
Draft Amendments to the Income Tax Act and Explanatory Notes

Relating to Securities Held
by Financial Institutions

Issued by
The Honourable Paul Martin P.C., M.P.
Minister of Finance

October 1994



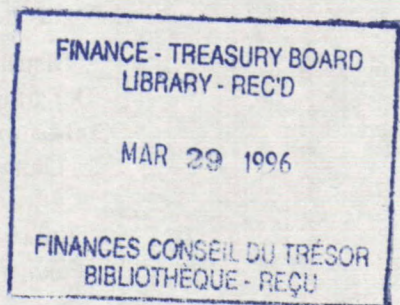
Canada

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Department of Finance
Canada

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Draft Amendments to the Income Tax Act

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SECURITIES HELD BY FINANCIAL INSTITUTIONS

DRAFT AMENDMENTS TO THE INCOME TAX ACT

1. (1) The portion of subsection 18(13) of the *Income Tax Act* before paragraph (a) is replaced by the following:

Superficial loss

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(13) Subject to subsection 142.6(7) and notwithstanding any other provision of this Act, where a taxpayer (other than an insurer)

(2) Subsection (1) applies to dispositions occurring on or after ANNOUNCEMENT DATE.

2. (1) Paragraphs 39(5)(b) to (e) of the Act are replaced by the following:

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(b) a financial institution (within the meaning assigned by subsection 142.2(1)),

(2) Subsection (1) applies to

(a) dispositions of property (other than property referred to in paragraph (b)) that occur after February 22, 1994, and

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(b) dispositions of property that is mark-to-market property (within the meaning assigned by subsection 142.2(1) of the Act) of a taxpayer for a taxation year that begins after ANNOUNCEMENT DATE.

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3. (1) The Act is amended by adding the following after section 51:

Conversion of debt obligation

51.1 Where

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(a) a taxpayer acquires a bond, debenture or note of a debtor (in this section referred to as the "new obligation") in exchange for a capital property of the taxpayer that is another bond, debenture or note of the same debtor (in this section referred to as the "convertible obligation"),

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(b) the terms of the convertible obligation conferred on the holder the right to make the exchange, and

(c) the amount payable to the holder of the new obligation on its maturity is the same as the amount that would have been payable to the holder of the convertible obligation on its maturity,

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the cost to the taxpayer of the new obligation and the proceeds of disposition of the convertible obligation shall be deemed to be equal to the adjusted cost base to the taxpayer of the convertible obligation immediately before the exchange.

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(2) Subsection (1) applies to exchanges occurring after ANNOUNCEMENT DATE.

4. (1) Paragraph (c) of the definition "superficial loss" in section 54 of the Act is replaced by the following:

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(c) was a disposition deemed by paragraph 33.1(11)(a), subsection 45(1), section 48 as it read in its application before 1993, section 50 or 70, subsection 104(4), section 128.1, subsection 138(11.3) or 142.5(2), paragraph 142.6(1)(b) or subsection 144(4.1) or (4.2) or 149(10) to have been made,

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(2) Subsection (1) applies to dispositions occurring after February 22, 1994.

5. (1) Paragraph 66.3(1)(a) of the Act is replaced by the following:

(a) shall, if acquired before November 13, 1981, be deemed

(i) not to be a capital property of the taxpayer,

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(ii) subject to subsection 142.6(3), to be inventory of the taxpayer, and

(iii) to have been acquired by the taxpayer at a cost to the taxpayer of nil; and

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(2) Subsection (1) applies to taxation years that begin after ANNOUNCEMENT DATE.

6. (1) Section 77 of the Act is repealed.

(2) Subsection (1) applies to exchanges occurring after ANNOUNCEMENT DATE.

7. (1) The portion of paragraph 85(1)(c.1) of the Act before subparagraph (i) is replaced by the following:

(c.1) where the property of the taxpayer was inventory, capital property (other than depreciable property of a prescribed class), a NISA Fund No. 2 or a property that is eligible property because of paragraph (1.1)(g) or (g.1), and the amount that the taxpayer and corporation have agreed on in their election in respect of the property is less than the lesser of

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(2) Paragraph 85(1.1)(g) of the Act is replaced by the following:

(g) a property that is a security or debt obligation used by the taxpayer in the year in, or held by it in the year in the course of, carrying on the business of insurance or lending money, other than

(i) a capital property,

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(ii) inventory, or

(iii) where the taxpayer is a financial institution in the year, a mark-to-market property for the year;

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(3) Subsection 85(1.1) of the Act is amended by adding the following after paragraph (g):

(g.1) where the taxpayer is a financial institution in the year, a specified debt obligation (other than a mark-to-market property of the taxpayer for the year);

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(4) Section 85 of the Act is amended by adding the following after subsection (1.3):

Definitions

(1.4) For the purpose of subsection (1.1), "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings assigned by subsection 142.2(1).

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(5) Subsections (1), (3) and (4) apply to dispositions occurring after February 22, 1994.

(6) Subsection (2) applies to dispositions occurring in taxation years that begin after ANNOUNCEMENT DATE.

8. (1) Section 87 of the Act is amended by adding the following after subsection 87(1.4):

Definitions

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(1.5) For the purpose of this section, "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings assigned by subsection 142.2(1).

(2) Paragraph 87(2)(e) of the Act is replaced by the following:

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Capital property

(e) subject to paragraph (e.4) and subsection 142.6(5), where a capital property (other than depreciable property or an interest in a partnership) has been acquired by the new corporation from a predecessor corporation, the cost of the property to the new corporation shall be deemed to be the amount that was the adjusted cost base of the property to the predecessor corporation immediately before the amalgamation;

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(3) Paragraph 87(2)(e.2) of the Act is replaced by the following:

Security or debt obligation

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(e.2) subject to paragraphs (e.3) and (e.4) and subsection 142.6(5), where a property that is a security or debt obligation (other than a capital property or an inventory) of a predecessor corporation used by it in the year in, or held by it in the year in the course of, carrying on the business of insurance or lending money in the taxation year ending immediately before the amalgamation has been acquired by the new corporation from the predecessor corporation, the cost of the property to the new corporation shall be deemed to be the amount that was the cost amount of the property to the predecessor corporation immediately before the amalgamation;

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Financial institutions - specified debt obligation

(e.3) where the new corporation is a financial institution in its first taxation year, it shall be deemed, in respect of a specified debt obligation (other than a mark-to-market property) acquired from a predecessor corporation that was a financial institution in its last taxation year, to be the same corporation as, and a continuation of, the predecessor corporation;

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Financial institutions - mark-to-market property

(e.4) where

(i) the new corporation is a financial institution in its first taxation year and a property acquired by the new corporation from a predecessor corporation is a mark-to-market property of the new corporation for the year, or

(ii) a predecessor corporation was a financial institution in its last taxation year and a property acquired by the new corporation from the predecessor corporation was a mark-to-market property of the predecessor corporation for the year,

the cost of the property to the new corporation shall be deemed to be the amount that was the fair market value of the property immediately before the amalgamation;

Idem

(e.5) for the purposes of subsections 112(5) to (5.2) and (5.4) and the definition "mark-to-market property" in subsection 142.2(1), the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation;

(4) Subsection 87(2) of the Act is amended by adding the following after paragraph (g.1):

Financial institution rules

(g.2) for the purposes of subsections 142.5(4) to (7) and 142.6(1), the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation;

(5) Subsections (1), (2) and (4) and paragraph 87(2)(e.2) of the Act, as enacted by subsection (3), apply to taxation years that end after February 22, 1994.

(6) Paragraph 87(2)(e.3) of the Act, as enacted by subsection (3), applies to amalgamations occurring, and windings-up beginning, after February 22, 1994.

(7) Paragraph 87(2)(e.4) of the Act, as enacted by subsection (3), applies to amalgamations occurring after ANNOUNCEMENT DATE.

(8) Paragraph 87(2)(e.5) of the Act, as enacted by subsection (3), applies to amalgamations occurring at any time.

9. (1) The portion of paragraph 88(1)(a) of the Act before subparagraph (i) is replaced by the following:

(a) subject to paragraphs (a.1) and (a.3), each property (other than an interest in a partnership) of the subsidiary that was distributed to the parent on the winding-up shall be deemed to have been disposed of by the subsidiary for proceeds equal to

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(2) Subsection 88(1) of the Act is amended by adding the following after paragraph (a.2):

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(a.3) where

(i) the subsidiary was a financial institution in its taxation year in which its assets were distributed to the parent on the winding up, and

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(ii) the parent was a financial institution in its taxation year in which it received the assets of the subsidiary on the winding up,

each specified debt obligation (other than a mark-to-market property) of the subsidiary that was distributed to the parent on the winding-up shall, except for the purpose of subsection 69(11), be deemed not to have been disposed of, and for the purpose of this paragraph, "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings assigned by subsection 142.2(1);

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(3) The portion of paragraph 88(1)(c) of the Act before subparagraph (i) is replaced by the following:

(c) subject to paragraph 87(2)(e.3) (as modified by paragraph (e.2)), and notwithstanding paragraph 87(2)(e.1) (as modified by paragraph (e.2)), the cost to the parent of each property of the subsidiary distributed to the parent on the winding-up shall be deemed to be

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(4) The portion of paragraph 88(1)(e.2) of the Act before subparagraph (i) is replaced by the following:

(e.2) paragraphs 87(2)(c), (d.1), (e.1), (e.3), (g) to (l), (l.3) to (u), (x), (y.1), (z.1), (z.2), (cc), (ll), (nn), (pp), (rr), (tt) and (uu), subsection 87(6) and, subject to section 78, subsection 87(7) apply to the winding-up as if the references therein to

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(5) Subsection 88(1) of the Act is amended by striking out the word "and" at the end of paragraph (f) and by adding the following after paragraph (g):

(h) for the purposes of subsections 112(5) to (5.2) and (5.4) and the definition "mark-to-market property" in subsection 142.2(1), the parent shall be deemed to be the same corporation as, and a continuation of, the subsidiary; and

(i) for the purpose of subsection 142.5(2), the subsidiary's taxation year in which its assets were distributed to the parent on the winding-up shall be deemed to have ended immediately before the time when the assets were distributed.

(6) Subsections (1) to (4) apply to windings-up beginning after February 22, 1994.

(7) Paragraph 88(1)(h) of the Act, as enacted by subsection (5), applies to windings-up beginning at any time.

(8) Paragraph 88(1)(i) of the Act, as enacted by subsection (5), applies to windings-up beginning after ANNOUNCEMENT DATE.

10. (1) The portion of subsection 112(3) of the Act before paragraph (a) is replaced by the following:

Loss on share that is capital property

(3) Subject to subsections (5.5) and (5.6), where a corporation owns a share that is a capital property and receives a taxable dividend, a capital dividend or a life insurance capital dividend in respect of that share, the amount of any loss of the corporation arising from transactions with reference to the share on which the dividend was received shall, unless it is established by the corporation that

(2) The portion of subsection 112(3.1) of the Act before paragraph (a) is replaced by the following:

Idem

(3.1) Subject to subsections (5.5) and (5.6), where a corporation is a member of a partnership and the corporation receives a taxable dividend, a capital dividend or a life insurance capital dividend in respect of a share that is a capital property of the partnership, the corporation's share of any loss of the partnership arising with respect to the share on which the dividend was received shall, unless it is established by the corporation that

(3) The portion of subsection 112(3.2) of the Act before paragraph (a) is replaced by the following:

Idem

(3.2) Subject to subsections (5.5) and (5.6), where a corporation is a beneficiary of a trust (other than a prescribed trust) that owns a share that is capital property and the corporation receives a taxable dividend in respect of that share pursuant to a designation under subsection 104(19) or the trust has made a designation under subsection 104(20) in respect of the corporation for a capital dividend or a life insurance capital dividend on that share, the amount of any loss of the trust arising with respect to the share on which the dividend was subject to a designation shall, unless it is established by the corporation that

(4) The portion of subsection 112(4) of the Act before paragraph (a) is replaced by the following:

Loss on share that is not capital property

(4) Subject to subsections (5.5) and (5.6), where a taxpayer owns a share that is not a capital property and receives a dividend in respect of that share, the amount of any loss of the taxpayer arising from transactions with reference to the share on which the dividend was received shall, unless it is established by the taxpayer that

(5) The portion of subsection 112(4.2) of the Act before paragraph (a) is replaced by the following:

Loss on share that is not capital property

(4.2) Subject to subsections (5.5) and (5.6), where a taxpayer is a member of a partnership and the taxpayer receives a dividend in respect of a share that is not a capital property of the partnership, the taxpayer's share of any loss of the partnership arising with respect to the share on which the dividend was received shall, unless it is established by the taxpayer that

(6) The portion of subsection 112(4.3) of the Act before paragraph (a) is replaced by the following:

Idem

(4.3) Subject to subsections (5.5) and (5.6), where a taxpayer is a beneficiary of a trust (other than a prescribed trust) that owns a share that is not capital property and the taxpayer receives a taxable dividend

in respect of that share pursuant to a designation under subsection 104(19) or the trust has made a designation under subsection 104(20) in respect of the taxpayer for a dividend other than a taxable dividend on that share, the amount of any loss of the trust arising with respect to the share on which the dividend was subject to a designation shall, unless it is established by the taxpayer that

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(7) Section 112 of the Act is amended by adding the following after subsection (4.3):

Disposition of share by financial institution

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(5) Subsection (5.2) applies to the disposition of a share by a taxpayer in a taxation year where

(a) the taxpayer is a financial institution in the year;

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(b) the share is a mark-to-market property for the year; and

(c) the taxpayer received a dividend on the share at a time when the taxpayer and persons with whom the taxpayer was not dealing at arm's length held in total more than 5% of the issued shares of any class of the capital stock of the corporation from which the dividend was received.

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Share held for less than one year

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(5.1) Subsection (5.2) applies to the disposition of a share by a taxpayer in a taxation year where

(a) the disposition is an actual disposition;

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(b) the taxpayer held the share for less than 365 days;

(c) the taxpayer was a financial institution at any time at which it held the share; and

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(d) the share was a mark-to-market property of the taxpayer for a taxation year.

Adjustment re dividends

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(5.2) Subject to subsection (5.3), where subsection (5) or (5.1) provides that this subsection applies to the disposition of a share by a

taxpayer at any time, the taxpayer's proceeds of disposition shall be deemed to be the amount determined by the formula:

$$A + B - (C - D)$$

where

A is the taxpayer's proceeds determined without reference to this subsection,

B is the lesser of

(a) the loss, if any, from the disposition of the share that would be determined before the application of this subsection if there had been no deemed dispositions before that time, and

(b) the total of all amounts each of which is

(i) where the taxpayer is a corporation, a taxable dividend received by the taxpayer on the share, to the extent of the amount that was deductible under this section or subsection 115(1) or 138(6) in computing the taxpayer's taxable income or taxable income earned in Canada for any year,

(ii) where the taxpayer is a partnership, a taxable dividend received by the taxpayer on the share, to the extent of the amount that was deductible under this section or subsection 115(1) or 138(6) in computing the taxable income or taxable income earned in Canada for any year of members of the partnership

(iii) where the taxpayer is a trust, an amount designated under subsection 104(19) in respect of a taxable dividend on the share, or

(iv) a dividend (other than a taxable dividend or a dividend deemed by subsection 131(1) to be a capital gains dividend) received by the taxpayer on the share,

C is the total of all amounts each of which is the amount by which

(a) the taxpayer's proceeds of disposition on a deemed disposition of the share before that time were increased because of this subsection,

(b) where the taxpayer is a corporation or trust, a loss of the taxpayer on a deemed disposition of the share before that time was reduced because of subsection (3), (3.2), (4) or (4.3), or

(c) where the taxpayer is a partnership, a loss of a member of the partnership on a deemed disposition of the share before that time was reduced because of subsection (3.1) or (4.2), and

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D is the total of all amounts each of which is the amount by which the taxpayer's proceeds of disposition on a deemed disposition of the share before that time were decreased because of this subsection.

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Adjustment not applicable

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(5.3) Subsection (5.2) does not apply for the purpose of determining the cost of a share to a taxpayer on a deemed reacquisition of the share after a deemed disposition of the share.

Deemed dispositions

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(5.4) Where a taxpayer disposes of a share at any time,

(a) for the purpose of determining whether subsection (5.2) applies to the disposition, the conditions in paragraphs (5)(c) and (5.1)(b) shall be applied without regard to a deemed disposition or reacquisition of the share before that time; and

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(b) total amounts under subsection (5.2) in respect of the disposition shall be determined from the time when the taxpayer actually acquired the share.

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Stop-loss rules not applicable

(5.5) Subsections (3) to (4), (4.2) and (4.3) do not apply to the disposition of a share by a taxpayer in a taxation year that begins after ANNOUNCEMENT DATE where

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(a) the share is a mark-to-market property for the year and the taxpayer is a financial institution in the year; or

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(b) subsection (5.2) applies to the disposition.

Stop-loss rules restricted

(5.6) In their application to the disposition of a share that occurs

(a) because of subsection 142.5(2) in a taxation year that includes ANNOUNCEMENT DATE, or 5

(b) because of paragraph 142.6(1)(b) on or after ANNOUNCEMENT DATE, 10

subsections (3) to (4), (4.2) and (4.3) shall be read without reference to paragraph (a) of each of those subsections.

(8) Subsection 112(6) of the Act is amended by striking out the word "and" at the end of paragraph (a), by adding the word "and" at the end of paragraph (b) and by adding the following after paragraph (b): 15

(c) "financial institution" and "mark-to-market property" have the meanings assigned by subsection 142.2(1).

(9) Subsections (1) to (6) and subsection 112(5.6) of the Act, as enacted by subsection (7), apply to dispositions occurring on or after ANNOUNCEMENT DATE. 20

(10) Subsections 112(5) to (5.5) of the Act, as enacted by subsection (7), apply to dispositions in taxation years that begin after ANNOUNCEMENT DATE.

(11) Subsection (8) applies to taxation years that begin after ANNOUNCEMENT DATE. 25

11. (1) Paragraph 138(3)(b) of the Act is repealed.

(2) Paragraph 138(3)(d) of the Act is repealed.

(3) Subsection 138(4) of the Act is amended by adding the word "and" at the end of paragraph (a) and by repealing paragraph (b). 30

(4) Paragraph 138(4)(c) of the Act is repealed.

(5) Subsection 138(5.2) of the Act is repealed.

(6) Section 138 of the Act is amended by adding the following after subsection (9):

Application of financial institution rules

(10) Where in a taxation year an insurer (other than a resident of Canada that does not carry on a life insurance business) carried on an insurance business in Canada and in a country other than Canada, in computing the income of the insurer for the year from carrying on an insurance business in Canada, sections 142.3 to 142.5 apply with respect to property used by it in the year in, or held by it in the year in the course of, carrying on that business.

(7) Subsection 138(11) of the Act is repealed.

(8) The portion of subsection 138(11.3) of the Act before paragraph (a) is replaced by the following:

Deemed disposition

(11.3) Subject to subsection (11.31), and except for the purposes of paragraph 20(1)(l), the description of A in the definition "undepreciated capital cost" in subsection 13(21) and paragraph (b) of the definition of F in that definition and any regulations made for the purpose of the definition "property used by it in the year in, or held by it in the year in the course of" in subsection (12), where a life insurer resident in Canada, or a non-resident insurer, that carries on an insurance business in Canada and in a country other than Canada, at any time,

(9) Subsection 138(11.3) of the Act is amended by adding the word "or" at the end of paragraph (a) and by repealing paragraphs (c) and (d).

(10) Section 138 of the Act is amended by adding the following after subsection (11.3):

Exclusion from deemed disposition

(11.31) Subsection (11.3) does not apply in respect of a change in use of a property of an insurer where subsection 142.5(2) deemed the insurer to have disposed of the property in the taxation year ending immediately before the change in use.

(11) Subsection 138(11.4) of the Act is replaced by the following:

Deduction of loss

(11.4) Notwithstanding any other provision of this Act, where an insurer has a loss for a taxation year from the disposition, because of subsection (11.3), of a property other than a specified debt obligation (within the meaning assigned by subsection 142.2(1)), and the loss would, but for this subsection, have been deductible in the year, the loss shall be deductible only in the taxation year in which the taxpayer disposes of the property otherwise than because of subsection (11.3).

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(12) Subsection 138(11.41) of the Act is repealed.

(13) Paragraph 138(11.5)(e) of the Act is replaced by the following:

(e) subject to paragraph (k.2), where the fair market value, at that time, of the consideration (other than shares of the capital stock of the transferee or a right to receive any such shares) received or receivable by the transferor for the transferred property does not exceed the total of the cost amounts to the transferor, at that time, of the transferred property, the proceeds of disposition of the transferor and the cost to the transferee of the transferred property shall be deemed to be the cost amount, at that time, to the transferor of the transferred property, and in any other case, the provisions of subsection 85(1) shall be applied in respect of the transfer,

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(14) Paragraph 138(11.5)(k) of the Act is replaced by the following:

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(k) for the purposes of this section, sections 12, 12.3, 12.4, 20, 138.1, 140 and 142, subsections 142.5(4) to (7), section 148 and Part XII.3 of this Act and section 33 of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, as it applied to taxation years and fiscal periods beginning before June 18, 1987, the transferee shall, in its taxation years following its taxation year referred to in paragraph (h), be deemed to be the same person as, and a continuation of, the transferor in respect of the business referred to in paragraph (a), the transferred property referred to in paragraph (b) and the obligations referred to in paragraph (c),

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(k.1) where the transferor has deducted an amount under subsection 142.5(4) or elected an amount under subsection 142.5(6),

(i) paragraph (k) shall apply with respect to the part of the amount that can reasonably be attributed to the business referred to in paragraph (a), and

(ii) for the purpose of applying subsections 142.5(5) and (7) to the transferor for a taxation year following its taxation year referred to in paragraph (h), the transferor shall be deemed not to have deducted or elected the part of the amount referred to in subparagraph (i),

(k.2) except for the purpose of this subsection, where the provisions of subsection 85(1) are not required to be applied in respect of the transfer,

(i) the transferor shall be deemed not to have disposed of a transferred property that is a specified debt obligation (other than a mark-to-market property), and

(ii) the transferee shall be deemed, in respect of a transferred property that is a specified debt obligation (other than a mark-to-market property), to be the same person as, and a continuation of, the transferor,

and for the purpose of this paragraph, "mark-to-market property" and "specified debt obligation" have the meanings assigned by subsection 142.2(1),

(k.3) for the purposes of subsections 112(5) to (5.2) and (5.4) and the definition "mark-to-market property" in subsection 142.2(1), the transferee shall be deemed to be the same person as, and a continuation of, the transferor,

(15) The definitions "Canada security" and "cost" in subsection 138(12) of the Act are repealed.

(16) The formula in the definition "gross investment revenue" in subsection 138(12) of the Act is replaced by the following:

$$A + B + C + D + E + F - \underline{G}$$

(17) The description of A in the definition "gross investment revenue" in subsection 138(12) of the Act is replaced by the following:

A is the total of the following amounts included in its gross revenue for the year:

(a) taxable dividends, and

(b) amounts received or receivable as, on account of, in lieu of or in satisfaction of, interest, rentals or royalties, other than amounts in respect of debt obligations to which subsection 142.3(1) applies for the year,

(18) The description of E in the definition "gross investment revenue" in subsection 138(12) of the Act is replaced by the following:

E is the total of all amounts required by paragraph 142.3(1)(a) to be included in computing its income for the year,

(19) The definition "gross investment revenue" in subsection 138(12) of the Act is amended by adding the following after the description of F:

G is the total of all amounts each of which is

(a) an amount deemed by subparagraph 16(6)(a)(ii) to be paid by it in respect of the year as interest, or

(b) an amount deductible under paragraph 142.3(1)(b) in computing its income for the year;

(20) Subsection 138(13) of the Act is replaced by the following:

Variation in "tax basis" and "amortized cost"

(13) Where

(a) in a taxation year ending after 1968 and before 1978 an insurer carried on a life insurance business in Canada and an insurance business in a country other than Canada,

(b) the insurer did not make an election in respect of the year under subsection 138(9) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, as it applied to that year, and

(c) the ratio of the value for the taxation year of the insurer's specified Canadian assets to its Canadian investment fund for the taxation year exceeded one,

each of the amounts included or deducted as follows in respect of the year shall be multiplied by the ratio referred to in paragraph (c):

(d) under paragraph (c), (d), (k) or (l) of the definition "tax basis" in subsection 142.4(1) in determining the tax basis of a debt obligation to the insurer, or

(e) under paragraph (c), (d), (f) or (h) of the definition "amortized cost" in subsection 248(1) in determining the amortized cost of a debt obligation to the insurer.

(21) Subsections (1), (3), (7) and (15) apply to taxation years that begin after February 22, 1994 and

(a) paragraph 138(3)(b) of the Act, as it applies to a taxation year that includes February 22, 1994, shall be read as follows:

(b) the total of losses sustained in the year by the insurer in respect of Canada securities owned by it that were disposed of by it in the year and before February 23, 1994;

and

(b) paragraph 138(4)(b) of the Act, as it applies to a taxation year that includes February 22, 1994, shall be read as follows:

(b) the total of profits or gains made in the year by the insurer in respect of Canada securities owned by it that were disposed of by it in the year and before February 23, 1994; and

(22) Subsections (2), (4), (6), (17), (18) and (20) apply to taxation years that end after February 22, 1994.

(23) Subsection (5) applies to dispositions occurring on or after ANNOUNCEMENT DATE.

(24) Subsections (8) and (10) apply to changes in use of property occurring in taxation years that begin after ANNOUNCEMENT DATE.

(25) Subsections (9) and (12) apply to changes in use of property occurring after February 22, 1994.

(26) Subsection (11) applies to property deemed by subsection 138(11.3) of the Act to be disposed of after 1994.

(27) Subsection (13) and paragraph 138(11.5)(k.2) of the Act, as enacted by subsection (14), apply to transfers of insurance businesses occurring after February 22, 1994. 5

(28) Paragraphs 138(11.5)(k) and (k.1) of the Act, as enacted by subsection (14), apply to transfers of insurance businesses occurring after ANNOUNCEMENT DATE. 10

(29) Paragraph 138(11.5)(k.3) of the Act, as enacted by subsection (14), applies to transfers of insurance businesses occurring at any time.

(30) Subsections (16) and (19) apply to taxation years that end after October 16, 1991, except that, in its application to taxation years that end before February 23, 1994, the description of G in the definition "gross investment revenue" in subsection 138(12) of the Act, as enacted by subsection (19), shall be read as follows: 15

G is the total of all amounts deemed by subparagraph 16(6)(a)(ii) to be paid by it in respect of the year as interest; 20

12. (1) The Act is amended by adding the following after section 142.1:

FINANCIAL INSTITUTIONS

Interpretation 25

Definitions

142.2 (1) In this section and sections 142.3 to 142.6, 30

"financial institution"

« institution financière »

"financial institution" at any time means

(a) a corporation that is, at that time,

(i) a corporation referred to in any of paragraphs (a) to (e) of the definition "restricted financial institution" in subsection 248(1),

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(ii) an investment dealer, or

(iii) a corporation controlled by one or more persons or partnerships each of which is a financial institution at that time, other than a corporation the control of which was acquired by reason of the default of a debtor where it is reasonable to consider that control is being retained solely for the purpose of minimizing any losses in respect of the debtor's default, and

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(b) a trust or partnership more than 50% of the fair market value of all interests in which are held at that time by one or more financial institutions,

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but does not include

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(c) a corporation that is, at that time,

(i) an investment corporation,

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(ii) a mortgage investment corporation,

(iii) a mutual fund corporation, or

(iv) a deposit insurance corporation (within the meaning assigned by subsection 137.1(5)),

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(d) a trust that is a mutual fund trust at that time, nor

(e) a prescribed person or partnership;

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"investment dealer"

« courtier en valeurs mobilières »

"investment dealer" at any time means a corporation that is, at that time, a registered securities dealer;

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"mark-to-market property"

« bien évalué à la valeur du marché »

"mark-to-market property" of a taxpayer for a taxation year means property of the taxpayer that is

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(a) a share,

(b) where the taxpayer is not an investment dealer, a specified debt obligation that

(i) at the end of each fiscal period of the taxpayer ending after the time the taxpayer acquired the obligation and before the year, was reflected in the financial statements of the taxpayer at fair market value, or

(ii) was disposed of in the same fiscal period in which it was acquired, where it is reasonable to expect that the obligation would have been reflected in the taxpayer's financial statements for that fiscal period at fair market value if the taxpayer had not disposed of the obligation, and

(c) where the taxpayer is an investment dealer, a specified debt obligation,

but does not include

(d) a share of a corporation in which the taxpayer has a significant interest at any time in the year, nor

(e) a prescribed property;

"specified debt obligation"

« titre de créance déterminé »

"specified debt obligation" of a taxpayer means the interest held by the taxpayer in a loan, bond, debenture, mortgage, note, agreement of sale or any other indebtedness, other than an interest in an income bond, an income debenture, a small business development bond, a small business bond or a prescribed property.

Significant interest

(2) For the purpose of this section, a taxpayer has a significant interest in a corporation at any time if

(a) the taxpayer is related (otherwise than by reason of a right referred to in paragraph 251(5)(b)) to the corporation at that time; or

(b) the taxpayer holds, at that time,

(i) shares of the corporation that give the taxpayer 10% or more of the votes that could be cast under all circumstances at an annual meeting of shareholders of the corporation, and

(ii) shares of the corporation having a fair market value of 10% or more of the fair market value of all the issued shares of the corporation.

Rules re significant interest

(3) For the purpose of determining under subsection (2) whether a taxpayer has a significant interest in a corporation at any time,

(a) the taxpayer shall be deemed to hold each share that is held at that time by a person or partnership to whom the taxpayer is related (otherwise than by reason of a right referred to in paragraph 251(5)(b));

(b) a share of the corporation acquired by the taxpayer by reason of the default of a debtor shall be disregarded where it is reasonable to consider that the share is being retained for the purpose of minimizing any losses in respect of the debtor's default; and

(c) a share of the corporation that is prescribed in respect of the taxpayer shall be disregarded.

Extension of meaning of "related"

(4) For the purposes of this subsection and subsections (2) and (3), a trust or partnership shall be deemed to be related to a person or partnership where they would be related if all partnerships and trusts were considered to be corporations for the purpose of section 251.

Income from Specified Debt Obligations

Amounts to be included and deducted

142.3 (1) Subject to subsection (2), where a taxpayer that is, in a taxation year, a financial institution other than an investment dealer, holds a specified debt obligation at any time in the year,

(a) there shall be included in computing the income of the taxpayer for the year the amount, if any, prescribed in respect of the obligation;

(b) there shall be deducted in computing the income of the taxpayer for the year the amount, if any, prescribed in respect of the obligation; and

(c) except as provided by this subsection and paragraphs 12(1)(d) and (i) and 20(1)(l) and (p), no amount shall be included or deducted in respect of the obligation (otherwise than in respect of a disposition of the obligation) in computing the income of the taxpayer for the year.

Exception for certain obligations

(2) Subsection (1) does not apply for a taxation year in respect of a specified debt obligation of a taxpayer that is

(a) a mark-to-market property for the year, or

(b) an indexed debt obligation, other than a prescribed obligation.

Disposition of Specified Debt Obligations

Definitions

142.4 (1) In this section,

"tax basis"

« montant de base »

"tax basis" of a specified debt obligation at any time to a taxpayer means the amount, if any, by which the total of all amounts each of which is

(a) the cost of the obligation to the taxpayer,

(b) an amount included under subsection 12(3) or 16(2) or (3) or paragraph 142.3(1)(a) in respect of the obligation in computing the taxpayer's income for a taxation year beginning before that time,

(c) subject to subsection 138(13), where the taxpayer acquired the obligation in a taxation year ending before February 23, 1994, the part of the amount, if any, by which

(i) the principal amount of the obligation at the time it was acquired

exceeds

(ii) the cost to the taxpayer of the obligation

that was included in computing the taxpayer's income for a taxation year ending before February 23, 1994,

(d) subject to subsection 138(13), where the taxpayer is a life insurer, an amount in respect of the obligation that was deemed by paragraph 142(3)(a) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, as it read in its application to the 1977 taxation year, to be a gain for a taxation year ending before 1978,

(e) where the obligation is an indexed debt obligation, an amount determined under subparagraph 16(6)(a)(i) in respect of the obligation and included in computing the income of the taxpayer for a taxation year beginning before that time,

(f) an amount in respect of the obligation that was included in computing the taxpayer's income for a taxation year ending at or before that time in respect of changes in the value of the obligation attributable to the fluctuation in the value of a currency of a country other than Canada relative to Canadian currency, other than an amount included under paragraph 142.3(1)(a),

(g) an amount in respect of the obligation that was included under paragraph 12(1)(i) in computing the taxpayer's income for a taxation year beginning before that time, or

(h) where the obligation was a capital property of the taxpayer on February 22, 1994, an amount required by paragraph 53(1)(f) or (f.1) to be added in computing the adjusted cost base of the obligation to the taxpayer on that day

exceeds the total of all amounts each of which is

(i) an amount deducted under paragraph 142.3(1)(b) in respect of the obligation in computing the taxpayer's income for a taxation year beginning before that time,

- (j) the amount of a payment (other than proceeds of disposition of the obligation) received by the taxpayer under the obligation at or before that time in respect of an amount included by any of paragraphs (a) to (f) in determining the tax basis of the obligation to the taxpayer at that time, 5
- (k) subject to subsection 138(13), where the taxpayer acquired the obligation in a taxation year ending before February 23, 1994, the part of the amount, if any, by which 10
- (i) the cost to the taxpayer of the obligation exceeds
- (ii) the principal amount of the obligation at the time it was acquired 15
- that was deducted in computing the taxpayer's income for a taxation year ending before February 23, 1994, 20
- (l) subject to subsection 138(13), where the taxpayer is a life insurer, an amount in respect of the obligation that was deemed by paragraph 142(3)(b) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, as it read in its application to the 1977 taxation year, to be a loss for a taxation year ending before 1978, 25
- (m) an amount that was deducted under subsection 20(14) in respect of the obligation in computing the taxpayer's income for a taxation year beginning before that time, 30
- (n) where the obligation is an indexed debt obligation, an amount determined under subparagraph 16(6)(a)(ii) in respect of the obligation and deducted in computing the income of the taxpayer for a taxation year beginning before that time, 35
- (o) an amount in respect of the obligation that was deducted in computing the taxpayer's income for a taxation year ending at or before that time in respect of changes in the value of the obligation attributable to the fluctuation in the value of a currency of a country other than Canada relative to Canadian currency, other than an amount deducted under paragraph 142.3(1)(b), 40

(p) an amount in respect of the obligation that was deducted under paragraph 20(1)(p) in computing the taxpayer's income for a taxation year ending at or before that time, or

(q) where the obligation was a capital property of the taxpayer on February 22, 1994, an amount required by paragraph 53(2)(b.2) or (g) to be deducted in computing the adjusted cost base of the obligation to the taxpayer on that day;

"transition amount"

« montant de transition »

"transition amount" of a taxpayer in respect of a specified debt obligation at any time has the meaning assigned by regulation.

Scope of section

(2) This section applies with respect to the disposition of a specified debt obligation by a taxpayer that is a financial institution other than an investment dealer, except that this section does not apply with respect to the disposition of a specified debt obligation that is a mark-to-market property for the taxation year in which the disposition occurs.

Rules applicable to disposition

(3) Where a taxpayer has disposed of a specified debt obligation after February 22, 1994,

(a) except as provided by this section, no amount shall be included or deducted in respect of the disposition in computing the income of the taxpayer; and

(b) except where the obligation is an indexed debt obligation (other than a prescribed obligation), paragraph 20(14)(a) shall not apply in respect of the disposition.

Inclusions and deductions re disposition

(4) Subject to subsection (5), where after 1994 a taxpayer has, in a taxation year, disposed of a specified debt obligation,

(a) where the current amount in respect of the disposition of the obligation is positive, it shall be included in computing the income of the taxpayer for the year;

(b) where the current amount in respect of the disposition of the obligation is negative, it shall be deducted in computing the income of the taxpayer for the year;

(c) where the taxpayer has a gain from the disposition of the obligation, there shall be included in computing the taxpayer's income for taxation years that end on or after the day of disposition the amount allocated, in accordance with prescribed rules, to the year in respect of the residual portion of the gain; and

(d) where the taxpayer has a loss from the disposition of the obligation, there shall be deducted in computing the taxpayer's income for taxation years that end on or after the day of disposition the amount allocated, in accordance with prescribed rules, to the year in respect of the residual portion of the loss.

Gain or loss not amortized

(5) Where a taxpayer has, in a taxation year and after February 22, 1994, disposed of a specified debt obligation, and either

(a) the obligation is

(i) an indexed debt obligation (other than a prescribed obligation), or

(ii) a debt obligation prescribed in respect of the taxpayer, or

(b) the disposition occurred

(i) before 1995,

(ii) after 1994 in connection with the transfer of all or part of a business of the taxpayer to a person or partnership, or

(iii) because of paragraph 142.6(1)(b),

the following rules apply:

(c) subsection (4) does not apply with respect to the disposition,

(d) where the taxpayer has a gain from the disposition of the obligation, the gain shall be included in computing the income of the taxpayer for the year, and

(e) where the taxpayer has a loss from the disposition of the obligation, the loss shall be deducted in computing the income of the taxpayer for the year.

Gain or loss from disposition of obligation

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(6) For the purposes of this section,

(a) where the amount determined under paragraph (c) in respect of the disposition of a specified debt obligation by a taxpayer is positive, that amount is the taxpayer's gain from the disposition of the obligation;

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(b) where the amount determined under paragraph (c) in respect of the disposition of a specified debt obligation by a taxpayer is negative, that amount is the taxpayer's loss from the disposition of the obligation; and

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(c) the amount determined under this paragraph in respect of the disposition of a specified debt obligation by a taxpayer is the positive or negative amount determined by the formula

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$$A - (B + C)$$

where

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A is the taxpayer's proceeds of disposition,

B is the tax basis of the obligation to the taxpayer immediately before the time of disposition, and

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C is

(a) where subsection (4) applies with respect to the disposition, the taxpayer's transition amount in respect of the obligation at the time of disposition, and

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(b) in any other case, nil.

Current amount

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(7) For the purpose of subsection (4), the current amount in respect of the disposition of a specified debt obligation by a taxpayer is the positive or negative amount determined by the formula

A + B

where

- A is the taxpayer's transition amount in respect of the obligation at the time of disposition, and 5
- B is
- (a) where the taxpayer has a gain from the disposition of the obligation, the part, if any, of the gain that is reasonably attributable to a material increase in the probability, or perceived probability, that the debtor will make all payments as required by the obligation, and 10
- (b) where the taxpayer has a loss from the disposition of the obligation, the negative amount that the taxpayer claims not exceeding in magnitude the part, if any, of the loss that is reasonably attributable to a default by the debtor or a material decrease in the probability, or perceived probability, that the debtor will make all payments as required by the obligation. 15 20

Residual portion of gain or loss

- (8) For the purpose of subsection (4), where a taxpayer has a gain or loss from the disposition of a specified debt obligation, the residual portion of the gain or loss is the part of the gain or loss that is not included in determining the amount B in the formula in subsection (7) in respect of the disposition. 25

Disposition of part of obligation

- (9) Where a taxpayer disposed of part of a specified debt obligation, this section and any regulations made for the purpose of this section apply as if the part disposed of and the part retained were separate specified debt obligations. 30 35

Mark-to-Market Properties

Income treatment for profits and losses 40

- 142.5 (1) Where, in a taxation year that begins after ANNOUNCEMENT DATE, a taxpayer that is a financial institution in the year disposes of a property that is a mark-to-market property for the year, 45

(a) there shall be included in computing the taxpayer's income for the year the profit, if any, from the disposition; and

(b) there shall be deducted in computing the taxpayer's income for the year the loss, if any, from the disposition.

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Mark-to-market requirement

(2) Where a taxpayer that is a financial institution in a taxation year holds, at the end of the year, a mark-to-market property for the year, the taxpayer shall be deemed

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(a) to have disposed of the property immediately before the end of the year for proceeds equal to its fair market value at the time of disposition, and

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(b) to have reacquired the property at the end of the year at a cost equal to those proceeds.

Mark-to-market debt obligation

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(3) Where a taxpayer is a financial institution in a particular taxation year that begins after ANNOUNCEMENT DATE, the following rules apply with respect to a specified debt obligation that is a mark-to-market property of the taxpayer for the particular year:

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(a) paragraph 12(1)(c) and subsections 12(3) and 20(14) and (21) do not apply in respect of the obligation in computing the taxpayer's income for the particular year;

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(b) there shall be included in computing the taxpayer's income for the particular year an amount received by the taxpayer in the particular year as, on account of, in lieu of payment of, or in satisfaction of, interest on the obligation, to the extent that the interest was not included in computing the taxpayer's income for a preceding taxation year; and

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(c) for the purpose of paragraph (b), where the taxpayer was deemed by subsection (2) or paragraph 142.6(1)(b) to have disposed of the obligation in a preceding taxation year, no part of an amount included in computing the income of the taxpayer for that preceding year because of the disposition shall be considered to be in respect of interest on the obligation.

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Transition - deduction re non-capital amounts

(4) There may be deducted in computing the income of a taxpayer for the taxpayer's taxation year that includes ANNOUNCEMENT DATE such amount as the taxpayer claims not exceeding a prescribed amount in respect of properties (other than capital properties) disposed of by the taxpayer because of subsection (2).

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Transition - inclusion re non-capital amounts

(5) Where a taxpayer deducts an amount under subsection (4), there shall be included in computing the taxpayer's income for each taxation year that begins before 1999 and ends on or after ANNOUNCEMENT DATE, the prescribed portion for the year of the amount so deducted.

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Transition - deduction re net capital gains

(6) Where subsection (2) applies to a taxpayer for its taxation year that includes ANNOUNCEMENT DATE, and

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(a) the total of all amounts each of which is a taxable capital gain of the taxpayer for the year from the disposition, because of subsection (2), of a property, other than a taxable capital gain that

(i) because of section 142, is not included in computing the taxpayer's income for the year, or

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(ii) where the taxpayer is non-resident in the year, is not from the disposition of a taxable Canadian property

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exceeds

(b) the total of all amounts each of which is an allowable capital loss of the taxpayer for the year from the disposition, because of subsection (2), of a property, other than an allowable capital loss that

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(i) because of section 142, is not taken into account in computing the taxpayer's income for the year, or

(ii) where the taxpayer is non-resident in the year, is not from the disposition of a taxable Canadian property

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such amount as the taxpayer elects, not exceeding a prescribed portion of the excess, shall be deemed to be an allowable capital loss of the taxpayer for the year from the disposition of property.

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Transition - inclusion re net capital gains

(7) Where a taxpayer elects an amount under subsection (6), the taxpayer shall be deemed, for each taxation year that begins before 1999 and ends on or after ANNOUNCEMENT DATE, to have a taxable capital gain for the year from the disposition of property equal to the prescribed portion for the year of the amount so elected. 5

First deemed disposition of debt obligation

(8) Where 10

(a) in a particular taxation year that ends on or after ANNOUNCEMENT DATE, a taxpayer disposed of a specified debt obligation that is a mark-to-market property of the taxpayer for the following taxation year, and 15

(b) either

(i) the disposition occurred because of subsection (2) and the particular year includes ANNOUNCEMENT DATE, or 20

(ii) the disposition occurred because of paragraph 142.6(1)(b),

the following rules apply: 25

(c) subsection 20(21) shall not apply in respect of the disposition, and

(d) where

(i) an amount has been deducted under paragraph 20(1)(p) in respect of the obligation in computing the taxpayer's income for the particular year or a preceding taxation year, and 30

(ii) section 12.4 does not apply in respect of the disposition, 35

there shall be included in computing the taxpayer's income for the particular year the amount, if any, by which

(iii) the total of all amounts referred to in subparagraph (i) 40

exceeds

(iv) the total of all amounts included under paragraph 12(1)(i) in respect of the obligation in computing the taxpayer's income for the particular year or a preceding taxation year.

Transition - property acquired on rollover

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(9) Where

(a) a taxpayer acquired a property before ANNOUNCEMENT DATE at a cost less than the fair market value of the property at the time of acquisition,

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(b) the property was transferred, directly or indirectly, to the taxpayer by a person that would never have been a financial institution before the transfer if the definition "financial institution" in subsection 142.2(1) had always applied,

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(c) the cost is less than the fair market value because subsection 85(1) applied in respect of the disposition of the property by the person, and

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(d) subsection (2) deemed the taxpayer to have disposed of the property in its particular taxation year that includes ANNOUNCEMENT DATE,

the following rules apply:

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(e) where the taxpayer would, but for this paragraph, have a taxable capital gain for the particular year from the disposition of the property, the part of the taxable capital gain that can reasonably be considered to have arisen while the property was held by a person described in paragraph (b) shall be deemed to be a taxable capital gain of the taxpayer from the disposition of the property for the taxation year in which the taxpayer disposes of the property otherwise than because of subsection (2), and not to be a taxable capital gain for the particular year, and

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(f) where the taxpayer has a profit (other than a capital gain) from the disposition of the property, the part of the profit that can reasonably be considered to have arisen while the property was held by a person described in paragraph (b) shall be included in computing the taxpayer's income for the taxation year in which the taxpayer disposes of the property otherwise than because of subsection (2), and shall not be included in computing the taxpayer's income for the particular year.

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Additional Rules

Becoming or ceasing to be a financial institution

- 142.6 (1) Where, at a particular time after February 22, 1994, a taxpayer becomes or ceases to be a financial institution, the following rules apply: 5
- (a) where a taxation year of the taxpayer would not, but for this paragraph, end immediately before the particular time, 10
- (i) the taxation year of the taxpayer that would otherwise have included the particular time shall be deemed to have ended immediately before that time and a new taxation year of the taxpayer shall be deemed to have begun at that time, and 15
- (ii) for the purpose of determining the taxpayer's fiscal period after the particular time, the taxpayer shall be deemed not to have established a fiscal period before that time; 20
- (b) where the taxpayer becomes a financial institution, the taxpayer shall be deemed to have disposed, immediately before the end of its taxation year that ends immediately before the particular time, of each property held by the taxpayer that is 25
- (i) a specified debt obligation (other than a mark-to-market property for the year), or
- (ii) where the year ends on or after ANNOUNCEMENT DATE, a mark-to-market property for the year 30
- for proceeds equal to its fair market value at the time of disposition;
- (c) where the taxpayer ceases to be a financial institution, the taxpayer shall be deemed to have disposed, immediately before the end of its taxation year that ends immediately before the particular time, of each property held by the taxpayer that is a specified debt obligation (other than a mark-to-market property of the taxpayer for the year), for proceeds equal to its fair market value at the time of disposition; and 40
- (d) the taxpayer shall be deemed to have reacquired, at the end of the taxation year referred to in paragraph (b) or (c), each property deemed by that paragraph to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property. 45

Deemed disposition not applicable

(2) For the purposes of this Act, the determination of when a taxpayer acquired a share shall be made without regard to a disposition or acquisition that occurred because of subsection (1) or 142.5(2).

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Property not inventory

(3) Where a taxpayer is a financial institution in a taxation year, inventory of the taxpayer in the year does not include property that is

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(a) a specified debt obligation (other than a mark-to-market property for the year), or

(b) where the year begins after ANNOUNCEMENT DATE, a mark-to-market property for the year.

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Property that ceases to be inventory

(4) Where a taxpayer that was a financial institution in its particular taxation year that includes February 23, 1994 held, on that day, a specified debt obligation (other than a mark-to-market property for the year) that was inventory of the taxpayer at the end of its preceding taxation year,

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(a) the taxpayer shall be deemed to have disposed of the property at the beginning of the particular year for proceeds equal to

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(i) where subparagraph (ii) does not apply, the amount at which the property was valued at the end of the preceding taxation year for the purpose of computing the taxpayer's income for the year, and

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(ii) where the taxpayer is a bank and the property is prescribed property for the particular year, the cost of the property to the taxpayer (determined without reference to paragraph (b));

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(b) for the purpose of determining the taxpayer's profit or loss from the disposition, the cost of the property to the taxpayer shall be deemed to be the amount referred to in subparagraph (a)(i); and

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(c) the taxpayer shall be deemed to have reacquired the property, immediately after the beginning of the particular year, at a cost equal to the proceeds of disposition of the property.

Debt obligations acquired in rollover transactions

(5) Where,

(a) on February 23, 1994, a financial institution that is a corporation held a specified debt obligation (other than a mark-to-market property for the taxation year that includes that day) that was at any particular time before that day held by another corporation, and

(b) between the particular time and February 23, 1994, the only transactions affecting the ownership of the property were rollover transactions,

the financial institution shall be deemed, in respect of that obligation, to be the same corporation as, and a continuation of, the other corporation.

"rollover transaction" defined

(6) For the purpose of subsection (5), "rollover transaction" means a transaction to which subsection 87(2), 88(1) or 138(11.5) or (11.94) applies, other than a transaction in respect of which paragraph 138(11.5)(e) requires the provisions of subsection 85(1) to be applied.

Superficial loss rule not applicable

(7) Subsection 18(13) does not apply to the disposition of a property by a taxpayer on or after ANNOUNCEMENT DATE where

(a) the taxpayer is a financial institution when the disposition occurs and the property is a specified debt obligation or a mark-to-market property for the taxation year in which the disposition occurs, or

(b) the disposition occurs because of paragraph (1)(b).

(2) Sections 142.2 to 142.4 and subsections 142.6(2) to (6) of the Act, as enacted by subsection (1), apply to taxation years that end after February 22, 1994, except that section 142.3 of the Act does not apply to debt obligations disposed of before February 23, 1994.

(3) Section 142.5 of the Act, as enacted by subsection (1), applies to taxation years that end on or after ANNOUNCEMENT DATE.

(4) Subsection 142.6(1) of the Act, as enacted by subsection (1), applies after February 22, 1994.

(5) Subsection 142.6(7) of the Act, as enacted by subsection (1), applies to dispositions occurring on or after ANNOUNCEMENT DATE.

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13. (1) The definition "amortized cost" in subsection 248(1) of the Act is amended by adding the following after paragraph (c):

(c.1) the total of all amounts each of which is an amount in respect of the loan or lending asset that was included in computing the taxpayer's income for a taxation year ending at or before that time in respect of changes in the value of the loan or lending asset attributable to the fluctuation in the value of a currency of a country other than Canada relative to Canadian currency,

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(2) The definition "amortized cost" in subsection 248(1) of the Act is amended by adding the following after paragraph (f):

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(f.1) the total of all amounts each of which is an amount in respect of the loan or lending asset that was deducted in computing the taxpayer's income for a taxation year ending at or before that time in respect of changes in the value of the loan or lending asset attributable to the fluctuation in the value of a currency of a country other than Canada relative to Canadian currency,

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(3) The definition "cost amount" in subsection 248(1) of the Act is amended by adding the following after paragraph (c):

(c.1) where the taxpayer was a financial institution in its taxation year that includes that time and the property was a mark-to-market property for the year, the cost to the taxpayer of the property,

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(4) Paragraph (e) of the definition "cost amount" in subsection 248(1) of the Act is replaced by the following:

(d.1) where the property was a loan or lending asset (other than a net income stabilization account or a property in respect of which paragraph (b), (c), (c.1) or (d.2) applies), the amortized cost of the property to the taxpayer at that time,

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(d.2) where the taxpayer was a financial institution in its taxation year that includes that time and the property was a specified debt obligation (other than a mark-to-market property for the year), the tax basis of the property to the taxpayer at that time,

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(e) where the property was a right of the taxpayer to receive an amount, other than property that is

(i) a debt the amount of which was deducted under paragraph 20(1)(p) in computing the taxpayer's income for a taxation year ending before that time,

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(ii) a net income stabilization account, or

(iii) a right in respect of which paragraph (b), (c), (c.1), (d.1) or (d.2) applies,

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the amount the taxpayer has a right to receive,

(5) The definition "cost amount" in subsection 248(1) of the Act is amended by adding the following after paragraph (f):

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and, for the purposes of this definition, "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings assigned by subsection 142.2(1), and "tax basis" has the meaning assigned by subsection 142.4(1);

(6) Subsections (1) and (2) apply to taxation years that begin after June 17, 1987 and end after 1987.

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(7) Subsection (3) applies to taxation years that begin after ANNOUNCEMENT DATE.

(8) Subsections (4) and (5) apply to the determination of cost amount at a time after February 22, 1994.

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Explanatory Notes

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SECURITIES HELD BY FINANCIAL INSTITUTIONS

EXPLANATORY NOTES TO DRAFT AMENDMENTS TO THE INCOME TAX ACT

Clause 1

Superficial Loss

5

ITA

18(13)

Subsection 18(13) of the *Income Tax Act* prohibits a taxpayer whose ordinary business includes the lending of money from deducting a "superficial loss" sustained on the disposition of a non-capital property that is a share or debt obligation used in the business. Subsection 18(13) is amended to provide that it is subject to new subsection 142.6(7). That subsection provides that subsection 18(13) does not apply to the disposition by a financial institution of a specified debt obligation or a mark-to-market property. (These terms are defined in new subsection 142.2(1).) It also excludes dispositions that are deemed to occur when a taxpayer becomes a financial institution.

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Subsection 18(13) is also amended to remove the reference to subsection 138(5.2) and to exclude insurance corporations from its application. Subsection 138(5.2), which is a superficial loss rule for insurers, is being repealed.

20

The amendments to subsection 18(13) apply to dispositions of property on or after ANNOUNCEMENT DATE.

Clause 2

Canadian Securities Election

25

ITA

39(5)

Subsection 39(4) of the Act allows taxpayers to elect to treat all their Canadian securities as capital property. This election is not available to

any taxpayer listed in subsection 39(5). Subsection 39(5) is amended to add to the list a financial institution (as defined in new subsection 142.2(1)). The amendment also removes from the list banks, trust companies, credit unions and insurance corporations, since those entities are included in the definition of a financial institution.

5

The amendment to subsection 39(5) applies to dispositions of mark-to-market property in taxation years that begin after ANNOUNCEMENT DATE, and to dispositions of other property after February 22, 1994.

Clause 3

10

Conversion of Debt Obligation

ITA

51.1

Section 77 of the Act provides a tax-free rollover where a taxpayer exchanges a bond for another bond of the same debtor pursuant to a conversion right in the exchanged bond. With the introduction of new rules for debt obligations held by financial institutions, this rollover is being restricted to capital properties. Consequently, the rollover is moved to new section 51.1.

15

In addition, the rollover is amended to clarify that it applies to a wide range of debt obligations. The references in section 77 to a "bond" are replaced by references to a "bond, debenture or note". This is consistent with the scope of the rollover under subsection 51(1), which applies on the exchange of a bond, debenture or note for a share.

20

New section 51.1 applies to exchanges occurring after ANNOUNCEMENT DATE.

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Clause 4

Superficial Loss

ITA

54

"superficial loss"

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Paragraph 40(2)(g) of the Act deems the loss from a disposition of property to be nil if the loss is a superficial loss. Section 54 defines "superficial loss" for this purpose, and excludes losses on dispositions listed in paragraphs (c) to (e) of the definition from being superficial losses. Paragraph (c) is amended so that it also excludes losses on deemed dispositions under new subsection 142.5(2) (mark-to-market requirement) and new paragraph 142.6(1)(b) (deemed disposition when a taxpayer becomes a financial institution). This amendment applies to dispositions after February 22, 1994.

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Clause 5

15

Exploration and Development Shares

ITA

66.3(1)(a)

Section 66.3 of the Act contains rules relating to exploration and development shares (generally referred to as "flow-through" shares). Paragraph 66.3(1)(a) deems such shares acquired before November 13, 1981 to be inventory acquired at a cost of nil. This paragraph is amended to make it subject to new subsection 142.6(3), which deems certain property of financial institutions not to be inventory. The new rules for shares held by financial institutions will continue to make the profit on the sale of these flow-through shares fully taxable as business income.

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The amendment to paragraph 66.3(1)(a) applies to taxation years that commence after ANNOUNCEMENT DATE.

Clause 6**Bond Conversion****ITA****77**

Section 77 of the Act provides a tax-free rollover where a taxpayer exchanges a bond for another bond of the same debtor pursuant to a conversion right in the exchanged bond. With the introduction of new rules for debt obligations held by financial institutions, this rollover is being restricted to capital properties. Consequently, the rollover is moved to new section 51.1, and section 77 is repealed. The repeal applies to exchanges occurring after ANNOUNCEMENT DATE. 5 10

Clause 7**Transfer of Property to Corporation by Shareholders****ITA****85(1)(c.1) 15**

Subsection 85(1) of the Act contains rules that enable a taxpayer to transfer eligible property on a rollover basis to a taxable Canadian corporation in exchange for consideration that includes shares of the corporation. The taxpayer's proceeds of disposition of a transferred property and the corporation's cost of the property are equal to the amount that the taxpayer and the corporation designate in their joint election. A number of rules in subsection 85(1) deem the designated amount to be different from the amount actually designated in certain circumstances. 20

Paragraph 85(1)(c.1) deems the amount designated in respect of certain property to be the lesser of the fair market value of the property and the property's cost amount at the time of disposition, where the amount actually designated is less. This paragraph is amended to alter the properties to which it applies. The amendment is consequential on amendments to subsection 85(1.1), which specifies the types of property that are eligible for rollover treatment. The amendment to paragraph 85(1)(c.1) replaces the reference to property that is a security or debt obligation used by the taxpayer in an insurance or 25 30

money-lending business with a reference to property described in paragraphs 85(1.1)(g) and (g.1). This amendment applies to dispositions of property after February 22, 1994

ITA

85(1.1)(g) and (g.1)

5

Subsection 85(1.1) defines "eligible property" for the purpose of the rollover provided by subsection 85(1). Paragraph 85(1.1)(g) includes as eligible property a security or debt obligation used by the taxpayer in the business of insurance or lending money, where the property is neither capital property nor inventory. This paragraph is amended to exclude, where the taxpayer is a financial institution, property that is mark-to-market property. ("Financial institution" and "mark-to-market property" are defined in new subsection 142.2(1).) A rollover is not permitted for mark-to-market property of a financial institution because such property is required to be revalued to fair market value on a regular basis for tax purposes. This amendment applies with respect to dispositions in taxation years that begin after ANNOUNCEMENT DATE.

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15

The definition of eligible property is also amended by adding new paragraph 85(1)(g.1), which includes a specified debt obligation held by a financial institution as eligible property, unless the obligation is a mark-to-market property. ("Specified debt obligation" is defined in new subsection 142.2(1).) This amendment is applicable with respect to dispositions of property after February 22, 1994.

20

ITA

85(1.4)

25

New subsection 85(1.4) provides that, for the purpose of subsection 85(1.1), the terms "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings given by new subsection 142.2(1).

30

Clause 8**Amalgamations****ITA****87**

Section 87 contains rules which apply on the amalgamation of two or more taxable Canadian corporations. The amalgamated corporation is generally treated as a continuation of the predecessor corporations for the purposes of the Act. 5

Definitions**ITA 10****87(1.5)**

New subsection 87(1.5) provides that, for the purposes of section 87, the terms "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings given by new subsection 142.2(1).

Capital property 15**ITA****87(2)(e)**

Paragraph 87(2)(e) provides that, on an amalgamation, the cost to the new corporation of a capital property (other than a depreciable property or an interest in a partnership) acquired from a predecessor corporation is equal to the adjusted cost base of the property to the predecessor corporation immediately before the amalgamation. This paragraph is amended to make it subject to new paragraph 87(2)(e.4) and new subsection 142.6(5), which may provide a different cost for the new corporation. For further information, see the commentary on those provisions. The amendment to paragraph 87(2)(e) applies with respect to taxation years that end after February 22, 1994. 20 25

Security or debt obligation

ITA

87(2)(e.2)

Paragraph 87(2)(e.2) provides that, on an amalgamation, the cost to the new corporation of a security or debt obligation (other than capital property or inventory) acquired from a predecessor corporation that was used by the predecessor in the business of insurance or lending money is equal to the cost amount of that property to the predecessor corporation immediately before the amalgamation. This paragraph is amended to make it subject to new paragraphs 87(2)(e.3) and (e.4) and new subsection 142.6(5), which may provide a different cost for the new corporation. For further information, see the commentary on those provisions. The amendment to paragraph 87(2)(e.2) applies with respect to taxation years that end after February 22, 1994.

Financial institutions - specified debt obligation 15

ITA

87(2)(e.3)

New paragraph 87(2)(e.3) applies with respect to an amalgamation where the new corporation is a financial institution that has acquired a specified debt obligation (other than a mark-to-market property) from a predecessor corporation that was a financial institution. Paragraph 87(2)(e.3) deems the new corporation to be the same corporation as, and a continuation of, the predecessor corporation in respect of that specified debt obligation. This continuity is required so that the tax treatment of specified debt obligations under new sections 142.3 and 142.4 is the same for the new corporation as it would have been for the predecessor corporations. For further information, see the commentary on new subsection 142.6(5), which contains a similar continuity rule.

New paragraph 87(2)(e.3) applies with respect to amalgamations occurring after February 22, 1994. 30

Financial institutions - mark-to-market property

ITA

87(2)(e.4)

New paragraph 87(2)(e.4) applies with respect to a property that the new corporation has acquired from a predecessor corporation on an amalgamation where either (i) the new corporation is a financial institution and the property is a mark-to-market property for the new corporation, or (ii) the predecessor corporation was a financial institution and the property was a mark-to-market property for the predecessor corporation. Paragraph 87(2)(e.4) provides that the cost of the property to the new corporation is equal to its fair market value immediately before the amalgamation. Paragraph 87(2)(e.4) applies with respect to amalgamations occurring after ANNOUNCEMENT DATE. 5 10

It should be noted that the predecessor corporation is deemed to have disposed of the property just before the amalgamation for proceeds equal to its fair market value. If the predecessor was a financial institution before the amalgamation, this disposition occurs because of new subsection 142.5(2). Otherwise, it occurs by the combined effect of new paragraphs 87(2)(g.2) and 142.6(1)(b). 15

Financial institutions - mark-to-market property 20

ITA

87(2)(e.5)

New paragraph 87(2)(e.5) provides that, for the purposes of new subsections 112(5) to (5.2) and (5.4) and the definition of "mark-to-market property" in new subsection 142.2(1), the new corporation formed on an amalgamation is deemed to be the same corporation as, and a continuation of, each predecessor corporation. Paragraph 87(2)(e.5) applies with respect to amalgamations occurring at any time, including amalgamations that have already occurred. 25

Subsections 112(5) to (5.2) and (5.4) contain a stop-loss rule applicable where a financial institution has losses from the disposition of shares on which dividends have been received. Paragraph 87(2)(e.5) ensures that the stop-loss rule applies in the same way to the new corporation as it would have applied to each predecessor corporation had the 30

amalgamation not occurred. For example, dividends received by a predecessor corporation are taken into account in applying the stop-loss rule to the new corporation.

The definition of "mark-to-market property" includes certain debt obligations that have always been accounted for on a mark-to-market basis for financial statement purposes. As a result of the continuity rule in paragraph 87(2)(e.5), a predecessor corporation's accounting for a debt obligation is relevant in determining whether the obligation is a mark-to-market property of the new corporation.

Financial institution rules

ITA

87(2)(g.2)

New paragraph 87(2)(g.2) provides that, for the purposes of new subsections 142.5(4) to (7) (transition rules for the mark-to-market requirement) and new subsection 142.6(1) (taxpayer becoming or ceasing to be a financial institution), the new corporation formed on an amalgamation is deemed to be the same corporation as, and a continuation of, each predecessor corporation. Thus, the rules in subsection 142.6(1) will apply with respect to a predecessor corporation where that corporation is a financial institution and the new corporation is not, or vice versa.

New paragraph 87(2)(g.2) applies with respect to taxation years that end after February 22, 1994. Its application does not depend on when an amalgamation occurs.

Clause 9

Winding-up

ITA

88(1)

Subsection 88(1) contains rules that apply where a subsidiary has been wound up into its parent if both corporations are taxable Canadian

corporations and the parent holds at least 90% of the issued shares of each class of the subsidiary's capital stock.

ITA

88(1)(a) and (a.3)

When a subsidiary corporation distributes property (other than a partnership interest) to its parent corporation on a winding-up to which subsection 88(1) applies, paragraph 88(1)(a) deems the subsidiary to have disposed of the property for proceeds of disposition specified in the paragraph. Paragraph 88(1)(a) is amended to make it subject to new paragraph 88(1)(a.3). 5
10

New paragraph 88(1)(a.3) applies to a winding-up involving a subsidiary and a parent that are both financial institutions. It provides that the subsidiary is deemed not to have disposed of a specified debt obligation (other than a mark-to-market property) distributed to the parent on the winding-up. This rule, in conjunction with new paragraph 87(2)(e.3) (which applies to windings-up by reason of an amendment to paragraph 88(1)(e.2)), ensures that the tax treatment of specified debt obligations under new sections 142.3 and 142.4 is not affected by the winding-up. As an exception, paragraph 88(1)(a.3) does not apply for the purpose of the anti-avoidance rule in subsection 69(11). 15
20

For the purpose of paragraph 88(1)(a.3), the terms "financial institution", "mark-to-market property" and "specified debt obligation" have the meanings given by new subsection 142.2(1).

The amendment to paragraph 88(1)(a), and new paragraph 88(1)(a.3), apply to with respect to windings-up beginning after February 22, 1994. 25

ITA

88(1)(c)

Paragraph 88(1)(c) determines the cost to the parent corporation of property that it receives from its subsidiary corporation on a winding-up. Paragraph 88(1)(c) is amended to make it subject to new paragraph 87(2)(e.3), as that paragraph applies to windings-up. This amendment is made for the same reason as the amendment adding new 30

paragraph 88(1)(a.3). The amendment to paragraph 88(1)(c) applies with respect to windings-up beginning after February 22, 1994.

ITA

88(1)(e.2)

Paragraph 88(1)(e.2) provides that certain rules that are applicable to the amalgamation of two or more corporations also apply, with appropriate modifications, to the winding-up of a subsidiary by a parent corporation. This paragraph is amended to add a reference to new paragraph 87(2)(e.3). Thus, where the parent and the subsidiary are both financial institutions, the parent is deemed, in respect of a specified debt obligation (other than a mark-to-market property) distributed to it on the winding-up, to be the same corporation as, and a continuation of, the subsidiary. For the rationale for this rule, see the commentary on new paragraph 87(2)(e.3). 5 10

The amendment to paragraph 88(1)(e.2) applies with respect to windings-up beginning after February 22, 1994. 15

ITA

88(1)(h)

New paragraph 88(1)(h) deems the parent corporation on a winding-up to which subsection 88(1) applies to be the same corporation as, and a continuation of, the subsidiary, for the purposes of subsections 112(5) to (5.2) and (5.4) and the definition of "mark-to-market property" in new subsection 142.2(1). For an explanation of this rule, see the commentary on new paragraph 87(2)(e.5), which contains a similar rule for amalgamations. Paragraph 88(1)(h) applies to windings-up beginning at any time. 20 25

ITA

88(1)(i)

New paragraph 88(1)(i) provides that, for the purpose of subsection 142.5(2) (mark-to-market requirement for financial institutions), the taxation year of a subsidiary in which its assets were distributed to its parent on a winding-up shall be deemed to have ended 30

immediately before the distribution of the assets. Consequently, if the subsidiary is a financial institution, subsection 142.5(2) will deem it to have disposed of its mark-to-market property just before the distribution for proceeds equal to fair market value. Paragraph 88(1)(i) applies to windings-up beginning at any time.

5

Clause 10

Taxable Dividends Received by Corporations

Loss on share

ITA

112(3) to (4), (4.2) and (4.3) 10

Subsection 112(3) contains a "stop-loss" rule that reduces the loss of a corporation from the disposition of a share that is capital property, to the extent that the corporation has received tax-free dividends on the share. Subsections 112(3.1) and (3.2) contain similar stop-loss rules that apply to a corporation's share of the loss of a partnership from the disposition of a share, or to a trust's loss from the disposition of a share where the trust has a corporation as a beneficiary. Corresponding stop-loss rules in subsections 112(4), (4.2) and (4.3), applicable to a broader range of taxpayers, apply to losses from the disposition of shares that are not capital property. All these stop-loss rules apply only if the share was held for less than 365 days, or if a dividend was received at a time when a 5% share-ownership test was met.

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These subsections are amended, with respect to dispositions on or after ANNOUNCEMENT DATE, to provide that they are subject to new subsections 112(5.5) and (5.6). Those new subsections limit the circumstances in which the existing stop-loss rules apply. One reason for the restriction is that a new stop-loss rule has been added in subsection 112(5.2) for shares held by financial institutions. Another reason is that it is inappropriate for the existing stop-loss rules to apply where a share that has been held for less than 365 days is deemed to be disposed of under the mark-to-market requirement for financial institutions. For further information on the restrictions to the existing stop-loss rules, see the commentary on new subsections 112(5.5) and (5.6).

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30

Adjustment to proceeds of disposition

ITA

112(5) to (5.3)

New subsection 112(5.2) contains a rule that may adjust a taxpayer's proceeds from the disposition of a share if the taxpayer has received dividends on the share. This subsection applies in the circumstances set out in new subsections 112(5) and (5.1), but does not apply for the purpose set out in subsection 112(5.3). Subsections 112(5) to (5.3) apply to dispositions in taxation years beginning after ANNOUNCEMENT DATE. 5 10

Subsection 112(5) provides that subsection 112(5.2) applies where a financial institution disposes of a share that is a mark-to-market property and the financial institution received a dividend on the share at a time when the financial institution and non-arm's length persons held between them more than 5% of the issued shares of any class of the corporation paying the dividend. 15

Subsection 112(5.1) provides that subsection 112(5.2) applies where a taxpayer disposes of a share that was held for less than 365 days if (i) the disposition was an actual disposition, i.e., not a deemed disposition, (ii) the taxpayer was a financial institution at any time while it held the share, and (iii) the share was at any time a mark-to-market property of the taxpayer. 20

Where subsection 112(5.2) applies to the disposition of a share by a taxpayer, the taxpayer's proceeds of disposition are determined by the following formula: 25

$$A + B - (C - D)$$

where

A = the taxpayer's proceeds of disposition before the application of subsection 112(5.2);

B = the lesser of two amounts: 30

- the loss (if any) from the disposition that would be determined before the application of subsection 112(5.2) if

all deemed dispositions and reacquisitions after the taxpayer actually acquired the share were ignored, i.e., the loss determined using the original cost of the share to the taxpayer, and

- the total of the deductible taxable dividends and the non-taxable dividends received by the taxpayer on the share – in the case of a partnership, taxable dividends are included in the total to the extent they are deductible to members of the partnership; in the case of a trust, taxable dividends are included in the total to the extent they have been allocated to beneficiaries of the trust; 5 10

C = the sum of

- amounts by which subsection 112(5.2) increased the taxpayer's proceeds on deemed dispositions of the share before the current disposition, 15
- where the taxpayer is a corporation or trust, amounts by which losses of the taxpayer on deemed dispositions of the share before the current disposition were reduced by the stop-loss rule in subsection 112(3), (3.2), (4) or (4.3), and
- where the taxpayer is a partnership, amounts by which losses of members of the taxpayer on deemed dispositions of the share before the current disposition were reduced by the stop-loss rule in subsection 112(3.1) or (4.2); and 20

D = amounts by which subsection 112(5.2) decreased the taxpayer's proceeds on deemed dispositions of the share before the current disposition. 25

In general terms, this formula is designed to prevent a taxpayer from obtaining a deduction for the part of the taxpayer's overall loss in respect of a share from the time of actual acquisition to the time of a particular disposition, to the extent that the taxpayer has received dividends on the share. This is the same result as would occur under the existing stop-loss rules in section 112. However, subsection 112(5.2) is a more complex rule because it takes into account the adjustments that have occurred on each deemed disposition of a share. 30 35

Subsection 112(5.2) may increase or decrease a taxpayer's proceeds of disposition. Proceeds would be decreased where the taxpayer's loss from the disposition of the share, measured from original acquisition, has decreased because of an increase in the value of the share from one disposition to the next (assuming the dividends received between the two dispositions were less than the amount of the increase in value). The effect of an increase in the proceeds could be to reduce a loss, to turn a loss into a gain, or to increase a gain. A decrease in the proceeds could reduce a gain, turn a gain into a loss, or increase a loss.

5

New subsection 112(5.3) provides that the adjustment made by subsection 112(5.2) to a taxpayer's proceeds of disposition of a share does not apply for the purpose of determining the cost of the share to the taxpayer on a deemed reacquisition of the share after a deemed disposition. Thus, the adjustment will only affect the taxpayer's profit or loss from the deemed disposition.

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15

Deemed dispositions

ITA

112(5.4)

Generally, where a taxpayer is deemed to have disposed of a property and then reacquired it, the Act applies after the reacquisition as if the taxpayer had not previously owned the property. New subsection 112(5.4) contains certain exceptions to this principle for the purposes of subsections 112(5) to (5.2). Paragraph 112(5.4)(a) provides that the conditions in paragraphs 112(5)(c) (dividend received at a time when more than 5% of shares held) and 112(5.1)(b) (share held for less than 365 days) are to be applied without regard to any deemed dispositions and reacquisitions of the share. Paragraph 112(5.4)(b) provides that the total amounts determined for the purpose of the formula in subsection 112(5.2) are to be measured from the day on which the taxpayer actually acquired the share.

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Stop-loss rules not applicable

ITA

112(5.5)

New subsection 112(5.5) provides that the existing stop-loss rules in subsections 112(3) to (4), (4.2) and (4.3) do not apply to a disposition of a mark-to-market property by a financial institution, nor to a disposition to which subsection 112(5.2) applies. In the case of subsections 112(3.1) and (4.2), the test of whether a disposition is an excluded disposition applies to the partnership. These two exclusions (which overlap to a considerable extent) apply to dispositions in taxation years beginning after ANNOUNCEMENT DATE.

Stop-loss rules restricted

ITA

112(5.6)

New subsection 112(5.6) restricts the circumstances in which the existing stop-loss rules in subsections 112(3) to (4), (4.2) and (4.3) apply where a share is deemed to be disposed of by new subsection 142.5(2) (mark-to-market requirement) in a taxation year that includes ANNOUNCEMENT DATE. Subsection 112(5.6) also applies to a deemed disposition under new paragraph 142.6(1)(b) (deemed disposition on becoming a financial institution) on or after ANNOUNCEMENT DATE. Subsection 112(5.6) provides that, in these cases, the holding of a share for less than 365 days does not cause the stop-loss rules to apply. Thus, the rules will apply only by virtue of the 5% share-ownership test.

The reason that subsection 112(5.6) does not apply to deemed dispositions under subsection 142.5(2) in taxation years beginning after ANNOUNCEMENT DATE is that new subsection 112(5.5) excludes such dispositions from the existing stop-loss rules.

Definitions

ITA

112(6)

Subsection 112(6) of the Act defines certain terms used in section 112. This subsection is amended to provide that the terms "financial institution" and "mark-to-market property" have the meanings assigned by new subsection 142.2(1).

5

Clause 11

Insurance Corporations

Section 138 of the Act sets out detailed rules relating to the taxation of insurance corporations. The amendments to this section make consequential changes as a result of the introduction of new rules in sections 142.2 to 142.6 of the Act for shares and debt obligations held by financial institutions.

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ITA

138(3)(b) and (d)

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Subsection 138(3) allows a life insurer to deduct certain amounts in computing its income from carrying on a life insurance business in Canada, including amounts in respect of Canada securities. Canada securities are debt obligations used by an insurer in its Canadian life insurance business. Paragraph 138(3)(b) permits the full amount of the loss from the disposition of a Canada security to be deducted. Paragraph 138(3)(d) allows the premium on the acquisition of a Canada security to be deducted each year to the extent it is deducted by the insurer in computing its profit for the year.

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Paragraph 138(3)(b) is amended as it applies to taxation years that include February 22, 1994 to provide that it does not apply to dispositions after that date. In addition, the paragraph is repealed for taxation years beginning after February 22, 1994. Paragraph 138(3)(d) is repealed for taxation years ending after February 22, 1994.

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ITA**138(4)(b) and (c)**

Subsection 138(4) requires a life insurer to include certain amounts in computing its income from carrying on a life insurance business in Canada, including amounts in respect of Canada securities. 5
 Paragraph 138(4)(b) requires the full amount of the gain from the disposition of a Canada security to be included in income.
 Paragraph 138(4)(c) requires the discount on the acquisition of a Canada security to be included each year to the extent it is included by the insurer in computing its profit for the year. 10

Paragraph 138(4)(b) is amended as it applies to taxation years that include February 22, 1994 to provide that it does not apply to dispositions after that date. In addition, the paragraph is repealed for taxation years beginning after February 22, 1994. Paragraph 138(4)(c) is repealed for taxation years ending after February 22, 1994. 15

ITA**138(5.2)**

Subsection 138(5.2) denies an insurer a deduction for a "superficial loss" sustained on the sale of a share or debt obligation that is not capital property. This subsection is repealed for dispositions occurring on or after ANNOUNCEMENT DATE. 20

ITA**138(10)**

New subsection 138(10) applies to a resident multinational life insurer or a non-resident insurer. It provides that, in computing the income of such an insurer from carrying on an insurance business in Canada, the new financial institution rules in sections 142.3 to 142.5 apply to "property used by it in the year in, or held by it in the year in the course of" carrying on the business. Section 2400 of the Regulations contains rules for determining which properties are so used or held (the "designated properties"). 25
 30

Subsection 138(10), which serves a purpose similar to paragraph 138(9)(a), ensures that the new financial institution rules apply to designated properties, and only to designated properties, for the purpose of computing an insurer's income from carrying on an insurance business in Canada. In other words, it ensures that the financial institution rules apply to designated properties rather than to properties determined on a factual basis.

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ITA 138(11)

Subsection 138(11) specifies how the profit or loss of a life insurer from the disposition of a Canada security is to be determined for the purpose of paragraphs 138(3)(b) and (4)(b). With the amendment and repeal of those paragraphs, they do not apply to dispositions after February 22, 1994. As a consequence, subparagraph 138(11) is also repealed.

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ITA 138(11.3)

Subsection 138(11.3) provides for a deemed disposition and reacquisition of property at fair market value where an insurer changes the use of the property in one of the following ways:

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- property that was acquired for use in an insurance business in Canada begins to be used for another purpose, or vice versa; or
- property that is a debt obligation that was acquired for use in a life insurance business in Canada begins to be used in another business, or vice versa.

25

Subsection 138(11.3) is amended to limit its application to the first type of change of use. Thus, there will no longer be a deemed disposition where a debt obligation is moved from a life insurance business in Canada to an accident and sickness insurance business in Canada, or vice versa. This amendment, which involves the repeal of paragraphs 138(11.3)(c) and (d), applies to changes in use occurring after February 22, 1994.

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Subsection 138(11.3) is also amended to make its application subject to new subsection 138(11.31), which provides that subsection 138(11.3) does not apply to certain changes in use occurring in taxation years that begin after ANNOUNCEMENT DATE.

ITA 138(11.31)

5

New subsection 138(11.31) provides that subsection 138(11.3) does not apply to a change in use of property of an insurer where new subsection 142.5(2) (mark-to-market requirement) deems the property to have been disposed of at the end of the taxation year ending immediately before the change in use. The purpose of subsection 138(11.31) is to prevent two deemed dispositions of the same property from occurring, one immediately after the other. Subsection 138(11.31) applies to changes in use occurring in taxation years that begin after ANNOUNCEMENT DATE.

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ITA 138(11.4)

Subsection 138(11.4) provides that if an insurer has a loss – either a capital loss or a loss on income account – on a deemed disposition of property by virtue of subsection 138(11.3), the loss cannot be recognized until the property is actually disposed of or is deemed by another provision to be disposed of. Subsection 138(11.4) is amended to exclude from its scope specified debt obligations (as defined in new subsection 142.2(1)) that are deemed by subsection 138(11.3) to be disposed of after 1994.

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ITA 138(11.41)

Subsection 138(11.41) defers the recognition of a gain where an insurer is deemed by subsection 138(11.3) to dispose of a debt obligation because of a change in use referred to in paragraph 138(11.3)(c) or (d). Subsection 138(11.41) is repealed as a consequence of the repeal of paragraphs 138(11.3)(c) and (d) for changes in use occurring after February 22, 1994.

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ITA**138(11.5)**

Subsection 138(11.5) contains rules which enable a non-resident insurer to transfer, on a rollover basis, an insurance business carried on in Canada to a qualified related corporation. These rules also apply, by virtue of subsection 138(11.94), to the transfer by a resident insurer of a Canadian insurance business to a subsidiary wholly-owned corporation. Paragraphs 138(11.5)(e) and (k) are amended, and new paragraphs 138(11.5)(k.1) to (k.3) are added, as described below.

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ITA**138(11.5)(e)**

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Paragraph 138(11.5)(e) provides that where the fair market value of the non-share consideration received by the transferor does not exceed the total of the cost amounts of the transferred property to the transferor, the transferor's proceeds of disposition and the transferee's cost of each transferred property are equal to the cost amount of the property to the transferor. Otherwise, subsection 85(1) is required to be applied in respect of the transferred property.

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Paragraph 138(11.5)(e) is amended to make it subject to new paragraph 138(11.5)(k.2), which contains continuity rules for specified debt obligations. This amendment is applicable to transfers of insurance businesses occurring after February 22, 1994.

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ITA**138(11.5)(k) and (k.1)**

Paragraph 138(11.5)(k) contains a continuity rule that provides that the transferee of the insurance business is considered, for the purposes of a number of provisions in the Act, to be the same person as, and a continuation of, the transferor in respect of the business, the transferred property and the transferred obligations. Paragraph 138(11.5)(k) is amended to add new subsections 142.5(4) to (7) as provisions for which the paragraph applies. These subsections contain transition rules that apply with respect to the commencement of the mark-to-market requirement for financial institutions.

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New paragraph 138(11.5)(k.1) contains further rules that apply where the transferor of an insurance business has deducted an amount under subsection 142.5(4) or elected an allowable capital loss under subsection 142.5(6).

Subparagraph 138(11.5)(k.1)(i) provides that the continuity rule in paragraph 138(11.5)(k) applies only with respect to the part of the deducted amount or allowable capital loss that is reasonably attributable to the transferred business. This rule is relevant where the transferor does not transfer all its insurance businesses.

Subparagraph 138(11.5)(k.1)(ii) provides that, for the purpose of determining the amounts included under subsection 142.5(5) in the transferor's income after the transfer of the business, the transferor is deemed not to have deducted the amount that the transferee is considered to have deducted under subsection 142.5(4) by virtue of the continuity rule in paragraph 138(11.5)(k). This rule ensures that the transferor does not have to include in income the transition adjustments that the transferee is required to include in income. Subparagraph 138(11.5)(k.1)(ii) also contains a similar rule for determining the amount of taxable capital gains that the transferor must recognize under the transition rule in subsection 142.5(7).

The amendment to paragraph 138(11.5)(k) and the addition of paragraph 138(11.5)(k.1) apply with respect to transfers of insurance businesses after ANNOUNCEMENT DATE.

ITA

138(11.5)(k.2)

New paragraph 138(11.5)(k.2) applies where paragraph 138(11.5)(e) does not require subsection 85(1) to be applied in respect of the transfer of the insurance business. It deems the transferor not to have disposed of transferred property that is a specified debt obligation (other than a mark-to-market property), and it deems the transferee to be a continuation of the transferor in respect of such property. ("Mark-to-market property" and "specified debt obligation" are defined in new subsection 142.2(1).) This continuity is required so that the tax treatment of specified debt obligations under new sections 142.3 and 142.4 is not affected by the transfer. For further information, see the

commentary on new subsection 142.6(5), which contains a similar continuity rule.

New paragraph 138(11.5)(k.2) applies with respect to transfers of insurance businesses after February 22, 1994.

ITA

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138(11.5)(k.3)

New paragraph 138(11.5)(k.3) deems the transferee to be a continuation of the transferor for the purpose of new subsections 112(5) to (5.2) and (5.4) and the definition of "mark-to-market property" in new subsection 142.2(1).

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Subsections 112(5) to (5.2) and (5.4) contain a stop-loss rule applicable where a financial institution has losses from the disposition of shares on which dividends have been received. Paragraph 138(11.5)(k.3) ensures that the stop-loss rule applies in the same way to the transferee as it would have applied to the transferor had the business not been transferred. For example, dividends received by the transferor are taken into account in applying the rule to the transferee.

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The definition of "mark-to-market property" includes certain debt obligations that have always been accounted for on a mark-to-market basis for financial statement purposes. As a result of the continuity rule in paragraph 138(11.5)(k.3), the transferor's accounting for transferred debt obligations must be considered in determining whether the obligations are mark-to-market property of the transferee. This rule may be of little relevance to insurers, since it would be unusual for an insurer to account for its debt obligations on a mark-to-market basis.

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ITA

138(12)

Subsection 138(12) defines a number of terms that are used in section 138.

"Canada security"

The definition of "Canada security" is repealed as a consequence of the repeal of the provisions that use this term.

"cost"

The definition of "cost" is repealed. This term was defined for the purpose of the definition of "amortized cost" when that definition was included in subsection 138(12).

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"gross investment revenue"

Subsection 138(9) requires a resident multinational life insurer or a non-resident insurer to include, in computing its income from its Canadian insurance businesses for a year, the gross investment revenue for the year from property designated in accordance with the rules in section 2400 of the Regulations. Subsection 138(12) defines gross investment revenue for this purpose. Several amendments are made to the formula in this definition:

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- Quantity A in the formula, which is currently defined to equal total taxable dividends, interest, rents and royalties, is modified to exclude amounts in respect of debt obligations to which new subsection 142.3(1) applies. Income from these obligations is included in quantity E. This change applies to taxation years that end after February 22, 1994.

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- Quantity E in the formula, which is currently defined to equal total accrued interest on debt obligations, is amended so that it is equal to the total of the amounts required by new paragraph 142.3(1)(a) to be included in computing income. Paragraph 142.3(1)(a) applies to specified debt obligations (as defined in new subsection 142.2(1)) held by financial institutions. Regulations made for the purpose of that paragraph will require a taxpayer's return from a specified debt obligation to be recognized on an accrual basis, taking into account the total economic return to the taxpayer. This change applies to taxation years that end after February 22, 1994.

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- New quantity G is subtracted in computing gross investment revenue. It is defined to equal amounts determined under subparagraph 16(6)(a)(ii) (adjustments for deflation) in respect of indexed debt obligations, and amounts deductible under new paragraph 142.3(1)(b) in respect of specified debt obligations. This change applies to taxation years that end after October 16, 1991, except that the inclusion of amounts deductible under paragraph 142.3(1)(b) does not apply for taxation years that end before February 23, 1994. 5

ITA 138(13) 10

Subsection 138(13) applies where an insurer used the "proportional method" under subsection 138(9) for determining the portion of its gross investment revenue to include in income for a taxation year ending before 1978. In some cases, subsection 138(13) modifies certain components of the calculation of the amortized cost of a debt obligation that was held in that year. Subsection 138(13) is amended so that it also applies for the purpose of the definition of the "tax basis" of a specified debt obligation in new subsection 142.4(1). 15

Clause 12 20

Financial Institutions

New sections 142.2 to 142.6 of the Act contain rules for the tax treatment of most shares and debt obligations held by financial institutions. In brief, the purpose of each section is as follows:

- Section 142.2 defines several terms that are used in these sections (and in other provisions of the Act). 25
- Section 142.3 provides that the income from specified debt obligations is to be determined in accordance with rules set out in the Regulations.
- Section 142.4 sets out the rules for the measurement and timing of recognition of gains and losses from the disposition of specified debt obligations. 30

- Section 142.5 requires shares and certain debt obligations to be marked to market each year, and puts the gain or loss on income account. It also contains transition rules for the introduction of the mark-to-market requirement.
- Section 142.6 contains a number of additional rules that apply in various situations. 5

Interpretation

ITA 142.2

New section 142.2 of the Act contains interpretation provisions. Subsection 142.2(1) defines several terms for the purposes of that subsection and new sections 142.3 to 142.6. The definitions are also referenced in other provisions of the Act. Subsections 142.2(2) to (4) contain rules relating to the definition of "mark-to-market property" in subsection 142.2(1). Section 142.2 applies to taxation years that end after February 22, 1994. 10 15

Definitions

ITA 142.2(1)

Subsection 142.2(1) defines the terms "financial institution", "investment dealer", "mark-to-market property" and "specified debt obligation". 20

"financial institution"

The definition of "financial institution" is used for identifying the taxpayers that are subject to the new rules for shares and debt obligations. A financial institution is any of the following (unless listed in the exclusions described below): 25

- a corporation referred to in any of paragraphs (a) to (e) of the definition of "restricted financial institution" in subsection 248(1) of the Act – a bank, a trust company, a credit union, an insurance

corporation or a corporation whose principal business is any combination of the lending of money to, and the purchasing of debt obligations issued by, arm's length persons;

- an investment dealer;
- a corporation controlled by one or more financial institutions, unless the control was acquired because of the default of a debtor and control is being retained in order to minimize losses – for example, because there is no ready market for the shares; 5
- a trust or partnership if financial institutions hold interests totalling more than 50% of the fair market value of all interests. 10

The following are excluded from the definition of a financial institution:

- investment corporations, mortgage investment corporations and mutual fund corporations;
- deposit insurance corporations (as defined in subsection 137.1(5) of the Act); 15
- mutual fund trusts; and
- prescribed persons and partnerships.

"investment dealer"

An "investment dealer" is a corporation that is a registered securities dealer. As announced in a release issued by the Minister of Finance on June 23, 1994, "registered securities dealer" will be defined in subsection 248(1) of the Act to be a person who is registered or licensed in a province to trade in securities without any restriction on the types or kinds of securities in which the person may trade. 20

"mark-to-market property" 25

A "mark-to-market" property of a taxpayer for a taxation year is a property that is

- a share;
- if the taxpayer is not an investment dealer, a specified debt obligation that has been marked to market – that is, reflected at fair market value – in the taxpayer's financial statements for all fiscal periods before the taxation year. A specified debt obligation that is sold in the same year in which it is acquired is a mark-to-market property if it is reasonable to expect that it would have been marked to market in the financial statements if it had been held at year end; or 5
- if the taxpayer is an investment dealer, a specified debt obligation. 10

Certain properties are excluded from being mark-to-market properties for a year. One exclusion is for shares of a corporation in which the taxpayer has a significant interest at any time in the year. New subsections 142.2(2) to (4) provide rules for determining when a significant interest exists. 15

The second exclusion is for prescribed properties. It is intended that the following be prescribed:

- A qualified small business share. A share of a corporation will be a qualified small business share if, at the time the share is acquired, 20
 - the corporation is a Canadian-controlled private corporation, and an eligible corporation (as defined in subsection 5100(1) for the purposes of the deferred income plan rules);
 - the total assets of the corporation and all related corporations do not exceed \$50 million; and 25
 - the corporation and all related corporations have no more than 500 employees.
- A preferred share held by a bank and reported as a substitute for a loan.
- A debt obligation held by a bank where the obligation is a debt of a country that has been designated by the Office of the Superintendent of Financial Institutions or is a United Mexican 30

States Collateralized Par or Discount Bond Due 2019 (a "Brady bond").

The rules in new section 142.5 deem a financial institution to dispose of its mark-to-market properties at the end of each year for proceeds equal to fair market value, and they put the gains and losses on income account (except the first time that the rules apply).

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"specified debt obligation"

A "specified debt obligation" of a taxpayer is the taxpayer's interest in a loan, bond, debenture, mortgage, note, agreement of sale or any other indebtedness. However, it does not include an interest in an income bond, an income debenture, a small business development bond, a small business bond or a prescribed property.

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While there is a substantial amount of overlap between specified debt obligations and lending assets (as defined in subsection 248(1) of the Act), there are some differences between the two categories. One difference is that lending assets include shares held by banks as loan substitutes, whereas shares are not included as specified debt obligations. Another difference is that certain debt obligations are prescribed not to be lending assets. It is not intended at this time that any debt obligations be prescribed for exclusion from the definition of a specified debt obligation.

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With respect to lending assets, it is proposed that the regulation that excludes certain securities be amended. At present, a security held in the trading account of a bank or in the inventory of a taxpayer other than a bank is prescribed not to be a lending asset. This exclusion will be replaced by one that prescribes mark-to-market property of financial institutions and inventory of other taxpayers. Consequently, a debt obligation held by a bank in its trading account will be treated as a lending asset if it is not a mark-to-market property.

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Significant interest in corporation

ITA

142.2(2) to (4)

The definition of "mark-to-market property" in subsection 142.2(1) excludes a share of a corporation in which a taxpayer has a significant interest. Subsections 142.2(2) to (4) define significant interest and contain related rules. 5

Subsection 142.2(2) provides that a taxpayer has a significant interest in a corporation at any time if the taxpayer is related to the corporation at that time (ignoring any rights described in paragraph 251(5)(b) of the Act) or if the taxpayer holds shares of the corporation carrying at least 10% of the votes and representing at least 10% of the fair market value of all issued shares. 10

Subsection 142.2(3) contains rules for the purpose of subsection 142.2(2): 15

- Paragraph 142.2(3)(a) provides that shares held by a person or partnership related to the taxpayer are to be considered to be held by the taxpayer.
- Under paragraph 142.2(3)(b), shares held by the taxpayer are to be disregarded if they were acquired because of the default of a debtor and are being retained in order to minimize losses. Consequently, such shares are not to be taken into account in determining whether the taxpayer is related to the corporation or holds more than 10% of the votes and value of the corporation. 20
- Paragraph 142.2(3)(c) provides that shares that are prescribed in respect of the taxpayer are to be disregarded. It is intended that certain preferred shares issued by a corporation in financial difficulty be prescribed. This will ensure, in particular, that a taxpayer does not cease to have a significant interest in a corporation because the corporation has, as a consequence of financial difficulty, issued preferred shares to its debtors. 25 30

Subsection 142.2(4) contains a rule for determining when a partnership or trust is considered to be related to any person or partnership for the purpose of determining whether a taxpayer has a significant interest in

a corporation. It provides that the rules in section 251, which are based on control, are to be used, and that all trusts and partnerships are to be considered to be corporations for the purpose of those rules.

Income from Specified Debt Obligations

ITA

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142.3

New section 142.3 of the Act applies to financial institutions other than investment dealers. It provides that the amounts included or deducted in respect of a specified debt obligation in computing income are to be determined in accordance with rules set out in the Regulations. These inclusions and deductions are in respect of the holding of an obligation; the measurement and treatment of gains and losses on disposition are determined under section 142.4. Section 142.3 applies to taxation years ending after February 22, 1994, except that it does not apply to a debt obligation disposed of before February 23, 1994.

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Under paragraph 142.3(1)(a), a prescribed amount is to be included in income each year in respect of a specified debt obligation. Regulations will require the taxpayer's return from an obligation to be recognized on an accrual basis. For this purpose, the return will take into account both interest and the difference between the acquisition price and the face amount of the obligation – that is, the total economic return to the taxpayer. The amount to be included in income each year will usually correspond to the amount determined under generally accepted accounting principles. Additional amounts may be included in income in respect of foreign currency denominated obligations and obligations with payments that are subject to contingencies.

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Paragraph 142.3(1)(b) provides that a prescribed amount is to be deducted in respect of a specified debt obligation in computing a taxpayer's income for a year. This is to enable deductions to be claimed in certain situations in respect of foreign currency denominated obligations and obligations with payments that are subject to contingencies.

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The regulations will provide for foreign currency denominated obligations to be translated to their Canadian dollar equivalent each year. Any foreign exchange gain or loss will be included in the amount

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prescribed for the purposes of paragraph 142.3(1)(a) or (b). Most financial institutions currently follow this mark-to-market approach for recognizing foreign exchange gains and losses in preparing their financial statements.

In the case of obligations under which one or more payments are subject to contingencies, differences between these payments and the estimated amounts used for accrual purposes may give rise to adjustments to be included in income or deducted. 5

Paragraph 142.3(1)(c) provides that, with the exception of the doubtful and bad debt rules, the only rules for determining amounts to be included and deducted in respect of a specified debt obligation in computing income are those set out in the regulations under subsection 142.3(1). In particular, subsection 12(3) of the Act does not apply, nor do the accrual rules in section 7000 of the Regulations. Reserves for doubtful debts continue to be claimed under paragraph 20(1)(l) and deductions for bad debts under paragraph 20(1)(p). 10 15

Subsection 142.3(2) provides that subsection 142.3(1) does not apply to specified debt obligations that are mark-to-market property, nor does it apply to indexed debt obligations (as defined in subsection 248(1) of the Act). Mark-to-market property is excluded because marking to market is an alternative to recognizing income on an accrual basis. Indexed debt obligations are excluded because of the special accrual rules for these obligations under subsection 16(6) of the Act. However, subsection 143.2(1) will apply to indexed debt obligations that are prescribed. While it is not intended at this time to prescribe any obligations, obligations that are only partially indexed may be prescribed at a future date. 20 25

Disposition of Specified Debt Obligations

ITA 142.4 30

New section 142.4 of the Act, which applies to financial institutions other than investment dealers, contains rules for the measurement and timing of recognition of gains and losses from the disposition of

specified debt obligations (other than mark-to-market properties). The section applies to debt obligations disposed of after February 22, 1994.

Definitions

ITA

142.4(1)

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Subsection 142.4(1) defines the terms "tax basis" and "transition amount" for the purpose of section 142.4.

"tax basis"

The "tax basis" of a specified debt obligation is analogous to the adjusted cost base of capital property. It is used to measure the gain or loss from a disposition of the obligation. Also, the definition of cost amount in subsection 248(1) of the Act is amended to provide that the cost amount of a specified debt obligation to a financial institution is equal to the tax basis of the obligation.

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The tax basis of a specified debt obligation at any time to a taxpayer is defined to be the sum of the following amounts relating to the obligation:

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- (a) the cost of the obligation to the taxpayer -- this includes amounts advanced under a loan;
- (b) amounts included under subsection 12(3) (accrual of interest), subsection 16(2) or (3) (discount bonds issued by governments and other tax exempts), or new paragraph 142.3(1)(a) (accrual rules for financial institutions) in computing the taxpayer's income for taxation years beginning before that time;
- (c) if the taxpayer acquired the obligation at a discount in a taxation year ending before February 23, 1994, the amount of the discount that has been included in computing the taxpayer's income for taxation years ending before that date;
- (d) if the taxpayer is a life insurer, amounts that were deemed by paragraph 142(3)(a) to be gains for taxation years ending before 1978;

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- (e) if the obligation is an indexed debt obligation, amounts determined under subparagraph 16(6)(a)(i) (inflation adjustments) that have been included in computing the taxpayer's income for taxation years beginning before that time; 5
- (f) if the obligation is denominated in a foreign currency, amounts included in computing the taxpayer's income for taxation years ending at or before that time in respect of changes in the value of the obligation attributable to fluctuations in the value of the foreign currency (other than amounts included under new paragraph 142.3(1)(a)); 10
- (g) amounts included under paragraph 12(1)(i) (recovery of bad debts) in computing the taxpayer's income for taxation years beginning before that time; and
- (h) if the obligation was a capital property of the taxpayer on February 22, 1994, amounts added under paragraphs 53(1)(f) and (f.1) (denied capital losses) in computing the taxpayer's adjusted cost base on that day; 15

minus the following amounts:

- (i) amounts deducted under new paragraph 142.3(1)(b) in computing the taxpayer's income for taxation years beginning before that time; 20
- (j) payments (other than proceeds of disposition) received by the taxpayer at or before that time in respect of amounts added to the tax basis of the obligation as described in (a) to (f); 25
- (k) if the taxpayer acquired the obligation at a premium in a taxation year ending before February 23, 1994, the amount of the premium that has been deducted in computing the taxpayer's income for taxation years ending before that date;
- (l) if the taxpayer is a life insurer, amounts that were deemed by paragraph 142(3)(b) to be losses for taxation years ending before 1978; 30

- (m) amounts deducted under subsection 20(14) (interest accrued before acquisition) in computing the taxpayer's income for taxation years beginning before that time;
- (n) if the obligation is an indexed debt obligation, amounts determined under subparagraph 16(6)(a)(ii) (adjustments for deflation) that have been deducted in computing the taxpayer's income for taxation years beginning before that time; 5
- (o) if the obligation is denominated in a foreign currency, amounts deducted in computing the taxpayer's income for taxation years ending at or before that time in respect of changes in the value of the obligation attributable to fluctuations in the value of the foreign currency (other than amounts deducted under new paragraph 142.3(1)(b)); 10
- (p) amounts deducted under paragraph 20(1)(p) (bad debt deduction) in computing the taxpayer's income for taxation years beginning before that time; and 15
- (q) if the obligation was a capital property of the taxpayer on February 22, 1994, amounts deducted under paragraphs 53(2)(b.2) and (g) (reduction of ACB on change of control and on debt forgiveness) in computing the taxpayer's adjusted cost base on that day. 20

If a taxpayer has disposed of a specified debt obligation and later reacquired it (including a deemed disposition and reacquisition), the tax basis is determined using amounts in respect of the period from the most recent acquisition of the obligation. 25

For insurers, subsection 138(13) may adjust the amounts referred to in (c), (d), (k) and (l) where the insurer has held the specified debt obligation since a taxation year ending before 1978.

"transition amount"

The "transition amount" of a taxpayer in respect of a specified debt obligation at any time is an amount defined by regulation. In general terms, it will be the difference between the amount included to that time in the taxpayer's income in respect of the obligation and the amount that 30

would have been included if the accrual rules prescribed for the purpose of new subsection 142.3(1) had applied from the time the taxpayer acquired the obligation. Transition amounts will generally be nil for taxpayers that have been accruing discounts and premiums for income tax purposes. For other taxpayers, the transition amount in respect of an obligation will normally equal the portion of an acquisition discount or premium accrued to the beginning of the taxpayer's taxation year that includes February 23, 1994.

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Section 142.4 requires the transition amount in respect of an obligation to be included in income (or deducted, if it is negative) in the taxation year in which the taxpayer disposes of the obligation.

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Scope of section

ITA

142.4(2)

Subsection 142.4(2) sets out the taxpayers and debt obligations to which section 142.4 applies. The section applies to the disposition of a specified debt obligation by a financial institution other than an investment dealer. However, it does not apply to the disposition of a mark-to-market property.

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Rules applicable to disposition

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ITA

142.4(3)

Subsection 142.4(3) provides that where a taxpayer disposes of a specified debt obligation after February 22, 1994, the amounts to be included or deducted in respect of the disposition are the amounts determined under section 142.4. Thus, other provisions of the Act are not applicable. Subsection 142.4(3) also provides that paragraph 20(14)(a) does not apply on the disposition of an obligation unless it is an indexed debt obligation (other than a prescribed obligation). Paragraph 20(14)(a) requires the transferor of a debt obligation to include in income interest accrued to the date of transfer. Under the new rules, this interest will be included in income by section 142.3.

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Inclusions and deductions re disposition

ITA

142.2(4)

Subsection 142.4(4) applies to the disposition of a specified debt obligation after 1994, except a disposition to which subsection 142.4(5) applies. It requires the taxpayer to include or deduct amounts in respect of the disposition in computing income. 5

Under paragraphs 142.4(4)(a) and (b), the current amount in respect of the disposition of a specified debt obligation is required to be included (if positive) or deducted (if negative) in computing the taxpayer's income for the taxation year in which the disposition occurs. Subsection 142.4(7) defines the "current amount" as the sum of the taxpayer's transition amount in respect of the obligation and the portion of the taxpayer's gain or loss from the disposition that is attributable to a default by the debtor or to a material change in the likelihood that the debtor will satisfy its obligations. "Transition amount" is defined in subsection 142.4(1). 10 15

Paragraph 142.4(4)(c), which applies where a taxpayer has a gain from the disposition of a specified debt obligation, provides for the tax treatment of the residual portion of the gain. The residual portion (as defined in subsection 142.4(8)) is equal to the gain computed in accordance with subsection 142.4(6) minus any credit-related part of the gain that has been included in the taxpayer's current amount in respect of the disposition. There is no adjustment for the transition amount because it is taken into account under subsection 142.4(6) in measuring the gain. 20 25

Paragraph 142.4(4)(c) requires a prescribed part of the residual portion of the gain to be included in income each year, starting in the year of disposition. The regulations for this paragraph will provide for the residual portion of a gain to be amortized over the remaining term to maturity of the obligation. 30

Paragraph 142.4(4)(d) contains a rule for residual losses that is similar to the rule for residual gains in paragraph 142.4(4)(c).

Gain or loss not amortized**ITA****142.4(5)**

Subsection 142.4(5) applies to the disposition after February 22, 1994 of a specified debt obligation where the obligation is referred to in paragraph 142.4(5)(a) or the disposition is described in paragraph 142.4(5)(b). Where the subsection applies, the full gain or loss from the disposition (as determined under subsection 142.4(6)) is required to be included or deducted in computing income for the taxation year in which the disposition occurs. 5 10

The specified debt obligations to which subsection 142.4(5) applies by virtue of paragraph 142.4(5)(a) are indexed debt obligations (other than those that are prescribed) and debt obligations prescribed under subparagraph 142.4(5)(a)(ii). It is intended that the regulations will prescribe debt obligations that have less than two years to maturity from the end of the taxation year in which they are disposed of. Excluding such obligations from the requirement under subsection 142.4(4) to spread gains and losses will facilitate compliance with the new rules. However, a financial institution that spreads all gains and losses for financial statement purposes will be allowed to elect that its obligations with less than two years to maturity not be prescribed. 15 20

The dispositions to which subsection 142.4(5) applies by virtue of paragraph 142.4(5)(b) are the following:

- a disposition before 1995;
- a disposition after 1994 in connection with the transfer of all or part of a business; and 25
- a deemed disposition under paragraph 142.6(1)(b), which provides that a taxpayer that becomes a financial institution at any time is deemed to dispose of its specified debt obligations immediately before that time. 30

Gain or loss from disposition of obligation

ITA

142.4(6)

Subsection 142.4(6) provides that a taxpayer's gain or loss from the disposition of a specified debt obligation is equal to

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- the taxpayer's proceeds of disposition

minus

- the tax basis of the obligation to the taxpayer, and
- if subsection 142.4(4) applies to the disposition, the taxpayer's transition amount in respect of the obligation.

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Where a debt obligation was acquired at a premium, the transition amount may be negative. In this case, the corresponding positive amount would be added in determining the gain or loss from the disposition.

Where subsection 142.4(4) applies to a disposition, the gain or loss is measured as if the transition amount had been deducted or included in income immediately before the disposition. The reason is that the transition amount would not always be a portion of the gain or loss if the gain or loss were measured as the difference between the proceeds of disposition and the tax basis. For example, the transition amount could be positive even though the proceeds of disposition are less than the tax basis. This adjustment for the transition amount is not necessary where subsection 142.4(5) applies because the full gain or loss from the disposition is recognized in the year of disposition.

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Expenses related to the disposition of a specified debt obligation are not taken into account in calculating the gain or loss, but instead are separately deductible.

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Current amount**ITA****142.4(7)**

Where subsection 142.4(4) applies to the disposition of a specified debt obligation, two amounts must be determined: the current amount in respect of the disposition and the residual portion of the gain or loss. The current amount is recognized in the year in which the disposition occurs while, under the proposed regulations for subsection 142.4(4), the residual portion of the gain or loss is amortized over the remaining term to maturity of the obligation.

Subsection 142.4(7) defines the current amount in respect of the disposition of a specified debt obligation by a taxpayer as the positive or negative amount that is equal to the sum of:

- the taxpayer's transition amount in respect of the obligation – the transition amount is defined in subsection 142.4(1);
- if the taxpayer has a gain from the disposition, the part of the gain reasonably attributable to a material increase in the probability that the debtor will make all payments under the obligation; and
- if the taxpayer has a loss from the disposition, the negative amount claimed by the taxpayer not exceeding the part of the loss reasonably attributable to a default by the debtor or to a material decrease in the probability that the debtor will make all payments under the obligation.

The inclusion of credit-related losses in the current amount is primarily intended to enable a financial institution to claim an immediate deduction for the bad or doubtful portion of a debt obligation. For example, without this deduction, a financial institution that has to include a doubtful debt reserve in income in the year in which it disposes of an obligation might have to spread the corresponding loss over several years.

Subsection 142.4(7) does not require a financial institution to treat credit-related losses as current amounts. For administrative ease, a financial institution may choose, for example, not to identify the

credit-related component on dispositions of certain categories of debt obligations.

Residual portion of gain or loss

ITA

142.4(8)

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Subsection 142.4(8) defines the residual portion of the gain or loss from the disposition of a specified debt obligation as the part of the gain or loss that is not included under subsection 142.4(7) in determining the credit-related component of the current amount in respect of the disposition. The residual component is explained in the commentary on subsections 142.4(4) and (7).

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Disposition of part of obligation

ITA

142.4(9)

Subsection 142.4(9) provides that where a financial institution disposes of part of a specified debt obligation, section 142.4 and the regulations made for the purpose of the section apply as if that part and the retained part were separate debt obligations. Consequently, the tax basis of each part would have to be determined by allocating, on a reasonable basis, the amounts that entered into the determination of the obligation's tax basis before the partial disposition. Subsection 142.4(9) would apply, for example, where a financial institution strips the coupons from a specified debt obligation and sells them separately.

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Mark-to-Market Properties

ITA

142.5

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New section 142.5 of the Act requires shares and certain debt obligations to be marked to market each year, and puts the profit or loss on income account. It also contains transition rules for the introduction of the mark-to-market requirement. Section 142.5 applies to taxation

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years that end on or after ANNOUNCEMENT DATE, except for the requirement to treat profits and losses on income account, which applies to dispositions in taxation years beginning after ANNOUNCEMENT DATE.

Income treatment for profits and losses

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ITA

142.5(1)

Subsection 142.5(1) provides that where a financial institution disposes of a mark-to-market property (as defined in subsection 142.2(1)) and has a profit from the disposition, the profit is required to be included in the financial institution's income. Similarly, a loss from the disposition is fully deductible. The profit or loss from a disposition is determined for this purpose under general income tax principles. As a consequence of subsection 142.5(1), capital gains treatment does not apply to profits and losses from the disposition of mark-to-market properties.

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Subsection 142.5(1) applies to dispositions in taxation years beginning after ANNOUNCEMENT DATE.

Mark-to-market requirement

ITA

142.5(2)

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Subsection 142.5(2) requires a financial institution to recognize annually the change in value of its mark-to-market property. The subsection does this by deeming the financial institution to have disposed of the property immediately before the end of each taxation year for fair market value proceeds, and to have reacquired the property at the end of the year at a cost equal to those proceeds.

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Subsection 142.5(2) initially applies at the end of a financial institution's first taxation year ending on or after ANNOUNCEMENT DATE. Since subsection 142.5(1) does not commence to apply until the following taxation year, the treatment of profits and losses from the initial deemed disposition will be determined under the existing rules. Transition measures in subsections 142.5(4) to (7) apply to those profits and losses.

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Mark-to-market debt obligation

ITA

142.5(3)

Subsection 142.5(3) contains rules that apply, in taxation years beginning after ANNOUNCEMENT DATE, to specified debt obligations that are mark-to-market property. These rules ensure that the treatment of interest on such obligations is consistent with the mark-to-market approach for recognizing changes in value. 5

Paragraph 142.5(3)(a) provides that the rules in paragraph 12(1)(c), subsection 12(3) and paragraph 20(14)(a) for including interest in income do not apply to mark-to-market debt obligations. Instead, paragraph 142.5(3)(b) requires interest to be included in income when it is received. Interest that has accrued or become receivable but that has not been received is reflected in the fair market value of the obligation, and so will be recognized by virtue of the deemed disposition of the obligation. 10 15

Paragraph 142.5(3)(a) also provides that paragraph 20(14)(b) does not apply to mark-to-market debt obligations. That paragraph permits the purchaser of a debt obligation to deduct interest that accrued before the debt obligation was acquired. This deduction is not appropriate for mark-to-market obligations because the cost of the obligation will include an amount in respect of the accrued interest. Hence, the amount paid for the accrued interest will be taken into account in determining the profit or loss from the disposition of the obligation. 20

Paragraph 142.5(3)(b) includes received interest in income only to the extent that it has not been included in computing income for a preceding year. This would exclude, for example, interest that was included in income on an accrual basis under subsection 12(3) before subsection 142.5(3) commenced to apply. Paragraph 142.5(3)(c) provides that, for the purpose of this exclusion, amounts included in income because of a deemed disposition of an obligation by virtue of subsection 142.5(2) (end of year disposition of mark-to-market property) or paragraph 142.6(1)(b) (deemed disposition of property on becoming a financial institution) are not considered to be in respect of interest. 25 30

EXAMPLE

Bank A's taxation year is November 1 to October 31. On October 31, 1995, Bank A holds a specified debt obligation that is a mark-to-market property. The obligation provides for semi-annual interest payments of \$40 to be made on November 1 and May 1. The fair market value of this obligation on October 31, 1995 is \$1,100. Bank A sells the obligation on January 3, 1996 for \$1,080.

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Results:

1. In computing its income for its taxation year ending October 31, 1996, Bank A will include the \$40 interest payment received on November 1, 1995.

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2. Bank A's loss from the disposition, ignoring any costs of disposition, is \$20 (= \$1,100 - \$1,080). This loss is deductible in computing Bank A's income for its taxation year ending October 31, 1996.

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3. No amount is included by paragraph 20(14)(a) in Bank A's income in respect of the disposition of the obligation.

Transition - deduction re non-capital amounts**ITA
142.5(4)**

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Subsection 142.5(4) is a transition rule for non-capital property that is deemed to be disposed of on the initial application of the mark-to-market requirement. This subsection allows a financial institution to deduct an amount not exceeding a prescribed amount in its taxation year that includes ANNOUNCEMENT DATE. Subsection 142.5(5), in conjunction with the regulations under that provision, includes the deducted amount in income over a 5-year period starting in the taxation year that includes ANNOUNCEMENT DATE.

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The maximum amount that can be deducted will be prescribed to be:

- the financial institution's total profits from the disposition of non-capital mark-to-market properties (other than properties

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described below) that subsection 142.5(2) deems the taxpayer to dispose of in the year

minus

- the financial institution's total losses from the disposition of non-capital mark-to-market properties (other than properties described below) that subsection 142.5(2) deems the taxpayer to dispose of in the year, and 5
- the financial institution's net losses (i.e., losses minus profits) from actual dispositions in the year of non-capital mark-to-market properties (other than properties described below). 10

If a financial institution was already marking some of its properties to market for tax purposes, properties that it is reasonable to consider would have been marked to market without the requirement to do so are to be disregarded for the purpose of determining the prescribed amount.

Transition - inclusion re non-capital amounts 15

ITA

142.5(5)

Subsection 142.5(5) applies to a financial institution that has claimed a transition deduction under subsection 142.5(4). It requires a prescribed portion of the deducted amount to be included in income in each taxation year starting with the year that includes ANNOUNCEMENT DATE. Regulations for the purpose of subsection 142.5(5) will prorate the deducted amount over a 5-year period starting at the beginning of the taxation year that includes ANNOUNCEMENT DATE. The amount allocated to the days in a particular taxation year will be the prescribed portion for that year. 20
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Transition - deduction re net capital gains**ITA****142.5(6)**

Subsection 142.5(6) is a transition rule for capital property that is deemed to be disposed of on the initial application of the mark-to-market requirement. This subsection permits a financial institution to claim, for its taxation year that includes ANNOUNCEMENT DATE, an allowable capital loss not exceeding a prescribed portion of the financial institution's net taxable capital gains from the deemed disposition of certain capital property. Subsection 142.5(7), in conjunction with the regulations under that provision, require an equivalent amount of taxable capital gains to be recognized over a 5-year period starting in the taxation year that includes ANNOUNCEMENT DATE.

The maximum allowable capital loss that can be claimed will be prescribed to be:

- the financial institution's total taxable capital gains (other than taxable capital gains described below) from the disposition of mark-to-market properties that subsection 142.5(2) deems the taxpayer to dispose of in the year

minus

- the financial institution's total allowable capital losses (other than allowable capital losses described below) from the disposition of mark-to-market properties that subsection 142.5(2) deems the taxpayer to dispose of in the year, and
- the financial institution's net allowable capital losses (i.e., allowable capital losses minus taxable capital gains, other than those described below) from actual dispositions in the year of mark-to-market properties.

The following taxable capital gains and allowable capital losses are not taken into account in determining the allowable capital loss that a financial institution may claim under subsection 142.5(6):

- if the financial institution is a resident life insurer that carries on an insurance business outside Canada, gains and losses that section 142 excludes from the determination of the insurer's income; and
- if the financial institution is a non-resident, gains and losses from property that is not taxable Canadian property (as defined in subsection 115(1)).

Subsection 142.5(6) allows a financial institution to elect the amount of allowable capital loss that it is claiming under that subsection. An election should be made by including a letter with the financial institution's tax return for its taxation year that includes ANNOUNCEMENT DATE stating the amount of allowable capital loss elected under the subsection.

Transition - inclusion re net capital gains

ITA 142.5(7)

Subsection 142.5(7) applies to a financial institution that has elected to claim an allowable capital loss under subsection 142.5(6) for its taxation year that includes ANNOUNCEMENT DATE. Subsection 142.5(7) deems the financial institution to have a taxable capital gain for that year and for subsequent years equal to the portion of the elected amount prescribed for the year. Regulations for the purpose of subsection 142.5(7) will prorate the elected amount over a 5-year period starting at the beginning of the taxation year that includes ANNOUNCEMENT DATE. The amount allocated to the days in a particular taxation year will be the prescribed portion for that year.

First deemed disposition of debt obligation

ITA 142.5(8)

Subsection 142.5(8) contains rules that apply on the initial deemed disposition under subsection 142.5(2) of a mark-to-market property that is a specified debt obligation, where the disposition occurs in the

financial institution's taxation year that includes ANNOUNCEMENT DATE. The rules in subsection 142.5(8) also apply on a disposition of such property where the disposition is deemed to occur by paragraph 142.6(1)(b) (deemed disposition when a taxpayer becomes a financial institution).

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Paragraph 142.5(8)(c) provides that subsection 20(21) does not apply to the disposition of the specified debt obligation. Subsection 20(21) permits a taxpayer to deduct an amount on the disposition of a debt obligation equal to the excess of the interest that has been included in the taxpayer's income in respect of the obligation over interest that the taxpayer has received. This deduction is inappropriate in the circumstances in which subsection 142.5(8) applies because the unreceived interest will be reflected in the deemed cost of the obligation to the taxpayer.

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Paragraph 142.5(8)(d) applies (except as noted below) where a taxpayer has claimed a bad debt deduction under paragraph 20(1)(p) in respect of a specified debt obligation. The paragraph requires the taxpayer to include an amount in computing income for the year in which the deemed disposition occurs equal to the excess of the bad debt deductions claimed in respect of the obligation over any recoveries included in income under paragraph 12(1)(i). This paragraph is intended to prevent a taxpayer from benefiting from both a loss from the deemed disposition of the obligation and a bad debt deduction.

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Paragraph 142.5(8)(d) does not apply to the deemed disposition of a specified debt obligation that is inventory at the time of the disposition, since section 12.4 will apply to undo any bad debt deductions.

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Transition - property acquired on rollover

ITA

142.5(9)

Subsection 142.5(9) provides grandfathering treatment with respect to the accrued gains on certain mark-to-market property that a financial institution has acquired on a rollover basis. More specifically, the subsection applies with respect to a property that a taxpayer is deemed by subsection 142.5(2) to dispose of in its taxation year that includes ANNOUNCEMENT DATE where the following conditions are satisfied:

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- the taxpayer acquired the property before ANNOUNCEMENT DATE at a cost less than its fair market value at the time of acquisition;
- the property was acquired, directly or indirectly, from a person that was never a financial institution (assuming that the definition of financial institution in subsection 142.2(1) had always been applicable); and 5
- the reason for the difference between the cost and the fair market value when the property was acquired by the taxpayer is that subsection 85(1) applied in respect of the transfer of the property by that other person. 10

Where subsection 142.5(9) applies with respect to the deemed disposition of a capital property, the part of the taxable capital gain that can reasonably be considered to have accrued while the property was held by that other person (or any other person that was never a financial institution) is deemed to be a taxable capital gain of the taxpayer for the taxation year in which the taxpayer disposes of the property otherwise than because of the mark-to-market requirement in subsection 142.5(2). Generally, this would be the year in which the taxpayer actually disposes of the property. 15 20

Subsection 142.5(9) provides for a similar postponement of the recognition of the profit in the case of non-capital property.

Additional Rules

ITA 142.6 25

Section 142.6 contains a number of rules that apply in various situations:

- Subsection 142.6(1) provides for the deemed disposition of property and for a deemed taxation year end when a taxpayer becomes or ceases to be a financial institution. 30
- Subsection 142.6(2) provides that deemed dispositions of shares are to be disregarded for certain purposes.

- Subsection 142.6(3) excludes specified debt obligations and mark-to-market property from inventory.
- Subsection 142.6(4) contains rules that apply with respect to specified debt obligations (other than mark-to-market property) that were inventory in a financial institution's most recent taxation year ending before February 23, 1994. 5
- Subsections 142.6(5) and (6) provide a continuity rule for specified debt obligations (other than mark-to-market property) that have been acquired in various rollover transactions occurring before February 23, 1994. 10
- Subsection 142.6(7) excludes certain property from the superficial loss rule in subsection 18(13).

Becoming or ceasing to be a financial institution

ITA 142.6(1) 15

Subsection 142.6(1) contains rules that apply where a taxpayer becomes or ceases to be a financial institution after February 22, 1994. This is most likely to happen where the change of status occurs because the taxpayer becomes (or ceases to be) controlled by financial institutions.

If a taxation year of the taxpayer does not end immediately before the time at which its status changes, paragraph 142.6(1)(a) deems the taxpayer's taxation year that would otherwise have included that time to end immediately before that time. A new taxation year begins at that time, and the taxpayer is permitted to adopt a new fiscal period. One purpose for the deemed year end is to ensure the proper application of the new rules for specified debt obligations in section 142.3. 20 25

Paragraph 142.6(1)(b), which applies where a taxpayer becomes a financial institution, deems the taxpayer to have disposed of all its specified debt obligations and mark-to-market properties immediately before the end of its taxation year that ends just before its status changes, for proceeds equal to the fair market value of each property. However, if the change of status occurs before ANNOUNCEMENT 30

DATE, the deemed disposition does not apply to mark-to-market properties.

Paragraph 142.6(1)(c) contains a similar deemed disposition rule that applies where a taxpayer ceases to be a financial institution. However, this paragraph is limited to specified debt obligations that are not mark-to-market properties, since subsection 142.5(2) will deem the mark-to-market properties to have been disposed of.

Paragraph 142.6(1)(d) provides that a taxpayer is deemed to have immediately reacquired each property that it is deemed by paragraph 142.6(1)(b) or (c) to have disposed of, and the cost is deemed to equal the proceeds of disposition of the property.

Deemed disposition not applicable

ITA 142.6(2)

Generally, where a taxpayer is deemed to have disposed of a property and then reacquired it, the Act applies after the reacquisition as if the taxpayer had not previously owned the property. Subsection 142.6(2) contains an exception to this principle. It provides that a deemed disposition and reacquisition of a share because of subsection 142.5(2) (mark-to-market requirement) or subsection 142.6(1) (deemed disposition on becoming or ceasing to be a financial institution) does not affect the time at which the taxpayer is considered to have acquired the share. This rule is relevant, for example, if the tax treatment of dividends paid on the share depends on when the share was acquired.

Property not inventory

ITA 142.6(3)

Subsection 142.6(3) provides that specified debt obligations and mark-to-market properties held by a financial institution are not inventory of the institution. For specified debt obligations that are not mark-to-market properties, this rule applies to taxation years that end

after February 22, 1994. For mark-to-market properties, it applies to taxation years that begin after ANNOUNCEMENT DATE.

Property that ceases to be inventory

ITA

142.6(4) 5

Subsection 142.6(4) applies with respect to specified debt obligations (other than obligations that are mark-to-market property) that a financial institution holds on February 23, 1994 and that were inventory of the financial institution in its preceding taxation year.

Except as described below, subsection 142.6(4) deems the financial institution to have disposed of each specified debt obligation at the beginning of its taxation year that includes February 23, 1994 for proceeds equal to the amount at which the obligation was valued at the end of the preceding year for the purpose of computing the institution's income. This amount is also deemed to be the cost of the obligation for the purpose of the disposition, so the financial institution has no profit or loss from the disposition. It is then deemed to have reacquired the obligation immediately after the deemed disposition at a cost equal to the proceeds of disposition. 10 15

The deemed disposition and reacquisition of an obligation ensure that the accrual rules prescribed under new subsection 142.3(1) will apply as if the financial institution had not previously owned the obligation. The deemed cost is necessary both for those rules and for the rules in section 142.4 that apply on a subsequent disposition. 20

In its application to a bank, subsection 142.6(4) provides that a specified debt obligation that is prescribed property is deemed to have been disposed of for proceeds equal to the original cost of the obligation to the bank. Apart from this, the subsection applies in the same way as it does to other specified debt obligations. Consequently, any net gain or loss in respect of such property that has been recognized under the inventory rules will be reversed. It is intended to prescribe for this purpose specified debt obligations of countries that have been designated by the Office of the Superintendent of Financial Institutions, and also United Mexican States Collateralized Par and Discount Bonds Due 2019 ("Brady bonds"). 25 30 35

Debt obligations acquired in rollover transactions

ITA

142.6(5) and (6)

Where a specified debt obligation (other than a mark-to-market property) has been acquired in a rollover transaction, the tax treatment to the transferee may not be the same as it would have been to the transferor if the transferee is not considered to be a continuation of the transferor. For example, the accrual rules for specified debt obligations that will be prescribed under subsection 142.3(1) will require an acquisition discount or premium to be amortized from the date of acquisition. Without a continuity rule, this will be a different date for the transferee than it is for the transferor. Similarly, the transition amount that is determined by regulation for the purpose of the disposition rules in section 142.4 may not be the same without a continuity rule.

A new rule in paragraph 87(2)(e.3) provides that on an amalgamation, the new corporation is a continuation of the predecessor corporation in respect of a specified debt obligation that it acquired from the predecessor corporation. This rule, which also applies to windings-up, applies only if the amalgamation occurs, or the winding-up begins, after February 22, 1994.

New paragraph 138(11.5)(k.2) contains a similar rule for transfers of insurance businesses to which the rollover rules in subsection 138(11.5) apply without resort to subsection 85(1). This rule applies to transfers of insurance businesses occurring after February 22, 1994.

Subsection 142.6(5) contains a continuity rule for specified debt obligations that have been transferred in rollover transactions occurring before February 23, 1994. The subsection applies where, on February 23, 1994, a financial institution held a specified debt obligation (other than a mark-to-market property) that was held by another corporation before that day, if all changes of ownership from that other corporation to the financial institution occurred as a result of rollover transactions. In this case, the financial institution is deemed, with respect to its ownership of the obligation, to be the same corporation as, and a continuation of, that other corporation.

Subsection 142.6(6) defines a rollover transaction, for the purpose of subsection 142.6(5), to be an amalgamation, a winding-up to which subsection 88(1) applies or a transfer of an insurance business to which subsection 138(11.5) or (11.94) applies (except a transfer to which paragraph 138(11.5)(e) requires subsection 85(1) to be applied).

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Superficial loss rule not applicable

ITA

142.6(7)

Subsection 18(13) prohibits a taxpayer whose ordinary business includes the lending of money from deducting a "superficial loss" sustained on the disposition of a non-capital property that is a share or debt obligation used in the business. Subsection 142.6(7) provides that subsection 18(13) does not apply to the disposition by a financial institution on or after ANNOUNCEMENT DATE of a specified debt obligation or a mark-to-market property. It also excludes the deemed disposition of property pursuant to paragraph 142.6(1)(b) when a taxpayer becomes a financial institution.

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Clause 13

Definitions

ITA

248(1)

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"amortized cost"

The definition in subsection 248(1) of the "amortized cost" of a loan or lending asset is amended to take into account amounts in respect of fluctuations in the value of a foreign currency relative to the Canadian dollar. Specifically, amounts included in a taxpayer's income in respect of changes in the value of a loan or lending asset attributable to such fluctuations are included in the amortized cost of the loan or lending asset to the taxpayer. Amounts deducted in respect of such changes in value are subtracted in determining amortized cost. These amendments apply to taxation years that begin after June 17, 1987 and end after 1987.

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"cost amount"

The expression "cost amount", which is defined in subsection 248(1), is used throughout the Act, particularly in provisions relating to transfers of properties to or from corporations, trusts and partnerships.

New paragraph (c.1) provides that where a taxpayer is a financial institution, the cost amount at any time of a mark-to-market property is the cost of the property to the taxpayer. This paragraph applies to taxation years that begin after ANNOUNCEMENT DATE. 5

New paragraph (d.1) provides that the cost amount at any time of a loan or lending asset is the amortized cost at that time of the loan or lending asset to the taxpayer. This rule has been moved to paragraph (d.1) from existing paragraph (e). A debt obligation that is a net income stabilization account, capital property or inventory or, if the taxpayer is a financial institution, a mark-to-market property or specified debt obligation, is excluded from the application of paragraph (d.1). 10 15

New paragraph (d.2) provides that where a taxpayer is a financial institution, the cost amount at any time of a specified debt obligation (other than a mark-to-market property) is the tax basis of the property to the taxpayer at that time.

Paragraph (e) currently applies to debts owing to a taxpayer and to other rights of a taxpayer to receive an amount, with certain exceptions. Paragraph (e) is amended to restrict it to property that is a right of a taxpayer to receive an amount, other than property that is a debt that has been deducted as a bad debt under paragraph 20(1)(p), a net income stabilization account, or a property to which another paragraph applies. 20 25
Where paragraph (e) applies to a right to receive an amount, the cost amount of the right is the amount owing.

New paragraphs (d.1) and (d.2), and the amendments to paragraph (e), apply to the determination of cost amount at any time after February 22, 1994. 30

The terms "financial institution", "mark-to-market property" and "specified debt obligation" are defined in new subsection 142.2(1). The "tax basis" of a specified debt obligation is defined in new subsection 142.4(1).

