Revised Draft Amendments to the Income Tax Act and Regulations

Foreign Affiliates
Corporate Divisive Reorganizations

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

June 1994

Canada

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Revised Draft Amendments to the *Income Tax Act*

Borrowed Money

1.(1) The portion of subsection 20(3) of the Income Tax Act after paragraph (*b*) is replaced by the following:

subject to subsection 20.1(6), the borrowed money shall, for the purposes of paragraphs (1)(*c*),(*e*) and (*e*.1), subsections 20.1(1) and (2), section 21 and subparagraph 95(2)(*a*)(ii) and for the purposes of paragraph 20(1)(*k*) of the *Income Tax Act*, Chapter 148 of the revised statutes of Canada, 1952, be deemed to have been used for the purpose for which the money previously borrowed was used or was deemed by this subsection to have been used, or to acquire the property in respect of which the said amount was so payable, as the case may be.

(2) Subsection (1) applies to expenses incurred in taxation years of a foreign affiliate of a taxpayer that begin after 1994.

Foreign Affiliate - Definition

2.(1) The definition "foreign affiliate" in subsection 95(1) of the Act is replaced by the following:

"foreign affiliate"

"foreign affiliate", at any time, of a taxpayer resident in Canada that is not a non-resident-owned investment corporation means a non-resident corporation in which, at that time, the taxpayer's equity percentage is not less than 1% and the total of the equity percentages of the taxpayer and each person related to the taxpayer (each such equity percentage determined as if the determinations under paragraph (*b*) of the definition "equity percentage" in subsection (4) were made without reference to the equity percentage of any person in the taxpayer or in any person that is related to the taxpayer) is not less than 10%;

Foreign Accrual Property Income - Definition

(2) The portion of the description of A in the definition "foreign accrual property income" in subsection 95(1) of the Act before paragraph (*a*) is replaced by the following:

A is the total of the affiliate's incomes for the year from property and businesses other than active businesses (determined as if any amounts described in clause (2)(*a*)(ii)(B) paid or payable by the affiliate were nil), other than

(3) The description of D in the definition "foreign accrual property income" in subsection 95(1) of the Act is replaced by the following:

D is the total of the affiliate's losses for the year from property and businesses other than active businesses determined as if there were not included in the affiliate's income any amount described in any of paragraphs (*a*) to (*d*) of the description of A and as if any amounts described in clause (2)(*a*)(ii)(B) paid or payable by the affiliate were nil,

Definitions

(4) Subsection 95(1) of the Act is amended by adding the following definitions in alphabetical order:

"active business"

"active business" of a foreign affiliate of a taxpayer means any business carried on by the affiliate other than an investment business carried on by the affiliate or a business that is deemed by subsection (2) to be a business other than an active business of the affiliate;

"income from an active business"

"income from an active business" of a foreign affiliate of a taxpayer for a taxation year means the income of the affiliate for the year from an active business of the affiliate including any income of the affiliate for the year that pertains to or is incident to that business, but does not include income of the affiliate for the year from property;

"income from property"

"income from property" of a foreign affiliate of a taxpayer for a taxation year includes the income of the affiliate for the year from an investment business of the affiliate and the income of the affiliate for the year from an adventure or concern in the nature of trade;

"investment business"

"investment business" of a foreign affiliate of a taxpayer means a business carried on by the affiliate in a taxation year (other than a business deemed by subsection (2) to be a business other than an active business of the affiliate) the principal purpose of which is to derive income from property (including interest, dividends, rents,

royalties, insurance premiums or any similar returns or substitutes therefor and profits from the disposition of investment property) unless, throughout the period in the year during which the business was carried on by the affiliate,

(*a*) the affiliate is a corporation (other than a corporation whose principal business is trading or dealing in debt obligations on its own account or on the account of persons with whom it does not deal at arm's length)

(i) whose only business is the business (other than any such business conducted principally with persons with whom the affiliate does not deal at arm's length) carried on by it as a foreign bank (within the meaning of the Bank Act), a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated in the country in which the business is principally carried on, or

(ii) whose principal business is the development of real estate for sale, the lending of money, the leasing or licensing of property, the insurance of risks or a combination thereof (other than the development of real estate for sale to, the lending of money to, the leasing or licensing of property to, or the insurance of risks of persons with whom the affiliate does not deal at arm's length), and

(*b*) the affiliate or, where the affiliate carries on the business as a member of a partnership (other than where the affiliate is a specified member of the partnership in a fiscal period of the partnership ending in the year), the partnership employs more than 5 employees full time in the active conduct of the business;

"investment property"

"investment property" of a foreign affiliate of a taxpayer includes

(*a*) a share of the capital stock of a corporation other than a share of the capital stock of another foreign affiliate of the taxpayer that is excluded property of the affiliate,

(*b*) an interest in a partnership other than an interest in a partnership that is excluded property of the affiliate,

(*c*) an interest in a trust other than an interest in a trust that is excluded property of the affiliate,

(*d*) indebtedness or annuities,

(*e*) commodities or commodity futures

(*f*) currency of a country

(*g*) real estate

(*h*) Canadian and foreign resource properties,

(*i*) interests in funds and entities other than corporations, partnerships and trusts, and

(*j*) interests or options in respect of property described in this definition;

"lease obligation"

"lease obligation" of a person includes an obligation under an agreement which authorizes the use of or the production or reproduction of property including information or any other thing;

"lending of money"

"lending of money" by a person (in this definition referred to as the "lender") includes the purchasing of trade accounts receivable (other than a trade accounts receivable from a person with whom the lender does not deal at arm's length) of another person (in this definition referred to as the "borrower") and the purchasing of foreign resource properties (other than a resource property that is a rental or royalty payable by a person with whom the lender does not deal at arm's length) of the borrower;

"licensing of property"

"licensing of property" includes authorizing the use of or the production or reproduction of property including information or any other thing;

Determination of Foreign Accrual Property Income

(5) Paragraph 95(2)(*a*) of the Act is replaced by the following:

(*a*) in computing the income from an active business of a particular foreign affiliate of a taxpayer for a taxation year there shall be included any income of the affiliate for that year from sources in a country other than Canada that would otherwise be income from property of the affiliate for the year to the extent that

(i) the income

(A) is derived by the particular affiliate from activities that could reasonably be considered to be directly related to the active business activities carried on by any other non-resident corporation to which the particular affiliate is related in the course of carrying on an active business in a country other than Canada, and

(B) would be included in computing the amount prescribed to be that other non-resident corporation's earnings or loss from an active business carried on in a country other than Canada if that other non-resident corporation were a foreign affiliate of the taxpayer and the income was earned by it, or

(ii) the income is derived from amounts paid or payable, directly or indirectly, to the particular affiliate or a partnership of which the particular affiliate was a member

(A) by a non-resident corporation to which the particular affiliate is related to the extent that, if the non-resident corporation was a foreign affiliate of the taxpayer, those amounts paid or payable would be deductible by the non-resident corporation in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada, or

(B) by another foreign affiliate of the taxpayer to which the particular affiliate is related (in this clause referred to as the "second affiliate") to the extent that the amounts were paid or payable by the second affiliate pursuant to a legal obligation to pay interest on borrowed money used to acquire, or on an amount of indebtedness for the acquisition of, shares of the capital stock of a foreign affiliate of the taxpayer to which the particular affiliate was related (in this clause referred to as the "third affiliate") that are excluded property and the amounts paid or payable are relevant in computing the liability for taxes of a corporate group of which the second affiliate and

the third affiliate are members in a country in which they are resident and subject to income taxation;

(*a*.1) in computing the income from a business other than an active business of a foreign affiliate of a taxpayer for a taxation year there shall be included the income of the affiliate for the year from the sale of property (which, for the purposes of this paragraph, includes the income of the affiliate for the year from the performance of services as an agent in relation to a purchase or sale of property) where

(i) it is reasonable to conclude that the cost to any person of the property (other than property manufactured, produced, grown, extracted or processed in Canada by the taxpayer or a person with whom the taxpayer does not deal at arm's length in the course of carrying on a business in Canada that was subsequently sold to the affiliate for sale to non-resident persons) is relevant in computing the income from a business carried on by the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length or is relevant in computing the income from a business carried on in Canada by a non-resident person with whom the taxpayer does not deal at arm's length, and

(ii) the property was not manufactured, produced, grown, extracted or processed in the country under whose laws the affiliate was formed or organized and in which the affiliate's business is principally carried on,

unless more than 90% of the gross income of the affiliate for the year from the sale of property is derived from the sale of property (other than a property described in subparagraph (ii) the cost of which to any person is a cost referred to in subparagraph (i)) to persons with whom the affiliate deals at arm's length and, where this paragraph applies to include income of the affiliate from the sale of property in the income of the affiliate from a business other than an active business

(iii) the sale of such property shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

(iv) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(*a*.2) in computing the income from a business other than an active business of a foreign affiliate of a taxpayer for a taxation year there shall be included the income of the affiliate for the year from the insurance of a risk (which, for the purposes of this paragraph, includes income of the affiliate for the year from the reinsurance of a risk) where the risk was in respect of

(i) a person resident in Canada,

(ii) a property situated in Canada, or

(iii) a business carried on in Canada

unless more than 90% of the gross premium income of the affiliate for the year from the insurance of risks (net of reinsurance ceded) was in respect of the insurance of risks (other than risks in respect of a person, a property or a business described in subparagraphs (i) to (iii)) of persons with whom the affiliate deals at arm's length and, where this paragraph applies to include income of the affiliate from the insurance of risks in the income of the affiliate from a business other than an active business

(iv) the insurance of those risks shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

(v) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(*a*.3) there shall be included in computing the income from a business other than an active business of a foreign affiliate of a taxpayer for a taxation year the income of the affiliate for the year derived directly or indirectly from indebtedness and lease obligations (which, for the purposes of this paragraph, includes the income of the affiliate for the year from the purchase and sale of indebtedness and lease obligations on its own account)

(i) of persons resident in Canada, or

(ii) in respect of businesses carried on in Canada by non-resident persons

unless more than 90% of the gross income of the affiliate derived directly or indirectly from indebtedness and lease obligations was derived directly or indirectly from indebtedness and lease obligations of non-resident persons with whom the affiliate deals at arm's length and, where this paragraph applies to include income of the affiliate

for the year in the income of the affiliate from a business other than an active business

(iii) those activities carried out to earn such income shall be deemed to be a separate business, other than an active business, carried on by the affiliate, and

(iv) any income of the affiliate that pertains to or is incident to that business shall be deemed to be income from a business other than an active business;

(6) Subsections (1) to (5) apply to taxation years of a foreign affiliate of a taxpayer that begin after 1994.

Business

3.(1) The definition "business" in subsection 248(1) of the Act is replaced by the following:

"business"

"business" includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(*c*), section 54.2, subsection 95(1) and paragraph 110.6(14)(*f*), an adventure or concern in the nature of trade but does not include an office or employment;

(2) Subsection (1) applies to taxation years of a foreign affiliate of taxpayer that begin after 1994.

Foreign Affiliates

Explanatory Notes to Revised Draft Amendments to the *Income Tax Act*

Clause 1

Borrowed Money

ITA
20(3)

Subsection 20(3) of the Act provides a rule that applies when a taxpayer uses borrowed money to repay an existing debt. For the purposes of the provisions of the Act set out therein, the borrowed money is treated as having been used for the same purpose as that of the money previously borrowed but repaid. The amendment to this subsection simply makes the provision apply also for the purposes of proposed new subparagraph 95(2)(a)(ii) of the Act. That provision deals with foreign affiliates and the definition of foreign accrual property income which is discussed in the explanatory notes relating to subsection 95(2) of the Act. The amendment is applicable for expenses incurred in taxation years of a foreign affiliate of a taxpayer that begin after 1994. Thus, where a foreign affiliate of a taxpayer borrows money to repay a loan, the funds are considered to have been used for the same purpose as the use made of the funds that were derived from the repaid loan.

Clause 2

Foreign Affiliate - Definition

ITA
95(1)

Subsection 95(1) of the Act defines the term "foreign affiliate" of a taxpayer resident in Canada for the purposes of the rules in the Act which deal with the taxation of shareholders of non-resident corporations. Under the current definition, a corporation not resident in Canada will be considered to be a foreign affiliate of a taxpayer resident in Canada if the taxpayer's equity percentage in the corporation as defined in subsection 95(4) of the Act is not less than 10%. Among other things, the term is relevant for the purposes of the rules in section 91 of the Act dealing with the taxation of foreign accrual property income and the rules in section 113 of the Act

dealing with the deduction for dividends received from a foreign corporation by a corporation resident in Canada.

The definition is amended applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994. The amendment provides that a corporation not resident in Canada will be considered to be a foreign affiliate of a taxpayer where the taxpayer has an equity percentage in that corporation that is not less than 1% and the total of the equity percentages of the taxpayer and persons related to the taxpayer in that corporation is not less than 10%. For this purpose, the equity percentages are to be determined without reference to the equity percentages of any person in the taxpayer or in any persons related to the taxpayer. The amendment ensures that a taxpayer resident in Canada cannot avoid the foreign accrual property income rules by arranging to have shares of a non-resident corporation held by other persons related to the taxpayer.

As an example, assume that corporation A resident in Canada owns an 82% interest in the outstanding shares of a foreign corporation. Corporations B and C which are related to corporation A and are resident in Canada each own a 9% interest in the outstanding shares of the same foreign corporation. Under existing paragraph 95(1)(d) of the Act, the foreign corporation would be a foreign affiliate of corporation A but not of corporation B or C since the equity percentage of each of those corporations in the foreign corporation is less than 10%. Since corporation A controls the foreign corporation, the foreign corporation is a controlled foreign affiliate of corporation A. Corporation A would then report as income 82% of the foreign accrual property income of that controlled foreign affiliate.

The amendment to the definition would treat the foreign corporation as a foreign affiliate of corporations B and C since the total of the equity percentages of the three related corporations in the foreign corporation is not less than 10%. Since the foreign corporation is controlled by corporation A which is related to corporations B and C, it is also a controlled foreign affiliate of corporations B and C (see the definition of a "controlled foreign affiliate" in subsection 95(1) of the Act). Therefore, 100% of the foreign accrual property income of the controlled foreign affiliate will be included in the income of the Canadian shareholders - corporation A (82%), corporation B (9%) and corporation C (9%).

Foreign Accrual Property Income - Definition

ITA
95(1)

Subsection 95(1) of the Act defines "Foreign accrual property income" of a foreign affiliate of a taxpayer.

The description for the letter A and the formula in that definition includes in foreign accrual property income the affiliate's income for the year from property and businesses other than active businesses with some exceptions. The amendment to the description for the letter A provides that such income is to be determined without reference to those expenses of the foreign affiliate that are referred to in proposed new clause 95(2)(a)(ii)(B) of the Act. Under proposed new subsection 5907(2.8) of the Regulations, such expenses of the affiliate are to be deducted in computing the income or loss of the affiliate from an active business carried on or deemed to have been carried on by it in the country of which it is a resident for income tax purposes of that country. This amendment ensures that exempt surplus of an affiliated group is not overstated.

The description for the letter D and the formula in the definition deducts from foreign accrual property income the affiliate's losses from property and businesses other than active businesses. The amendment to the description for the letter D provides that those losses are also to be determined without reference to those expenses of the affiliate referred to in proposed new clause 95(2)(a)(ii)(B) of the Act which is discussed in the explanatory notes for that provision.

The amendments are applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994.

Definitions

ITA
95(1)

The proposed new definitions in subsection 95(1) of the Act are applicable to taxation years of a foreign affiliate of a taxpayer that

begin after 1994. They define "active business", "income from an active business", "income from property" and "investment business" of a foreign affiliate of a taxpayer as well as other terms relevant in determining the foreign accrual property income of a foreign affiliate.

"Active business" of a foreign affiliate of a taxpayer is defined as any business carried on by the affiliate other than an investment business or any activities that are deemed to be a separate business other than an active business of the affiliate under subsection 95(2) of the Act.

"Income from an active business" of a foreign affiliate of a taxpayer for a taxation year means the income of the affiliate for the year from an active business of the affiliate including any income of the affiliate for the year that pertains to or is incident to that active business but does not include any income for the year from property.

"Income from property" of a foreign affiliate of a taxpayer for a taxation year includes income of the affiliate for the year from an investment business of the affiliate and the income of the affiliate for the year from an adventure or concern in the nature of trade.

"Investment business" means a business carried on by the affiliate in a taxation year (other than a business that is deemed by subsection 95(2) of the Act to be a business other than an active business) the principal purpose of which is to derive income from property (including interest, dividends, rent, royalties, insurance premiums or similar returns or substitutes therefor and profits from the disposition of investment property).

This investment business definition will not apply to a business carried on by a foreign affiliate of a taxpayer where, throughout the period in the year during which the business was carried on, certain conditions are met.

First, the affiliate must be a corporation (other than a corporation whose principal business is trading and dealing in debt obligations on its own account or on the account of persons with whom the affiliate does not deal at arm's length)

- whose only business is the business carried on by it principally with arm's length persons as a regulated foreign financial

institution that is a bank, trust company, credit union, insurance corporation or a trader or dealer in securities or commodities, or

- whose principal business is the development of real estate for sale to, the lending of money to, the leasing or licensing of property to or the insurance of risks of arm's length persons or any combination thereof.

Second, the affiliate or, where the affiliate carries on the business as a member of a partnership, the partnership must employ more than five employees full time in the active conduct of the business. The affiliate can not be a "specified member" of the partnership in any fiscal period of the partnership ending in the year of the affiliate in which the business was carried on. The term "specified member" of a partnership is defined in subsection 248(1) of the Act and refers to passive partners and limited partners.

"Investment property" of a foreign affiliate of a taxpayer is defined to include a share in a corporation and an interest in a partnership or trust other than any such property that is excluded property of the affiliate, indebtedness and annuities, commodities and commodity futures, currency of a country, real estate, resource properties, interests in funds and entities other than corporations, partnerships and trusts and interests and options in respect of the property described in the definition.

"Lease obligation" of a person is defined to include an obligation under an agreement that authorizes the use of or the production or reproduction of property including information or any other thing (such as a software licensing agreement). This definition is relevant for the purposes of the rule in proposed new paragraph 95(2)(a.3) of the Act.

"Lending of money" by a person (the lender) is defined to include the purchasing from persons (the borrower) of trade accounts receivable owing by persons that deal at arm's length with the lender and the purchasing of foreign resource properties other than rents or royalties payable by persons that do not deal at arm's length with the lender. This definition is relevant for the purpose of the definition "investment business".

"Licensing of property" includes authorizing the use of or production or reproduction of property including information or any other thing. This definition is relevant for the purposes of the definition "investment business".

As an example, assume a corporation resident in Canada has three controlled foreign affiliates - FA1, FA2 and FA3. Foreign affiliates FA1 and FA2 carry on a manufacturing business in different countries and FA3 serves as a financing affiliate for FA1 and FA2 by making interest-bearing loans to them. The interest cost in respect of such loans reduces the amount prescribed to be the active business earnings of FA1 and FA2. The manufacturing income of FA1 is $1900 and it has $15 of interest income from the short term investment of funds used in the manufacturing business. FA2 has manufacturing income of $1500. FA3 has interest income from loans made to FA1 and FA2 of $160 and interest income from other short-term investments of $60.

FA1 has income from an active business of $1915 (the $1900 derived from manufacturing business and the $15 of interest income from the short term investment of funds used in that business) by reason of the definition of "income from an active business". FA2 has income from an active business of $1500. Under proposed new clause 95(2)(a)(ii)(A) of the Act, FA3 will include $160 in its income from an active business (the interest derived from the loans to FA1 and FA2). FA3 will also have $60 of income from property (the $60 of interest income from short-term investments) that will be included in its foreign accrual property income.

As another example, assume a corporation resident in Canada has a number of foreign affiliates each of which operate a manufacturing businesses in a separate foreign country with which Canada has a ratified tax treaty. It also has a separate foreign affiliate which insures the risks of the Canadian corporation and its manufacturing affiliates. The insurance affiliate derives $1000 of insurance income (net premiums minus claims and related expenses etc.) from insuring the Canadian corporation's risks (the "Canadian insurance business") and $300 of insurance income derived from the insurance of the foreign affiliates' risks (the "Foreign insurance business"). As well, the investment of the Canadian business net premiums and capital earns $500 of interest income while the investment of foreign business net

premiums and capital earns $150 of interest income. There is no income derived from assets not employed in the businesses.

The insurance affiliate has income from an investment business which is included in its income from property equal to its income from the foreign insurance business of $450 ($300 from net premiums + $150 from investments). The foreign insurance income of $300 derived from the insurance of foreign risks would usually be treated as active business income under proposed new clause 95(2)(a)(ii)(A) of the Act. The remaining $150 will not be included in the foreign accrual property income of the affiliate to the extent that new subparagraph 95(2)(a)(i) of the Act applies to include the income in the active business income of the affiliate. The Canadian insurance income of $1500 ($1000 from premiums + $500 from investments) will be treated as income from a business other than an active business under proposed new subparagraph 95(2)(a.2) of the Act and included in the foreign accrual property income of the affiliate.

As a final example, assume a corporation resident in Canada has several foreign affiliates that carry on active businesses in foreign countries (the "active affiliates"). Funds generated by the active affiliates are transferred to a financing affiliate for use by that affiliate to conduct an adventure or concern in the nature of trade (a purchase and sale of a real estate property) and to purchase portfolio investments. The quick flip of a real estate property produces income from an adventure or concern in the nature of trade of $1000. The proceeds from the property sale as well as the other funds received from the active business affiliates are invested and produce income from an investment business of $1500.

The financing affiliate will have income from property of $2500 ($1000 from the property sale + $1500 from the investment business) which is to be included in its foreign accrual property income. However, the $1000 of income from the sale of the property could be included as active business income of the financing affiliate under proposed new subparagraph 95(2)(a)(i) of the Act if the conditions set out therein are met. Similarly, proposed new subparagraph 95(2)(a)(i) could apply to treat the $1500 of investment income derived from the investment of the funds as active business income of the financing affiliate. Investment income of the financing affiliate which is not included in the active business income of the affiliate under

subparagraph 95(2)(a)(i) would be included as income from property that is included in the foreign accrual property income of the affiliate.

Determination of Foreign Accrual Property Income

ITA 95(2)

Subsection 95(2) of the Act provides rules for determining the income of a foreign affiliate of a taxpayer resident in Canada from a particular source. A foreign affiliate is considered to have three sources of income - income from property, income from a business other than an active business and income from an active business. This sourcing of income is important since the foreign accrual property income of the affiliate is comprised of the affiliate's income from property and the affiliate's income from a business other than an active business. Where the affiliate is a controlled foreign affiliate, the taxpayer's share of the affiliate's foreign accrual property income must be included in the taxpayer's income for Canadian tax purposes whether or not the income is distributed. The income of a foreign affiliate from an active business is included in the taxpayer's income for Canadian tax purposes only when paid to the shareholder as a dividend.

ITA 95(2)(a)

Existing paragraph 95(2)(a) of the Act includes in the income from an active business of a foreign affiliate of a taxpayer the income of the affiliate from property and the income of the affiliate from a business other than an active business to the extent that

- the income pertains to or is incident to an active business carried on in a country other than Canada by the affiliate or by a non-resident corporation with which the taxpayer does not deal at arm's length, or

- the income is derived from amounts paid or payable to the affiliate or a partnership of which the affiliate is a member by another affiliate of the taxpayer or by a non-resident corporation with which the taxpayer does not deal at arm's length where the

amounts paid or payable reduce (or would reduce, if the non-resident corporation were a foreign affiliate of the taxpayer) the amounts prescribed to be the active business earnings of the payer from a business carried on in a country other than Canada.

That paragraph is being replaced applicable to taxation years of foreign affiliates that begin after 1994. The current wording of that paragraph causes some uncertainty particularly as it relates to the determination of what income of one affiliate pertains to or is incident to the active business carried on by another corporation. The matter of treating income pertaining to or incident to an active business of an affiliate as active business income of the affiliate is dealt with in the proposed new definitions of income from an active business of a foreign affiliate and income from property of a foreign affiliate in subsection 95(1) of the Act. As well, because of the new definitions in subsection 95(1), only income from property needs to be dealt with in paragraph 95(2)(a). Finally, the scope of proposed new subparagraph 95(2)(a) has been restricted to income of a group of related non-resident corporations.

Proposed new subparagraph 95(2)(a)(i) defines a situation where income from property of a particular foreign affiliate of a taxpayer will be treated as active business income of the affiliate. Such income will be considered to be income from an active business of the particular affiliate to the extent that it is derived by the affiliate from activities that could reasonably be considered to be directly related to active business activities carried on by any other non-resident corporation to which the particular affiliate is related in the course of carrying on an active business in a country other than Canada. As well, the income must be of the type that would be included in computing the amount prescribed to be that other non-resident corporation's earnings or loss from an active business carried on in a country other than Canada if it were a foreign affiliate of the taxpayer and it earned the income.

For example, if a foreign affiliate of a taxpayer that sells equipment that it makes decides, for business reasons, to use a wholly-owned subsidiary to hold equipment that is leased rather than sold to its customers, the rental income of the subsidiary might well constitute income from property of the subsidiary. Proposed new subparagraph 95(2)(a)(i) of the Act could deem that rental income to be active business income of the subsidiary. The leasing activity of

the subsidiary must be directly related to the active business activities carried on by the parent in the course of carrying on an active business outside Canada and the income derived from the leasing activity must be income that would be included in the amount prescribed to be the earnings or loss of the parent from the active business carried on outside Canada if earned by the parent (for example, in a division of the active business of the parent). If those conditions were met, the active business earnings of the related group would remain unaffected by the use of a separate corporation to carry on the leasing business.

As a second example, assume that a foreign affiliate of a taxpayer that carries on an active real estate development and sales business decides, for business reasons, to use a wholly-owned subsidiary with no employees to develop a single building that is an investment property. Any rental income or the income of the subsidiary from the sale of the building would, in this case, constitute income from property. Proposed new subparagraph 95(2)(a)(i) of the Act would, however, deem that income to be active business income of the subsidiary when the income is derived from activities of the subsidiary that are directly related to the active business activities carried on by the parent and the income would be included in the amount prescribed to be the earnings or loss from an active business carried on in a country other than Canada if it had been earned by the parent. Similarly, if the subsidiary was used to conduct an adventure or concern in the nature of trade such as a purchase and sale of a building, the resultant income would be income from property that would be treated as active business income of the subsidiary under proposed new subparagraph 95(2)(a)(i) of the Act if the conditions of that subparagraph are met.

As a final example, if a corporation resident in Canada which has a foreign affiliate in the manufacturing business, decides for business reasons, to set up a factoring affiliate to purchase and collect the accounts receivable of the manufacturing affiliate, the income of the factoring affiliate would constitute income from property. Proposed new subparagraph 95(2)(a)(i) of the Act would deem such income of the factoring affiliate to be active business income where the factoring activities are directly related to the active business activities of the manufacturing affiliate and the income would have been included in the amount prescribed to be the earnings or loss of the manufacturing affiliate from an active business carried on in a

country other than Canada if the manufacturing affiliate had itself earned the income (for example, in a division of the manufacturing business).

Proposed new subparagraph 95(2)(a)(ii) of the Act is similar to existing subparagraph 95(2)(a)(ii) of the Act except for the fact that the scope of the provision has been altered in two ways. First, the scope has been expanded to accommodate the use of holding corporations by a group of related foreign affiliates of a taxpayer. Second, its application has been restricted to income of a related group of non-resident corporations.

Income of a particular foreign affiliate of a taxpayer that would otherwise be income from property of the affiliate will be included in the income of the affiliate from an active business of the affiliate to the extent that

- under clause (A), the income is derived by the particular affiliate from amounts paid or payable, directly or indirectly, to it or a partnership of which it was a member by another non-resident corporation to which the particular affiliate is related, and, if the non-resident corporation was a foreign affiliate of the taxpayer, the amounts so paid or payable would reduce the amount prescribed to be its earnings from an active business other than an active business carried on in Canada, or

- under clause (B), the amounts were paid or payable by another foreign affiliate of the taxpayer related to the particular affiliate (second affiliate) pursuant to a legal obligation to pay interest on borrowed money used to acquire, or on an amount payable for the acquisition of, shares of the capital stock of another foreign affiliate of the taxpayer related to the particular affiliate (third affiliate) that are excluded property of the second affiliate and the amounts paid or payable are relevant in computing the liability for taxes of a corporate group of which the second and third affiliate are members in the country in which they are resident and subject to income taxation.

For example, if one foreign affiliate of a taxpayer loaned funds to another foreign affiliate of the taxpayer to which it is related, the interest on the loan would be income from property of the lender. However, proposed new clause 95(2)(a)(ii)(A) of the Act would

include that income in the active business income of the lender where the interest expense is deductible in computing the amount prescribed to be the borrower's earnings or loss from an active business, other than an active business carried on in Canada. Where foreign income tax rules such as the rules dealing with earnings stripping in the United States postpone an expense deduction, it is intended that this provision will apply to the extent that the payer would have been able to deduct the expense if its income for the year to which the expense relates had been sufficient. The affiliated group's active business earnings are then not affected by inter-affiliate debt charges. (Note, however, the new rules in proposed new subsection 5907(2.7) of the *Income Tax Regulations* with respect to the timing of the deduction of this interest in computing the amount prescribed to be the earnings from an active business of the borrower.) This rule is similar to the corresponding rule in section 125 of the Act for determining the income of a Canadian-controlled private corporation that is eligible for the small business deduction.

As another example, if a particular foreign affiliate of a taxpayer (the "first affiliate") loaned funds to another foreign affiliate of the taxpayer to which the particular affiliate is related (the "second affiliate") which then used the funds to purchase the outstanding shares of yet another affiliate of the taxpayer to which the particular affiliate is related (the "third affiliate"), the interest paid to the first affiliate by the second affiliate would be income from property of the first affiliate if the second affiliate did not carry on an active business and deduct the interest in computing its income from that active business. Where the second and third affiliates are part of a corporate group that computes the tax liabilities of the members using methods such as consolidation or deduction transfers and the interest is deducted in computing the income subject to tax in the country in which the affiliates are resident and subject to income taxation, proposed new clause 95(2)(a)(ii)(B) will treat the income of the first affiliate derived from the interest paid to it by the second affiliate as active business income. Proposed subsection 5907(2.8) of the *Income Tax Regulations* requires the second affiliate to deduct the interest paid to the first affiliate in computing its active business income or loss at the same time as the income derived from the interest is reported as active business income of the first affiliate. The affiliated group's active business income is then not affected by inter-group charges. As well, by reason of the amendment to

clause 5907(1)(b)(iv)(B) of the regulations, group exempt surplus is not affected.

ITA
95(2)(a.1)

Proposed new paragraph 95(2)(a.1) of the Act, which applies to taxation years of foreign affiliates that begin after 1994, includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the sale of property (including the income derived from services as agent provided in relation to a purchase or sale of property) where

- the cost of the property (other than property manufactured produced, grown, extracted or processed in Canada by the taxpayer or a person with which the taxpayer does not deal at arm's length in the course of carrying on a business in Canada that was subsequently sold to the affiliate for sale to non-resident persons) is relevant in computing the income from a business carried on by the taxpayer or persons resident in Canada that do not deal at arm's length with the taxpayer or a business carried on in Canada by non-resident persons that do not deal at arm's length with the taxpayer, and

- the property was not manufactured, produced, grown or extracted or processed in the country under whose laws the affiliate was formed or organized and in which the affiliate's business was principally carried on.

The rule does not apply where more than 90% of the gross income of the affiliate from the sale of property is derived from sales of property (other than property the cost of which falls within the rules described above) to persons that deal at arm's length with the affiliate. Where the rule applies to the foreign affiliate of the taxpayer, the sale of such property is deemed to be a separate business other than an active business of the affiliate. Any income that pertains or is incident to that business is deemed to be income of the affiliate from a business other than an active business of the affiliate.

This new rule will discourage the establishment of a foreign subsidiary by a corporation for the purpose of purchasing goods (and the provision of services as an agent in relation to a purchase or sale of goods) for resale or use in a business carried on in Canada either by the corporation itself or by any person with whom the corporation does not deal at arm's length.

ITA
95(2)(a.2)

Proposed new paragraph 95(2)(a.2) of the Act, which applies to taxation years of foreign affiliates that begin after 1994, includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the insurance of risks (including income from the reinsurance of risk) where the risks insured were in respect of

- a person resident in Canada
- property situated in Canada, or
- a business carried on in Canada.

The rule does not apply where more than 90% of the gross premium income of the affiliate from the insurance (net of reinsurance ceded) of risks was derived from the insurance of other risks of persons with whom the affiliate deals at arm's length. Where the rule applies to the foreign affiliate of the taxpayer, the insurance of those risks is deemed to be a separate business other than active business of the affiliate. The income derived from the investment of the insurance premiums and the surplus required to provide for those risks that are being insured is income from that separate business. Income derived from the investment of assets derived from that business that are not employed or at risk in that business is income from property.

The purpose of this new rule is to protect the Canadian tax base from erosion through the use of foreign affiliates by Canadian corporations to insure risks in Canada. For example, a Canadian corporation in the business of lending money could offer its customers insurance to cover the loan in the event of the borrower's death and could arrange for the insurance to be assumed by a

subsidiary in a low tax jurisdiction. This amendment prevents this method of avoiding Canadian tax on income that is derived in connection with the Canadian business activities.

ITA
95(2)(a.3)

Proposed new paragraph 95(2)(a.3) of the Act, which applies to taxation years of foreign affiliates that begin after 1994, includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate derived directly or indirectly from indebtedness or lease obligations (including any income of the affiliate derived from the purchase or sale of indebtedness and lease obligations on its own account) of persons resident in Canada or in respect of businesses of non-residents carried on in Canada. Lease obligation is defined in a proposed new definition in subsection 95(1) of the Act to include an obligation under a license.

The rule does not apply where more than 90% of the gross income of the foreign affiliate for the year was derived directly or indirectly from indebtedness or lease obligations of non-resident persons with whom the affiliate was dealing at arm's length. Where the rule applies to the foreign affiliate of the taxpayer, those activities are deemed to constitute a separate business other than an active business of the affiliate. Any income incident to or pertaining to that business is deemed to be income of the affiliate from a business other than an active business of the affiliate.

The purpose of this new rule is to protect the Canadian tax base from erosion through the use of foreign affiliates by Canadian corporations in the financing and leasing and licensing business to acquire debt and lease obligations of persons resident in Canada. For example, a corporation in the business of providing NHA mortgage loans to Canadians could transfer a part of its Canadian loan portfolio to a foreign subsidiary in a low tax jurisdiction to earn interest on the loan free from any Canadian tax including the non-resident withholding tax. This amendment ensures that this method of avoiding Canadian tax will not be successful.

Clause 3

Business

ITA
248(1)

Subsection 248(1) of the Act provides definitions for the purposes of the Act. The definition of "business" includes an adventure or concern in the nature of trade except for certain purposes. That definition is being amended to ensure that it does not include an adventure or concern in the nature of trade for the purposes of the proposed new definitions in subsection 95(1) of the Act.

The amendment is applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994.

Foreign Affiliates

Revised Draft Amendments to the *Income Tax Regulations*

Deductible Loss

1. Subsections 5903(1) and (2) of the Income Tax Regulations are replaced by the following:

5903.(1) For the purposes of determining the amount for F in the definition "foreign accrual property income" in subsection 95(1) of the Act, the amount prescribed to be the deductible loss of a foreign affiliate of a taxpayer for a taxation year and the five immediately preceding taxation years is the amount, if any, by which

(*a*) the total of all amounts each of which is the amount, if any, for each of the five immediately preceding taxation years of the affiliate during which it was a controlled foreign affiliate of the taxpayer or of a person described in any of subparagraphs 95(2)(*f*)(iv) to (vii) of the Act, by which

(i) the total of the amounts determined for D and E in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for that preceding year

exceeds

(ii) the total of the amounts determined for A, B and C in the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of the affiliate for that preceding year

exceeds the aggregate of

(*b*) the total of all amounts each of which is an amount determined for F in the definition "foreign accrual property income" in subsection 95(1) of the Act by the taxpayer or a person described in any of subparagraphs 95(2)(*f*)(iv) to (vii) of the Act in respect of any of the five immediately preceding taxation years of the affiliate to the extent that such amount relates to a loss of the affiliate described in the description of D and E in the definition "foreign accrual property income" in subsection 95(1) of the Act for any of those years and assuming that no amount is included in F in the definition "foreign accrual property income" in subsection 95(1) of the Act for any year in respect of a loss until the maximum amount of a loss for preceding taxation years has been deducted or included, and

(*c*) where a payment has been received by the foreign affiliate that can reasonably be considered to relate to a payment described in subsection 5907(1.3) made by another foreign affiliate of the taxpayer in respect of a loss or any portion thereof of the affiliate described in the description of D and E of the definition "foreign accrual property income" in subsection 95(1) of the Act in respect of any of the five

immediately preceding taxation years of the affiliate, the amount of such loss or portion thereof of the affiliate.

(2) For the purposes of subsection (1), each amount referred to in paragraph (1)(*c*) in respect of a controlled foreign affiliate of a taxpayer resident in Canada that is not otherwise determined in Canadian currency shall be converted to Canadian currency at the rate of exchange prevailing on the last day of the affiliate's taxation year referred to in the definition "foreign accrual property income" in subsection 95(1) of the Act.

Exempt Earnings

2.(1) Subparagraph 5907(1)(*b*)(iv) of the Income Tax Regulations is replaced by the following:

(iv) for the 1976 or any subsequent taxation year, where the affiliate is resident in a designated treaty country, each amount that is

(A) the affiliate's net earnings for the year from an active business carried on by it in Canada or a designated treaty country, or

(B) the earnings of the affiliate for the year from an active business to the extent that they derive from

(I) amounts by which the income of the affiliate from an active business for the year is increased because of subparagraph 95(2)(*a*)(i) of the Act that are derived by the affiliate from activities that could reasonably be considered to be directly related to business activities carried on by a non-resident corporation to which the affiliate is related in the course of carrying on an active business the income from which would, if the non-resident corporation was a foreign affiliate of a corporation, be included in computing the exempt earnings or the exempt loss of the non-resident corporation,

(II) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(*a*)(ii)(A) of the Act that are derived from amounts paid or payable to it by a non-resident corporation to which the affiliate is related to the extent that, if the non-resident corporation was a foreign affiliate of a corporation, the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the non-resident corporation, or

(III) amounts by which the income of the affiliate from an active business for the year is increased because of clause 95(2)(*a*)(ii)(B) of the Act that are derived from amounts paid or payable to it by another foreign affiliate of the corporation to which the affiliate is related (in this subclause referred to as the "second affiliate"), to the extent that the amounts paid or payable are on account of interest on borrowed money used to acquire or on indebtedness incurred on the acquisition of excluded property consisting of shares of the capital stock of a foreign affiliate of the corporation to which the affiliate is related (in this subclause referred to as the "third affiliate") and the second affiliate and the third affiliate and each other corporation relevant for the purposes of determining whether the shares of the third affiliate are excluded property, are resident in a designated treaty country and for the purposes of this subclause, the definition "excluded property" in subsection 95(1) of the Act shall be read without reference to amounts receivable referred to in subparagraph (*c*) thereof where the interest thereon is not, or would not if interest were payable thereon be deductible by the debtor in computing its exempt surplus or exempt loss, or

Exempt Loss

(2) Subparagraph 5907(1)(*c*)(iii) of the Regulations is replaced by the following:

(iii) for the 1976 or any subsequent taxation year where the affiliate is resident in a designated treaty country, each amount that is the affiliate's net loss for the year from an active business carried on by it in Canada or in a designated treaty country, or

Net Earnings

(3) That portion of subparagraph 5907(1)(*f*)(iii) of the Regulations preceding clause (A) is replaced by the following:

(iii) from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada) is the amount, if any, by which

Net Loss

(4) That portion of subparagraph 5907(1)(*g*)(iii) of the Regulations preceding clause (A) is replaced by the following:

(iii) from dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada) is the amount, if any, by which

Taxable Earnings

(5) Clause 5907(1)(*i*)(ii)(D) of the Regulations is replaced by the following:

(D) the affiliates net earnings for the year from the dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada), or

Taxable Loss

(6) Clause 5907(1)(*j*)(ii)(C) of the Regulations is replaced by the following:

(C) the affiliates net loss for the year from the dispositions of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country that is not a designated treaty country (other than Canada), or

Rule for Computing Active Business Earnings

(7) That portion of subsection 5907(2.1) of the said Regulations before paragraph (*a*) is replaced by the following:

(2.1) In computing the earnings of a foreign affiliate of a corporation resident in Canada for a taxation year of the affiliate from an active business carried on by it in Canada or in a designated treaty country, where the affiliate is resident in a designated treaty country and the corporation, together with all other corporations resident in Canada with which the corporation does not deal at arm's length and in respect of which the affiliate is a foreign affiliate, have so elected in respect of the business for the taxation year or any preceding taxation year of the affiliate, the following rules apply:

(8) Section 5907 of the Regulations is amended by adding the following after subsection (2.6):

(2.7) Where an amount is included in computing the income from an active business of a foreign affiliate of a taxpayer for a particular taxation year under subparagraph 95(2)(*a*)(i) of the Act or under clause 95(2)(*a*)(ii)(A) of the Act in respect of an amount paid or payable by a non-resident corporation to which the affiliate is related (in this subsection referred to as the "payer"), notwithstanding any other provision of this Part, in computing the earnings or loss from the active business of the payer for a taxation year, the amount paid or payable by it in respect of which an amount was included in the income or loss from an active business of the foreign affiliate of the taxpayer for the particular year shall be deducted by the payer in computing its earnings or loss from the active business for the taxation year of the payer that includes the earlier of the day on which the amount was paid and the day on which the amount became payable and not in any other taxation year.

(2.8) Where an amount is included in computing the income from an active business of a foreign affiliate of a taxpayer (in this subsection referred to as the "first affiliate") for a particular taxation year under clause 95(2)(*a*)(ii)(B) of the Act in respect of an amount of interest paid or payable by another foreign affiliate of the taxpayer to which the affiliate is related (in this subsection referred to as the "second affiliate") on borrowed money used to acquire, or on indebtedness incurred on the acquisition of, shares of the capital stock of a foreign affiliate of the taxpayer to which the affiliate is related (in this subsection referred to as the third affiliate"), notwithstanding any other provision of this Part, the second affiliate

(a) shall deduct, in computing its income from an active business carried on by it in the country in which, for the purposes of income taxation in that country, it was resident, such amount paid or payable by it (in respect of which an amount was included in computing the active business income of the first affiliate) for its taxation year that includes the earlier of the day on which such amount was paid by it and the day on which such amount became payable by it,

(b) shall be deemed to have carried on an active business in the country in which, for the purposes of income taxation purposes in that country, it was resident for each taxation year referred to in paragraph (*a*) in which such an active business was not otherwise carried on by it, and

(c) shall, in computing its income for a taxation year from any source, not deduct an amount in respect of an amount paid or payable by it that is referred to referred to in paragraph (*a*) except as is required under paragraph (*a*).

Listed Countries and Residence in Listed Countries

(9) Subsection 5907(11) of the Regulations is replaced by the following:

(11) For the purposes of this Part, a country is a "designated treaty country" for a taxation year of a foreign affiliate of a corporation when Canada and that country have entered into a comprehensive agreement or convention for the elimination of double taxation on income that has entered into force and has effect for that taxation year of the affiliate but, for greater certainty, that country does not include any territory, possession, department, dependency or area of that country to which that agreement or convention does not apply.

(11.1) For the purposes of subsection (11), where a comprehensive agreement or convention between Canada and another country for the elimination of double taxation on income has entered into force, that convention or agreement shall be deemed to have entered into force and have effect in respect of a taxation year of a foreign affiliate of a corporation any day of which is in the period that begins on the day on which the agreement or convention was signed and that ends on the last day of the last taxation year of the affiliate for which the agreement or convention is effective.

(11.2) For the purposes of subsection (1), a foreign affiliate of a corporation shall, at any time, be deemed not to be resident in a country with which Canada has entered into a comprehensive agreement or convention for the elimination of double taxation on income unless

(*a*) the affiliate is, at that time, a resident of that country for the purposes of that agreement or convention,

(*b*) the affiliate would, at that time, be a resident of that country for the purposes of that agreement or convention if the affiliate were treated, for the purposes of income taxation in that country, as a body corporate, or

(*c*) the affiliate would, at that time, be a resident of the country for the purposes of that agreement or convention , but for a provision in that agreement or convention which provides that such agreement or convention does not apply to the affiliate

or would be so resident, at that time, if the agreement or convention had entered into force.

3. Section 1 and subsections 2(1) and (8) apply to taxation years of a foreign affiliate of a taxpayer that begin after 1994, except that, in applying subparagraph 5907(1)(*b*)(iv) of the said Regulations, as enacted by subsection 2(1) for taxation years of a foreign affiliate of a taxpayer that begin before 1996 or for which an election was made by the taxpayer under section 4, the references to "designated treaty country" shall be read as "country listed in subsection (11)".

4. Subsections 2(2) to (7) and (9) apply to taxation years of a foreign affiliate of a corporation that begin after 1995, except that, where the corporation notifies the Minister of National Revenue in its return of income for its first taxation year that begins after 1994 or for a taxation year in which a dividend was paid by the foreign affiliate of its election to have subsections 5907(11), (11.1) and (11.2) of the Regulations, as enacted by subsection 2(9), apply to a taxation year of the foreign affiliate of the corporation that begins before 1996, subsections 2(2) to (7) and (9) apply to that taxation year that begins before 1996 and each subsequent taxation year of the foreign affiliate of the corporation.

Foreign Affiliates

Explanatory Notes to Revised Draft Amendments to the *Income Tax Regulations*

Clause 1

Deductible Loss

ITR
5903(1) and (2)

Subsection 95(1) of the Act defines foreign accrual property income of a foreign affiliate of a taxpayer. Foreign accrual property income is reduced by the amount of the prescribed "deductible losses" of the affiliate as determined under the rules in section 5903 of the Regulations. The deductible loss includes the losses of the affiliate for each of the five immediately preceding taxation years.

Subsections 5903(1) and (2) of the Regulations are being amended for taxation years of foreign affiliates that begin after 1994. The amendments ensure that losses will be included in a deductible loss of a foreign affiliate of a taxpayer only where the affiliate is a controlled foreign affiliate of the taxpayer during the year the loss was incurred. As well, the amendments provide that active business losses will not form part of a deductible loss of a foreign affiliate and will therefore no longer be available to reduce foreign accrual property income.

Clause 2

Exempt Earnings

ITR
5907(1)(b)(iv)

Paragraph 5907(1)(b) of the *Income Tax Regulations* defines exempt earnings of a foreign affiliate of a corporation for a taxation year. Subparagraph 5907(1)(b)(iv) includes in the exempt earnings of such a foreign affiliate resident in a country listed in subsection 5907(11) of the Regulations the net active business earnings of the affiliate from an active business carried on by it in countries listed in subsection 5907(11) of the Regulations and amounts deemed to be active business earnings of the affiliate under paragraph 95(2)(a) of the Act in certain circumstances. The amendments to this paragraph are consequential to the proposed amendments to paragraph 95(2)(a) of the Act and subsection 5907(11) of the Regulations and are

applicable to taxation years of a foreign affiliate of a corporation that begin after 1994.

First, references to "a country listed in subsection 5907(11)" are replaced by references to "a designated treaty country " as a consequence of the amendment to subsection 5907(11). The amendment to subsection 5907(11) removes the notion of countries being listed in that subsection and now sets out when a country is considered to be a designated treaty country for a taxation year of a foreign affiliate of a corporation. The effective date of the amendments to subparagraph 5907(1)(b)(iv) is for taxation years of foreign affiliates commencing after 1994 while the effective date for the amendments to subsection 5907(11) may be for later taxation years. For taxation years prior to the years to which the proposed new subsection 5907(11) is to be effective, the references in subparagraph 5907(1)(b)(iv) to "a designated treaty country" are to be read as references to "a country listed in subsection 5907(11)".

Second, proposed new subclause 5907(1)(b)(iv)(B)(I) includes in the exempt earnings of a foreign affiliate of a corporation the amounts determined under proposed new subparagraph 95(2)(a)(i) of the Act to be income from an active business of the affiliate. This will be the case where the activities of the affiliate referred to in that subparagraph that gave rise to the income are related to the business activities carried by any non-resident corporation to which the affiliate is related in the course of carrying on an active business the income from which would, if it were a foreign affiliate of a corporation, be included in computing the exempt earnings or the exempt loss of the non-resident corporation.

Third, proposed new subclause 5907(1)(b)(iv)(B)(II) includes in the exempt earnings of a foreign affiliate of a corporation the amount of income derived from amounts paid or payable to the affiliate by a non-resident corporation to which the affiliate is related that is deemed by proposed new clause 95(2)(a)(ii)(A) of the Act to be income from an active business of the affiliate. This will be the case to the extent that the amounts paid or payable would be deductible in computing the exempt earnings or the exempt loss of the payer if the payer was a foreign affiliate of a corporation.

Finally, proposed new subclause 5907(1)(b)(iv)(B)(III) includes in the exempt earnings of a foreign affiliate of a corporation the amount of

income derived from amounts paid or payable to it by another foreign affiliate of the corporation related to it (second affiliate) that is deemed by proposed new clause 95(2)(a)(ii)(B) of the Act to be the income from an active business of the affiliate where the amounts paid or payable is in respect of interest on borrowed money used to purchase shares of another foreign affiliate of the corporation related to it (third affiliate) or in respect of an amount owing in respect of the purchase of such shares. The second and third affiliates must be resident in designated treaty countries (see proposed new subsection 5907(11)) or countries listed in subsection 5907(11) of the Regulations.

Exempt Loss

ITR
5907(1)(c)(iii)

Subparagraph 5907(1)(c)(iii) includes in the exempt loss of a foreign affiliate of a corporation for a taxation year (for the 1976 and subsequent taxation years of a foreign affiliate of a corporation resident in a country listed in subsection 5907(11) of the Regulations), any net loss for year of the affiliate from an active business carried on by it in a country listed in subsection 5907(11) of the Regulations. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

Net Earnings

ITR
5907(1)(f)(iii)

Subparagraph 5907(1)(f)(iii) of the Regulations includes in the net earnings of a foreign affiliate of a corporation for a taxation year from the disposition of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country not listed in subsection 5907(11), the

amount by which the taxable capital gain from the disposition that accrued after November 12, 1991 exceeds related income taxes paid to that country. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

Net Loss

ITR
5907(1)(g)(iii)

Subparagraph 5907(1)(g)(iii) of the Regulations includes in the net loss of a foreign affiliate of a corporation for a taxation year from the disposition of property used or held by it principally for the purpose of gaining or producing income from an active business carried on by it in a country not listed in subsection 5907(11), the amount by which the allowable capital loss from the disposition that accrued after November 12, 1991 exceeds the related income tax refund made by that country. The amendments to the subparagraph simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

Taxable Earnings

ITR
5907(1)(i)(ii)(D)

Clause 5907(1)(i)(ii)(D) of the Regulations includes in the taxable earnings of a foreign affiliate of a corporation for a taxation year the net earnings of the affiliate for the year from the disposition of property held principally for the purpose of earning income from an active business carried on in a country not listed in subsection 5907(11) of the Regulations. The amendments to the clause simply replace references to "a country listed in

subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

Taxable Loss

ITR
5907(1)(j)(ii)(C)

Clause 5907(1)(j)(ii)(C) of the Regulations includes in the taxable loss of a foreign affiliate of a corporation for a taxation year the net loss of the affiliate for the year from the disposition of property held principally for the purpose of earning income from an active business carried on in a country not listed in subsection 5907(11) of the Regulations. The amendments to the clause simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

Rules for Computing Active Business Earnings

ITR
5907(2.1)

Subsection 5907(2.1) of the Regulations provides rules for the purpose of computing active business earnings of a foreign affiliate of a corporation carried on in a country listed in subsection 5907(11) of the Regulations. The amendments to the subsection simply replace references to "a country listed in subsection 5907(11)" with references to "a designated treaty country" and are consequential to the amendments to subsection 5907(11) of the Regulations. The amendments have the same effective dates as the amendments to subsection 5907(11) and are set out in the notes for that subsection.

ITR
5907(2.7)

Under proposed new subparagraph 95(2)(a)(i) of the Act and proposed new clause 95(2)(a)(ii)(A) of the Act, the income of a particular foreign affiliate of a taxpayer derived from amounts paid or payable to it by another foreign corporation to which the affiliate is related could be included in the active business income of the particular affiliate if the appropriate conditions are met. There could be a timing differences between the income reporting of the affiliate and the expense reporting of the non-resident corporation where, in the taxing jurisdiction in which the non-resident corporation is a resident, the payer corporation is restricted with respect to the amounts it may deduct for income tax purposes in computing its income from an active business for a year in respect of the amounts paid or payable. To eliminate the timing difference, proposed new subsection 5907(2.7) of the Regulations, which applies for taxation years of foreign affiliates that begin after 1994, provides that the amounts paid or payable are to be deducted by the payer in computing active business earnings or loss in the year that includes the earlier of the day on which the amounts are paid or the day on which the amounts become payable.

ITR
5907(2.8)

Under proposed new clause 95(2)(a)(ii)(B) of the Act, the income of a foreign affiliate of a taxpayer (first affiliate) that is derived from amounts paid or payable to it by another foreign affiliate of the taxpayer to which the first affiliate is related (second affiliate) is included in the active business income of the first affiliate. The amounts paid or payable by the second affiliate must be in respect of interest on borrowed money used for the acquisition of, or on the amount owing for the acquisition of, shares of the capital stock of another foreign affiliate of the taxpayer to which the first affiliate is related (third affiliate) that are excluded property within the meaning assigned by section 95 of the Act. As well, the amounts of interest paid or payable must be relevant in computing the tax liability of the second and third affiliates in the country in which those affiliates are resident for income tax purposes. In such circumstances, proposed new subsection 5907(2.8) of the Regulations provides that the second affiliate must deduct such interest in computing its earnings or loss

from an active business carried on in the country in which it was resident for income tax purposes of that country. It also provides that the second affiliate shall be deemed to be carrying on such an active business in the country of which it was resident for income tax purposes where no such business was carried on. The proposed new subsection is applicable to taxation years of foreign affiliates of corporations that begin after 1994.

Listed Countries and Residence in Listed Countries

ITR
5907(11), (11.1) and (11.2)

Subsection 5907(11) of the *Income Tax Regulations* lists countries for various purposes including the definitions of "exempt earnings" and "exempt loss" of a foreign affiliate. Exempt earnings and exempt losses of a foreign affiliate of a corporation resident in Canada are used in calculating the exempt surplus that can be paid to the corporation resident in Canada as a dividend, the full amount of which is deductible under section 113 of the Act in computing the corporation's taxable income for Canadian tax purposes. Exempt earnings and losses of an affiliate resident in a country listed in subsection 5907(11) of the Regulations for a taxation year are the earnings and losses of the affiliate derived from active businesses carried on by the affiliate in that year in the residence country or any other listed country.

This deduction in respect of dividends from foreign affiliates paid to a corporation resident in Canada out of exempt surplus of the affiliate is a simple means for eliminating double taxation on foreign business income earned by the foreign affiliate. It was intended to apply where the foreign affiliate was resident in and the business income was earned in a country with which Canada had a ratified comprehensive international tax treaty. Some countries with which negotiations were undertaken were listed in anticipation of a treaty being ratified. Some treaties were never ratified or concluded. As well, some countries with which Canada has entered into a ratified treaty have not yet been listed.

The repeal of subsection 5907(11) and its replacement with proposed new subsections 5907(11), (11.1) and (11.2) accomplishes a number of objectives.

First, countries will no longer be listed in subsection 5907(11) of the Regulations. That subsection will provide that, for the purposes of Part LIX of the Regulations, a country will be considered to be a designated treaty country for a taxation year of a foreign affiliate of a corporation only where a comprehensive agreement or convention for the elimination of double taxation on income between Canada and that country has entered into force and has effect. Therefore, a country will automatically be included as a designated treaty country at such time as the comprehensive tax treaty takes effect. References in Part LIX of the regulations to "a country listed in subsection 5907(11) will be changed to references to "a designated treaty country".

In addition, new subsection 5907(11.1) provides that, once an agreement or convention actually enters into force, it will be considered to have entered into force and have effect for a taxation year of an affiliate any day of which is in the period that begins on the day on which the Canadian and foreign governments signed the treaty and ends on the last day of the last taxation year of the affiliate for which the agreement or convention has effect. Consequently, this subsection accommodates the repatriation of active business earnings derived from investments made in foreign affiliates resident in a designated treaty country that took place after the signing but prior to the ratification of the treaty.

The changes to Regulation 5907(11) will have no effect with respect to foreign affiliates in those countries with which Canada has a comprehensive tax treaty. However, for affiliates in those countries that are listed in the existing subsection and with which such a treaty has not entered into force, their earnings for taxation years that begin after 1995 will no longer qualify as exempt earnings. As a result, any dividends paid out of the earnings for such years will cease to be exempt from tax in the hands of the Canadian corporate shareholders.

Proposed new subsection 5907(11.2) provides rules for determining when a foreign affiliate of a corporation is to be considered to be resident in a particular designated treaty country. The determination of residency is important for the purposes of the rules dealing with

the calculation of exempt surplus. Net earnings from an active business is included in the exempt surplus of a foreign affiliate of a corporation only where the affiliate is resident in a designated treaty country and the business is carried on in a designated treaty country. Under this proposed new subsection, an affiliate will be considered to be a resident of such a country only where it is a resident of that country for the purposes of the ratified agreement or convention with that country (paragraph (a)) or would be so resident if the affiliate were treated as a corporation under the tax laws of the country in which it is formed or organized (paragraph (b)). The rule in paragraph (b) would treat as foreign affiliates, corporations such as limited liability companies in certain U.S. States which are treated as corporations for Canadian tax purposes but are treated as partnerships for U.S. tax purposes. Where an affiliate is a resident of a country with which Canada has a ratified treaty or convention but that treaty or convention does not apply in respect of the affiliate, it is intended that the affiliate be considered to be a resident of that country for the purposes of that treaty and this clarification is provided in paragraph (c).

The proposed new subsections 5907(11), (11.1) and (11.2) and the consequential amendments to subparagraphs 5907(1)(c)(iii), (f)(iii) and (g)(iii) and clauses 5907(1)(i)(ii)(D) and (j)(ii)(C) are to apply to the taxation years of a foreign affiliate of a corporation that begin after 1995. However, where the corporation resident in Canada notifies the Minister of National Revenue, in its return of income for its first taxation year that begins after 1994 or for a taxation year in which a dividend was paid by the foreign affiliate, of its desire to have the subsections apply in respect of an earlier taxation year, the proposed new provisions will be effective for that earlier taxation year and each subsequent taxation year of the foreign affiliate.

Corporate Divisive Reorganizations

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Corporate Divisive Reorganizations

Draft Amendments to the *Income Tax Act*

Avoidance

1. (1) Section 55 of the Income Tax Act is amended by adding the following before subsection (2):

Definitions

55. (1) In this section,

"distribution"

"distribution" means a direct or indirect transfer of property of a corporation (referred to in this section as the "distributing corporation") to one or more corporations (each of which is referred to in this section as a "transferee corporation") where, in respect of each type of property owned by the distributing corporation immediately before the transfer, each transferee corporation receives property of that type the fair market value of which is equal to or approximates the amount determined by the formula

$$A \times \frac{B}{C}$$

where

A is the fair market value of all property of that type owned by the distributing corporation immediately before the transfer,

B is the fair market value immediately before the transfer of all the shares of the capital stock of the distributing corporation owned at that time by the transferee corporation, and

C is the fair market value immediately before the transfer of all the issued shares of the capital stock of the distributing corporation;

"permitted acquisition"

"permitted acquisition" in relation to a distribution by a distributing corporation means an acquisition of property by a person or partnership on, or as part of,

(*a*) a distribution, or

(*b*) a permitted exchange or permitted redemption in relation to a distribution by another distributing corporation;

"permitted exchange"

"permitted exchange" in relation to a distribution by a distributing corporation means

(*a*) an exchange of shares of the capital stock of the distributing corporation to which subsection 86(1) applies, other than an exchange that resulted in an acquisition of control of the distributing corporation by any person or group of persons, and

(*b*) an exchange of shares of the capital stock of the distributing corporation by one or more shareholders of the distributing corporation (each of whom is referred to in this paragraph as a "participant") for shares of the capital stock of a transferee corporation in contemplation of the distribution where

(i) no share of the capital stock of the transferee corporation is immediately after the exchange owned by any person or partnership other than a participant, and

(ii) the fair market value, immediately before the distribution, of each participant's shares of the capital stock of the transferee corporation is equal to the amount determined by the formula

$$A \times \frac{B}{C}$$

where:

A is the fair market value, immediately before the distribution, of all the shares of the capital stock of the transferee corporation then outstanding (other than shares issued to participants in consideration for shares of a specified class in relation to the exchange),

B is the fair market value, immediately before the exchange, of all the shares of the capital stock of the distributing corporation (other than shares of a specified class in relation to the exchange) then owned by the participant, and

C is the fair market value, immediately before the exchange, of

(A) where all the shares of the capital stock of the distributing corporation owned by each participant are transferred to the transferee corporation on the exchange, all the shares of the capital stock of the distributing corporation so transferred, and

(B) in any other case, all the shares (other than shares of a specified class in relation to the exchange) of the capital stock of the distributing corporation outstanding immediately before the exchange;

"permitted redemption"

"permitted redemption" in relation to a distribution by a distributing corporation means

(*a*) a redemption or purchase for cancellation by the distributing corporation, as part of the reorganization in which the distribution was made, of all the shares of its capital stock owned by a transferee corporation in relation to the distributing corporation, and

(*b*) a redemption or purchase for cancellation by a transferee corporation in relation to the distributing corporation, as part of the reorganization in which the distribution was made, of all of the shares of its capital stock owned by the distributing corporation;

"specified class"

"specified class" in relation to an exchange of shares of the capital stock of a distributing corporation for shares of the capital stock of a transferee corporation in relation to the distributing corporation means a class of shares of the capital stock of the distributing corporation where

(*a*) none or all of the shares of that class outstanding immediately before the exchange are transferred to the transferee corporation on the exchange,

(*b*) the paid-up capital in respect of the class immediately before the beginning of the series of transactions or events that includes the exchange was not less than the fair market value of the consideration for which the shares of that class then outstanding were issued,

(*c*) under neither the terms and conditions of the shares nor any agreement in respect of the shares (other than the agreement providing for the exchange) are the shares convertible into or exchangeable for shares other than shares of a specified class in relation to the exchange, and

(*d*) under neither the terms and conditions of the shares nor any agreement in respect of the shares is any holder of the shares entitled to receive on the redemption, cancellation or acquisition of the shares by the corporation or by any person with whom the corporation does not deal at arm's length (excluding any premium for early redemption) an amount greater than the total of the fair market value of the consideration for which the shares were issued and the amount of any unpaid dividends thereon.

(2) Subparagraphs 55(3)(*a*)(i) and (ii) of the Act are replaced by the following:

(i) a disposition of property to a person to whom that corporation was not related, or

(ii) a significant increase in the interest in any corporation of any person to whom the corporation that received the dividend was not related; or

(3) Paragraph 55(3)(*b*) of the Act is replaced by the following:

(*b*) if the dividend was received in the course of a reorganization in which

(i) a distribution was made by a distributing corporation to one or more transferee corporations, and

(ii) the distributing corporation was wound up or all of the shares of its capital stock owned by each transferee corporation immediately before the distribution were redeemed or cancelled otherwise than on an exchange to which subsection 51(1), 85(1) or 86(1) applies.

(4) Subsection 55(3.1) of the Act is replaced by the following:

Where paragraph (3)(*b*) not applicable

(3.1) Notwithstanding subsection (3), a dividend to which subsection (2) would, but for paragraph (3)(*b*), apply is not excluded from the application of subsection (2) where

(*a*) in contemplation of and before a distribution made in the course of the reorganization in which the dividend was received, property became property of the distributing corporation, a corporation controlled by it or a predecessor corporation of any such corporation otherwise than as a result of

(i) an amalgamation of corporations each of which was related to the distributing corporation,

(ii) an amalgamation of a predecessor corporation of the distributing corporation and one or more corporations controlled by that predecessor corporation,

(iii) a reorganization in which a dividend was received to which subsection (2) would, but for paragraph (3)(*b*), apply, or

(iv) a disposition of property by

(A) the distributing corporation, a corporation controlled by it or a predecessor corporation of any such corporation to a corporation controlled by the distributing corporation or a predecessor corporation of the distributing corporation,

(B) a corporation controlled by the distributing corporation or by a predecessor corporation of the distributing corporation to the distributing corporation or predecessor corporation, as the case may be, or

(C) the distributing corporation, a corporation controlled by it or a predecessor corporation of any such corporation for consideration that consists only of money or indebtedness that is not convertible into other property, or of any combination thereof,

(*b*) the dividend was received as part of a series of transactions or events in which

(i) a person or partnership (referred to in this subparagraph as the "vendor") disposed of property and

(A) the property is

(I) a share of the capital stock of a distributing corporation that made a distribution as part of the series or of a transferee corporation in relation to the distributing corporation, or

(II) property 10% or more of the fair market value of which was, at any time during the course of the series, derived from one or more shares described in subclause (I),

(B) the vendor was, at any time during the course of the series, a specified shareholder of the distributing corporation or of the transferee corporation, and

(C) the property or any other property (other than property received by the transferee corporation on the distribution) acquired by any person or partnership in substitution therefor was acquired (otherwise than on a permitted acquisition, permitted exchange or permitted redemption in relation to the distribution) by a person (other than the vendor) who was not related to the vendor or, as part of the series, ceased to be related to the vendor or by a partnership,

(ii) control of a distributing corporation that made a distribution as part of the series or of a transferee corporation in relation to the distributing corporation was acquired (otherwise than as a result of a permitted acquisition, permitted exchange or permitted redemption in relation to the distribution) by any person or group of persons, or

(iii) in contemplation of a distribution by a distributing corporation, a share of the capital stock of the distributing corporation was acquired (otherwise than on a permitted acquisition or permitted exchange in relation to the distribution or on an amalgamation of 2 or more predecessor corporations of the distributing corporation) by

(A) a transferee corporation in relation to the distributing corporation or by a person or partnership with whom the transferee corporation did not deal at arm's length from a person to whom the acquiror was not related or from a partnership,

(B) a person or any member of a group of persons who acquired control of the distributing corporation as part of the series,

(C) a particular partnership any interest in which is held, directly or indirectly through one or more partnerships, by a person referred to in clause (B), or

(D) a person or partnership with whom a person referred to in clause (B) or a particular partnership referred to in clause (C) did not deal at arm's length, or

(*c*) if, immediately after the reorganization in the course of which a distribution was made and the dividend was received, the distributing corporation that made the distribution was not related to a transferee corporation in relation to the distributing corporation, in respect of either the distributing corporation or the transferee corporation (each of which is referred to in this paragraph as the "particular corporation") the total of all amounts each of which is the fair market value, at the time of acquisition, of a property that

(i) was acquired, as part of the series of transactions or events that includes the receipt of the dividend, by a person (other than the particular corporation) who was not related to the particular corporation or, as part of the series, ceased to be related to the particular corporation or by a partnership, otherwise than

(A) as a result of a disposition in the ordinary course of business, or

(B) on a permitted acquisition in relation to a distribution, and

(ii) is a property (other than a share of the capital stock of the particular corporation or a property more than 10% of the fair market value of which is attributable to one or more such shares)

(A) more than 10% of the fair market value of which was, at any time after the distribution and before the end of the series, attributable to

(I) where the particular corporation is the transferee corporation, property that was received by it on the distribution, and

(II) where the particular corporation is the distributing corporation, property that was owned by it immediately before the distribution and not disposed of by it on the distribution, or

(B) to which, at any time during the course of the series, more than 10% of the fair market value of a property referred to in subclause (A)(I) or (II), as the case may be, was attributable

is greater than 10% of the fair market value of all the property referred to in subclause (ii)(A)(I) or (II), as the case may be, immediately after the distribution.

Idem

(3.2) For the purpose of paragraph (3.1)(b),

(*a*) in determining whether the vendor referred to in paragraph (3.1)(*b*)(i) is at any time a specified shareholder of a transferee corporation or of a distributing corporation, the references in the definition "specified shareholder" in subsection 248(1) to "taxpayer" shall be read as "person or partnership",

(*b*) a corporation that is formed by the amalgamation of 2 or more corporations (each of which is referred to in this paragraph as a "predecessor corporation") shall be deemed to be the same corporation as, and a continuation of, each of the predecessor corporations,

(*c*) where, immediately after a reorganization in the course of which a distributing corporation made a distribution, a transferee corporation in relation to the distributing corporation was not related to the distributing corporation, the transferee corporation shall be deemed not to be related to each person

(i) from whom the transferee corporation acquired a share of the capital stock of the distributing corporation in contemplation of the distribution, or

(ii) who acquired a share of the capital stock of the distributing corporation from the transferee corporation in contemplation of the distribution,

(*d*) subject to paragraph (*e*), where at any time a share of the capital stock of a corporation is redeemed or cancelled (otherwise than on an amalgamation), the corporation shall be deemed to have acquired the share at that time, and

(*e*) where a share of the capital stock of a corporation is redeemed, acquired or cancelled by the corporation pursuant to the exercise of a statutory right of dissent by the holder of the share, the corporation shall be deemed not to have acquired the share.

(5) Subsection 55(4) of the Act is replaced by the following:

Avoidance of subsection (2)

(4) For the purposes of this section, where it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause 2 or more persons to be related to each other or to cause a corporation to control another corporation, so that subsection (2) would, but for this subsection, not apply to a dividend, those persons shall be deemed not to be related to each other or the corporation shall be deemed not to control the other corporation, as the case may be.

(6) Paragraph 55(5)(*e*) of the Act is replaced by the following:

(*e*) in determining whether 2 or more persons are related to each other, in determining whether a person is at any time a specified shareholder of a corporation and in determining whether control of a corporation has been acquired by a person or group of persons,

(i) a person shall be deemed not to be related to another person and to be dealing with the other person at arm's length if the person is the brother or sister of the other person,

(ii) where at any time a person is related to each beneficiary (other than a registered charity) under a trust who is or may (otherwise than by reason of the death of another beneficiary under the trust) be entitled to share in the income or capital of the trust, the person and the trust shall be deemed to be related at that time to each other and, for this purpose, a person shall be deemed to be related to himself, herself or itself;

(iii) a trust and a person shall be deemed not to be related to each other unless they are deemed by subparagraph (ii) to be related to each other or the person is a corporation that is controlled by the trust, and

(iv) persons who are related to each other solely because of a right referred to in paragraph 251(5)(*b*) shall be deemed not to be related to each other; and

(7) Subsections (1), (3) and (4) apply to dividends received after February 21, 1994 other than dividends received before 1995 in the course of a reorganization that was required on February 22, 1994 to be carried out pursuant to a written agreement entered into before February 22, 1994, except that, in applying the Act to dividends received before Announcement Date to which subsections (1), (3) and (4) apply,

(a) paragraph 55(3.1)(*b*) of the Act, as enacted by subsection (4), shall be read as follows:

(*b*) the dividend was received as part of a series of transactions or events in which

(i) a person or partnership (referred to in this subparagraph as the "vendor") disposed of property and

(A) the property is

(I) a share of the capital stock of a distributing corporation that made a distribution as part of the series or of a transferee corporation in relation to the distributing corporation, or

(II) property 10% or more of the fair market value of which was, at any time during the course of the series, derived from one or more shares described in subclause (I),

(B) the property or any other property (other than property received by the transferee corporation on the distribution) acquired by any person or partnership in substitution therefor was acquired (otherwise than on a permitted acquisition, permitted exchange or permitted redemption in relation to the distribution) by a person (other than the vendor) who was not related to the vendor or, as part of the series, ceased to be related to the vendor or by a partnership, and

(C) either

(I) control of the distributing corporation or of a transferee corporation in relation to the distributing corporation was acquired (otherwise than as a result of a permitted acquisition, permitted exchange or permitted redemption in relation to the distribution) by any person or group of persons, or

(II) the vendor was, at any time during the course of the series, a specified shareholder of the distributing corporation or a transferee corporation in relation to the distributing corporation, or

(ii) a share of the capital stock of a distributing corporation was acquired (otherwise than on a permitted acquisition or permitted exchange in relation to a distribution by the distributing corporation or on an amalgamation of 2 or more predecessor

corporations of the distributing corporation), in contemplation of a distribution by the distributing corporation, by

(A) a transferee corporation in relation to the distributing corporation, or by any person or partnership with whom the transferee corporation did not deal at arm's length from a person to whom the acquiror was not related,

(B) a person or any member of a group of persons who acquired control of the distributing corporation as part of the series,

(C) a particular partnership any interest in which is held, directly or indirectly through one or more partnerships, by a person referred to in clause (B), or

(D) a person or partnership with whom a person referred to in clause (B) or a particular partnership referred to in clause (C) did not deal at arm's length, or

(*b*) the Act shall be read without reference to paragraphs 55(3.1)(*c*) and (3.2)(*c*) and (*d*) as enacted by subsection (4).

(8) Subsections (2), (5) and (6) apply to dividends received after February 21, 1994, other than dividends received as part of a transaction or event or a series of transactions or events that was required on February 22, 1994 to be carried out pursuant to a written agreement entered into before February 22, 1994.

Winding-up

2.(1) The portion of paragraph 88(1)(*c*) of the Act after clause (ii)(B) is replaced by the following:

plus, where the property was a capital property (other than an ineligible property) of the subsidiary at the time that the parent last acquired control of the subsidiary and was owned by the subsidiary thereafter without interruption until such time as it was distributed to the parent on the winding-up, the amount determined under paragraph (*d*) in respect of the property and, for the purposes of this paragraph, "ineligible property" means

(iii) depreciable property,

(iv) property transferred to the parent on the winding-up where the transfer is part of a distribution (within the meaning assigned by subsection 55(1)) made in the course of a reorganization in which a dividend was received to which subsection 55(2) would, but for paragraph 55(3)(*b*) apply,

(v) property transferred to the subsidiary by the parent or by any person or partnership that was not, otherwise than because of a right referred to in paragraph 251(5)(*b*), dealing at arm's length with the parent, and

(vi) property disposed of by the parent as part of the series of transactions or events that includes the winding-up where, as part of the series,

(A) the parent acquired control of the subsidiary, and

(B) the property or any other property acquired by any person in substitution therefor is acquired at any time by

(I) a particular person (other than a specified person) that, at any time during the course of the series and before control of the subsidiary was last acquired by the parent, was a specified shareholder of the subsidiary, or

(II) a corporation (other than a specified person) of which a particular person referred to in subclause (I) is, at any time during the course of the series and after control of the subsidiary was last acquired by the parent, a specified shareholder;

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

(*c*.2) for the purposes of this paragraph and subparagraph (*c*)(vi),

(i) "specified person" at any time means the parent and each person that would, if this Act were read without reference to paragraph 251(5)(*b*), be related to the parent at that time and, for this purpose, a person shall be deemed not to be related to the parent where it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause the person to be related to the parent so as to prevent a property that was distributed to the parent on the winding-up from being an ineligible property for the purpose of paragraph (*c*), and

(ii) where at any time a property is owned or acquired by a partnership or a trust,

(A) the partnership or the trust, as the case may be, shall be deemed to be a person that is a corporation having one class of issued shares, which shares have full voting rights under all circumstances,

(B) each member of the partnership or beneficiary under the trust, as the case may be, shall be deemed to own at that time the proportion of the number of issued shares of the capital stock of the corporation that

(I) the fair market value at that time of that member's interest in the partnership or that beneficiary's interest in the trust, as the case may be,

is of

(II) the fair market value at time of all the members' interests in the partnership or beneficiaries' interests in the trust, as the case may be, and

(C) the property shall be deemed to have been owned or acquired at that time by the corporation;

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

(*d*) the amount determined under this paragraph in respect of each property of the subsidiary distributed to the parent on the winding-up is such portion of the amount, if any, by which the total determined under subparagraph (*b*)(ii) exceeds the total of

(4) Subsections (1) to (3) apply to windings-up that begin after February 21, 1994 except that, in applying the Act to a winding-up that begins after February 21, 1994 and before Announcement Date, subclause 88(1)(c)(vi)(B)(II) of the Act, as enacted by subsection (1), shall be read as follows:

> (II) any person (other than a specified person) that at any time during the course of the series did not deal at arm's length with a particular person (other than a specified person) referred to in subclause (I);

Acquisition of Control

3.(1) The portion of subsection 256(7) of the Act before paragraph (*a*) is replaced by the following:

Acquiring control

(7) For the purposes of subsection 13(24), sections 37 and 55, subsections 66(11), (11.4) and (11.5), 66.5(3), 66.7(10) and (11), 85(1.2), 87(2.1) and (2.11), 88(1.1) and (1.2) and 89(1.1), sections 111 and 127 and subsection 249(4),

(2) The portion of subsection 256(8) of the Act after paragraph (*a*) is replaced by the following:

(*b*) the application of subsection 13(24), paragraph 37(1)(*h*), or subsection 55(2), 66(11.4) or (11.5), 111(4), (5.1), (5.2) or (5.3), or

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

in determining whether control of the corporation has been acquired for the purposes of subsection 13(24), sections 37 and 55, subsections 66(11), (11.4) and (11.5), 66.5(3) and 66.7(10) and (11), sections 111 and 127 and subsection 249(4), the taxpayer shall be deemed to have acquired the shares at that time.

(3) Subsection (1) applies to amalgamations, acquisitions, redemptions and cancellations that occur after February 21, 1994.

(4) Subsection (2) applies to acquisitions that occur after Announcement Date.

Corporate Divisive Reorganizations

Explanatory Notes to Draft Amendments to the *Income Tax Act*

Clause 1

Avoidance

ITA
55

Section 55 of the Act deals with certain tax avoidance transactions.

Subsection 55(2) of the Act is an anti-avoidance provision directed against certain arrangements designed to convert a capital gain on a disposition of shares into a tax-free dividend. It treats the dividend received in these circumstances either as a capital gain or as proceeds of disposition that are taken into account in computing a capital gain.

Subsection 55(3) of the Act provides two exceptions to this rule. The first applies to a dividend received as part of a series of transactions or events that does not result in a disposition of property to, or a significant increase in the interest in any corporation of, any person who deals at arm's length with the dividend recipient. The second exception (referred to in these notes as the "butterfly exemption") applies to a dividend received in the course of a reorganization - commonly referred to as a butterfly reorganization - in which property of a corporation is transferred to one or more of its corporate shareholders with each transferee corporation receiving its pro rata share, based on the fair market value of its shares of the transferor corporation, of each type of property so transferred.

Example A illustrates a typical butterfly reorganization in which the businesses of one corporation are divided up and transferred to separate corporations owned separately by the shareholders of the original corporation.

Example A:

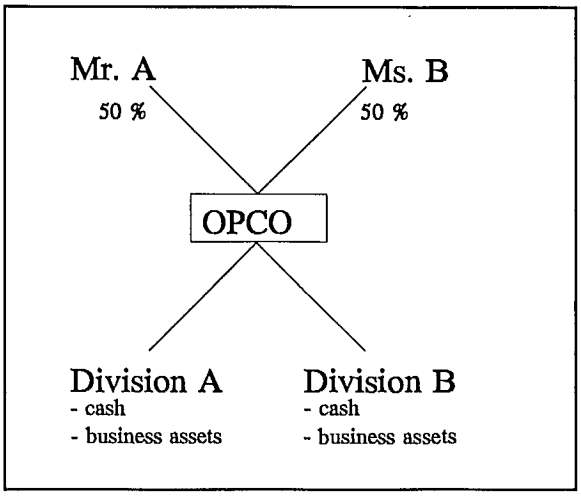

Figure 1: Pre-butterfly structure

Two unrelated individuals, Mr. A and Ms. B, each own 50% of the shares of the capital stock of a taxable Canadian corporation (Opco). Opco operates two businesses (Division A and Division B) of approximately equal value. It has only two types of property; cash and properties used in its businesses. (See figure 1).

Mr. A and Ms. B wish to separate their interests so that Mr. A can own and operate Division A and Ms. B can own and operate Division B. If the assets of Opco were simply distributed to them on a winding-up, the distribution of Opco's assets and the disposition of their shares of Opco would be considered for income tax purposes to have occurred at fair market value. Instead, they undertake the following steps:

Step 1: Mr. A transfers, on a tax-deferred basis under section 85 of the Act, his shares of Opco to a newly incorporated holding corporation (Aco) in exchange for shares of Aco. Ms. B likewise transfers her shares of Opco to a new corporation (Bco) in exchange for shares of Bco.

Step 2: Opco transfers, also on a tax-deferred basis under section 85 of the Act,

- *one-half of Opco's cash and all of the business and assets of Division A to Aco in exchange for redeemable preferred shares of Aco; and*

- *one-half of Opco's cash and all of the business and assets of Division B to Bco in exchange for redeemable preferred shares of Bco.*

The new shares issued to Opco by Aco and Bco in consideration for the transferred assets will have an adjusted cost base to Opco equal to the tax cost of the transferred assets immediately before the transfer. The paid-up capital of the new shares will not exceed their adjusted cost base.

Step 3: Aco and Bco each redeem the shares of their capital stock that were issued to Opco in step 2. Each of them issues a promissory note to Opco in payment of the redemption price.

Step 4: Opco is wound up and, in the course of the winding-up, the promissory notes issued by Aco and Bco in step 3 are distributed to Aco and Bco, respectively. As a result, the obligations under these notes are extinguished.

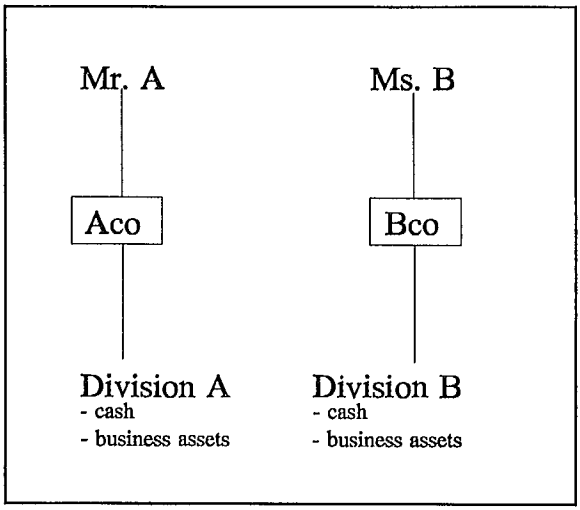

Figure 2: Post-butterfly structure

Result: Division A is owned by Aco which is wholly owned by Mr. A. Division B is owned by Bco which is wholly owned by Ms. B. (See figure 2).

The redemptions in step 3 result in tax-free intercorporate dividends by virtue of subsections 84(3) and 112(1) of the Act. By virtue of paragraph (j) of the definition "proceeds of disposition" in section 54 of the Act, these dividends reduce the capital gains that would otherwise have been realized on a disposition of the shares. Assuming that the paid-up capital of the shares of Opco does not exceed their adjusted cost base to Aco and Bco, Aco and Bco will also be treated as having received a dividend (rather than

having realized a capital gain) on the disposition of those shares on the winding-up. The butterfly exemption provided by paragraph 55(3)(b) prevents these dividends from being recharacterized as proceeds of disposition under subsection 55(2).

A number of changes are made to section 55. The main purpose of these changes is to limit the tax-free distribution of assets by a corporation to its corporate shareholders to those situations in which there is a certain degree of continuity of interest in the underlying assets of the corporation. This means that the tax-free distribution will be generally be available only where no-one has acquired a direct or indirect equity interest in the distributing corporation in contemplation of the distribution and there is a continuity of interest, after the distribution, in the distributed assets by the shareholders of the transferee corporation and in the remaining assets of the distributing corporation by the remaining shareholders of the distributing corporation.

The main effect of these changes is to eliminate the tax advantages that previously could be obtained by structuring a sale of corporate assets as a so-called "purchase butterfly" reorganization and, as such, they modify and extend the restrictions that were introduced in 1993 for purchase butterfly reorganizations of Canadian corporations with non-resident shareholders. Where a dividend that would otherwise qualify for the butterfly exemption in paragraph 55(3)(*b*) of the Act is received as part of a series of transactions or events that satisfies any of the conditions set out in subsection 55(3.1) of the Act, the butterfly exemption will not be available to protect the dividend from the application of subsection 55(2) of the Act. This means that an otherwise tax-free inter-corporate dividend may be recharacterized under subsection 55(2) as a capital gain or as proceeds of disposition of a share that are taken into account in computing a capital gain.

A purchase butterfly reorganization is a series of transactions designed to minimize tax on a sale of corporate assets or an interest therein. It typically involves a transfer by a distributing corporation of a portion of its assets on a tax-deferred basis to a corporate shareholder of the distributing corporation as part of a series of transactions or events that results in shares of the capital stock of the distributing corporation or the transferee corporation being owned by one or more persons who were not shareholders of the distributing

corporation at the beginning of the series. Example B illustrates a typical purchase butterfly.

Example B:

A corporate purchaser (Buyer) wishes to acquire from another corporation (Opco) certain equipment (the target assets) used by Opco in its business. On a direct sale of the target assets to Buyer, Opco would have had to recognize a certain amount of recapture of capital cost allowance previously claimed in respect of the equipment.

In order to avoid these tax consequences, and the tax consequences of a distribution of the after-tax proceeds of sale by Opco to its shareholder (Parent), the transaction is structured in such a manner that Buyer purchases some of the shares of Opco from Parent and receives, on a butterfly reorganization of Opco, the target assets in exchange for those shares.

The new restrictions affecting butterfly reorganizations are contained in amended subsection 55(3.1) of the Act. Certain terms relevant to these restrictions are defined in new subsection 55(1) of the Act and additional interpretive rules are contained in new subsection 55(3.2) of the Act. Paragraphs 55(3)(*a*) and (5)(*e*) and subsection 55(4) of the Act are also amended. The new restrictions are generally effective for dividends received after February 21, 1994, other than dividends received in the course of a reorganization or as part of a series of transactions that was required on February 22, 1994 to be carried out pursuant to a written agreement entered into before February 22, 1994.

ITA
55(1)

New subsection 55(1) of the Act sets out a number of definitions for the purposes of section 55 of the Act.

"Distribution"

"Distribution" means the direct or indirect transfer of property of a corporation (referred to in these notes and in section 55 as a "distributing corporation") to one or more of its corporate

shareholders such that each corporation that receives property on the distribution (referred to as a "transferee corporation") receives its pro rata share of each type of property owned by the distributing corporation immediately before the distribution.

Under existing paragraph 55(3)(*b*) of the Act, the pro rata test requires that each transferee corporation receive its pro rata share of each type of property of the distributing corporation transferred on the distribution. The definition "distribution" modifies this test to require that each transferee corporation receive its pro rata share of each type of property owned by the distributing corporation immediately before the distribution. This change will prevent a corporation from effecting a 'partial butterfly' reorganization in which some, but not all, of the types of property owned by it are distributed to one or more of its shareholders.

The following definitions "permitted acquisition", "permitted exchange" and "permitted redemption" are relevant in determining whether the new restrictions in paragraphs 55(3.1)(*b*) and (*c*) of the Act will prevent dividends from being protected from the application of subsection 55(2) by the butterfly exemption in paragraph 55(3)(*b*).

"Permitted acquisition"

The definition "permitted acquisition" is intended to allow for sequential butterfly reorganizations as illustrated by the following examples.

Example A:

A public corporation (Pubco1) wishes to transfer one of its businesses to a new public corporation (Pubco2) the shares of the capital stock of which will be owned, at least initially, by the shareholders of Pubco1. Pubco1 owns 30% of the shares of the capital stock of another corporation (Subco1) that owns, among other things, a property (the "target property") that Pubco1 wishes to transfer to Pubco2 as part of the reorganization of Pubco1.

The first step is a butterfly reorganization of Subco. This involves a distribution (within the meaning assigned by subsection 55(1) of the Act) by Subco of some of its properties (including the target

property) to Pubco1. Upon completion of that reorganization, Pubco1 is no longer a shareholder of Subco and holds its pro rata share of each type of property formerly owned by Subco.

The second step is a butterfly reorganization of Pubco1. The shareholders of Pubco1 exchange a portion of their shares of the capital stock of Pubco1 for shares of the capital stock of Pubco2 in a manner that will satisfy the requirements of the definition "permitted exchange" in subsection 55(1) of the Act. Pubco1 then transfers certain properties, including the target property acquired by it on the earlier distribution by Subco, to Pubco2 on a distribution (within the meaning assigned by subsection 55(1) of the Act) by Pubco1.

Example B:

Assume the same facts as in Example A except that Subco is a wholly owned subsidiary of Pubco1 and that Pubco1 is not controlled by any person or group of persons. Pubco1 wishes to transfer to Pubco2 the business and assets of one of its divisions, including some of the property of Subco related to that business (the "target property"). For business reasons, Subco cannot be wound up.

The first step is a butterfly reorganization of Subco. Pubco1 transfers, on a tax-deferred basis under section 85 of the Act, some of its shares of the capital stock of Subco to a newly incorporated, wholly owned subsidiary (Newco) in exchange for shares of the capital stock of Newco. Property of Subco (including the target property) is then transferred to Newco on a distribution (within the meaning assigned by subsection 55(1) of the Act) by Subco.

The second step is a butterfly reorganization of Pubco1. This is the same as the second step in Example except that the property distributed by Pubco1 to Pubco2 includes shares of the capital stock of Newco (a transferee corporation in relation Subco), rather than the target property itself.

Dividends received in the course of the two reorganizations described in each of these examples would not qualify for the butterfly exemption because of paragraphs 5(3.1)(*b*) and (*c*) if it were not for the exceptions in those paragraphs for permitted acquisitions.

- In example A, Pubco1, a transferee corporation in relation to Subco, receives the target property on the distribution by Subco. That property is subsequently acquired as part of the same series of transactions or events by Pubco2, a person to whom Pubco1 is not related. However, because the target property is acquired on a distribution by Pubco1, the acquisition is a permitted acquisition for the purpose of subparagraph 55(3.1)(*c*)(i) and therefore does not cause the dividends to be ineligible for the butterfly exemption.

- In example B, Pubco1, which is a specified shareholder of Newco (a transferee corporation in relation to Subco), disposes of shares of the capital stock of Newco to Pubco2, a corporation to which Pubco1 is not related. However, because the acquisition of those shares by Pubco2 occurs on, or as part of, a distribution by Pubco1, it is a permitted acquisition for the purpose of subparagraph 55(3.1)(*b*)(i) and therefore does not cause the dividends to be ineligible for the butterfly exemption.

- In addition, if more than 10% of the fair market value of the shares of the capital stock of Pubco1 in each example were attributable to Pubco1's shares of the capital stock of Subco, the butterfly reorganizations would also be tainted by the exchange of shares of the capital stock of Pubco1 for shares of the capital stock of Pubco2 if it were not for the exceptions for permitted acquisitions. Although this exchange is a permitted exchange in relation to the distribution by Pubco1, it is not a permitted exchange in relation to the distribution by Subco. Paragraph (*b*) of the definition "permitted acquisition" ensures that a permitted exchange or permitted redemption in relation to a distribution by one distributing corporation will not, by itself, taint dividends received in the course of another butterfly reorganization that would otherwise qualify for the butterfly exemption.

"Permitted exchange"

The definition "permitted exchange" encompasses two types of share-for-share exchanges. The first is an exchange of shares of the capital stock of the distributing corporation to which subsection 86(1) of the Act applies except where the exchange results in an acquisition of control of the distributing corporation. The second is an exchange

of shares of the capital stock of the distributing corporation for shares of the capital stock of a transferee corporation made in contemplation of the transfer of property of the distributing corporation to the transferee corporation.

In order for the second type of exchange to qualify as a permitted exchange, each shareholder participating in the exchange must receive his or her pro rata share of shares of the capital stock of the transferee corporation on the exchange and, immediately after the exchange, all of the issued shares of the capital stock of the transferee corporation must be owned by those who participated in the exchange. In addition, where not all of the shares of the capital stock of the distributing corporation owned by a participant immediately before the exchange are transferred to the transferee corporation on the exchange, all of the shareholders of the distributing corporation (other than shareholders holding only shares of a specified class) must participate in the exchange on a pro rata basis. Where a participant holds shares of a specified class in addition to other shares, the shares of the specified class will be ignored in determining whether the participants have participated on a pro rata basis.

The requirements of the definition "permitted exchange" will generally limit the use of the butterfly exemption to two basic types of butterfly reorganizations which could be described as

- the spin-off, in which some property of each type of property owned by the distributing corporation is transferred to a new corporation having the same shareholders as the distributing corporation; and

- the split-up, in which one or more of the existing shareholders of the distributing corporation cease to be shareholders of the distributing corporation and, in so doing, receive their pro rata share of each type of property owned by the distributing corporation.

These requirements will have to be satisfied in every situation in which a transferee corporation acquires a share of the capital stock of the distributing corporation in contemplation of the distribution from a person to whom the transferee corporation is not related. For this purpose, the transferee corporation is considered not to be related to

the person from whom it acquired a share unless the transferee corporation is related, after the reorganization that includes the distribution, to the distributing corporation. (See new paragraph 55(3.2)(*c*) of the Act).

"Permitted redemption"

"Permitted redemption" is defined as a redemption or purchase for cancellation, as part of the butterfly reorganization, of all of the shares of the capital stock of the distributing corporation held by the transferee corporation and a similar redemption or purchase for cancellation of all of the shares of the capital stock of the transferee corporation held by the distributing corporation. Where shares of the capital stock of the distributing corporation or a transferee corporation are acquired on a permitted redemption or where a permitted redemption results in an acquisition of control of either the distributing corporation or a transferee corporation, such acquisition of shares or control will not, by itself, cause a dividend to fail to qualify for the butterfly exemption. Under new paragraph 55(3.2)(*d*) of the Act, a corporation that redeems or cancels a share of its capital stock is treated as having acquired the share except where that redemption or cancellation occurs pursuant to the exercise of a statutory right of dissent. (See new paragraph 55(3.2)(*e*) of the Act).

"Specified class"

The definition "specified class" is relevant in determining whether an exchange of shares of the capital stock of a distributing corporation for shares of the capital stock of a transferee corporation constitutes a permitted exchange for the purposes of paragraph 55(3.1)(*b*) of the Act. A share of the capital stock of a distributing corporation will qualify as a share of a specified class in relation to an exchange only where

- none or all of the shares of that class are transferred to a transferee corporation on the exchange,

- the paid-up capital in respect of the class at the beginning of the series of transactions or events that includes the exchange is not less than the fair market value of the consideration for which the shares of that class were issued,

- the share is not convertible into or exchangeable for any other share (other than a share of a specified class), and

- the holder is not entitled to receive, on the redemption, cancellation or acquisition of the share by the distributing corporation or by any person who does not deal at arm's length with the distributing corporation, an amount (excluding any premium for early redemption) greater than the fair market value of the consideration for which the share was issued plus the amount of any unpaid dividends on the share.

ITA
55(3)(*a*)

Paragraph 55(3)(*a*) of the Act provides an exemption from the application of subsection 55(2) for dividends received in certain non-arm's-length situations. Paragraph 55(3)(*a*) is amended, effective for dividends received after February 21, 1994, to change the arm's-length test to a "related" test. The main reason for this change is to provide greater certainty in determining whether subsection 55(2) applies in specific situations. The amended rule exempts dividends received as part of a series of transactions or events that does not result in a disposition of property to, or a significant increase in the interest in any corporation of, any person who is not related to the corporation that received the dividend. Amendments to subsection 55(4) and paragraph 55(5)(*e*) ensure that, in determining whether any person is related to the corporation that received the dividend, persons will be considered not to be related to each other where

- they are related as a result of any transaction or series of transactions one of the main purposes of which was to make them related to each other in order to avoid the application of subsection 55(2), or

- one is the brother or sister of the other.

These rules are similar to the existing rules for determining whether two or more persons are considered to deal with each other at arm's length. A new rule is added that would treat persons as being unrelated where they are related only by reason of a right referred to

in paragraph 251(5)(*b*) of the Act with respect to shares. In addition, a person will be considered to be related to a trust only where

- the person is related to each beneficiary (other than a registered charity) who is or may be entitled (otherwise than because of the death of another beneficiary) to share in the income or the capital of the trust, or

- the person is a corporation controlled by the trust.

ITA
55(3)(*b*)

Paragraph 55(3)(*b*) of the Act provides an exemption from the application of subsection 55(2) for dividends received in the course of certain corporate reorganizations commonly referred to as divisive or butterfly reorganizations. A butterfly reorganization involves a series of transactions the object of which is to distribute the property of a distributing corporation pro rata among its corporate shareholders on a tax-deferred basis. (See the comments above on section 55 for an illustration of a typical butterfly reorganization).

Existing paragraph 55(3)(*b*) sets forth the requirements of a pro rata distribution of property to one or more corporate shareholders of a distributing corporation. This paragraph is amended, consequential on the enactment of the definition "distribution" in new subsection 55(1) which sets forth those requirements, to simply require that the dividend be received in the course of a reorganization in which a distribution was made by a distributing corporation.

Paragraph 55(3)(*b*) is also amended to add the requirement that, as part of the reorganization in the course of which the dividend was received, the distributing corporation be wound up or all of its shares owned by each transferee corporation immediately before the distribution be redeemed or cancelled (otherwise than on an exchange to which subsection 51(1), 85(1) or 86(1) applies).

The existing rules also prevent paragraph 55(3)(*b*) from applying where property has been acquired (otherwise than as a result of a specifically permitted transaction) by the distributing corporation, a corporation controlled by it or a predecessor of either such corporation in contemplation of the transfer of property of the

distributing corporation to a transferee corporation. This restriction is deleted consequential on the amendment to subsection 55(3.1). New paragraph 55(3.1)(*a*) incorporates this restriction and modifies the description of the specifically permitted transactions.

ITA
55(3.1)

Draft amendments to subsection 55(3.1) of the Act introduced in 1993 provide that the butterfly exemption in paragraph 55(3)(*b*) does not apply in certain circumstances involving a sale of shares of the capital stock of the distributing corporation or the transferee corporation by a non-resident vendor and an acquisition of those shares, or of any substituted property, by any person who dealt at arm's length with the vendor. This rule was intended primarily to eliminate the tax advantages that previously could be obtained by structuring a sale of assets of a Canadian corporation with non-resident shareholders as a so-called "purchase butterfly" reorganization.

Subsection 55(3.1) is replaced by new subsections 55(3.1) and (3.2). These provisions further limit the circumstances in which the butterfly exemption in paragraph 55(3)(*b*) will apply. Whereas the rules in previously proposed subsection 55(3.1) are limited to butterfly reorganizations involving arm's-length dispositions of shares by non-resident shareholders, the new provisions will apply to all purchase butterfly reorganizations. The new provisions will also ensure that sales and purchases by shareholders with insignificant interests will not taint a butterfly reorganization that would otherwise qualify for the butterfly exemption in paragraph 55(3)(*b*) of the Act.

Specifically, a dividend will be denied the protection of the butterfly exemption where the conditions set out in any of paragraphs 55(3.1)(*a*) to (*c*) are satisfied. New paragraph 55(3.1)(*a*) replaces the mid-amble prohibition in existing paragraph 55(3)(*b*). New paragraphs 55(3.1)(*b*) and (*c*) are intended to ensure that the butterfly exemption will apply only where the shareholders of the distributing corporation at the beginning of the series of transactions or events (the historical shareholders) maintain a sufficient degree of continuity of interest in the underlying businesses and assets of the distributing corporation. There will generally not be a sufficient

degree of continuity of interest by the historical shareholders where, as part of the series of transactions or events,

- a specified shareholder of the distributing corporation or of a transferee corporation (i.e., a person who owns, or does not deal at arm's length with persons who own, 10 percent or more of the shares of any class of the capital stock of such corporation) disposes of a share of the capital stock of either such corporation and the share (or property acquired in substitution therefor) is acquired (otherwise than as a result of certain permitted transactions) by a person who is not related to the vendor or by a partnership,

- there is an acquisition of control of the distributing corporation or of a transferee corporation (otherwise than as a result of certain permitted transactions),

- a transferee corporation, or any person with whom the transferee corporation does not deal at arm's length, acquired shares of the capital stock of a distributing corporation in contemplation of a distribution, otherwise than as a result of certain permitted transactions, from a person to whom the acquiror was not related,

- a share of the capital stock of the distributing corporation was acquired (otherwise than as a result of certain permitted transactions), in contemplation of a distribution, by a person or member of a group of persons who acquired control of the distributing corporation as part of the series or by a partnership in which any such person has an interest or by anyone else with whom any such person or partnership does not deal at arm's length, or

- a significant portion of the property of a distributing corporation owned by it after a distribution or of the property received by a transferee corporation on the distribution was acquired by a person who was not related to the distributing corporation or the transferee corporation, as the case may be, or by a partnership.

ITA
55(3.1)(*a*)

New paragraph 55(3.1)(*a*) of the Act replaces the mid-amble prohibition in existing paragraph 55(3)(*b*) of the Act. The prohibition against the acquisition of property remains substantially the same. Dividends received in the course of a butterfly reorganization will be denied the protection of the butterfly exemption where any property has, in contemplation of the transfer of property of the distributing corporation to a transferee corporation, become property of the distributing corporation, a corporation controlled by it or a predecessor of any such corporations otherwise than as a result of a specifically permitted transaction. This restriction is intended primarily to prevent the bartering of assets on a tax-deferred basis and to prevent temporary changes to the types of property owned by the distributing corporation that would allow a shareholder to be cashed out on a tax-free basis. The specifically permitted transactions are similar to those that were permitted under existing subparagraphs 55(3)(*b*)(iii) to (viii), with the following exceptions:

- New subparagraph 55(3.1)(*a*)(ii) permits the acquisition of property on an amalgamation of a predecessor corporation of the distributing corporation with one or more corporations controlled by that predecessor corporation. This is intended to allow a corporation and its subsidiary to amalgamate to form the distributing corporation even though (having regard to subsection 251(3.1) of the Act) neither of them is related to the distributing corporation because the distributing corporation formed by the amalgamation is not controlled by any person or group of persons.

- New subparagraph 55(3.1)(*a*)(iv) combines and broadens the scope of the permitted acquisitions of property described in existing subparagraphs 55(3)(*b*)(vi) and (vii). The scope for acquisitions of property in contemplation of a distribution is broadened to allow for

  - the acquisition of property as a result of a disposition of property by a corporation controlled by the distributing corporation for consideration that consists only of money or non-convertible debt, and

- property to be transferred not only down the corporate chain or from one subsidiary to another subsidiary, but also up the corporate chain from a subsidiary to the distributing corporation or a predecessor of the distributing corporation. (This eliminates the need for the rule in existing paragraph 55(3)(*b*)(iv) which specifically allowed for the acquisition of property on the winding-up of a corporation controlled by the distributing corporation).

- As no transactions have been prescribed for the purpose of existing subparagraph 55(3)(*b*)(viii), the reference to prescribed transactions does not appear in new paragraph 55(3.1)(*a*).

ITA
55(3.1)(*b*)

New paragraph 55(3.1)(*b*) of the Act denies the protection of the butterfly exemption for any dividend that is received as part of a series of transactions or events in which

- a person or partnership (referred to as a "vendor") that, at any time during the course of the series, was specified shareholder of a distributing corporation or of a transferee corporation disposes of a share of the capital stock of the distributing corporation or a transferee corporation or of other property 10% or more of the value of which is attributable to such shares and the share or other property (or any substituted property) is acquired (otherwise than on a permitted acquisition, exchange or redemption as defined in new subsection 55(1) of the Act) by any person to whom the vendor is not related,

- there is an acquisition of control (otherwise than on a permitted acquisition, exchange or redemption) of the distributing corporation or of a transferee corporation, or

- a share of the capital stock of the distributing corporation is acquired (otherwise than as a result of certain permitted transactions), in contemplation of a distribution by the distributing corporation, by

  - a transferee corporation or any person or partnership with whom the transferee corporation does not deal at arm's

length from a partnership or from a person to whom the acquiror is not related,

- a person or member of a group of persons who acquired control of the distributing corporation as part of the series, a partnership in which such a person has an interest, or anyone else with whom such person or partnership does not deal at arm's length.

For this purpose, an acquisition of a share of the capital stock of a distributing corporation in contemplation of a distribution will not taint the butterfly reorganization where it is acquired on a permitted exchange (within the meaning assigned by subsection 55(1) of the Act) or on an amalgamation of 2 or more predecessor corporations of the distributing corporation.

A purchase butterfly reorganization typically involves a purchaser acquiring shares of a distributing corporation in anticipation of receiving property of the distributing corporation in exchange for those shares. Alternatively, the existing shareholders of the distributing corporation might transfer some of their shares of the distributing corporation to a new corporation in exchange for shares of the capital stock of the new corporation which they then sell to a purchaser after a distribution of property of the distributing corporation to the new corporation. This type of transaction, often referred to as an internal purchase butterfly, is illustrated by the following example:

Example A:

An individual, Mr. A, owns all of the shares of the capital stock of a taxable Canadian corporation (Opco) that operates a construction business. Opco has only two types of property; a small amount of cash and the assets used in its construction business. Opco wishes to sell the land and building (the "target asset") used in its business to a buyer (Buyco). The fair market value of the target asset is approximately 1/2 of the value of all of Opco's business assets. (See figure 3).

Rather than have Opco sell the target asset to Buyco directly, which would result in a capital gain and recapture of previously claimed capital cost allowance in respect of the building, Mr. A

and Buyco structure the transaction as follows:

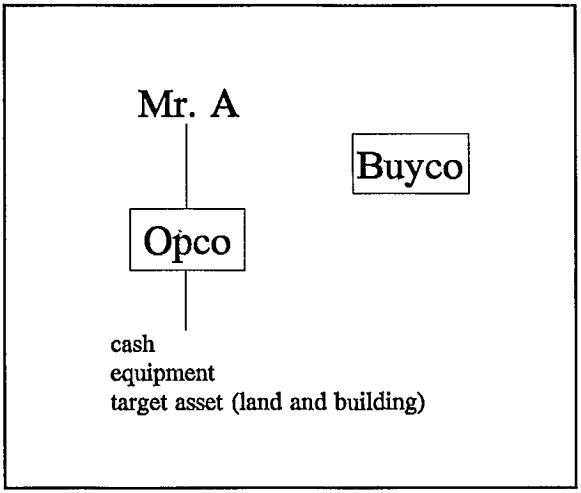

Figure 3: Pre-butterfly structure

Step 1: Mr. A transfers, on a tax-deferred basis under section 85 of the Act, 1/2 of his shares of the capital stock of Opco to a new corporation (Newco) in exchange for common shares of Newco.

Step 2: Opco transfers, also on a tax-deferred basis under section 85, the target asset and 1/2 of Opco's cash to Newco in exchange for redeemable preferred shares of Newco. These shares have an adjusted cost base to Opco equal to the total of the cash and the tax cost to Opco of the target asset. The paid-up capital of these shares is equal to their adjusted cost base.

Step 3: Newco redeems the shares of its capital stock issued to Opco in step 2. Newco issues a promissory note to Opco in payment of the redemption price.

Step 4: Opco purchases for cancellation the shares of its capital stock that were transferred to Newco in step 1. Opco issues a promissory note to Newco in payment of the purchase price.

Step 5: The promissory notes issued in steps 3 and 4 are set off against each other and cancelled.

At this point, Mr. A owns all the shares of two corporations, Opco (which continues to own and operate the construction business) and Newco (which owns the target asset and a small amount of cash). (See figure 4)

Final steps: Mr. A sells his shares of Newco to Buyco. Buyco causes Newco to be wound up, which results in the target asset being owned directly by Buyco.

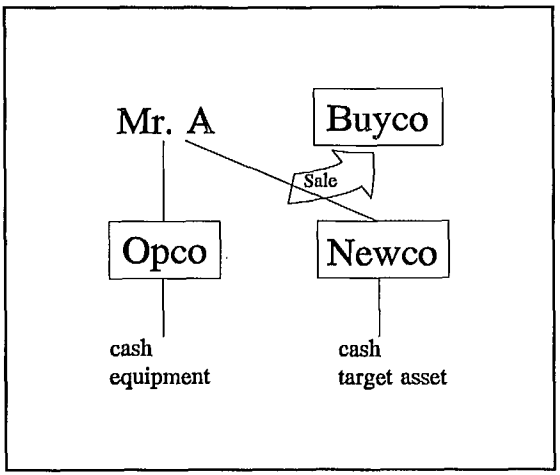

Figure 4: Post-butterfly structure

*In this example, recognition of the capital gain and the recapture of capital cost allowance that would have been realized on a direct sale of the target asset is deferred until such time as the target asset is subsequently disposed of in a taxable transaction. The deemed dividends arising on the redemption of shares in step 3 and the purchase for cancellation of shares in step 4 reduce the capital gains that, but for the dividends, would have been realized on a disposition of those shares. These dividends would have enjoyed the protection of the butterfly exemption under existing paragraph 55(3)(*b*). However, paragraph 55(3.1)(*b*) will deny them the protection of the butterfly exemption, with the result that these dividends may be recharacterized as proceeds of disposition under subsection 55(2).*

Subparagraph 55(3.1)(*b*)(i) of the Act denies the protection of the butterfly exemption not only where a vendor disposes of shares of the capital stock of the distributing corporation or of the transferee corporation, but also where the vendor sells property 10 percent or more of the fair market value of which is attributable to one or more such shares. This will ensure that the rules in subsection 55(3.1) will also apply where the vendor's interest in the distributing corporation or a transferee corporation is held through one or more trusts, partnerships or corporations.

Further, subparagraph 55(3.1)(*b*)(i) denies the protection of the butterfly exemption not only where a partnership or a person not related to the vendor acquires (otherwise than on a permitted

acquisition, exchange or redemption as defined in subsection 55(1) of the Act) a share of the capital stock of the distributing corporation or of a transferee corporation directly or indirectly from the vendor, but also where the partnership or person acquires property acquired by any person or partnership in substitution therefor. For this purpose, property received by a transferee corporation on a butterfly distribution is not considered to have been acquired in substitution for shares of the distributing corporation. (See new paragraph 55(3.1)(*c*) of the Act for the restrictions regarding dispositions of property received by a transferee corporation on a butterfly distribution).

A dividend received in the course of a butterfly reorganization will not be tainted under subparagraph 55(3.1)(*b*)(i) unless the vendor is, at any time during the course of the series of transactions or events that includes the reorganization, a specified shareholder of the distributing corporation or of a transferee corporation. This is intended to ensure that a disposition of shares by a shareholder who has not held a significant interest in either corporation will not, by itself, cause the dividends received in the course of the reorganization to be ineligible for the butterfly exemption.

Subparagraph 55(3.1)(*b*)(ii) of the Act denies the protection of the butterfly exemption where control of the distributing corporation or of a transferee corporation is acquired (otherwise than as a result of a permitted acquisition, exchange or redemption) by any person or group of persons. In this regard, subsection 256(7) of the Act is amended to ensure that, in the circumstances described in that subsection, control will be considered not to have been acquired for the purposes of paragraph 55(3)(*b*). Subsection 256(8) of the Act is also amended to add a reference to section 55 of the Act in order to ensure that taxpayers cannot, by using rights to acquire shares in order to avoid or defer an acquisition of control of a corporation, avoid the application of subsection 55(2) of the Act.

New subparagraph 55(3.1)(*b*)(iii) of the Act denies the protection of the butterfly exemption where, in contemplation of a distribution by a distributing corporation, a share of its capital stock has been acquired (otherwise than on a permitted acquisition or exchange or on an amalgamation of 2 or more predecessor corporations of the distributing corporation) by

- a transferee corporation or a person or partnership with whom the transferee corporation does not deal at arm's length from a partnership or from a person to whom the acquiror is not related,

- a person or member of a group of persons who acquired control of the distributing corporation as part of the series of transactions or events or any other person with whom such person does not deal at arm's length, or

- a partnership in which any person or member of a group of persons who acquired control of the distributing corporation as part of the series holds an interest, directly or indirectly through one or more partnerships.

Examples B and C demonstrate the application of the restrictions in subparagraph 55(3.1)(b)(iii) of the Act.

Example B:

A corporation (Opco) has 20 shareholders, each of whom owns 5 percent of its shares. Opco wishes to sell to Buyco, without realizing the accrued gain, a business asset (the "target property") that has a fair market value equal to 1/4 of the fair market value of all of its business assets. Instead of having Opco sell the target property to Buyco directly, each of the shareholders of Opco sells 1/4 of his or her shares of the capital stock of Opco to Buyco. Buyco then acquires the target property from Opco on a butterfly reorganization of Opco.

The dividends received in the course of the butterfly reorganization of Opco in example B would not be denied the protection of the butterfly exemption by subparagraph 55(3.1)(b)(i) or (ii) because none of the vendors is a specified shareholder of Opco and there is no acquisition of control of Opco or Buyco. However, the dividends would be denied the protection of the butterfly exemption by subparagraph 55(3.1)(b)(iii) because Buyco (the transferee corporation), in contemplation of the distribution by Opco (the distributing corporation), acquired shares of the capital stock of Opco from one or more persons to whom Buyco was not related.

Example C:

Assume the same facts as in example B. However, instead of causing the target property to be transferred to Buyco in the course of a butterfly reorganization, the shareholders of Opco, after selling 1/4 of their shares of the capital stock of Opco to Buyco, transfer their remaining Opco shares to a new corporation (Newco) on a tax-deferred basis under section 85 of the Act. The assets of Opco (other than the target property) are then distributed to Newco in the course of a butterfly reorganization.

In example C, Newco could be considered to have acquired control of Opco when it acquires the shares of Opco from the existing shareholders. However, this acquisition would occur on a permitted exchange (within the meaning assigned by subsection 55(1) of the Act). Buyco could also be considered to have acquired control of Opco when the shares of Opco owned by Newco are purchased for cancellation. However, this purchase of shares for cancellation would be a permitted redemption (within the meaning assigned by subsection 55(1) of the Act). Under subparagraph 55(3.1)(*b*)(ii), acquisitions of control that occur as a result of a permitted exchange or redemption do not taint a butterfly reorganization. The dividends received by Opco and Newco in the course of the butterfly reorganization would be denied the protection of the butterfly exemption by subparagraph 55(3.1)(*b*)(iii) because Buyco, the controlling shareholder of Opco at the end of the series, acquired shares of the capital stock of Opco in contemplation of the distribution by Opco.

ITA
55(3.1)(*c*)

New paragraph 55(3.1)(*c*) of the Act denies the protection of the butterfly exemption for a dividend received in circumstances where, as part of the series of transactions or events that includes the dividend, a significant portion of the property received by a transferee corporation on a distribution, or of the property owned by a distributing corporation after a distribution, becomes property of a partnership or of a person who is not related to the transferee corporation or to the distributing corporation, as the case may be. This restriction is intended to ensure that, in order to qualify for the tax-deferred distribution permitted by the butterfly exemption, the

shareholders maintain a certain continuity of interest in not only the shares of the capital stock of the distributing corporation or the transferee corporation, but also the underlying business and assets. It also ensures that a sale of assets of a distributing corporation cannot be used to cash out a corporate shareholder by distributing the assets to the shareholder on a butterfly reorganization prior to the sale of those assets to a third party.

Paragraph 55(3.1)(*c*) does not apply where, immediately after the butterfly reorganization, the distributing corporation and the transferee corporation are still related to each other. This exception is intended to allow members of a group of related corporations to transfer property from one member of the group to another in the course of a butterfly reorganization in contemplation of a sale of the property to a buyer outside the group.

Where paragraph 55(3.1)(*c*) applies, a disposition of property in the ordinary course of business, a disposition of property to a related person and a disposition of property on a subsequent distribution will not cause a butterfly reorganization to be tainted. In addition, the distributing corporation or the transferee corporation is permitted to sell or transfer, outside the ordinary course of business, property having a total fair market value not greater than 10% of the fair market value, at the time of the distribution, of property owned by it immediately after the distribution.

The following examples illustrate the application of paragraph 55(3.1)(*c*) of the Act.

Example A:

A corporation (Aco) owns 40% of the issued shares of the capital stock a second corporation (Opco). These shares have a low paid-up capital and an accrued gain a significant portion of which is not attributable to the retained earnings of Opco. The remaining 60% of the shares are owned by a third corporation (Bco). Opco owns only two types of property, namely, business property worth $100,000 and $10,000 in cash. A fourth corporation (Buyer) wishes to acquire a business asset (the target property) from Opco worth $40,000. Aco wishes to withdraw from the business.

If Aco were to sell its Opco shares to Bco, Aco would realize a capital gain. If the shares were redeemed or purchased for cancellation by Opco, the dividend arising under subsection 84(3) of the Act on the redemption would be recharacterized by subsection 55(2) of the Act as a capital gain.

In order to enable Aco to avoid the capital gain on the disposition of its shares of Opco, Aco and Bco undertake a butterfly reorganization of Opco in the course of which the target property and Aco's pro rata share of Opco's cash are transferred to Aco and Opco purchases or redeems all of the shares of its capital stock owned by Aco. Aco then sells the target property to Buyer.

In this example, the dividend arising on the purchase or redemption of Aco's shares of the capital stock of Opco in the course of the butterfly reorganization does not qualify for the butterfly exemption because of paragraph 55(3.1)(*c*). The target property, the fair market value of which is greater than 10% of the fair market value of all the property received by Aco on the distribution by Opco, is acquired outside the ordinary course of Aco's business by Buyer which is not related to Aco. It would not be appropriate for Aco to use the sale of the target property to Buyer to shelter the dividend arising on the redemption of its shares of the capital stock of Opco from the application of subsection 55(2) of the Act.

Example B

A corporation (Aco) owns 20% of the issued shares of the capital stock of a second corporation (Opco). Opco owns 2 types of property, namely business property having a fair market value of $100,000 and $10,000 in cash. The business property relates to two businesses, Division A, the business assets of which have a fair market value of $19,000, and Division B, the business assets of which have a fair market value of $81,000. Aco wishes to dispose of its interest in Opco and continue to operate Division A.

In order defer the tax on the disposition of the property relating to Division A and the tax on the redemption or purchase for cancellation of Aco's shares of the capital stock of Opco, the parties undertake a butterfly reorganization in the course of which Aco receives its pro rata share of the business property and cash

of Opco and its shares of the capital stock of Opco are purchased by Opco for cancellation. However, in order for Aco to receive its pro rata share of Opco's business property (so that the transfer of property to Aco qualifies as a distribution within the meaning assigned by subsection 55(1) of the Act), certain business properties relating to Division B are transferred to Aco.

After the reorganization, Aco sells the properties relating to Division B (having a fair market value of $1,000) back to Opco for cash consideration.

In Example B, the subsequent sale of property relating to Division B back to Opco would not, by itself, taint the butterfly reorganization because the value of the property disposed of by Aco outside the ordinary course of its business is not greater than 10% of the fair market value of all the property received by it on the distribution by Opco.

ITA
55(3.2)

New subsection 55(3.2) of the Act sets out a number of interpretive rules for the purpose of paragraph 55(3.1)(*b*).

New paragraph 55(3.2)(*a*) of the Act broadens the meaning of the definition "specified shareholder" in subsection 248(1) of the Act for the purpose of determining whether the vendor referred to in subparagraph 55(3.1)(*b*)(i) is at any time a specified shareholder of a distributing corporation or of a transferee corporation. The references in that definition to "taxpayer" are to be read as "person or partnership". A partnership owning 10 percent or more of the shares of any class of the capital stock of a corporation will therefore be a specified shareholder of the corporation for the purposes of subsection 55(3.1). Effectively, a partnership is treated as a person for the purpose of determining whether a sufficient degree of continuity of interest is maintained by the historical shareholders in the underlying businesses and assets of the distributing corporation.

New paragraph 55(3.2)(*b*) of the Act provides that a corporation formed by the amalgamation of two or more predecessor corporations is deemed to be the same corporation as, and a continuation of, each predecessor corporation. This rule is intended to ensure that

taxpayers cannot avoid the restrictions imposed by subsection 55(3.1) by arranging for an intervening amalgamation. For instance, a specified shareholder of a predecessor corporation of the distributing corporation that disposed of a share of the capital stock of the predecessor corporation to a non-related purchaser before the amalgamation by which the distributing corporation was formed will be considered to have been a specified shareholder of the distributing corporation and to have disposed of a share of the capital stock of the distributing corporation.

New paragraph 55(3.2)(*c*) of the Act (which generally applies to dividends received after Announcement Date) treats a transferee corporation as not being related to

- each person from whom it acquired a share of the capital stock of the distributing corporation, and

- each person to whom it disposed of a share of the capital stock of the distributing corporation.

This rule only applies where the distributing corporation is not related, immediately after the reorganization in which a distribution is made by it, to a transferee corporation. This exception is intended to allow the members of a related corporate group to rely on the butterfly exemption to protect inter-corporate dividends from the application of subsection 55(2) even though the distributed property may be disposed of to a non-related purchaser as part of the series of transactions or events that includes the distribution.

The deeming provision in paragraph 55(3.2)(*c*) is designed to ensure that, except in circumstances where the butterfly reorganization is used to facilitate the transfer of property within a related corporate group, persons transferring shares of the capital stock of the distributing corporation to a transferee corporation in anticipation of a distribution must satisfy the requirements of a permitted exchange. In addition, it prevents a transferee corporation from effecting a partial split-up by disposing of some its shares of the capital stock of the distributing corporation prior to a distribution.

New paragraph 55(3.2)(*d*) of the Act (which also generally applies to dividends received after Announcement Date) deems a share of the capital stock of a corporation that is redeemed or cancelled by the

corporation to have been acquired by the corporation. This is relevant in determining whether, for the purpose of subparagraph 55(3.1)(*b*)(i), a share or other property disposed of by a vendor referred to in that subparagraph has been acquired (otherwise than on a permitted acquisition, exchange or redemption) by a person who was not related to, or ceased to be related to, the vendor. The rule ensures that taxpayers cannot avoid the restrictions in subparagraph 55(3.1)(*b*)(i) by having their shares of the capital stock of the distributing corporation or of a transferee corporation redeemed instead of having them purchased by a non-related purchaser. This rule does not apply where new paragraph 55(3.2)(*e*) of the Act applies. Under that provision, a corporation that acquires, redeems or cancels a share of its capital stock pursuant to the exercise of a statutory right of dissent is deemed, for the purpose of paragraph 55(3.1)(*b*) of the Act, not to have acquired the share.

The amendments to subsection 55(3.1) and new subsection 55(3.2) generally apply to dividends received after February 21, 1994, other than dividends received before 1995 in the course of a reorganization (referred to as a "grandfathered reorganization") that was required on that date to be carried out pursuant to a written agreement entered into before February 22, 1994.

Where a dividend is received after February 21, 1994 and before Announcement Date (otherwise than in the course of a grandfathered reorganization), the new rules are to be read without reference to paragraphs 55(3.1)(*c*) and (3.2)(*c*) and (*d*). In addition, paragraph 55(3.1)(*b*) of the Act is modified to ensure that an acquisition of control of the distributing corporation or of a transferee corporation will not, by itself, cause a dividend not to qualify for the butterfly exemption.

ITA
55(4)

Existing subsection 55(4) of the Act deems persons not to be related and to deal with each other at arm's length for the purposes of section 55 where the principal purpose of one or more transactions or events is to make them related to each other or not to deal with each other at arm's length in order to avoid the application of subsection 55(2). A similar rule is provided for transactions designed to cause one corporation to control another corporation.

Subsection 55(4) is amended, consequential on the amendments to paragraph 55(3)(*a*), to remove the references to non-arm's-length dealings which are no longer relevant. It is also amended to ensure that it applies not only when one of the purposes described in that paragraph is the principal purpose of one or more transactions or events, but also where it is one of the main purposes thereof. The broadening of the purpose test makes it consistent with the purpose test in several other anti-avoidance provisions in the Act.

These amendments to subsection 55(4) are effective for dividends received after February 21, 1994.

ITA
55(5)(*e*)

Existing paragraph 55(5)(*e*) of the Act deems persons to be dealing with each other at arm's length and not to be related to each other if one is the brother or sister of the other. This rule applies in determining, for the purposes of section 55, whether two or more persons are dealing with each other at arm's length. This paragraph is amended, effective for dividends received after February 21, 1994, to treat persons as not being related to each other if one is the brother or sister of the other or if they are related to each other by virtue only of a right referred to in paragraph 251(5)(*b*) of the Act. In addition, a person will be considered to be related to a trust only where the person is a corporation controlled by the trust or the person is related to each beneficiary (other than a registered charity) who is or may be entitled (otherwise than by reason of the death of another beneficiary of the trust) to share in the income or capital of the trust. These rules apply in determining for the purposes of section 55 whether two or more persons are related to each other, whether a person is a specified shareholder of a corporation and whether control of a corporation has been acquired by any person or group of persons.

Clause 2

Winding-up

ITA
88(1)(*c*), (*c*.2) and (*d*)

Subsection 88(1) of the Act sets out detailed rules dealing with the winding-up of a taxable Canadian corporation (the subsidiary) into a parent corporation that owns not less than 90 percent of the shares of each class of the capital stock of the subsidiary.

Existing paragraph 88(1)(*c*) provides that the cost to the parent corporation of each property distributed to it by the subsidiary on the winding-up is equal to the subsidiary's proceeds of disposition determined under paragraph 88(1)(*a*) plus, where the property satisfies certain conditions, an amount determined under paragraph 88(1)(*d*) in respect of the property.

Paragraph 88(1)(*c*) is amended, effective for windings-up that begin after February 21, 1994, to clarify and add to the conditions that must be satisfied in order for the property to qualify for the increase in cost determined under paragraph 88(1)(*d*). A property (other than an ineligible property) will so qualify where it was a capital property of the subsidiary at the time that the parent last acquired control of the subsidiary and was thereafter continuously owned by the subsidiary until it was distributed to the parent on the winding-up.

For these purposes, "ineligible property" means:

(i) depreciable property,

(ii) property that is transferred to the parent on the winding-up of the subsidiary as part of a distribution of the property to the parent in the course of a butterfly reorganization,

(iii) property transferred to the subsidiary by the parent or by any person with whom the parent did not deal at arm's length, and

(iv) property that is subsequently disposed of by the parent as part of a series of transactions in which the parent acquired control

of the subsidiary and the property or any substituted property is acquired by

- any person (other than a specified person) who, at any time during the series and before the parent acquired control of the subsidiary, was a specified shareholder of the subsidiary, or

- a corporation (other than a specified person) of which any such shareholder of the subsidiary is a specified shareholder.

The first three of these types of property are already ineligible, under the existing rules, for an increase in adjusted cost base under paragraph 88(1)(*c*). The fourth type of property is added in order to prevent taxpayers from circumventing the restrictions against purchase butterfly reorganizations set out in subsection 55(3.1) of the Act by means of a series of transactions that effectively result in a sale of part of a corporation's assets to an arm's-length corporate purchaser on a tax-deferred basis as illustrated by the following example.

Example:

An individual, Ms. A, owns all of the shares of the capital stock of a corporation (Opco) that wishes to retain its wholesale division but wishes to sell its retail division to an arm's-length purchaser (Buyco). New subsections 55(3.1) to (3.3) prevent the transfer of the assets of the retail division to Buyco on a tax-deferred basis. Ms. A and Buyco therefore structure the transaction as follows:

Step 1: Opco transfers, on a tax-deferred basis under section 85 of the Act, all of the business and assets of the wholesale division to a newly incorporated subsidiary of Opco (Subco) in exchange for shares of the capital stock of Subco.

Step 2: Ms. A sells all of her shares of Opco to Buyco.

Step 3: Buyco causes Opco to be wound up. The winding-up occurs on a tax-deferred basis under subsection 88(1) of the Act. Buyco makes a designation under existing subsection 88(1)(d) in respect of the shares of Subco distributed to Buyco on the winding-up, thereby increasing the adjusted cost base of those shares to their fair market value.

Step 4: Ms. A purchases the shares of Subco from Buyco at fair market value but, because of the increase in their adjusted cost base, there is no taxable gain.

Result: The business and assets of the retail division would, under the existing rules, have effectively been sold to Buyco on a tax-deferred basis. However, under paragraph 88(1)(c) as amended, Buyco would not obtain an increase in the adjusted cost base of its shares of Subco prior to the sale of those shares back to Ms. A.

The new rules prevent the parent corporation from obtaining an increase in the adjusted cost base of a property distributed to it on the winding-up of its subsidiary where a person (other than a specified person) who had a significant interest in the subsidiary before the parent last acquired control of the subsidiary acquires, directly or indirectly, a significant interest in the property after the winding-up.

"Specified person" for this purpose is defined in new subparagraph 88(1)(*c*.2)(i) of the Act to mean the parent and each person who would be related to the parent if rights referred to in paragraph 251(5)(*b*) of the Act were ignored. A person is considered not to be related to the parent if it can reasonably be considered that one of the main purposes of one or more transactions or events was to cause them to be related so that a property would not be ineligible for the increase in adjusted cost base provided for in paragraph 88(1)(*c*) of the Act.

A person will be considered to have had a significant interest in the subsidiary where the person was a specified shareholder (within the meaning assigned by subsection 248(1) of the Act) of the subsidiary. Generally, a person is a specified shareholder of a corporation if the person owns more than 10% of the issued shares of any class of the capital stock of the corporation and, for this purpose, the person is deemed to own all the shares owned by each other person with whom the person does not deal at arm's length.

A person will be considered to have acquired a significant interest in a property that was distributed to the parent on the winding-up of the subsidiary if the person acquires the property or is a specified shareholder of a corporation that acquires the property. For this

purpose, new subparagraph 88(1)(*c*.2)(ii) of the Act treats a partnership and a trust as a corporation

- the shares of the capital stock of which are owned by its members or beneficiaries, as the case may be, pro rata in proportion to the fair market value of their interests in the partnership or trust, and

- that is considered to own or to acquire each property that is owned or acquired by the partnership or trust, as the case may be.

Consequential on the amendments to paragraph 88(1)(*c*), paragraph 88(1)(*d*) of the Act is amended, effective for windings-up commencing after February 21, 1994, by deleting the restrictions on the types of property in respect of which the parent may designate an amount for the purpose of obtaining an increase under paragraph 88(1)(*c*) in the cost of a property distributed to the parent on the winding-up. Those restrictions are now set forth in the new definition "ineligible property" in paragraph 88(1)(*c*).

These amendments to subsection 88(1) of the Act apply to windings-up that begin after February 21, 1994 except that, where the winding-up began after that day and before Announcement Day, an acquisition of a property distributed to the parent on a winding-up will not cause the increase in the adjusted cost base of the property to be denied unless the property was acquired by

- a particular person (other than a specified person) who was a specified shareholder of the subsidiary before the parent last acquired control of the subsidiary, or

- a person (other than a specified person) with whom the particular person did not deal arm's length.

Clause 3

Acquisition of Control

ITA
256(7)

Subsection 256(7) of the Act sets out rules for determining whether there has been an acquisition of control for the purposes of certain provisions of the Act. An intercorporate dividend received in the course of a reorganization referred to in paragraph 55(3)(*b*) of the Act is exempt from the application of subsection 55(2) of the Act. Subsection 55(3.1) of the Act denies the benefit of the exemption provided by paragraph 55(3)(*b*) if certain conditions are satisfied. One of these conditions is an acquisition of control of the distributing corporation or of a transferee corporation referred to in paragraph 55(3)(*b*). Subsection 256(7) is amended, effective for acquisitions, amalgamations, redemptions and cancellations that occur after February 21, 1994, by adding a reference to section 55.

ITA
256(8)

Subsection 256(8) of the Act extends the circumstances in which an acquisition of control is considered to have occurred for certain purposes, including the rules relating to the carry-over of losses and certain other amounts. An intercorporate dividend received in the course of a reorganization referred to in paragraph 55(3)(*b*) of the Act is exempt from the application of subsection 55(2) of the Act. Paragraph 55(3.1)(*b*) of the Act denies the benefit of the exemption provided by paragraph 55(3)(*b*) if certain conditions are satisfied. One of these conditions is an acquisition of control of the distributing corporation or of a transferee corporation referred to in paragraph 55(3)(*b*). Subsection 256(8) is amended, effective for acquisitions that occur after Announcement Date, so that it applies also in determining for the purpose of section 55 of the Act whether control of a corporation has been acquired.