a parent corporation to claim any unused Part I.3 tax credits of a subsidiary corporation following its winding-up. This amendment is applicable to amalgamations occurring and windings-up commencing after June, 1989.

Subclause 19(2)

ITA
87(2)(tt)

New paragraph 87(2)(tt) of the Act provides that the new corporation formed on an amalgamation must include in its income amounts deferred to a subsequent year by a predecessor corporation under subsections 80.3(2) and (4) of the Act. Section 80.3 provides a deferral of recognition of amounts received by farmers as a result of the forced destruction of livestock or the sale of breeding animals in prescribed drought areas. This amendment applies to amalgamations occurring and windings-up commencing after 1987.

Clause 20

Windings-Up

ITA
88(1)(e.2)

Paragraph 88(1)(e.2) of the Act provides that certain rules that are applicable to the amalgamation of two or more corporations also apply to the winding-up of a subsidiary by a parent corporation. This paragraph is amended to add a reference to new paragraph 87(2)(tt) to ensure that, upon a winding-up, an amount previously deducted by a subsidiary under subsection 80.3(2) or (4) of the Act will be included in the income of the parent under subsection 80.3(3) or (5) of the Act. Section 80.3 provides a deferral of recognition of amounts received by farmers as a result of the forced destruction of livestock or the sale of breeding animals in prescribed drought areas. This amendment applies to windings-up that commence after 1987.

Clause 21

Deduction for Part VI.1 Tax

ITA
110(1)(k)

Paragraph 110(1)(k) of the Act provides a deduction in computing a corporation's taxable income equal to 2 1/2 times the amount of any tax payable by it for the year under Part VI.1 of the Act on dividends paid on taxable preferred shares. The purpose of this provision is to permit an approximate offset of any Part VI.1 tax payable for a year by providing a deduction in computing a corporation's taxable income either for that year or for another year through the non-capital loss carry-back and carry-forward mechanism. This amendment adjusts the amount of the offset to reflect prevailing corporate income tax rates more accurately by providing a deduction of 2 1/4 times, rather than 2 1/2 times, tax payable under Part VI.1.

This amendment is applicable to the 1990 and subsequent taxation years, except that where the taxation year straddles the end of 1989, the 2 1/4 multiple applies only to taxable preferred share dividends paid in the portion of the year in 1990 and only to the extent that those dividends exceed the corporation's dividend allowance.

Clause 22

Inter-Corporate Dividends

ITA
112(2.3)

Section 112 is the principal provision of the Act dealing with the treatment of dividends received by one corporation from another. In particular, subject to certain conditions, subsections 112(1) and (2) permit a corporation to deduct in computing its taxable income the amount of any taxable dividends received from a taxable corporation. New subsection 112(2.3) denies this inter-corporate dividend deduction in respect of dividends received by a corporation after April 30, 1989 as part of a "dividend rental arrangement". The expression "dividend rental arrangement" is now defined in subsection 248(1) of the Act.

In a typical dividend rental arrangement, a profitable taxable corporation that would otherwise invest surplus funds in short-term interest-bearing debt obligations would instead purchase dividend-yielding shares from a taxpayer that was not taxable. Following payment of the dividend, the shares would be resold to the non-taxable taxpayer at a price based on the market value of the share at the time of the original transfer. Thus, any gain or loss accruing on the shares would remain with the non-taxable taxpayer, rather than the taxable corporation that received the dividend.

The effect of such an arrangement would be that the taxable corporation would receive a higher after-tax return (by reason of the availability of the inter-corporate dividend deduction) in the form of dividends on the purchased shares than would have been available if it had invested in interest-bearing debt. In addition, the non-taxable taxpayer would receive a higher before-tax return from the short-term use of the cash proceeds than it would have received if it had continued to hold the shares and received the dividends thereon. The effect of new subsection 112(2.3) will be to deny the inter-corporate dividend deduction in an arrangement such as this so as to neutralize the tax treatment as between interest and dividends.

This amendment is also relevant for the purposes of subsection 138(6) of the Act, which provides a deduction from taxable income for taxable dividends received by a life insurer similar to that provided in subsection 112(1) and (2) for other corporations.

This amendment applies to dividends received on shares acquired after April, 1989.

Clause 23

Dispositions by Non-Residents

ITA
116(5)

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

Subsection 116(2) of the Act requires the Minister of National Revenue to issue a certificate in prescribed form where, prior to the disposition of a property, a non-resident vendor has paid on account of his tax 33 1/3% (30% before 1990) 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 33 1/3% (30% before 1990) of the excess of his proceeds over his adjusted cost base. The 33 1/3% 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.

Where no certificate has been issued in respect of the disposition, the purchaser may be required to pay on account of the non-resident vendor's tax 15% of the cost to the purchaser of the property, pursuant to subparagraph 116(5)(a)(i) of the Act. In addition, where a certificate has been issued prior to the disposition and the cost to the purchaser of the property exceeds the purchase price specified in the certificate, clause 116(5)(a)(ii)(B) requires that the purchaser pay on account of tax the lesser of 15% of the cost of the property to him and 33 1/3% (30% before 1990) of the amount by which the cost of the property to the purchaser exceeds the certificate limit.

The difference in tax payable between 15% of the purchase price and 33 1/3% of the gain may in some circumstances provide a non-resident vendor with an unwarranted opportunity to have a lesser amount paid on account of Canadian tax. Subsection 116(5) is therefore amended, applicable to dispositions occurring after April 27, 1989, to increase the amount of tax that may be payable by the purchaser from 15% to 33 1/3% (30% before 1990) of the purchase price when a certificate has not been issued under subsection 116(4) of the Act, to the extent that the purchase price exceeds the limit fixed by the certificate, if any, issued under subsection 116(2) of the Act.

Clause 24

Annual Adjustment

ITA
117.1

Section 117.1 of the Act provides for the annual indexing of various amounts. Paragraph 117.1(1)(b) is amended as a consequence of new Part I.2 of the Act dealing with the repayment of federal family allowances and old age security benefits. Such a repayment by a taxpayer occurs when the taxpayer's income for a given year exceeds $50,000. Beginning in 1990, the $50,000 threshold will be indexed, based on the annual increase in the Consumer Price Index in excess of three per cent. This amendment is applicable to the 1990 and subsequent taxation years.

Clause 25

Medical Expenses

ITA
118.2(2)

Subsection 118.2(2) of the Act sets out the various expenses that are considered qualifying medical expenses. This amendment, applicable to the 1988 and subsequent taxation years, adds to the list of qualifying medical expenses reasonable costs for arranging a bone marrow or organ transplant and costs relating to certain home modifications to enable individuals who lack normal physical development or who are necessarily confined to a wheelchair to be mobile and functional within their home.

Clause 26

Income Not Earned in a Province

ITA
120(1)

Subsection 120(1) of the Act provides for the payment by an individual of an additional tax at the rate of 47% of the federal tax otherwise payable in respect of the portion of the individual's income for the year that is not earned in a province. The additional tax has the effect of setting the individual's tax on income earned outside Canada at a level approximating that which would apply if provincial income tax were exigible (i.e. combined federal plus provincial tax). This amendment increases the rate of the additional tax to 49 1/2% for 1989 and 52% for the 1990 and subsequent taxation years.

Clause 27

Refundable Federal Sales Tax Credit

ITA
122.4(3)

Subsection 122.4(3) of the Act provides the refundable federal sales tax credit. This subsection is amended to increase the amount of the refundable sales tax credit from $70 to $100 for 1989 and to $140 for 1990 for an eligible individual and for the individual's spouse, and from $35 to $50 for 1989 and to $100 for 1990 for each other qualified relation of the individual. In addition, paragraph 122.4(3)(e) of the Act is amended to increase the income threshold for the federal sales tax credit from $16,000 to $18,000 for the 1990 taxation year.

Clause 28

Corporate Surtax

ITA
123.2(a) to (d)

Section 123.2 of the Act levies a surtax of 3% on the federal income tax payable by a corporation, other than a non-resident-owned investment corporation. This section is amended to provide that the corporate surtax is to be calculated on the amount of federal income tax payable, before taking into account any deduction under section 125 (the small business deduction), section 125.1 (the manufacturing and processing tax credit), and new section 125.3 (the credit in respect of the new tax on large corporations under Part I.3 of the Act), and before any allowance for tax payable by a Canadian-controlled private corporation that is included in its refundable dividend tax on hand

under section 129 of the Act. This amendment also deletes references to section 123.1 and subsections 127(13), 127.2(1) and 127.3(1) of the Act, which provisions no longer affect a corporation's tax payable under Part I.

New paragraphs 123.2(a) to (d) are applicable to taxation years ending after June, 1989. A transitional provision will allow corporations with a taxation year beginning before July 1, 1989 to determine their surtax liability for the portion of the year falling before that date on the basis of Part I tax payable after the deduction of any amounts allowable under sections 125, 125.1 or 129 for that year.

Clause 29

Tax Credit: Large Corporations Tax

ITA
125.3(1)

New Part I.3 of the Act levies a tax on taxable capital employed in Canada by large corporations. New subsection 125.3(1) of the Act permits a corporation to deduct from its tax otherwise payable under Part I its Part I.3 tax liability for the year plus such amount as it chooses of its unused Part I.3 tax credits for the seven preceding and three following taxation years. The amount deductible under this provision, however, may not exceed the corporation's Canadian surtax payable for the year.

The terms "unused Part I.3 tax credit" and "Canadian surtax payable" are both defined in new subsection 125.3(4) of the Act.

ITA
125.3(2)

New paragraph 125.3(2)(a) provides that unused Part I.3 tax credits must be utilized in the order in which they arose so that, for example, an unused Part I.3 tax credit for a corporation's 1991 taxation year must be claimed before a credit in respect of its 1992 taxation year may be utilized. New paragraph 125.3(2)(b) ensures that an unused Part I.3 tax credit claimed in a particular taxation year may not be deducted again in a subsequent year.

ITA
125.3(3)

New subsection 125.3(3) of the Act restricts the amount deductible in respect of a corporation's Part I.3 tax liability where control of the corporation has been acquired either prior to or after the taxation year in which that liability arose. In such circumstances, Part I.3 tax payable by the corporation for a taxation year ending before control was acquired is deductible (pursuant to the carryover provisions and subject to the

limitations set out in new subsection 125.3(1)) in a taxation year ending after control is acquired only if the business to which the tax relates is carried on throughout that later year and only against the portion of the corporation's Canadian surtax payable for the later year that relates to that business or similar businesses. Similar restrictions apply in deducting an unused Part I.3 tax credit for a taxation year ending after the time at which control of a corporation has been acquired in computing Part I tax payable for a taxation year ending before that time.

ITA
125.3(4)

New subsection 125.3(4) of the Act provides definitions for the terms "unused Part I.3 tax credit" and "Canadian surtax payable" for the purposes of determining the amount a corporation is permitted to deduct from its Part I tax payable pursuant to new subsection 125.3(1).

The "unused Part I.3 tax credit" of a corporation for a taxation year is the amount by which the corporation's Part I.3 tax payable for the year exceeds the amount deductible from its tax payable under Part I pursuant to new subsection 125.3(1).

The "Canadian surtax payable" of a corporation for a taxation year is, in the case of a corporation that was at no time in the year resident in Canada, the surtax payable under section 123.2 by the corporation for the year. In the case of any other corporation, the "Canadian surtax payable" of a corporation for a taxation year is the portion of the corporation's surtax payable for the year that is prescribed by regulation. It is intended that Part IV of the Income Tax Regulations be used for the purposes of determining the portion of a corporation's tax payable under section 123.2 that is its Canadian surtax payable for the year.

In determining the "Canadian surtax payable" of a corporation for a taxation year commencing before July, 1989, the amount determined under new paragraph 125.3(4)(b) is to be prorated based on the number of days in the year after June, 1989.

Clause 30

Refundable Dividend Tax on Hand

ITA
129(1)

The investment income of a corporation is taxed at the full corporate tax rate. A portion of this tax (referred to as "refundable dividend tax on hand") is refunded to Canadian-controlled private corporations upon payment of taxable dividends to their shareholders. If a corporation has filed its tax return for a taxation year within three

years from the end of the year and the Minister of National Revenue has not paid the dividend refund upon issuing the assessment of tax for the year, the corporation will be entitled to receive the refund if an application for it is made under subsection 129(1) of the Act within the three or six-year reassessment period provided in subsection 152(4).

As a consequence of the one-year extension of the reassessment periods in subsection 152(4) for mutual fund trusts and corporations other than Canadian-controlled private corporations, subsection 129(1) is amended to refer more generally to the reassessment periods under paragraphs 152(4)(b) and (c) of the Act rather than specifically to the three-year and six-year periods previously referred to in those paragraphs. The amendments to subsection 129(1) are applicable after April 27, 1989.

Clause 31

Mutual Fund Corporations

ITA
131(2)

The taxable capital gains of mutual fund corporations are subject to the full corporate tax rate. This tax (referred to as "refundable capital gains tax on hand") is, however, refunded to the corporation when the taxable capital gains are distributed to its shareholders in the form of "capital gains dividends". If a mutual fund corporation has filed its tax return for a taxation year within three years from the end of the year and the Minister of National Revenue has not paid the capital gains refund upon issuing the assessment of tax for the year, the corporation will be entitled under subsection 131(2) of the Act to receive the refund if an application for it is made within the three-year or six-year reassessment period provided in subsection 152(4).

As a consequence of the one-year extension of the reassessment periods for mutual fund trusts and corporations other than Canadian-controlled private corporations, subsection 131(2) is amended to refer more generally to the reassessment periods under paragraphs 152(4)(b) and (c) of the Act, rather than specifically to the three-year and six-year periods previously referred to in those paragraphs. As a result of this amendment, the general refund application period under subsection 131(2) is extended from three to four years, and the refund application period where the capital gains refund is related to the carryback of an amount from a subsequent year, such as a loss or an investment tax credit, is extended from six to seven years.

The amendments to subsection 131(2) of the Act are applicable after April 27, 1989.

Clause 32

Mutual Fund Trusts

ITA
132(1)(b)

The taxable capital gains of a mutual fund trust are subject to federal income tax act at a rate of 29 per cent. This tax (referred to as "refundable capital gains tax on hand") is refunded to the trust as the trust's unit holders redeem their interests in the trust. If a mutual fund trust has filed its tax return for a year within three years from the end of the year and the Minister of National Revenue has not paid the capital gains refund upon issuing the assessment of tax for the year, the trust is entitled under subsection 132(1) of the Act to receive the refund if an application for it is made within the three-year or six-year reassessment period provided in subsection 152(4) of the Act.

Subsection 152(4) is being amended to extend the three-year and six-year reassessment periods for a mutual fund trust to four years and seven years. As a consequence, the refund provision in subsection 132(1) is amended to refer more generally to the reassessment periods under paragraphs 152(4)(b) and (c) of the Act, rather than specifically to the three-year and six-year periods previously referred to in those paragraphs. As a result of this amendment, the general refund application period under subsection 132(1) is extended from three to four years, and the refund application period where the capital gains refund is related to the carryback of an amount from a subsequent taxation year, such as a loss or an investment tax credit, is extended from six to seven years.

The amendments to subsection 132(1) of the Act are applicable after April 27, 1989.

Clause 33

Non-Resident-Owned Investment Corporations

ITA
133(6)

A non-resident-owned investment corporation (an "NRO") is subject to a 25 per cent rate of tax which approximates that which would have been payable if its non-resident shareholders had invested in Canada directly rather than through the corporation. The portion of this tax paid on its taxable income, other than capital gains (its "allowable refundable tax on hand") is, however, refunded to the corporation upon payment of taxable dividends to its shareholders. If an NRO has filed its tax return for a year within three years from the end of the year and the Minister of National Revenue has not paid the allowable refund upon issuing the assessment of tax for the year, the NRO will be entitled under subsection 133(6) of the Act to receive the refund if an application for it is made within the three-year or six-year reassessment period provided in subsection 152(4) of the Act.

As a consequence of the one-year extension of the reassessment periods in subsection 152(4) for mutual fund trusts and corporations other than Canadian-controlled private corporations, subsection 133(6) is amended to refer more generally to the reassessment periods under paragraphs 152(4)(b) and (c) of the Act, rather than specifically to the three-year and six-year periods previously referred to in those paragraphs. As a result of this amendment, the general refund application period under subsection 133(6) is extended from three to four years.

The amendments to subsection 133(6) of the Act are applicable after April 27, 1989.

Clause 34

Cooperative Corporations

ITA
136(1)

Sections 135 and 136 of the Act contain special rules that apply to cooperative corporations. Subsection 136(1) provides that a cooperative corporation that would otherwise be a private corporation is not to be considered a private corporation except for the purposes of certain provisions of the Act that are listed in that subsection.

Subsection 136(1) is amended to add a reference to section 152 to that list of provisions, as a consequence of the amendments to section 152 that extend the reassessment periods for mutual fund trusts and corporations other than Canadian-controlled private corporations (CCPCs) from three years and six years to four years and seven years. As a result of this amendment to subsection 136(1), the general reassessment period under subsection 152(4) for a cooperative corporation that is a CCPC will continue to be three years and the reassessment period for such a corporation where there has been a carryback of an amount from a subsequent taxation year such as a loss or an investment tax credit will continue to be six years. The amendment to subsection 136(1) is applicable after April 27, 1989.

Clause 35

Credit Unions

ITA
137(7)

Section 137 of the Act contains special rules relating to credit unions. Subsection 137(7) provides that a credit union that would otherwise be a private corporation is not to be considered a private corporation except for the purposes of certain provisions of the Act that are listed in that subsection. Subsection 137(7) is amended, effective after

April 27, 1989, to add a reference to section 152 to that list of provisions, as a consequence of the amendments to section 152 that extend the reassessment periods for mutual fund trusts and corporations other than Canadian-controlled private corporations (CCPCs) from three years and six years to four years and seven years. As a result of this amendment to subsection 137(7), the general reassessment period under subsection 152(4) for a credit union that is a CCPC will continue to be three years and the reassessment period for such a corporation where there has been a carryback of an amount from a subsequent taxation year such as a loss or investment tax credit will continue to be six years.

Clause 36

RRSP Advantages

ITA
146(2), (12) and (13.1)

Subsection 146(2) of the Act sets out the conditions for registration of a registered retirement savings plan (RRSP). Under paragraph 146(2)(c.4), to be registered a plan must contain a requirement that no advantage (other than one specifically set out in any of subparagraphs 146(2)(c.4)(i) to (iv)) which is in any way dependent upon the existence of the plan may be extended to an annuitant or to a person not dealing at arm's length with the annuitant. Such advantages could include, for example, trips, appliances and interest-free loans.

Subparagraph 146(2)(c.4)(ii) is amended to ensure that paragraph 146(2)(c.4) does not apply to payments or allocations of any amount to an RRSP by the RRSP issuer. As a consequence paragraph 146(2)(c.4) would not apply to advantages such as those derived from the savings portion of a life insurance policy (as was already provided in subparagraph 146(2)(c.4)(ii)) and bonus rates of interest on RRSP deposits.

Under subsection 146(12) of the Act an RRSP becomes an "amended plan" if it is revised or amended or a new plan is substituted for it. If the amended plan does not comply with RRSP registration requirements, the plan loses its status as an RRSP and under paragraph 146(12)(b) the taxpayer who was the annuitant under the plan is required to include in income the fair market value of the property of the plan. Under subsection 146(13.1), an RRSP is treated as becoming an amended plan pursuant to subsection 146(12) if an advantage that is extended that would be prohibited if the registration requirement in paragraph 146(2)(c.4) were met.

Subsections 146(12) and (13.1) are amended to impose a penalty on an issuer of an RRSP if the issuer extends an advantage in contravention of paragraph 146(2)(c.4). Each time an advantage is extended by an issuer to an annuitant (or a person not dealing at arm's length with an annuitant) in contravention of paragraph 146(2)(c.4), the issuer will

be liable to a penalty equal to $100 or the amount or value of the advantage, whichever is greater. The extension of such an advantage will, by virtue of amended subsections 146(12) and (13.1), not result in any adverse consequence to RRSP annuitants.

These amendments are applicable with respect to advantages extended after 1988.

Clause 37

Amounts Included in Computing Policyholders' Income

ITA
148(9)(a)

Section 148 of the Act provides for the inclusion of various amounts in computing the income of a taxpayer for a taxation year in respect of certain life insurance policies.

Subparagraphs 148(9)(a)(v.1) and (x), which require certain inclusions in calculating the "adjusted cost basis" of an interest in a life insurance policy, refer to the third anniversary of the policy occurring in a taxation year. Subparagraphs 148(9)(a)(vi) and (x) are amended to refer to the anniversary of a policy, consequential upon the changes to subsections 12.2(3) and (4) of the Act which introduce annual accrual reporting requirements in respect of policies acquired after 1989, These amendments are generally effective with respect to policies acquired after 1989.

Clause 38

Assessments

Subclauses 38(1) to (3)

ITA
152(3.1), (4) and (5)

Section 152 of the Act contains rules relating to assessments, reassessments and additional assessments of tax, interest and penalties payable by a taxpayer.

Existing subsection 152(4) of the Act provides that, in the absence of fraud or misrepresentation, the Minister of National Revenue generally may not reassess tax after three years from the date of mailing of the original notice of assessment unless the taxpayer has filed a waiver within the three-year period. Subsection 152(4) is amended, and new subsection 152(3.1) is introduced, to lengthen the reassessment period by one year for mutual fund trusts and corporations other than Canadian-controlled private corporations (CCPCs).

New subsection 152(3.1) defines "normal reassessment period" for a taxpayer for a taxation year, for the purposes of subsections 152(4) and (5). For most taxpayers, that period is the three years beginning after the day of mailing of a notice of an original assessment for the year or the day of mailing of a notification that no tax is payable for the year. Where the taxpayer is a mutual fund trust or a corporation other than a CCPC, the normal reassessment period is four years after that day.

Amended subsection 152(4) of the Act provides for reassessments within the normal reassessment period, as defined in new subsection 152(3.1). This amendment extends the existing three-year reassessment period to four years for mutual fund trusts and corporations other than CCPCs, and preserves the three-year reassessment period for all other taxpayers. Existing subsection 152(4) provides a special six-year reassessment period during which the Minister of National Revenue may reassess in respect of an amount carried back from a subsequent taxation year, such as a loss carryover or an investment tax credit. Subsection 152(4) is also amended to increase this six-year period to seven years for mutual fund trusts and corporations other than CCPCs.

Subsection 152(5) of the Act provides that where the Minister of National Revenue reassesses tax for a year beyond the general three-year reassessment period in a case of fraud or misrepresentation or on the authority of a waiver filed by a taxpayer, the reassessment shall not include in income any amount not previously included in respect of which the taxpayer did not commit a fraud or misrepresentation or that does not relate to a matter specified in the taxpayer's waiver. This subsection is amended to apply to reassessments made after the normal reassessment period, as defined in new subsection 152(3.1), rather than after a three-year period, as a consequence of the amendment to subsection 152(4) that increases the general reassessment period to four years for mutual fund trusts and corporations other than a CCPCs.

The amendments to section 152 of the Act are applicable after April 27, 1989, except that they do not apply to extend the period for reassessing a taxpayer's taxation year where the original notice of assessment for the year, or notification that no tax was payable for the year, was mailed on or before April 27, 1986.

Subclause 38(4)

ITA
152(6)

Subsection 152(6) of the Act requires the Minister of National Revenue to reassess a taxpayer's return of income for a taxation year where the taxpayer files for a subsequent taxation year a prescribed form claiming a carry-back in respect of a deduction arising in the subsequent year. New paragraph 152(6)(f) of the Act is consequential on the introduction of the Part I.3 tax credit under new section 125.3 which permits a three-year carryback of unused Part I.3 tax credits. This amendment, which is applicable to taxation years ending after June 1989, requires the Minister to reassess preceding taxation years in order to give effect to a taxpayer's carryback of unused Part I.3 credits.

Clause 39

Instalments

ITA
156.1

Section 156.1 of the Act provides an exception to the obligation of making tax instalments as required by sections 155 and 156. Essentially, this section provides that where the income tax payable by an individual for a particular year does not exceed $1,000 instalment payments are not required to be made for that year. This amendment clarifies that the $1,000 threshold is applicable to the total of the income tax and surtax payable by the individual. This amendment is applicable to the 1989 and subsequent taxation years.

Clause 40

Corporations: Tax Payments

ITA
157(1)(a)(i)

Subparagraph 157(1)(a)(i) of the Act contains a formula by which a corporation may calculate its monthly income tax instalments. Under this provision, instalment liability is determined, in part, by reference to a corporation's estimated tax liability before deducting any amount pursuant to paragraph 125.2(1)(a) of the Act on account of any tax payable under Part VI of the Act. Subparagraph 157(1)(a)(i) is amended, applicable to the 1990 and subsequent taxation years, to remove the reference to paragraph 125.2(1)(a), thereby allowing corporations to determine their instalment obligations on the basis of their Part I tax liability after the deduction of any credit in respect of Part VI taxes. This amendment also deletes references to sections 123.1, 127.2 and 127.3, which no longer affect a taxpayer's liability under Part I of the Act.

Clause 41

Interest on Excess Refunds

ITA
160.1(1)(b)

Subsection 160.1(1) of the Act provides for the recovery of an amount refunded to a taxpayer under the Act in excess of the amount to which the taxpayer was entitled. Paragraph 160.1(1)(b) provides that interest is to be paid by the taxpayer on the amount recovered at the rate prescribed for the purposes of subsection 161(1) of the Act. This paragraph is amended to provide for interest to be paid at the prescribed rate, rather

than at the rate prescribed for the purposes of subsection 161(1). This amendment is consequential on the amendments under which the prescribed rate of interest to be charged on overdue taxes, and to be paid on tax refunds, is to be increased by two per cent per annum. The amendment conforms the wording of paragraph 160.1(1)(b) with the wording of other provisions of the Act requiring interest to be paid at the prescribed rate. This amendment is applicable with respect to interest calculated in respect of periods that are after September 1989.

Clause 42

Interest

Subclause 42(1)

ITA
161(4.1)(a)(i)

Paragraph 161(4.1)(a) of the Act provides that for the purposes of determining the amount of interest payable by a corporation on late or deficient instalments of its tax liability under Part I the corporation is considered to have been liable to pay instalments calculated by reference to its tax payable under Part I for the year, its first instalment base for the year or a combination of its first and second instalment bases, whichever method gives rise to the least amount of interest charges. This amendment deletes the reference in this paragraph to sections 123.1, 127.2 and 127.3, which no longer affect the amount of tax payable under Part I, and also removes the reference to paragraph 125.2(1)(a) which is the tax credit in respect of tax payable by a financial institution under Part VI of the Act.

This amendment, which is applicable to the 1990 and subsequent taxation years, is made as a consequence of amendments to Part VI which now require tax payable under that Part to be paid in monthly rather than quarterly instalments.

Subclause 42(2)

ITA
161(7)(a)

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 earlier years is calculated without regard to the reduction until the later of the day following the end of the subsequent year and the date on which the taxpayer's return for that subsequent year is filed.

New subparagraph 161(7)(a)(vii) of the Act is added as a consequence of the introduction of the Part I.3 tax credit under new section 125.3 which permits a three-year carry-back of unused Part I.3 tax credits. This new subparagraph, which is applicable to taxation years ending after June, 1989, provides that a reduction of tax resulting from the carry-back of an unused Part I.3 tax credit from a subsequent taxation year will not affect a corporation's interest liability until the later of the dates referred to above.

Clause 43

Refund of Taxes

Subclause 43(1)

ITA
164(1)(b)

Subsection 164(1) of the Act provides that if a taxpayer has filed a tax return for a taxation year within three years from the end of the year, the Minister of National Revenue may refund any overpayment of tax for the year. It also provides that the Minister is required to make the refund if an application for the refund is made within the three-year reassessment period provided in subsection 152(4), or within the special six-year reassessment period provided in that subsection that applies where an amount such as a loss or investment tax credit is being carried back from a subsequent taxation year.

As a consequence of the amendments to section 152 of the Act which extend the general reassessment period from three years to four years for mutual fund trusts and corporations other than Canadian-controlled private corporations, paragraph 164(1)(b) of the Act is amended to provide that the Minister is required to refund an overpayment of tax for the year only if the taxpayer has applied for the refund before the end of whichever reassessment period applies in respect of the taxpayer under paragraph 152(4)(b) or (c). This amendment is applicable after April 27, 1989.

Subclauses 43(2) and (3)

ITA
164(5) and (5.1)

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 on the later of the day following the end of the subsequent year and the date on which the taxpayer's return for the subsequent year was filed.

New paragraph 164(5)(h) of the Act is added as a consequence of the introduction of the Part I.3 tax credit under new section 125.3 which permits a three year carry-back of unused Part I.3 tax credits. This amendment, which is applicable to taxation years ending after June, 1989, provides that an overpayment of tax resulting from the carry-back of an unused Part I.3 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 referred to above.

Subsection 164(5.1) of the Act parallels the rules contained in subsection 164(5) except that this provision deals with interest payable in respect of a repayment of an amount in controversy rather than a refund of an overpayment of tax. The amendment to subsection 164(5.1) is identical to that made to subsection 164(5) which is discussed above. This amendment is also applicable to taxation years ending after June, 1989.

Clause 44

Validity of Reassessment

ITA
165(5)

Subsection 165(5) of the Act empowers the Minister of National Revenue to reassess tax for a year after receiving a notice of objection from a taxpayer, even though the three-year period provided under subsection 152(4) of the Act for making a reassessment has expired. New subsection 152(4) now provides a four-year reassessment period for mutual fund trusts and corporations other than Canadian-controlled private corporations. As a consequence of that amendment subsection 165(5) is amended, effective after April 27, 1989, to provide that where the Minister of National Revenue has received a notice of objection from a taxpayer, the Minister may reassess even though the relevant reassessment period determined under paragraph 152(4)(b) or (c) of the Act has expired.

Clause 45

Reference to Court

ITA
173(2)(a)

Under subsection 173(1) of the Act the Minister of National Revenue and a taxpayer may agree to refer a question of law, fact or mixed law and fact arising under the Act to the Federal Court (or, as of a day to be fixed by order of the Governor in Council, to the Tax Court of Canada).

Paragraph 173(2)(a) of the Act provides that the period of time during which any question is being considered shall not be included in computing the three-year and six-year periods during which a reassessment of tax may be made by the Minister under subsection 152(4) of the Act.

As a consequence of the amendments which extend the three-year and six-year reassessment periods under subsection 152(4) by one year for mutual fund trusts and corporations other than Canadian-controlled private corporations, paragraph 173(2)(a) is amended to adopt more general wording that provides that the period during which any question referred to the court under subsection 173(1) is being considered shall not be included in computing the reassessment periods determined under subsection 152(4). This amendment is applicable after April 27, 1989.

Clause 46

Reference of Common Questions

ITA
174(5)(c)

Section 174 of the Act permits the Minister of National Revenue to refer a question of law, fact or mixed law and fact that is common to the assessments of two or more taxpayers to the Tax Court of Canada for a determination. Paragraph 174(5)(c) provides that the period of time during which any question is being considered shall not be included in computing the three-year and six-year periods during which a reassessment of tax may be made by the Minister under subsection 152(4) of the Act.

As a consequence of the amendments which extend the three-year and six-year reassessment periods under subsection 152(4) by one year for mutual fund trusts and corporations other than Canadian-controlled private corporations, paragraph 174(5)(c) is amended to adopt more general wording that provides that the period during which any question referred to the court under section 174 is being considered shall not be included in computing the reassessment periods determined under subsection 152(4). This amendment is applicable after April 27, 1989.

Clause 47

Surtax on Individuals

ITA
180.1

Section 180.1 of the Act levies a surtax on individuals. This amendment increases the rate of the surtax from 3% to 4% of tax payable under Part I of the Act for the 1989 taxation year and to 5% for the 1990 and subsequent taxation years. Individuals whose tax payable under Part I for a taxation year exceeds $15,000 will pay an additional surtax on the excess at a rate of 1 1/2% for the 1989 taxation year and 3% for 1990 and subsequent taxation years. The requirement that the individual estimate the amount of the surtax payable has been moved from subsection 180.1(3) to subsection 180.1(4) which now includes a reference to section 151. Revised subsection 180.1(3) requires the filing of a return of income where surtax is payable even where no income tax under Part I of the Act is exigible. These amendments are applicable to the 1989 and subsequent taxation years.

Clause 48

Tax on Family Allowances and Old Age Security Benefits

Part I.2

ITA
180.2

New Part I.2 of the Act provides for the repayment by a taxpayer of federal family allowances and old age security benefits included in computing the taxpayer's income, to the extent that the taxpayer's income is in excess of a $50,000 indexed threshold. The amount of the repayment required is equal to 15% of the taxpayer's income in excess of the $50,000 threshold, up to the total of the federal family allowances and old age security benefits included in the taxpayer's income. This amendment is applicable to the 1989 and subsequent taxation years. However, for 1989 and 1990, the amount to be repaid is equal to 1/3 and 2/3, respectively, of the amount of the repayment otherwise required.

Tax on Large Corporations

Part I.3

ITA
181 to 181.9

New Part I.3 of the Act levies a 0.175% annual tax on a corporation's capital employed in Canada in excess of $10 million. This tax will be payable for taxation years ending

after June, 1989 and will be required to be paid in monthly instalments commencing in 1990. The new tax will be creditable against the 3% corporate surtax imposed under section 123.2 of the Act to the extent that it is levied on income earned in Canada.

ITA 181(1)

New subsection 181(1) of the Act defines several terms for the purposes of new Part I.3.

The term "financial institution" means a bank, a credit union, an insurance corporation, a loan or trust company, a securities dealer, a deposit insurance corporation or a corporation prescribed to be a financial institution.

For the purposes of Part I.3 "long-term debt" consists of bank debentures, or where the issuer of the debt is not a bank, subordinate debt obligations issued for a term of at least 5 years.

The term "reserves" is defined to include all of a corporation's reserves, provisions and allowances including any provision for deferred taxes.

ITA
181(2)

The meanings of the terms "attributed surplus", "Canadian assets", "Canadian premiums", "Canadian reserve liabilities", "permanent establishment", "total assets", "total premiums" and "total reserve liabilities" are to be prescribed in the Income Tax Regulations.

ITA
181(3)

New subsection 181(3) of the Act establishes the rules to be followed in determining, for the purposes of new Part I.3, the carrying value of an asset or any other amount in respect of a corporation's capital, investment allowance, taxable capital or taxable capital employed in Canada or in respect of a partnership in which a corporation has an interest. These amounts are to be based on the corporation's balance sheet at the end of the year for which tax is payable. If the corporation did not prepare a balance sheet, or prepared a balance sheet that does not accord with generally-accepted accounting principles, the amounts used will be those that would have been reflected in a balance sheet that had been prepared in accordance with generally-accepted accounting principles. Banks and insurance corporations that are regulated by the Superintendent of Financial Institutions or a similar provincial authority will be required to use the amounts in the statements accepted by that authority for regulatory purposes. The requirement to use amounts reflected in a corporation's balance sheet is subject to an exception in paragraph 181(3)(a) which provides that if the equity or consolidation methods of accounting were used in preparing the balance sheet the amounts used in calculating Part I.3 tax should be those that would be on the balance sheet if these methods were not employed.

ITA
181(4)

New subsection 181(4) of the Act is an interpretive rule that provides that unless a contrary intention is evident an amount is not to be included or deducted more than once in determining the Part I.3 tax base.

ITA
181.1(1)

New subsection 181.1(1) of the Act is the charging provision for new Part I.3. This subsection sets the annual rate of the new Part I.3 Tax on Large Corporations at 0.175 % of a corporation's taxable capital employed in Canada in excess of its capital deduction for the year. The terms "taxable capital employed in Canada" and "capital deduction" are both defined in other provisions in Part I.3 (see commentary below).

ITA
181.1(2)

New subsection 181.1(2) of the Act deals with the situation where a corporation has a short taxation year. If the taxation year of a corporation is less than 51 weeks the Part I.3 tax payable by the corporation for the year will be pro-rated on the basis of the number of days in the year over 365.

ITA
181.1(3)

New subsection 181.1(3) of the Act exempts certain corporations from Part I.3 tax, namely, a non-resident-owned investment corporation, a bankrupt corporation, a corporation exempt from income tax under Part I of the Act and a corporation that neither was resident in Canada nor carried on business from a permanent establishment in Canada at any time in the year.

ITA
181.2(1)

New subsection 181.2(1) of the Act provides that the taxable capital employed in Canada of a Canadian resident corporation that is not a financial institution is to be determined under the Income Tax Regulations. It is intended that the taxable income allocation formula in Part IV of the Regulations will be used for the purposes of determining the portion of a corporation's taxable capital that is considered to be employed in Canada for the purposes of new Part I.3.

ITA
181.2(2)

New subsection 181.2(2) of the Act provides rules for determining the taxable capital of a corporation (other than a financial institution). A corporation's taxable capital for a taxation year its capital for the year minus its investment allowance for the year. The "capital" and "investment allowance" of a corporation are determined under new subsections 181.2(3) and 181.2(4), respectively. (See commentary below.)

ITA
181.2(3)

New subsection 181.2(3) of the Act describes the capital of a corporation (other than a financial institution). A corporation's capital, which is computed at year-end, is the sum of its capital stock, retained earnings, surplus, non-deductible reserves, any loans or advances to the corporation, any debt obligations issued by the corporation, declared but unpaid dividends and any other indebtedness outstanding for more than one year.

Also included in the capital of a corporation is its share of the liabilities of any partnership of which it is a member. The amount of this share is determined on a prorated basis based on the corporation's share of the partnership's income or loss for its fiscal period ending in the corporation's taxation year. For the purposes of this rule, a partnership's liabilities includes all the liabilities and reserves (other than amounts owing to corporations that are members of the partnership) that would be included in computing a corporation's capital.

New subsection 181.2(3) also provides a deduction from capital for a corporation's deferred tax debit balance, as well as the amount of any deficit of the corporation, at the end of the year.

ITA
181.2(4) and (5)

A corporation is permitted a deduction in computing its taxable capital in respect of its investments in other corporations. The amount of this deduction, termed an "investment allowance", is determined under new subsection 181.2(4) of the Act for corporations other than financial institutions.

A corporation's investment allowance for a taxation year is the aggregate carrying value to the corporation at the end of the year of the following:

(a) shares of other corporations

(b) loans or advances to other corporations (other than financial institutions)

(c) bonds, notes, mortgages, hypothecs or similar obligations of other corporations (other than financial institutions)

(d) long-term debt of financial institutions, and

(e) interests in partnerships.

No allowance is provided in respect of investments in a corporation that is exempt from tax income under Part I of the Act.

For the purposes of determining a corporation's investment allowance, the carrying value of an interest of the corporation in a partnership is established under new subsection 181.2(5) of the Act to be a prorated portion of the partnership's assets that would qualify for an investment allowance if it were a corporation, based on the corporation's share of the partnership's income or loss for its fiscal period ending in the corporation's taxation year.

ITA
181.3(1)

New section 181.3 of the Act contains the rules used to determine the capital, taxable capital, taxable capital employed in Canada and investment allowance of a financial institution. The taxable capital employed in Canada of a financial institution is determined under new subsection 181.3(1).

In the case of a financial institution other than an insurance corporation, taxable capital employed in Canada for a taxation year is the aggregate of:

(a) the aggregate carrying value at the end of the year of the corporation's tangible property used in Canada (including a proportionate interest of all tangible property of any partnership of which the corporation is a member), and

(b) the proportion of its taxable capital for the year that its Canadian assets at the end of the year is of its total assets at the end of the year.

The taxable capital employed in Canada of an insurance corporation that was resident in Canada and carried on a life insurance business in the year is the aggregate of:

(a) the aggregate carrying value at the end of the year of the corporation's tangible property used in Canada that is non-segregated property (including a proportionate interest in all tangible property of any partnership of which the corporation is a member),

(b) the proportion of its taxable capital for the year that its Canadian reserve liabilities for the year is of its total reserve liabilities for the year, and

(c) the amount by which the amount of its reserves for the year (other than a reserve for amounts payable from segregated funds) established in respect of its Canadian insurance business exceeds

  (i) any portion thereof that was either deductible under subparagraph 138(3)(a)(i) of the Act or deducted in computing the corporation's income for the year under Part I, and

  (ii) the amount at the end of the year of policy loans made by the corporation (to the extent that they were deducted in computing the amount deductible by the corporation under subparagraph 138(3)(a)(i) of the Act).

The taxable capital employed in Canada of an insurance corporation that was resident in Canada in the year and throughout the year did not carry on a life insurance business is the aggregate of:

(a) the aggregate carrying value at the end of the year of the corporation's tangible property used in Canada that is non-segregated property (including a proportionate interest in all tangible property of any partnership of which the corporation is a member), and

(b) the proportion of its taxable capital for the year that its Canadian premiums for the year is of its total premiums for the year.

The taxable capital employed in Canada of an insurance corporation that was throughout the year not resident in Canada and carried on an insurance business in Canada at any time of the year is the aggregate carrying value at the end of the year of the corporation's tangible property used in Canada that is non-segregated property (including a proportionate interest in all tangible property of any partnership of which the corporation is a member), plus its taxable capital for the year.

ITA
181.3(2)

New subsection 181.3(2) of the Act provides rules for determining the taxable capital of a financial institution. The taxable capital of a financial institution for a taxation year is its capital for the year minus its investment allowance for the year. The "capital" and "investment allowance" of a financial institution are determined under new subsections 181.3(3) and 181.3(4), respectively (see commentary below).

ITA
181.3(3)

New subsection 181.3(3) of the Act provides the rules for determining the capital for a taxation year of a financial institution.

In the case of a financial institution other than an insurance corporation, capital is defined as the total of its long-term debt, capital stock, retained earnings, surpluses and its undeducted reserves. Any deferred tax debit balance or deficit of the corporation is deductible in determining its capital for the year.

The capital of an insurance corporation that was resident in Canada and carried on a life insurance business at any time in the year is the aggregate at the end of the year of its long-term debt, capital stock, retained earnings, contributed surplus and any other surpluses minus any deferred tax debit balance or deficit of the corporation.

In the case of an insurance corporation that was resident in Canada at any time in the year but did not carry on a life insurance business at any time in the year, capital includes the amount of the corporation's long-term debt, capital stock, retained

earnings, contributed surplus and any other surpluses. The capital of such a corporation also includes the aggregate amount of its reserves for the year (to the extent that they were not deducted in computing its income for the year under Part I) and may be reduced by the amount of any deferred tax debit balance or deficit of the corporation.

The capital of an insurance corporation that was throughout the year not resident in Canada but that carried on an insurance business in Canada at any time in the year is the sum of:

(a) the greater of its surplus funds derived from operations (as defined under paragraph 138(12)(o) of the Act) and its contributed surplus for the year, as well as any other surpluses relating to its Canadian insurance business,

(b) the amount of its long-term debt relating to its insurance business carried on in Canada, and

(c) the amount by which its reserves for the year established in respect of its insurance business carried on in Canada (to the extent that they were neither deducted in computing its income under Part I for the year nor deductible in computing its income for the year under subparagraph 138(3)(a)(i)) exceeds the aggregate amount of all policy loans at the end of the year (to the extent that they were deducted in computing the amount deductible by the corporation under subparagraph 138(3)(a)(i) of the Act).

ITA
181.3(4)

New subsections 181.3(4) of the Act provides rules for determining the investment allowance of a financial institution for a taxation year. This allowance is,

- in the case of a financial institution resident in Canada, the aggregate carrying value to the institution at the end of the year of shares or long-term debt of related financial institutions, provided, in the case of an insurance corporation, that these investments are non-segregated property as defined under paragraph 138(12)(j) of the Act.
- in the case of an insurance corporation that is not resident in Canada, the aggregate carrying value to the corporation at the end of the year of shares or long-term debt of related financial institutions that are non-segregated property and that are used in or held in the course of carrying on an insurance business in Canada, and
- in the case of any other financial institution, nil.

For the purposes of section 181.3, a credit union and any other credit union of which it is a shareholder or member are considered to be related to each other. Similarly, a deposit insurance corporation and its member institutions are deemed to be related to one another for the purposes of section 181.3.

ITA
181.4

New section 181.4 of the Act provides that where a corporation (other than a financial institution) is at no time in the year resident in Canada, its taxable capital employed in Canada for a taxation year is the aggregate carrying value at the end of the year of all assets of the corporation used in, or held in the course of carrying on, any business carried on by it through a permanent establishment in Canada during the year minus the total of:

(a) the amount of the corporation's indebtedness at the end of the year (other than indebtedness described in paragraphs 181.2(3)(c) to (f) of the Act) that may reasonably be regarded as relating to a business carried on by it during the year through a permanent establishment in Canada, and

(b) the aggregate carrying value of any assets of the corporation that qualify for the investment allowance under new subsection 181.2(4) and that were used in, or held in the course of carrying on, any business carried on by it through a permanent establishment in Canada during the year.

ITA
181.5

New section 181.5 of the Act provides that the capital deduction of a corporation for a taxation year is $10 million. Pursuant to new subsection 181.1(1), this amount may be deducted from a corporation's taxable capital employed in Canada for the year and is intended to ensure that the application of new Part I.3 is restricted to large corporations. Where, however, a corporation is related to another corporation any time in the year its capital deduction will be nil, subject to new subsection 181.5(4). In this case the related corporations must share the capital deduction by filing an agreement with the Minister of National Revenue as provided under subsection 181.5(2) or, if such an agreement is not filed, the Minister may, under subsection 181.5(3), allocate the $10 million among the corporation.

Where more than one amount is allocated to a corporation subsection 181.5(4) provides that the least amount allocated will be its capital deduction.

If a corporation has more than one taxation year ending in the same calendar year and is related in those years to another corporation under subsection 181.5(5) the capital deduction of the first corporation for each such year at the end of which it is related to the other corporation is the amount allocated to it for the first year.

New subsection 181.5(6) provides that, for the purpose of the allocation of the capital deduction and determining the investment allowance permitted to financial institutions, corporations will not be considered to be related merely because of the existence of a right to acquire control of a corporation or as a result of control of the corporations by Her Majesty in right of Canada or a province.

ITA
181.6

New section 181.6 of the Act requires a corporation liable to pay tax under new Part I.3 for a taxation year to file a return containing an estimate of its tax payable.

ITA
181.7(1)

New subsection 181.7(1) of the Act requires corporations which have a Part I.3 tax liability to make monthly instalment payments in respect of that liability. These instalment payments must be made in accordance with one of the following:

(1) each monthly payment equal to one twelfth of the amount estimated by the corporation to be its Part I.3 tax for the year;

(2) each monthly payment equal to one twelfth of its first instalment base for the year; or

(3) two initial monthly payments equal to one twelfth of its second instalment base for the year plus, in the case of each subsequent monthly payment, one tenth of the amount by which its first instalment base for the year exceeds one sixth of its second instalment base for the year.

For the purposes of these calculations, the terms "first instalment base" and "second instalment base" are both defined in subsection 181.7(2) of the Act (see commentary below).

New subsection 181.7(1) of the Act also provides that, if a corporation's Part I.3 tax payable for the year exceeds its instalment payments, the corporation is required to pay any balance by the end of either the second or third month following the end of the year, as determined in accordance with paragraph 157(1)(b) of the Act.

ITA
181.7(2)

New subsection 181.7(2) of the Act contains definitions of the terms "first instalment base" and "second instalment base". The first instalment base of a corporation for a taxation year is obtained by multiplying its tax payable under Part I.3 for its immediately preceding taxation year by the ratio that 365 is of the number of days in that preceding year. Accordingly, where a corporation has a short taxation year, its tax payable under Part I.3 for that year is to be restated at a full-year rate for the purposes of calculating its instalment base for subsequent years. The second instalment base of a corporation for a taxation year is the corporation's first instalment base for the immediately preceding taxation year.

In the case of a new corporation formed as a result of an amalgamation or merger, its first instalment base for the taxation year immediately following the amalgamation is the aggregate of the taxes payable under Part I.3 by any corporation that entered into the amalgamation or merger for its last taxation year, multiplied by the ratio that 365 is of the number of days in that year. Similarly, the second instalment base of the new corporation for its first taxation year is the total of the first instalment bases of the amalgamating or merging corporations for their last taxation years.

ITA
181.8

New section 181.8 of the Act provides that a corporation that is liable to pay tax under Part I.3 will also be liable to interest on late payments of taxes and instalments in the same manner as is applicable under Part I of the Act.

ITA
181.9

New section 181.9 of the Act provides that certain provisions of Part I of the Act relating to assessments, interest, penalties, objections and appeals are applicable with equal force to the Tax on Large Corporations under Part I.3.

New sections 181 to 181.9 of the Act are applicable to taxation years ending after June, 1989. Where such a taxation year of a corporation commences before July, 1989, the tax otherwise payable for the year under Part I.3 is reduced proportionately based on the number of days in the year that are before July, 1989.

Where a corporation has a taxation year ending before 1990, it is required to pay its Part I.3 tax for that year on the later of January 15, 1990 and the day by which the corporation is required to pay any remainder of its tax payable under Part I for the year.

In the case of a taxation year ending after 1989 and before July, 1993, a corporation is required to make monthly instalments on the last day of each month ending in the year and after 1989 of an amount equal to either:

(a) its Part I.3 tax for the year divided by the number of months in the year ending after 1989,

(b) its first instalment base for the year divided by the number of months in the year ending after 1989, or

(c) for each of the first two months in the year ending after 1989, its second instalment base for the year divided by the number of months in the year ending after 1989, and for each of the remaining months in the year an amount equal to the excess of its first instalment base for the year over its first two monthly payments, divided by the number of remaining months in the year.

For the purposes of calculating the instalment base of a corporation for taxation years ending before July, 1993, the tax payable under Part I.3 by a corporation for taxation year ending before July, 1989 is deemed to be the amount that would have been its tax payable if Part I.3 had applied in respect of that year and its capital deduction for that year were the same amount as its capital deduction for its first taxation year ending after June, 1989, and the tax payable under Part I.3 by the corporation for its first taxation year ending after June, 1989 is the amount of its tax otherwise payable under Part I.3 for that year multiplied by the ratio that the number of days in the year is of the number of days in the year ending after June, 1989.

Clause 49

Part VI – Definitions

ITA
190(1) and (1.1)

Subsection 190(1) of the Act sets out the definitions of certain terms used in Part VI. This amendment:

(a) removes the definition of "bank", which is contained in the *Interpretation Act* and applies for the purposes of the *Income Tax Act*;

(b) deletes the reference to "money" in paragraph (c) of the definition "financial institution" with respect to investing in mortgages or hypothecs on real estate; and

(c) deletes the reference in the definition "long-term debt" to the *Quebec Savings Banks Act*.

Subsection 190(1.1) of the Act provides that, for the purposes of Part VI, the terms "Canadian assets" and "total assets", which are currently defined in sections 190.14 and 190.15, respectively, have the meanings prescribed by regulation.

Clause 50

Part VI – Tax on Capital of Financial Institutions

ITA
190.1

Section 190.1 of the existing Act provides that a financial institution is liable to a tax under Part VI of the Act equal to 1.25% of its taxable capital for the year prorated on the basis of the number of days in the year that the corporation is a financial institution is of 365. Section 190.1 is amended to provide that a corporation that is a financial institution at any time during a taxation year shall pay a tax under Part VI of 1.25% of

the amount by which its taxable capital employed in Canada for the year exceeds its capital deduction for the year. A corporation's "taxable capital employed in Canada" and "capital deduction" for a taxation year are determined under sections 190.11 and 190.15, respectively. The tax payable by a corporation under subsection 190.1(1) is, pursuant to new subsection 190.1(2), prorated on the basis of the proportion that the number of days in the year on which the corporation is a financial institution is of 365.

ITA
190.11

Section 190.11 of the Act currently contains the formula for determining a corporation's taxable capital for a taxation year for the purposes of Part VI. New section 190.11 introduces the term "taxable capital employed in Canada", which is defined to be that proportion of a corporation's taxable capital for a taxation year that its Canadian assets for the year is of its total assets for the year.

ITA
190.12

New section 190.12 of the Act provides that for the purposes of Part VI the taxable capital of a corporation for a taxation year its capital for the year minus its investments in related financial institutions, as calculated under new section 190.14 (see commentary below).

ITA
190.13

Under new section 190.13 of the Act the capital of a financial institution for the purposes of Part VI is the total, computed at the end of the year on a non-consolidated basis, of its long-term debt, capital stock, retained earnings, contributed surplus and any other surpluses, and its provisions or reserves that were not deducted in computing its income under Part I for the year. Any deferred tax debit balance or deficit of the corporation may be deducted in determining its capital for the year under this Part.

ITA
190.14

New section 190.14 of the Act provides that a corporation's investment for a taxation year in a related financial institution is the aggregate of:

(a) the cost of any share of the capital stock and any long-term debt of the related institution owned by the corporation at the end of the year, determined from the corporation's balance sheet as if it were prepared on a non-consolidated basis, and

(b) the amount of any surplus of the related institution at the end of the year contributed by the corporation, to the extent that it was not otherwise included in determining the cost of the corporation's investment in that institution.

ITA
190.15

Capital Deduction

New section 190.15 of the Act contains the rules for determining the amount of a corporation's capital deduction for the purposes of Part VI. Under subsection 190.15(1) a corporation's capital deduction for a taxation year is $200 million plus the lesser of $20 million and 1/5 of its capital in excess of $200 million, unless the corporation was related to another financial institution at the end of the year. Where this is the case, the related financial institutions must share the capital deduction. Under new subsection 190.15(2) related corporations may file with the Minister an agreement in prescribed form on behalf of the related group allocating among the members of the related group for that year an amount that does not exceed $200 million plus the lesser of $20 million and 1/5 of the aggregate capital of each of the related corporations in excess of $200 million. If such an agreement is not filed the Minister of National Revenue may, pursuant to subsection 190.15(3), make such an allocation between the related institutions. Where related financial institutions fail to file an agreement and the Minister makes no allocation for them, subsection 190.15(4) provides that no capital deduction is available to the members of the related group for the taxation year in question.

New subsection 190.15(5) provides the rules for determining the capital deduction of a particular corporation which has more than one taxation year ending in the same calendar year and is related in two or more of those taxation years to another corporation that also has a taxation year ending in that calendar year. Where this occurs, the capital deduction of the particular corporation for each taxation year at the end of which it is related to the other corporation is equal to the amount allocated to it, under subsections 190.15(2) or (3), as its capital deduction for the first taxation year in that calendar year in which it is related to the other corporation.

Clause 51

Part VI – Administration

ITA
190.21(1)

New subsection 190.21(1) of the Act requires corporations which have a Part VI tax liability to make monthly instalment payments. These instalment payments must equal either:

(a) one-twelfth of the amount estimated to be its tax payable under Part VI for the year;

(b) one-twelfth of its first instalment base for the year; or

(c) two initial payments equal to one twelfth of its second instalment base for the year and, for each other payment, one-tenth of the amount by which its first instalment base for the year exceeds one-sixth of its second instalment base for the year.

For the purposes of these calculations, the terms "first instalment base" and "second instalment base" are both defined in new subsection 190.22 (see commentary below).

New subsection 190.21(1) of the Act also provides that where a corporation's tax payable under Part VI for the year exceeds the aggregate of its instalment payments the corporation is required to pay the balance by the end of the second month following the end of the year.

ITA
190.22

New subsection 190.22 of the Act provides definitions for the terms "first instalment base" and "second instalment base" for the purposes of Part VI. The first instalment base of a corporation for a taxation year is obtained by multiplying its tax payable under Part VI for the immediately preceding taxation year by the ratio that 365 is of the number of days in that preceding year. Accordingly, where a corporation has a short taxation year, its Part VI tax payable for that year is to be restated at a full-year rate for the purposes of calculating its instalment base for subsequent years. The second instalment base of a corporation for a taxation year is the corporation's first instalment base for the immediately preceding taxation year.

In the case of a new corporation formed as a result of an amalgamation or merger, its first instalment base for the taxation year immediately following the amalgamation is the aggregate of the taxes payable under Part VI by the corporations that entered into the amalgamation or merger for their last taxation years, multiplied by the ratio that 365 is of the number of days in each such year. Similarly, the second instalment base of the new corporation for its first taxation year is the aggregate of the first instalment bases of the amalgamating corporations for their last taxation years.

ITA
190.23

New section 190.23 of the Act provides that a corporation liable to pay tax under Part I.3 will also be liable to interest on late payments of any part or instalment of the tax in the same manner as is applicable under Part I of the Act.

ITA
190.24

New section 190.24 of the Act provides that certain provisions of Part I of the Act relating to assessments, interest, penalties, objections and appeals are applicable with equal force to Part VI.

Clause 52

Tax on Investment Income of Life Insurers

ITA
211.5

Part XII.3 of the Act levies a special tax on the accumulated investment income of life insurance companies. Section 211.5 of the Act requires an insurer who is liable to pay tax under Part XII.3 to pay interest, at the rate prescribed for the purposes of section 161 of the Act, in respect of any late or deficient payments of tax and instalments. Section 211.5 is amended to provide for interest to be paid at the prescribed rate, rather than at the rate prescribed for the purposes of section 161 (i.e., the prescribed rate plus 2%). The amendment is applicable with respect to interest to be calculated in respect of periods that are after September 1989.

Clause 53

Certificates for Unpaid Amounts

ITA
223(12)(b)

Subsection 223(12) of the Act provides that a certificate issued by the Minister of National Revenue and registered in the Federal Court of Canada in respect of a tax debt owing may refer to the interest rate to be charged on that debt as the rate prescribed under the Act, without specifying the exact rates that apply from time to time. The subsection is amended to refer to the rate prescribed "on amounts payable to the Receiver General". This amendment is consequential on the two per cent increase in the prescribed rate of interest to be charged on overdue taxes and to be paid on tax refunds.

It confirms that the prescribed rate that will apply for the purposes of certificates issued under section 223 is the increased prescribed rate (i.e. the prescribed rate plus 2%). This amendment is applicable in respect of interest to be calculated in respect of periods that are after September 1989.

Clause 54

Definitions

ITA
248(1)

Subclause 54(1)

"retiring allowance"

The definition "retiring allowance" in subsection 248(1) of the Act is amended to exclude from that definition any benefit arising as a result of counselling services described in new subparagraph 6(1)(a)(iv). This change is consequential on the amendments to paragraph 6(1)(a) of the Act excluding certain counselling benefits from a taxpayer's income.

Subclause 54(2)

"dividend rental arrangement"

This amendment adds the definition "dividend rental arrangement" to subsection 248(1) of the Act. The definition is relevant for the purposes of the amendments to paragraph 82(1)(b) and section 112 of the Act which deny a taxpayer who receives a dividend as part of such an arrangement the favourable treatment which is normally accorded dividends from taxable corporations.

A dividend rental arrangement of a person is any arrangement the main reason for which is to enable the person to receive a dividend on the share of a taxable corporation in circumstances where any increase or decrease in the value of the share will accrue to someone other than that person.

Subclause 54(3)

ITA
248(7)

Subsection 248(7) of the Act provides that anything sent by first class mail or its equivalent is considered to have been received by the recipient on the day that it was mailed, with the exception of remittances to the Receiver General of amounts deducted or

withheld under the Act or the Income Tax Regulations which are considered to have been remitted on the day they are actually received by the Receiver General. This subsection is amended to provide that any amount payable by a corporation under the Act or the regulations will likewise be deemed to have been remitted on the day the payments are actually received by the Receiver General. This amendment is applicable to amounts remitted or paid by a corporation that are due after 1989.

Subclause 54(4)

Compound Interest

ITA
248(11)

Subsection 248(11) of the Act provides that for specific provisions of the Act, compound interest, rather than simple interest, is required to be paid on refunds and charged on late payments of income tax, interest and penalties. The subsection also provides that where interest was required to be computed under one of the provisions of the Act listed in the subsection and it ceases to be required to be computed under that provision, but an amount of interest computed under that provision remains unpaid, compound interest must be computed on that unpaid amount until it is paid. This requirement is amended, effective on January 1, 1987 (the date on which subsection 248(11) first became effective), to clarify that the compound interest computed on that amount of unpaid interest must be paid or credited as it would have been required to be paid or credited if the interest had continued to be computed under the provision under which the unpaid amount arose.

Subsection 248(11) is also amended to add a reference to section 211.5 of the Act, effective with respect to taxation years commencing after June 17, 1987 that end after 1987. This coming into force corresponds with the effective date of section 211.5, which requires interest to be paid on late or deficient payments of the special Part XII.3 tax payable by life insurance companies on their accumulated investment income. This amendment confirms that the interest payable under section 211.5 is to be compounded on a daily basis.

Finally, subsection 248(11) is amended to add a reference to new subsections 181.8(1) and (2) of the Act, which relate to interest in respect of amounts payable under new Part I.3 of the Act.

Clause 55

Securities Lending

ITA
260

New section 260 of the Act sets out the rules relating to securities lending arrangements. These include non-tax motivated transactions and are given treatment different from dividend rental arrangements which are primarily tax motivated.

ITA
260(1)

New subsection 260(1) of the Act provides definitions for the terms "securities lending arrangement" and "qualified security" for the purposes of the new rules in section 260 relating to securities lending arrangements.

A "securities lending arrangement" is defined as an arrangement under which:

(a) a person (the lender) transfers or lends a "qualified security", as defined, to another person (the borrower) with whom he deals at arm's length,

(b) it may reasonably be expected, at the time that the transfer takes place, that the borrower will transfer or return an identical security to the lender,

(c) the lender is entitled to be compensated for all dividends, if any, paid on the security during the period that it is loaned, and

(d) there is no material change in the lender's position vis-à-vis any potential loss or gain with respect to the security.

A securities lending arrangement, however, does not include an arrangement one of the main purposes of which is to allow the lender to avoid or defer including any gain or profit with respect to the security in his income.

The special rules governing securities lending arrangements apply only with respect to qualified securities. A "qualified security" is defined as any security that is:

(a) a share of a class of the capital stock of a corporation that is listed on a prescribed stock exchange or a share of a class of the capital stock of a corporation that renders it a public corporation (i.e. a share that is publicly traded),

(b) a bond, debenture, note or similar obligation issued by a corporation referred to in (a) above or by a corporation that is controlled by such a corporation,

(c) a bond, debenture, note or similar obligation issued or guaranteed by a government or a corporation or organization controlled by a government, or

(d) a warrant, right, option or similar instrument with respect to a share described in (a) above.

ITA
260(2)

New subsection 260(2) of the Act provides that any transfer or loan of a security by a lender under a securities lending arrangement is deemed not to be a disposition of the security. This recognizes that the lender continues to bear the capital risk associated with the security and is designed to prevent an inappropriate recognition of a gain or loss in respect of the security. In addition, where the lender receives back an identical security, for the purposes of the Act, that identical security shall be deemed to be the same security as that originally loaned or transferred. Subsection 260(3) modifies this rule where the lender receives property other than an identical security.

ITA
260(3)

New subsection 260(3) of the Act deals with the situation where a lender under a securities lending arrangement receives back property that is not identical to the security that he originally transferred or lent to the borrower, in satisfaction of or in exchange for his right to receive such an identical security. The subsection provides that in this situation the security transferred or lent will be considered to have been disposed of for such property at the time that the property was received.

Notwithstanding this tax treatment, the subsection also provides that the lender of a security will be entitled to take advantage of the provisions of section 51, 85.1, 86 or 87, as the case may be, in respect of such a disposition as if the security had continued to have been the lender's property and the lender had received the property directly. These particular sections set out special rules that apply:

- section 51 – to exchanges of securities pursuant to a conversion privilege,
- section 85.1 – to exchanges of shares pursuant to a share-for-share exchange,
- section 86 – to exchanges of shares in the course of a reorganization of capital, and
- section 87 – to substitutions of securities of a predecessor corporation with those of the new company formed on an amalgamation.

ITA
260(4)

New subsection 260(4) of the Act deals with the situation where it may reasonably be considered that a lender of a security under a securities lending arrangement would have disposed of the security if it had not been lent, generally as a result of circumstances beyond his control, but where new subsection 260(3) does not apply because he has not actually received any proceeds of disposition. This might occur, for example, in the case of a takeover or reorganization of the corporation whose securities were lent or the redemption of the securities that were lent. In these circumstances, new subsection 260(4) provides that the lender will be deemed to have disposed of the security at the

time that he would reasonably be expected to have received proceeds of disposition if he had not entered into the securities lending arrangement.

ITA
260(5)

Under new subsection 260(5) of the Act, where an amount is received under a securities lending arrangement, from a person resident in Canada, from a person not resident in Canada where the amount was paid in the course of carrying on business in Canada through a permanent establishment, or by or from a registered securities dealer, as compensation for a dividend paid on a share, the amount will, to the extent of the amount of the dividend actually paid on the share, be deemed to have been received as a taxable dividend. As a result the amount received will generally qualify for the inter-corporate dividend deduction where the recipient is a corporation or the dividend tax credit where the recipient is an individual.

Dividend treatment does not occur where the amount is received by a corporation and one of the main reasons for the corporation entering into the arrangement was to enable it to receive an amount that would be treated as a dividend by this subsection. This restriction is intended to prevent corporations from using the provisions of this section to engage in after-tax financing activities.

ITA
260(6)

New subsection 260(6) of the Act provides that, where a payment is treated as having been received as a dividend by virtue of subsection 260(5), the person making the payment will not be entitled to a deduction for that amount in computing his income. This ensures that an amount paid as compensation for a dividend under a securities lending arrangement will have the character of a dividend for the purposes of the Act from the point of view of both the payor and the recipient.

ITA
260(7)

New subsection 260(7) of the Act provides that, where a corporation makes a payment which is deemed by new subsection 260(5) to be a taxable dividend, the corporation will also be entitled to treat the amount as the payment of a dividend for the purposes of section 129. This will ensure that a dividend compensation payment made by a corporation that is a private corporation will enable it to obtain a refund of its refundable dividend tax on hand.

ITA
260(8)

New subsection 260(8) of the Act provides that where a payment is made to a non-resident lender under a securities lending arrangement as compensation for any interest or dividend paid in respect of the security, for the purposes of the non-resident withholding tax provisions, the borrower of the security will be treated as having made a payment of interest. Where, however, the borrower has throughout the period during which the security was borrowed furnished to the lender cash or government debt obligations having at least 95% of the value of the security borrowed and the borrower enjoys the benefits of any income from or gain on the cash or debt obligation, the compensatory payment will be treated as a payment on the security by the borrower to the lender. Thus the lender will continue to be entitled to the benefit of the exemptions from the non-resident withholding tax in the case of a borrowed security that is a government or long-term corporate obligation.In addition, any amount which a non-resident lender receives in excess of this amount, including any profit which may reasonably be regarded as having been earned as a result of the securities lending arrangement, will be treated as a payment of interest. This is to ensure that any payments received by a non-resident lender under a securities lending arrangement will be subject to the appropriate non-resident tax and withholding requirements under Part XIII of the Act.

ITA
260(9)

New subsection 260(9) of the Act provides that where a lender under a securities lending arrangement is a restricted financial institution (RFI), the borrowing or reacquisition of a share under the arrangement will be deemed not to be an acquisition of the share for the purposes of determining the lender's liability for the special Part IV.1 tax under subsection 187.3(1) of the Act. In general terms, subsection 187.3(1) provides that a restricted financial institution is liable to a special tax equal to 10% of the dividends received by it on certain taxable RFI shares acquired after June 18, 1987. Accordingly, subsection 260(9) ensures that the provisions of subsection 187.3(1) are not triggered in respect of a share that the restricted financial institution acquired before June 18, 1987 but subsequently loaned and reacquired under a securities lending arrangement.

The new securities lending arrangement rules are generally applicable to transfers, loans and payments made after April 26, 1989. However, the denial of deductibility of dividend compensation payments by reason of new subsection 260(6) will be applicable for payments made after June, 1989. Moreover, for payments made by a registered securities dealer after June, 1989 but before April, 1990, only 1/3 of such amounts will be non-deductible. Accordingly only 1/3 of any dividend compensation payment made by a registered securities dealer after June, 1989 and before April, 1990 will be treated under new subsection 260(7) as a dividend the payment of which results in a dividend refund under section 129 of the Act.

Clause 56

Transfer Payments with Respect to Taxes Under Parts IV.1 and VI.1 of the *Income Tax Act*

Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977

14(1)(b)

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 portion of the taxes levied under Parts IV.1 and VI.1 of the *Income Tax Act*. Under subsection 14(1) of the Act a province is eligible to receive a payment only if the province has entered into a tax collection agreement which authorizes the federal government to collect the province's corporate taxes or if the province provides a deduction in computing a corporation's taxable income under the province's corporate income tax legislation of at least 5/2 of the tax payable by the corporation under Part VI.1 of the *Income Tax Act*. This amendment to paragraph 14(1)(b) of the Act, which is consequential to the amendment to paragraph 110(1)(k) of the *Income Tax Act*, provides that a province that is not a party to a corporate tax collection agreement will be eligible to receive a transfer payment of the Parts IV.1 and VI.1 taxes if its tax legislation provides a deduction of at least 9/4, rather than 5/2, of tax payable under Part VI.1 of the *Income Tax Act*. This amendment applies to the 1990 and subsequent taxation years.

Clause 57

Calculation of Income

OAS
13

Section 13 of the *Old Age Security Act* provides for the calculation of the income of an individual for the purposes of determining the amount of the guaranteed income supplement or spouse's allowance that may be paid to an applicant under that Act. This amendment is consequential on amendments made to the *Income Tax Act* which, through the repeal of the $500 employment expense deduction and the conversion of the Canada Pension Plan contributions and unemployment insurance premiums from a tax deduction to a tax credit, effectively increased the amount of income used for the purpose of determining the level of guaranteed income supplement or spouse's allowance which an applicant is entitled to receive. This amendment ensures that the amount of the benefits payable under the *Old Age Security Act* is not reduced as a result of these tax changes. A minor structural amendment is also being made to the French version of section 13 of that Act. These amendments are applicable to the 1988 and subsequent taxation years.

Clause 58

Public Utilities Income Tax Transfer Act

Subsections 3(2) and (3)

Section 3 of the *Public Utilities Income Tax Transfer Act* currently empowers the Minister of Finance to pay to a province 95% of the income tax paid by a corporation under Part I of the *Income Tax Act* that is attributable to the distribution and sale or generation and sale to the public in the province of electrical energy, steam or gas. This amendment provides that, in addition to the tax paid by a corporation for a taxation year under Part I of the *Income Tax Act*, 95% of the tax paid by the corporation for the year under new Part I.3 of that Act that are attributable to gross revenues from the activities described above may be paid by the Minister to the province.

This amendment is applicable to taxation years ending after June, 1989.

Clause 59

Land Improvement Costs

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. Section 30 was amended in chapter 55, Statutes of Canada, 1988, to 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 portion for deduction in a subsequent year. This amendment clarifies the coming-into-force provision for that amendment to ensure that the amendments to section 30 of the Act are not overridden by section 28 of the Act which provides the cash basis of reporting for farming and fishing businesses. While this clause deals only with taxation years commencing before 1989, amendments to section 28 of the Act described above will resolve this issue for later years.