Amendments to the Income Tax Act

Explanatory Notes

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

November 1994

Canada

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Department of Finance Canada
Ministère des Finances Canada

These explanatory notes are provided to assist in an understanding of amendments to the *Income Tax Act* and *Income Tax Application Rules.* These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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PREFACE

The legislation to which these explanatory notes relate contains amendments to the *Income Tax Act* and *Income Tax Application Rules*. These amendments are designed to implement a number of the income tax measures put forth in the Budget of February 22, 1994.

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

The Honourable Paul Martin
Minister of Finance

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Clause 1

Income from Office or Employment

ITA
6

Section 6 of the Act provides for the inclusion of employment-related benefits in an employee's income.

Subclauses 1(1) and (2)

ITA
6(4)

Subsection 6(4) of the Act includes in the income of an employee or former employee an amount in respect of life insurance provided as an employment benefit under a group term life insurance policy. This subsection applies in place of the general benefit rule in paragraph 6(1)(a).

In general terms, subsection 6(4) provides that a taxpayer's employment benefit in respect of group term life insurance is equal to the average cost per dollar of insurance, computed in the manner specified in the subsection, times the amount of the taxpayer's insurance in excess of $25,000. Any amount that the taxpayer has paid towards the cost of insurance in excess of $25,000 is subtracted.

Subsection 6(4) is amended, first as it applies with respect to insurance for periods in the initial 6 months of 1994, and second as it applies with respect to insurance for periods after June 1994.

The amendments to subsection 6(4), as it applies with respect to insurance for periods in the first 6 months of 1994, clarify how the subsection applies with respect to such insurance and they exclude prescribed premiums and prescribed insurance from the calculations in the subsection. The exclusion of prescribed premiums reduces the amount of premiums that enter into the calculation of the average cost of insurance to be applied to the amount of a taxpayer's insurance in excess of $25,000. The exclusion of prescribed insurance reduces the amount of insurance that enters into the calculation of the average cost of insurance and also reduces the amount of a taxpayer's insurance that gives rise to a benefit.

Draft section 2705 of the *Income Tax Regulations* (released by the Minister of Finance on June 16, 1994) prescribes premiums and insurance for the purpose of subsection 6(4). A prescribed premium is a premium that is paid after February 1994 in respect of an individual who is alive on July 1, 1994 where, in general terms, the premium is paid in respect of a period all or part of which is more than 13 months after the premium is paid. Prescribed insurance is insurance in respect of which a prescribed premium is paid. For further information, see the commentary on draft section 2705 of the Regulations contained in the release of June 16, 1994.

The amendments to subsection 6(4) for insurance for periods after June 1994 provide that a taxpayer's employment benefit in respect of group term life insurance is the amount determined by regulation. Draft Part XXVII of the Regulations (released by the Minister of Finance on June 16, 1994) contains the rules for determining the amount of the benefit. Those rules differ from the current rules in a number of respects, including the following:

- The amount of the taxable benefit will be based on the full amount of insurance, rather than the amount in excess of $25,000.

- Where a premium for insurance on the life of a taxpayer is paid in respect of a period all or part of which is more than 13 months after the premium is paid, the taxpayer will have a benefit equal to the amount of the premium less any amount paid by the taxpayer towards the insurance. This benefit is instead of a benefit based on the average cost of insurance under the policy. The benefit in respect of paid-up insurance, for example, will be determined in this way.

- Some flexibility will be allowed in the method used to determine the average cost of insurance.

- Starting in 1995, the average cost of insurance will have to be determined separately for each group of employees or former employees for whom a separate premium rate is established under the policy (except where premium rates differ by reason of age or sex).

- Sales tax in respect of premiums will be expressly included as part of the taxable benefit.

For further information on the new rules, see the commentary on draft Part XXVII of the Regulations contained in the release of June 16, 1994.

Subsection 6(4) is also amended, with respect to insurance for periods after June 1994, to delete the reference to insurance being provided by reason of an office or employment or former office or employment. This change is consequential on an amendment to the definition of "group term life insurance policy" to include this condition as part of the definition.

It should be noted that subsection 6(4) will generally include two amounts in an individual's income in 1994 in respect of insurance under a group term life insurance policy. The first amount is the taxable benefit for the first 6 months of 1994, determined under the subsection with the amendments described above. The second amount is the taxable benefit for the last 6 months of 1994, determined under the regulations made for the purpose of the subsection.

Subclause 1(3)

ITA
6(5)

Subsection 6(5) of the Act contains a rule that applies for the purpose of subsection 6(4) where a group term life insurance policy does not have a policy year ending in a particular calendar year. As a consequence of the amendments to subsection 6(4), this rule is no longer required. Accordingly, subsection 6(5) is repealed for 1995 and subsequent taxation years.

Clause 2

Inclusions in Computing Income from Business or Property

ITA
12(1)(z.1) and (z.2)

New paragraph 12(1)(z.1) of the Act provides that any amount received by a taxpayer in the taxpayer's capacity as a beneficiary of a mining reclamation trust is to be included in computing the taxpayer's income for tax purposes. This would most typically occur when amounts are released by the trust in order to fund the taxpayer's obligation to carry out reclamation work following closure of a mine. This result applies even where the amount received is also included under subsection 107.3(1) in the taxpayer's income for the year in which the amount was received or for any other taxation year. The income of a mining reclamation trust is attributed under that subsection to its beneficiaries on an annual basis. The definition "mining reclamation trust" for these purposes is provided under subsection 248(1).

New paragraph 12(1)(z.2) provides that consideration received by a taxpayer for the sale of the taxpayer's interest as a beneficiary of a mining reclamation trust is also included in computing the taxpayer's income. For this purpose, consideration does not include consideration that is the assumption of any mining reclamation obligation in respect of the trust. Thus, if the only consideration on the disposition to another person of a taxpayer's interest as a beneficiary under a mining reclamation trust is the assumption by the other person of the taxpayer's mining reclamation obligations in respect of the trust, no amount will be included in computing the taxpayer's income as a consequence of the disposition. (In these circumstances, the other person will not be entitled under new paragraph 20(1)(bb) to any deduction on the acquisition of the interest in the trust.)

Where a taxpayer is not resident in Canada, reference should be made to new paragraph 107.3(1)(b) which ensures that amounts included in a non-resident's income under paragraphs 12(1)(z.1) and (z.2) will be considered to be from the carrying on of a business in Canada through a fixed place of business.

It is intended that amounts included in income under paragraph 12(1)(z.1) or (z.2) will not be included for the purpose of the resource allowance and that Part XII of the *Income Tax Regulations* will be amended accordingly.

These amendments apply to taxation years ending after February 22, 1994.

Clause 3

Transition – Inclusion Re Unpaid Claims Reserve

ITA
12.3

Section 12.3 of the Act is a transitional provision introduced in conjunction with the 1987 tax reform measures affecting the treatment of the reserves of financial institutions. It required that such institutions include amounts deducted under subsection 20(26) of the Act in their income over a five-year period ending with the taxation year that began in 1992.

Section 12.3 is replaced by a transitional provision relating to the introduction of the requirement that insurers fully discount their unpaid claims reserves for tax purposes. As amended, section 12.3 applies where an insurer has deducted an amount in respect of its unpaid claims reserve adjustment under subsection 20(26) of the Act, as amended by this Bill. Amended section 12.3 requires the insurer to include in income in that taxation year, and in each of its subsequent taxation years beginning before 2004, the prescribed portion for the year of the amount so deducted.

The *Income Tax Regulations* will be amended to prescribe the relevant portion to be included in income each taxation year. If the insurer's taxation year coincides with the calendar year, the prescribed portion will be 5% for 1994 and 1995, 10% for 1996 to 2001, and 15% for 2002 and 2003 of the amount deducted under subsection 20(26). If the taxation year overlaps two calendar years or is only part of a single calendar year, the percentage used to obtain the prescribed portion will be prorated.

The Regulations will also be amended to provide that where an insurer transfers its insurance business in a rollover transaction, the transferee must include in income any amount that the transferor would have had to include under section 12.3 of the Act.

The amendment to section 12.3 applies to taxation years that end after February 22, 1994.

Clause 4

Recaptured Depreciation

ITA
13

Section 13 of the Income Tax Act provides rules relating to depreciable property. Generally, these rules apply for the purposes of sections 13 and 20 of the Act and the capital cost allowance regulations.

Subclauses 4(1) and (2)

ITA
13(7)

Subsection 13(7) of the Act provides rules relating to the capital cost of depreciable property. Subparagraph 13(7)(e)(i) contains a special rule that applies on the direct or indirect transfer of depreciable property between certain persons who do not deal at arm's length. This rule, which determines the capital cost of property to the transferee, is intended to prevent taxpayers from increasing the depreciable base of property through a non-arm's-length transfer in respect of which the transferor benefits from the capital gains exemption or from the fact that only 3/4 of the transferor's capital gain is taxable. Under the existing rule, the transferee's capital cost of the property is equal to the transferor's cost or capital cost of the property plus any portion of the transferor's taxable capital gain that was not sheltered by the capital gains exemption.

New subclause 13(7)(e)(i)(B)(IV) and new paragraph 13(7)(e.1) of the Act are added consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of the mechanism in new subsection 110.6(19) of the Act for recognizing gains accrued to that day.

Where a taxpayer elects under subsection 110.6(19) in respect of a depreciable property that is a non-qualifying real property for the purpose of the capital gains exemption, subsection 110.6(21) reduces the taxpayer's taxable capital gain resulting from the deemed disposition under subsection 110.6(19) by the portion of the gain that is not eligible for the capital gains exemption. Subsection 110.6(21) also requires the taxpayer's capital cost of the property to be reduced by 4/3 of the reduction in the taxable capital gain. This ensures that the ineligible portion of the gain will not be taxed until a subsequent disposition.

New subclause 13(7)(e)(i)(B)(IV) ensures that the reduction in the capital cost of a property required by subsection 110.6(21) is reflected in the capital cost of the property for capital cost allowance purposes. This will ensure that a taxpayer cannot obtain an increase in the depreciable base of property as a result of an election made under subsection 110.6(19) except to the extent that the gain resulting from the election is reflected in the taxpayer's taxable income.

New paragraph 13(7)(e.1) ensures that subparagraph 13(7)(e)(i) will apply to determine the capital cost to the taxpayer on the reacquisition of the property that occurs because of an election made under subsection 110.6(19). It also ensures that where the property is a depreciable property of a prescribed class or a separate prescribed class before the deemed disposition, it will be a depreciable property of the same prescribed class or separate prescribed class of the taxpayer on the deemed reacquisition of the property. (See Income Tax Regulation 1102(14)).

An election under subsection 110.6(19) in respect of a depreciable property will not result in recapture of depreciation because the amount included in the determination of F in the definition "undepreciated capital cost" in subsection 13(21) as a consequence of the deemed disposition of the property will be the same as the amount included in the determination of A in that definition as a result of the deemed reacquisition of the property.

(See the commentary on the amendments to subsection 20(1) of the *Income Tax Application Rules* for an example that illustrates the effect of those amendments and the amendments to subsection 13(7) of the Act).

Subclause 4(3)

ITA
13(18.1)

New subsection 13(18.1) of the Act provides that, in determining whether a particular property is prescribed energy conservation property, the Technical Guide to Class 43.1 (to be published by the Department of Energy, Mines and Resources and as amended from time to time) applies conclusively with respect to engineering and scientific matters. Proposed new section 8200.1 of the *Income Tax Regulations*, as released by the Minister of Finance on September 27, 1994, provided that "prescribed energy conservation property" would mean property described in paragraphs (c) to (g) of capital cost allowance Class 43 in Schedule II to the Regulations. In accordance with this legislation, the proposed Regulations will be revised to refer to paragraphs (a) to (e) of Class 43.1 instead of paragraphs (c) to (g) of Class 43. For further information, reference may be made to the Release of September 27, 1994.

This amendment applies to property acquired after February 21, 1994.

Clause 5

Eligible Capital Property

ITA
14

Section 14 of the Act provides rules concerning the tax treatment of expenditures and receipts of a taxpayer in respect of eligible capital properties.

Subclause 5(1)

ITA
14(1)(a)

Paragraph 14(1)(a) of the Act provides that where, at the end of a taxation year, the amounts required to be deducted from the cumulative eligible capital in respect of a business of an individual or a Canadian, non-corporate partnership (referred to in this commentary as a "taxpayer") exceed the amounts required to be added to that amount, that excess (referred to in this commentary as a "negative balance") is treated as a taxable capital gain except to the extent that it is required to be included in computing the taxpayer's income from the business for the year. Subparagraph 14(1)(a)(iv) recaptures amounts previously deducted under paragraph 20(1)(b) in computing the taxpayer's income from the business. Existing subparagraph 14(1)(a)(v) treats the remainder of the negative balance as a taxable capital gain.

Subparagraph 14(1)(a)(v) is amended, effective for fiscal periods that end after February 22, 1994 (otherwise than because of an election under subsection 25(1)), to require the negative balance in excess of the recapturable amount determined under subparagraph 14(1)(a)(iv) to be included in computing the taxpayer's income for the year from the business. As a result, where a taxpayer has a negative balance at the end of a fiscal period, the entire negative balance will be included in computing the taxpayer's income for the business for the taxation year in which that fiscal period ends.

A special rule for eligible capital property (such as a farm quota) that constitutes qualified farm property ensures that the $500,000 lifetime capital gains exemption will continue to be available for dispositions of such property after February 22, 1994. Under subparagraph 14(1)(a)(v) as amended, the portion of the amount included under that subparagraph in computing a taxpayer's business income that can reasonably be attributed to a gain realized in the year from the disposition of a qualified farm property will be treated, for the purposes of section 110.6 and paragraph 3(b) as it applies for the purposes of that section, as a taxable capital gain from the disposition of a qualified farm property. This amount will be treated as a taxable capital gain, not in computing the taxpayer's income, but for the purpose of section 110.6. This will allow the taxpayer to use the capital gains deduction under subsection 110.6(2) to offset the business income inclusion under subsection 14(1)(a)(v).

Where an individual elects under subsection 110.6(19) in respect of a business, the taxable capital gain resulting from the election will credited to a special account which is defined in subsection 14(5) as the individual's "exempt gains balance" in respect of the business. This exempt gains balance can be used by the individual to reduce the business income inclusion otherwise determined under subparagraph 14(1)(a)(v).

The following example illustrates the effect of an election under subsection 110.6(19) in respect of a business and the use of the exempt gains balance that results from such an election.

An individual purchased a franchise business in 1992. The eligible capital expenditure connected with the purchase was $40,000. The business has a December 31 year-end. Each year, the individual claimed the maximum deductions under paragraph 20(1)(b) in computing the individual's income from the business. The eligible capital property of the business had a fair market value on February 22, 1994 of $60,000. The taxpayer elected under subsection 110.6(19) in respect of the business in order to shelter the $20,000 accrued gain with the capital gains exemption. The business is sold in 1996 with $72,000 of the proceeds of disposition allocated to the eligible capital property.

Transaction or item	Increase/(Decrease)	CEC Balance
1992 taxation year		
Opening balance		$ 0
EC expenditure of $40,000 (.75 x 40,000)	$ 30,000	30,000
20(1)(*b*) deduction (.07 x 30,000)	(2,100)	27,900
1993 taxation year:		
20(1)(*b*) deduction (.07 x 27,900)	(1,953)	25,947
1994 taxation year:		
20(1)(*b*) deduction (.07 x 25,947)	(1,816)	24,131
1995 taxation year:		
20(1)(*b*) deduction (.07 x 24,131)	(1,689)	22,442
1996 taxation year:		
Proceeds of disposition of $72,000 (deduct .75 x $72,000)	(54,000)	(31,558)

The negative balance of $31,558 will result in the following inclusions in business income:

Recapture under subparagraph 14(1)(a)(iv):		
Lesser of:		
i. negative balance	*$31,558*	
ii. "F" in "cumulative eligible capital"	*$7,558*	
Recapture		*$7,558*
Income under subparagraph 14(1)(a)(v) using the formula "A - B - C - D":		
A (the negative balance)	*$31,558*	
B ("F" in "cumulative eligible capital")	*$7,558*	
C (1/2 of "Q" in "cumulative eligible capital")	*$0*	
D (exempt gains balance for 1996) .	*$15,000*[1]	
Income inclusion		*$9,000*
TOTAL business income inclusion under subsection 14(1) for 1996 . .		*$16,558*

[1] *The exempt gains balance for 1996 arises from the election under subsection 110.6(19) in respect of the business. That election resulted in a taxable capital gain under paragraph 110.6(19)(b) of $15,000. This is the amount that, under the existing legislation, would have been the taxable capital gain determined under subparagraph 14(1)(a)(v) if the 1994 fiscal period of the business had ended at the end of February 22, 1994 and the taxpayer had disposed of all the eligible capital property in respect of the business immediately before that time for proceeds of disposition of $60,000 (the amount designated in the election).*

Where an individual has disposed of a business before February 23, 1994 and, because of an election made under subsection 25(1) of the Act, the fiscal period of the business ends after February 22, 1994, the existing rules under subsection 14(1) apply to the gain, if any, realized on the disposition of the eligible capital property in respect of the business. The individual's taxable capital gain, if any, arising under existing paragraph 14(1)(a)(v) will be reflected in the individual's annual gains limit under subsection 110.6(1) because it arose as a result of a disposition that occurred before February 23, 1994.

However, where an individual still carries on a business on February 22, 1994, the new rules will apply to the business at the end of the fiscal period that includes that day notwithstanding the fact that the individual may have disposed of eligible capital property in respect of the business before February 23, 1994. This means that the disposition may result in a business income inclusion under subparagraph 14(1)(a)(v) rather than a taxable capital gain. If the individual wishes to shelter the gain from the disposition from tax with the capital gains exemption, the individual must elect under subsection 110.6(19) in respect of the business. The proceeds from the disposition will be taken into account in determining the individual's taxable capital gain under paragraph 110.6(19)(b). The taxable capital gain arising under that paragraph will be credited to the individual's exempt gains balance in respect of the business which can then be used to reduce the business income inclusion that would otherwise result from the application of subparagraph 14(1)(a)(v) to the business at the end of the fiscal period.

Subclauses 5(2) and 5(3)

ITA
14(5)

Subsection 14(5) of the Act contains several definitions for the purpose of section 14. Consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) for recognizing gains accrued to that day, the definition "cumulative eligible capital" is amended and the definition "exempt gains balance" is added.

The description of B in the definition "cumulative eligible capital" is amended as a consequence of the amendments to subparagraph 14(1)(a)(v). Effective for fiscal periods that end after February 22, 1994, there will be credited to a taxpayer's cumulative eligible capital in respect of a business the amounts that were included under that subparagraph in computing the taxpayer's income from the business for preceding taxation years or that would have been so included if the taxpayer had not used his or her exempt gains balance in respect of the business to reduce those amounts.

The new definition "exempt gains balance" is relevant in determining the amount by which a taxpayer is permitted to reduce the amount that would otherwise be included under subparagraph 14(1)(a)(v) in computing the taxpayer's income from a business. A taxpayer's exempt gains balance in respect of a business represents the unclaimed portion of the taxable capital gain that was included in computing the taxpayer's income as a result of an election made under subsection 110.6(19) in respect of the business. The election allows a taxpayer to recognize the gains accrued to February 22, 1994 with respect to eligible capital property in respect of a business of the taxpayer and the exempt gains balance provides a mechanism to ensure that those gains are not taxed again on a later disposition of the property.

A taxpayer's exempt gains balance in respect of a business cannot exceed the amount that would have been the taxpayer's taxable capital gain if the amount designated in the election under subsection 110.6(19) in respect of the business were equal to the fair market value at the end of February 22, 1994 of all the taxpayer's eligible capital property in respect of the business. In addition, where the designated amount exceeds that fair market value, the exempt gains balance will be reduced by 3/4 of the excess over 11/10 of that fair market value. This reduction is illustrated in the following example.

Assume that the fair market value of an individual's eligible capital property in respect of a business on February 22, 1994 was $60,000 and that the individual's taxable capital gain determined under paragraph 110.6(19)(b) would have been $25,000 if the individual had designated $60,000 in the election in respect of the property. If the individual designates $70,000 in the election, the individual's exempt gains balance, before any portion thereof is *used to shelter an income inclusion under subparagraph 14(1)(a)(v), will be $22,000 (that is, $25,000 - .75($70,000 - 1.1($60,000)). The reduction in the exempt gains balance will increase the amount included in income on a subsequent disposition of the property in those circumstances where the individual has overstated its value for the purposes of the special election under subsection 110.6(19) relating to the $100,000 capital gains exemption.*

Subclause 5(4)

ITA
14(9)

New subsection 14(9) of the Act is consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) for recognizing gains accrued to that day.

Where an individual has elected under subsection 110.6(19) of the Act to recognize a gain in respect of his or her eligible capital properties in respect of a business, the taxable capital gain resulting from the election will be reflected in the individual's income for the taxation year in which the fiscal period of the business that includes February 22, 1994 ends. Where the amount designated in an election in respect of a business is greater than 11/10 of the fair market value at the end of February 22, 1994 of the eligible capital property then owned by the individual making the election, the amount that is credited to the individual's exempt gains balance in respect of the business is the amount that would have been the individual's taxable capital gain if the designated amount had been equal to that fair market value less 3/4 of the excess. (For an illustration of the effect of an excessive election on an individual's exempt gains balance, see the commentary on the definition "exempt gains balance" in subsection 14(5)). Where the excess is greater than 4/3 of the maximum exempt gains balance that could have been obtained by an individual, the balance of the excess is deemed by new subsection 14(9) to be proceeds of disposition of eligible capital property in respect of the business. This will reduce the individual's cumulative eligible capital in respect of the business and could result in an income inclusion under subsection 14(1). The following example illustrates the operation of new subsection 14(9).

Mr. X started a business in 1993 and made eligible capital expenditures of $10,000 in respect of the business in that year. The business has a December 31 year-end. Mr. X claimed no deductions under paragraph 20(1)(b) in computing his income from the business. Accordingly, the cumulative eligible capital in respect of the business on January 1, 1994 was $7,500 (that is, .75($10,000)). The eligible capital property in respect of the business had a fair market value on February 22, 1994 of $12,000. However, Mr. X overestimated the value of the goodwill and designated $24,000 in his election under subsection 110.6(19) in respect of the business. This election resulted in a taxable capital gain of $10,500 (that is, .75($24,000) - $7,500) all of which was sheltered by the lifetime capital gains exemption.

The amount credited to Mr. X's exempt gains balance in respect of the business as a result of the election is reduced to nil because $8,100, being 3/4 of the excess over 11/10 of the fair market value on February 22, 1994 of the eligible capital property in respect of the business, is greater than the $1,500 taxable capital gain that would have resulted had he designated $12,000 in the election in respect of the business (that is, .75($24,000 - 1.1($12,000)) is greater than $1,500).

In addition, Mr. X is deemed by subsection 14(9) to have received proceeds of disposition of eligible capital property of $8,800 (that is, 4/3($8,100 - $1,500)). This results in a reduction of Mr. X's cumulative eligible capital in respect of the business to $900 (that is, $7,500 - .75($8,800)). If the cumulative eligible capital in respect of the business had been less than $6,600, the deemed proceeds of disposition would have resulted in a business income inclusion under paragraph 14(1)(a) for his 1994 taxation year.

Clause 6

Prohibited Deductions - Business and Property Income

ITA
18

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

Subclause 6(1)

ITA
18(9)(a)(iii)

Subsection 18(9) of the Act prohibits the deduction of certain prepaid expenses before the taxation year to which the expenses relate. Paragraph 18(9)(a) lists the amounts to which the subsection applies. Subparagraph 18(9)(a)(iii) provides that the subsection applies to an outlay made or an expense incurred as consideration for insurance in respect of a period after the end of the taxation year in which the outlay was made or the expense incurred, unless the taxpayer is an insurer and the consideration is for reinsurance.

Subparagraph 18(9)(a)(iii) is amended to also exclude a premium under a group term life insurance policy in respect of an individual where all or part of the premium is for insurance in respect of a period that ends more than 13 months after the premium is paid. In particular, premiums for paid-up life insurance under group term life insurance policies will not be subject to subsection 18(9). Rules are being introduced in new subsection 18(9.01) of the Act for the deduction of certain premiums paid before 1997 that are excluded from subparagraph 18(9)(a)(iii). For premiums paid after 1996 that are excluded from subparagraph 18(9)(a)(iii), no special deduction rules will apply.

The amendment to subparagraph 18(9)(a)(iii) applies to premiums paid after February 1994.

Subclause 6(2)

ITA
18(9.01)

New subsection 18(9.01) of the Act contains rules for the deduction of certain employer-paid premiums under group term life insurance policies. The subsection applies to a premium paid under such a policy after February 1994 and before 1997 for life insurance on an individual where the insurance is for the remainder of the individual's lifetime and no further premiums will be payable for the insurance. Such insurance is commonly referred to as paid-up insurance.

Where subsection 18(9.01) applies to a premium paid by a taxpayer, the taxpayer is, in general terms, required to spread the deduction of the premium over 3 years. More specifically, the amount that may be deducted in any taxation year is the lesser of the amount of the premium remaining to be deducted and the amount determined by the formula

$$1/3 \times A \times C/365$$

where

A = the deductible portion of the premium -- this will usually be the full amount of the premium, but could be a smaller amount where, for example, the taxpayer is the beneficiary for all or part of the insurance proceeds

C = the number of days in the taxation year.

If the individual in respect of whom the premium was paid dies before the taxpayer has deducted the full amount of the deductible portion of the premium, the remainder may be deducted in the year of death.

Where a taxpayer has elected under section 28 of the Act to use a cash-basis method of accounting in respect of a farming or fishing business, subsection 18(9.01) would not apply with respect to the deduction of premiums for paid-up insurance.

The rules in new subsection 18(9.01) ensure that deductions for premiums for paid-up insurance match, reasonably closely, the income inclusions required by the taxable benefit rules in draft section 2703 of the Regulations (released by the Minister of Finance on June 16, 1994).

Clause 7

Deductions in Computing Income from Business or Property

ITA
20

Section 20 of the Act provides rules relating to the deductibility of certain outlays, expenses and other amounts in computing a taxpayer's income for a taxation year from business or property.

Subclause 7(1)

ITA
20(1)(ss) and (tt)

New paragraph 20(1)(ss) of the Act provides that contributions made by a taxpayer to a mining reclamation trust of which the taxpayer is a beneficiary are deductible in computing the taxpayer's income for the taxation year in which the contributions were made. This measure applies to contributions made after February 22, 1994. However, a special transitional rule applies in the case of mining reclamation trusts to which contributions were first made after 1991 but before February 23, 1994. In this case, contributions made before February 23, 1994 will be considered to be made on February 23, 1994 so that they will qualify for deduction under new paragraph 20(1)(ss). For further discussion on this point, see the commentary on the definition "mining reclamation trust" in subsection 248(1).

New paragraph 20(1)(tt) provides that any consideration paid by a taxpayer for the acquisition of an interest in a mining reclamation trust is deductible in computing the taxpayer's income for the year of acquisition. For this purpose, taxpayer consideration does not include the assumption of a mining reclamation obligation in respect of the trust.

It is intended that amounts deductible under paragraph 20(1)(ss) or (tt) will not be deducted for the purposes of determining a taxpayer's resource allowance. Part XII of the *Income Tax Regulations* will be amended to this effect.

These amendments apply to taxation years ending after February 22, 1994.

Subclause 7(2)

ITA
20(4.2)(a)(ii)

Where a debt that arose on the disposition of eligible capital property subsequently becomes uncollectible, subsection 20(4.2) provides the taxpayer with a deduction equal to 3/4 of the unrecoverable amount except to the extent that it relates to a taxable capital gain that was sheltered by the lifetime capital gains exemption. To the extent that a deduction is denied because it relates to such a taxable capital gain, it is treated as an allowable capital loss.

Subparagraph 20(4.2)(a)(ii) is amended consequential on the elimination of the $100,000 lifetime capital gains exemption and the introduction of the mechanism to recognize gains accrued to February 22, 1994. Where the accrued gain in an individual's eligible capital properties in respect of a business is recognized by means of an election under subsection 110.6(19), 3/4 of the gain will ordinarily be reflected in the individual's exempt gains balance. This exempt gains balance can be used to shelter income inclusions that arise under subparagraph 14(1)(a)(v) when those gains are later realized.

Subparagraph 20(4.2)(a)(ii) is amended, effective for taxation years that end after February 22, 1994, to deny the deduction to the extent that the debt relates to proceeds of disposition that either resulted in a taxable capital gain that was sheltered by the lifetime capital gains exemption or, because of the recipient's exempt gains balance in respect of the business, did not result in an income inclusion under subsection 14(1).

Subclause 7(3)

ITA
20(26)

Subsection 20(26) of the Act is a transitional provision introduced in conjunction with the 1987 tax reform measures affecting the treatment of the reserves of financial institutions. It permitted such institutions to claim a deduction from income, based on their net reserve adjustment, in their first taxation year that began after June 17, 1987 and ended after 1987.

Subsection 20(26) is replaced by a transitional provision relating to the introduction of the requirement that insurers fully discount their unpaid claims reserves for tax purposes. As amended, subsection 20(26) permits an insurer to deduct, in calculating its income for its taxation year that includes February 23, 1994, an amount not exceeding the amount prescribed to be the insurer's unpaid claims reserve adjustment.

The *Income Tax Regulations* will be amended to provide that an insurer's unpaid claims reserve adjustment is the difference between the maximum unpaid claims reserve that was deductible by it, under subparagraph 1400(e)(ii) of the Regulations, in its last taxation year ending before February 23, 1994 and the maximum reserve that would have been deductible if the reserve for unpaid claims had been determined on a fully discounted basis.

Section 12.3 of the Act, as amended in this Bill, requires an insurer claiming a deduction under subsection 20(26) to include the amount deducted in income over a 10-year period, starting in the its first taxation year ending after February 22, 1994. For further information, see the commentary on section 12.3.

The amendment to subsection 20(26) applies to taxation years that include February 23, 1994.

Clause 8

Ceasing to Carry on Business

ITA
24(2)(d)(ii)

Subsection 24(2) provides a rollover of the cumulative eligible capital in respect of a business of an individual who ceases to carry on the business in circumstances where the eligible capital property in respect of the business is acquired by the individual's spouse or by a corporation controlled by the individual who thereafter carries on the business. Subparagraph 24(2)(d)(ii) is amended, consequential on the amendment to subparagraph 14(1)(a)(v), to ensure that there will not be an over-inclusion of income under that subparagraph for any subsequent dispositions by the individual's spouse or corporation because of deductions claimed under paragraph 20(1)(b) in respect of fiscal periods of the business that ended before the individual's adjustment time in respect of the business (within the meaning assigned by subsection 14(5)).

Clause 9

Scientific Research and Experimental Development

ITA
37

Section 37 of the Act sets out the rules for the deduction of expenditures incurred by a taxpayer on scientific research and experimental development (SR&ED) both inside and outside Canada.

Subclause 9(1)

ITA
37(1)

Subsection 37(1) of the Act allows a taxpayer carrying on business in Canada to deduct certain current and capital expenditures incurred on SR&ED carried on in Canada. The expenditures must be identified by the taxpayer in a prescribed form filed with the taxpayer's return of income for the year.

Under amended subsection 37(1), the time for filing the prescribed form is extended as a consequence of the new filing requirements in the definition "qualified expenditure" in subsection 127(9) of the Act. Amended subsection 37(1) provides that the prescribed form must be filed by the day on or before which the taxpayer's return of income is required to be filed under Part I, or would be so required if tax were payable, for the taxation year following the year in which the expenditures were incurred. This amendment applies after February 21, 1994 to SR&ED expenditures incurred at any time. For SR&ED expenditures incurred in taxation years ending before February 22, 1994, a taxpayer may file the prescribed form in respect of those expenditures by the later of the day provided for in new subsection 37(1) and the day that is 90 days after the date on which the Bill containing this legislation receives Royal Assent.

Subclause 9(2)

ITA
37(11)

New subsection 37(11) of the Act has the same effect as has subsection 127(11.4) of the Act. New subsection 37(11) provides that a taxpayer is not required to file the prescribed form referred to in subsection 37(1) for an SR&ED expenditure that is reclassified as such by the Minister of National Revenue where the reclassification is made in the course of an audit initiated by the Minister. In these circumstances, a taxpayer will not be prohibited from treating the expenditure as an SR&ED expenditure for the purpose of subsection 37(1) solely because the taxpayer failed to file the prescribed form in respect of the expenditure. The Minister of National Revenue will not, however, reclassify an expenditure as a result of a taxpayer requested adjustment.. New subsection 37(11) applies after February 21, 1994.

Clause 10

Meaning of Capital Gain and Capital Loss

ITA
39

Section 39 of the Act sets out the meaning of capital gain, capital loss and business investment loss and provides a number of special rules relating to capital gains.

Subclause 10(1)

ITA
39(1)(a)(v)

A taxpayer's capital gain for a taxation year from the disposition of property is determined under paragraph 39(1)(a) of the Act.

Subparagraph 39(1)(a)(v) is introduced so that a disposition from a property that is an interest of a beneficiary under a mining reclamation trust does not give rise to any capital gain.

This amendment applies to taxation years ending after February 22, 1994.

Subclause 10(2)

ITA
39(1)(b)(ii)

A taxpayer's capital loss for a taxation year from the disposition of property is determined under paragraph 39(1)(b) of the Act.

Subparagraph 39(1)(b)(ii) is amended to provide that a disposition from a property that is an interest of a beneficiary under a mining reclamation trust does not give rise to any capital loss.
Subparagraph 39(1)(b)(ii) is also amended to clarify that a disposition of a foreign resource property does not give rise to any capital loss.

These amendments apply to taxation years ending after February 22, 1994.

Subclause 10(3)

ITA
39(11)

Where an amount receivable by a taxpayer as proceeds of disposition of eligible capital property becomes uncollectible, 3/4 of the uncollectible amount may be deducted under subsection 20(4.2) to the extent that the proceeds did not relate to a taxable capital gain that was sheltered from tax by the lifetime capital gains exemption. The balance of the uncollectible amount is deemed by that subsection to be an allowable capital loss. Where the amount is later recovered, subsection 39(11) deems the portion of the recovered amount that was previously treated as a capital loss to be a taxable capital gain from the disposition of a capital property and, for the purposes of section 110.6, that property is deemed to have been disposed of in the year in which the amount is recovered.

Consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized after February 22, 1994 and the related changes to section 14, the reference to section 110.6 is deleted from subsection 39(11) for the 1995 and subsequent taxation years. For the 1994 taxation year, the taxable capital gain arising under that subsection is considered to have arisen, for the purposes of section 110.6, on the day of receipt of the recovered amount. Thus, where the recovered amount was received before February 23, 1994, the resulting taxable capital gain will still be eligible for the capital gains exemption.

Clause 11

Capital Gains

ITA
39.1

New section 39.1 of the Act is consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of the election mechanism under new subsection 110.6(19) for recognizing gains accrued to that day.

Where an individual elects under subsection 110.6(19) in respect of an interest in, or a share of the capital stock of, a certain type of flow-through entity, the gain recognized on the deemed disposition of the interest will not increase its adjusted cost base to the individual. Instead, the gain is credited to a special account that is defined as the "exempt capital gains balance" of the individual in respect of the entity. This exempt capital gains balance can be used to shelter the following gains:

- a capital gain realized on a later disposition of an interest in or share of the capital stock of the entity, and

- a capital gain of the entity that is flowed out to the individual.

Subsection 39.1(1) defines certain terms relevant to section 39.1. Subsection 39.1(2) provides the mechanism for reducing the capital gain otherwise determined on a disposition of an interest in or a share of the capital stock of a flow-through entity that was the subject of an election under subsection 110.6(19). Subsections 39.1(3), (4) and (6) provide the mechanism for reducing an individual's share of a partnership's taxable capital gains or an individual's taxable capital gains or capital gains that result from the capital gains flow-through mechanisms provided by subsections 104(21), 130.1(4), 131(1), 138.1(3) and (4) and 144(3). Subsection 39.1(5) provides the mechanism for reducing an individual's share of partnership business income to the extent of the individual's share of amounts included under subparagraph 14(1)(a)(v) in computing income at the partnership level. Subsection 39.1(7) reduces to nil the exempt capital gains balance of an individual in respect of a flow-through entity where the individual ceases to have any interest therein.

ITA
39.1(1)

New subsection 39.1(1) of the Act defines certain terms that are relevant to the application of section 39.1.

"Exempt capital gains balance"

The exempt capital gains balance of an individual for a taxation year in respect of a flow-through entity represents the unclaimed balance of the capital gains that were included in computing the individual's income as a result of elections made under subsection 110.6(19) in respect of the individual's interest in or shares of the capital stock of the entity.

Where the flow-through entity is a trust referred to in any of paragraphs (f) to (j) of the definition "flow-through entity" in this subsection, an individual's exempt capital gains balance for the 1994 taxation year will be the individual's capital gain resulting from elections made under subsection 110.6(19) in respect of his or her interests in the trust (which cannot exceed the individual's share of the net capital gains of the entity accrued to February 22, 1994). These types of flow-through entities include

- related segregated fund trusts,
- trusts governed by employees profit sharing plans,
- trusts created to hold shares of the capital stock of corporations for the benefit of their employees,
- trusts established for the benefit of creditors to secure certain debt obligations, and
- certain voting trusts where the purpose of the trust is to provide for the exercise of voting rights attached to shares held by the trust.

An individual's exempt capital gains balance for the 1994 taxation year in respect of any other type of a flow-through entity is the total of the individual's capital gains that resulted from elections made under subsection 110.6(19) in respect of the individual's interests in or shares of the capital stock of the entity. However, the exempt capital gains balance in respect of the entity cannot exceed the amount that would have been the individual's total capital gains resulting from the elections made in respect of the individual's interests in or shares of the capital stock of the entity if the amounts designated in the elections in respect of those interests or shares were equal to their fair market value at the end of February 22, 1994. Where the total of the designated amounts exceeds that fair market value, the individual's exempt capital gains balance for 1994 will be reduced by the excess above 11/10 of that fair market value. This reduction is illustrated in the following example.

Assume that the fair market value of an individual's units in a mutual fund trust at the end of February 22, 1994 was $60,000 and the total of their adjusted cost bases was $40,000. The individual's capital gain, had the individual designated $60,000 in the election in respect of the units, would have been $20,000. If the individual designates $70,000 in the election, the individual will recognize a capital gain of $30,000. However, the individual's exempt gains balance in respect of the fund (before any reductions for amounts claimed under subsections 39.1(2) to (6)) will be limited to $16,000 (that is, $20,000 - ($70,000 - 1.1($60,000))).

An individual's exempt capital gains balance in respect of a flow-through entity for a taxation year is reduced by amounts claimed in previous years under subsections 39.1(2) to (6) to reduce capital gains otherwise determined on dispositions of interests in or shares of the capital stock of the entity or taxable capital gains or capital gains flowed out to the individual by the entity.

An individual who elects in respect of interests in or shares of the capital stock of more than one flow-through entity will have a separate exempt capital gains balance in respect of each entity.

The definition "exempt capital gains balance" applies only to taxation years that end before 2005, so that capital gains realized in 2005 or a later year may no longer be reduced or eliminated through this mechanism. (See the note to new paragraph 53(1)(p) of the Act in this material.) In addition, where an individual ceases to have any interest in the entity, the individual's exempt capital gains balance in respect of the entity will be reduced by subsection 39.1(7) to nil.

"Flow-through entity"

"Flow-through entity" includes an investment corporation, a mortgage investment corporation, a mutual fund corporation, a mutual fund trust, a partnership, a related segregated fund trust, a trust governed by an employees profit sharing plan, a trust created to hold shares of the capital stock of a corporation for the benefit its employees, a trust established for the benefit of creditors to secure certain debt obligations and a trust established to hold shares where the purpose of the trust is provide for the exercise of voting rights attached to those shares. Generally, these types of entities are treated as conduits for income tax purposes, such that capital gains recognized by the entity are or may be flowed out to, and taxed as capital gains in the hands of, its members or investors.

ITA
39.1(2) to (6)

New subsection 39.1(2) allows an individual to claim a reduction in the capital gain otherwise determined for a taxation year from a subsequent disposition of an interest in or share of the capital stock of a flow-through entity. The reduction is limited to the individual's exempt capital gains balance for the year in respect of the entity.

Subsection 104(21) of the Act provides a flow-through mechanism for taxable capital gains of trusts. Where a trust makes a designation under that subsection in respect of a beneficiary, the designated amount is treated as a taxable capital gain of the beneficiary. New subsection 39.1(3) allows an individual to claim a reduction in the taxable capital gain otherwise determined for a taxation year as a result of a designation under subsection 104(21) by a flow-through entity. The reduction is limited to 3/4 of the individual's exempt capital gains balance for the year in respect of the entity.

A member of a partnership is taxed on his or her share of the income of a partnership for its fiscal period ending in the member's taxation year. For this purpose, taxable capital gains at the partnership level are treated as taxable capital gains of its members to the extent of their respective shares thereof. New subsection 39.1(4) allows an individual to claim a reduction in the individual's share of a partnership's taxable capital gains for a fiscal period ending in the individual's taxation year. The reduction is limited to 3/4 of the individual's exempt capital gains balance for the year in respect of the partnership.

New subsection 39.1(5) allows an individual who is a member of a partnership to shelter, with his or her exempt capital gains balance in respect of the partnership, that part of his or her share of the partnership's income from a business that is attributable to an amount included under subparagraph 14(1)(a)(v) in computing the partnership's income from the business. For this purpose, members of a partnership share in the amount determined under that subparagraph in respect of a business of the partnership pro rata in proportion to their share of the partnership's income from the business. Where a partnership has a loss from a business for a fiscal period, any inclusion under subparagraph 14(1)(a)(v) in respect of the business for that fiscal period will not give rise to a claim under subsection 39.1(5) by any of its members.

Subsections 130.1(4), 131(1), 138.1(3) and (4) and 144(3) provide flow-through mechanisms for capital gains of investment corporations, mortgage investment corporations, mutual fund corporations, related segregated fund trusts and trusts governed by employees profit sharing plans. New subsection 39.1(6) allows an individual to claim a reduction in the individual's capital gains otherwise determined for a taxation year under any of those provisions in respect of a flow-through entity. The reduction is limited to the individual's exempt capital gains balance for the year in respect of the entity.

An individual's exempt capital gains balance in respect of a flow-through entity is reduced by claims made under subsections (2) to (6) to reduce gains realized in connection with that entity.

The following example illustrates the calculation of an individual's exempt capital gains balance in respect of a mutual fund trust.

Assume an individual owns 1000 units of a mutual fund trust on February 22, 1994. Their fair market value at the end of that day is $10,000 and their adjusted cost base to the individual at that time is $8,000. The individual elects under subsection 110.6(19) and designates $10,000 ($10.00 per unit) in respect of the units. The units do not constitute non-qualifying real property.

In August 1994, the individual acquires 500 additional units of the trust for $5,500 ($11.00 per unit).

The trust designates $300 under subsection 104(21) in respect of the individual for 1994. This amount is deemed by that subsection to be taxable capital gain of the individual.

The individual disposes of 750 units in 1995 for proceeds of $7,650 ($10.20 per unit) and of the remaining 750 units in 1996 for proceeds of $7,850 ($10.47 per unit).

Event	Adjusted cost base	Proceeds	Capital gain	Taxable capital gain	Exempt capital gains balance /	year
110.6(19) election on 1,000 units	$8,000[1]	$10,000	$2,000	$1,500 [2]	+$2,000 $2,000	1994
Aug/94 purchase of 500 units	+$5,500 $13,500					
104(21) designation for 1994				$300 -$300 [3] nil	-$400 [4] $1,600	1995
1995 disposition of 750 units	-$6,750 $6,750	$7,650	$900 -$900 [5] nil	nil	-$900 [5] $700	1996
1996 disposition of remaining units	-$6,750 nil	$7,850	$1,100 -$700.[5] $400	$300	-$700.[5] nil	1997

1 *The election under subsection 110.6(19) does not affect the adjusted cost base of the units.*
2 *This amount will be exempt from tax because of the $100,000 lifetime capital gains exemption provided in subsection 110.6(3).*
3 *Reduction claimed under subsection 39.1(3).*
4 *4/3 of reduction claimed under subsection 39.1(3).*
5 *Reduction claimed under subsection 39.1(2).*

ITA
39.1(7)

Where at any time an individual ceases to have any interest in a flow-through entity, the individual's exempt capital gains balance in respect of the entity for all taxation years that begin after that time is reduced to nil. This would occur where, for example, an individual's units in a mutual fund trust declined in value after February 22, 1994 and all of the units are sold or redeemed for proceeds less than the amount designated by the individual in the election under subsection 110.6(19) in respect of the units.

Clause 12

Capital Gains and Losses - General Rules

ITA
40

Section 40 of the Act provides rules for determining a taxpayer's capital gain or capital loss from a disposition of property.

Subclause 12(1)

ITA
40(2)(b)

Existing paragraph 40(2)(b) of the Act reduces the capital gain otherwise determined with respect to the disposition of real property that was, at any time since it was last acquired by a taxpayer, the taxpayer's principal residence. This paragraph is amended, effective for dispositions that occur after February 22, 1994, as a consequence of the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of a mechanism in subsection 110.6(19) for recognizing gains accrued to that day.

As amended, paragraph 40(2)(b) reduces a taxpayer's capital gain otherwise determined with respect to the disposition of real property that was, at any time since it was last acquired by the taxpayer, the taxpayer's principal residence by two amounts. For this purpose, the capital gain otherwise determined is determined without reference to the deemed disposition and reacquisition of the property because of an election made under subsection 110.6(19). In other words, the capital gain that is reduced under paragraph 40(2)(b) is the capital gain that would have been determined if the adjusted cost base of the property had not been increased as the result of an election under that subsection.

- The first amount, which is the principal residence exemption provided in the existing Act, is a prorated portion of the gain otherwise determined. This is calculated by multiplying that gain by a fraction the numerator of which is one plus the number of taxation years that the property was the taxpayer's principal residence and the denominator of which is the number of taxation years during which the property was owned by the taxpayer.

- The second amount is 4/3 of the lesser of

  - the maximum taxable capital gain, which is the total taxable capital gains (after deducting the principal residence exemption) of the taxpayer and the spouse of the taxpayer that would have resulted from an election under subsection 110.6(19) in respect of the property or an interest therein that was owned by the taxpayer immediately before the disposition if

    - the election were not rendered ineffective by subsection 110.6(20), and

    - the amount designated in the election were equal to the fair market value of the property or interest at the end of February 22, 1994 or, where the amount actually designated exceeded 11/10 of that fair market value, the amount by which that fair market value exceeded that excess, and

  - the reported taxable capital gain, which is the amount that would have been the total taxable capital gains (after deducting the principal residence exemption) of the taxpayer and the spouse of the taxpayer that would have resulted from an election that was actually made under subsection 110.6(19) in respect of the property or an interest therein that was owned by the taxpayer immediately before the disposition if each principal residence designation made in a return of income for a taxation year that began after February 22, 1994 were ignored.

In determining for the purpose of paragraph 40(2)(b) when a property was last acquired by a taxpayer, the deemed reacquisition of the property under subsection 110.6(19) will be ignored if the property is designated as the taxpayer's principal residence for any taxation year in the taxpayer's return of income for the taxation year in which the property is subsequently disposed of or in which an option in respect of the property is granted.

In determining the maximum taxable capital gain (under clause (i)(A) of the description of D in paragraph 40(2)(b)) that would have resulted from the election, the taxpayer is required to take into account any principal residence designations made in respect of the property covered by the election regardless of whether they were made in the 1994 tax return or in the return for a subsequent year. This will ensure that a taxpayer does not obtain two deductions in respect of the gain accrued during a single period.

The impact of an election under subsection 110.6(19) in respect of a property that was for a time the elector's principal residence is illustrated in the following table.

		Example A	Example B	Example C	Example D
Assumptions:					
Original acquisition date		January 1983	March 1977	March 1973	January 1985
Adjusted cost base	(A)	$50,000	$35,000	$35,000	$40,000
FMV at end of 1981	(B)	n/a	$55,000	$50,000	n/a
FMV on Feb. 22, 1994	(C)	$110,000	$95,000	$105,000	$60,000
1994 deemed disposition:					
110.6(19) elected amount	(D)	$110,000	$95,000	$105,000	$80,000
Years designated as principal residence		1992 - 94	1977 - 81	none	1992 - 94
Gain otherwise determined for 40(2)(b) [D - A]	(E)	$60,000	$60,000	$70,000	$40,000
Principal residence portion	(F)	$20,000	$20,000	nil	$16,000
Capital gain [E - F]	(G)	$40,000	$40,000	$70,000	$24,000
Months owned before March 1992[1]	(H)	108	122	228	84
Months owned before March 1994[1]	(I)	108	146	252	84
Eligible real property gain [G x H/I]	(J)	$40,000	$33,425	$63,333	$24,000
Taxable capital gain [.75 x J]	(K)	$30,000	$25,068	$47,500	$18,000
ACB immediately after reacquisition [C - (G - J)]	(L)	$110,000	$88,425	$98,333	$46,000[2]
Subsequent disposition:					
Year of disposition		1996	1996	2002	2002
Years designated as principal residence		1992-96	none	1973-81	none
Proceeds of disposition	(M)	$125,000	$109,000	$130,000	$83,000
Costs of disposition	(N)	$5,000	$4,000	$5,000	$3,000
Capital gain [M - N - L]	(O)	n/a	$16,575	n/a	$34,000
Gain otherwise determined for 40(2)(b) [M - N - A]	(P)	$70,000	n/a	$90,000	n/a
Principal residence portion	(Q)	$30,000	n/a	$30,000	n/a
Maximum gain from deemed disposition	(R)	$40,000	n/a	$36,083[3]	n/a
Reported gain from deemed disposition	(S)	$40,000	n/a	$63,333	n/a
Lesser of (R) and (S)	(T)	$40,000	n/a	$36,083	n/a
Capital gain [P - Q - T]	(U)	$0	n/a	$23,917	n/a
Taxable capital gain [.75 x (O or U)]	(V)	$0	$12,431	$17,938	$25,500

[1] *Each month in a taxation year during with the property was the taxpayer's principal residence is excluded because of paragraph 110.6(18)*(d).

[2] *The property is considered to have been reacquired at a cost less than the designated proceeds of disposition (amount D) because the designated amount exceeded the fair market value of the property at the end of February 22, 1994 (amount C). The new cost (amount L) is the fair market value of the property at that time less the amount by which the designated amount exceeds 11/10 of that fair market value (that is, $60,000 - ($80,000 - 1.1($60,000))).*

[3] *Having designated the property as a principal residence for the 1973 to 1981 taxation years, the individual's maximum eligible real property gain that could have resulted from an election in respect of the property under subsection 110.6(19) is \$36,083 (that is, 122/146 x (\$70,000 - (9 + 1)/22(\$70,000))). For this purpose, the fraction 122/146 is determined excluding all months in those taxation years during which the property was a principal residence.*

Subclause 12(2)

ITA
40(3.1)

New subsection 40(3.1) of the Act provides that a member of a partnership is considered to realize a gain from the disposition, at the end of a fiscal period of the partnership, of the member's interest in the partnership where, at the end of the fiscal period, the member is a "limited partner" or was since becoming a partner a "specified member" of the partnership and the member's adjusted cost base of the interest is "negative" at that time. However, new subsection 40(3.1) does not apply where the partnership interest was held by the member on February 22, 1994 and is an "excluded interest".

Where new subsection 40(3.1) applies to a member of a partnership, the member is required to include in calculating income for the taxation year, which includes the time at which the partnership's fiscal period ends, a gain from the disposition of the member's partnership interest equal to the amount determined under new subsection 40(3.11) of the Act.

Reference should also be made to the definition "specified member" in subsection 248(1) of the Act. For details of whether a member is considered to be a "limited partner" of a particular partnership or has an "excluded interest", reference may be made to the commentary below on new subsections 40(3.14) and (3.15) of the Act. Also see new subparagraph 53(2)(c)(i.3) of the Act which provides a reduction to the adjusted cost base of a member's partnership interest to the extent of any limited-recourse debt of the member used to finance the purchase of the partnership interest.

Generally, new subsection 40(3.1) applies after February 21, 1994. However, subsection 40(3.1) does not apply to a member of a partnership until the end of the partnership's fifth fiscal period ending after 1994 where the conditions described in the "coming-into-force" provision for these amendments are satisfied.

For a description of further transitional relief, see the commentary on new subsections 40(3.15) to (3.18).

ITA
40(3.11)

New subsection 40(3.11) of the Act provides a formula to determine the gain of a member of a partnership for the purpose of new subsection 40(3.1). The amount determined by the formula equals any "negative" balance in the adjusted cost base of the member's partnership interest at the end of a fiscal period of the partnership.

Reference may also be made to new subparagraph 53(1)(e)(vi) of the Act which provides for an addition to the adjusted cost base of a member's partnership interest to the extent of any gain realized by the member under new subsection 40(3.1).

Generally, new subsection 40(3.11) applies after February 21, 1994.

ITA
40(3.12)

New subsection 40(3.12) of the Act provides that a corporation, an individual (other than a trust) or a testamentary trust which is a member of a partnership at the end of a fiscal period of the partnership may elect in certain circumstances to treat a positive adjusted cost base ("ACB") as a capital loss from the disposition of the partnership interest at that time. However, such amount may not exceed the amount by which previous gains required to be reported under new subsection 40(3.1) exceeds previous losses claimed under new subsection 40(3.12).

New subparagraph 53(2)(c)(i.2) provides a reduction to the ACB of a member's partnership interest to the extent of any loss realized by the member under this subsection.

Generally, new subsection 40(3.12) applies after February 21, 1994.

ITA
40(3.13)

New subsection 40(3.13) of the Act is an anti-avoidance rule designed to prevent artificial increases in the adjusted cost base of a partner's interest in a partnership by way of a contribution of capital to the partnership after February 21, 1994. This anti-avoidance rule applies to a member described in new subsection 40(3.1) where it is established that a loan or payment was made by the partnership (or a person with whom the partnership does not deal at arm's length) to the member (or a person with whom the member does not deal at arm's length) and the loan or payment was made or arose as part of a series of contributions to the partnership. In circumstances where this rule applies, the member's contribution of capital shall be treated as not having been made.

Generally, new subsection 40(3.13) applies after February 21, 1994.

ITA
40(3.14)

New subsection 40(3.14) of the Act provides an extended definition of "limited partner" which is relevant for the purpose of determining whether new subsection 40(3.1) applies to a member of a partnership.

Generally, new subsection 40(3.14) applies after February 21, 1994.

ITA
40(3.15)

New subsection 40(3.1) of the Act does not apply to a member of a partnership at the end of the fiscal period of a partnership if the member's partnership interest is an "excluded interest" and the member held the interest on February 22, 1994. New subsection 40(3.15) of the Act describes those partnership interests that are considered to be excluded interests for the purpose of new subsection 40(3.1).

An interest in a partnership at the end of a fiscal period of the partnership is an excluded interest if, at that time, the partnership actively carries on a business that was carried on by it continuously since February 22, 1994 (or earns income from a property that was owned by it throughout that period). However, a partnership interest will lose its status as an excluded interest if, after February 21, 1994, there has been a substantial contribution of capital to the partnership or a substantial partnership borrowing.

With respect to the determination of whether an amount is considered to be substantial, reference may be made to the commentary on new subsection 40(3.16) of the Act. Also, new subsections 40(3.17) and (3.18) of the Act provide rules concerning whether a partnership is considered to be carrying on business, or earning income from a property, throughout a period beginning on February 22, 1994.

Generally, new subsection 40(3.15) applies after February 21, 1994.

ITA
40(3.16)

New subsection 40(3.16) of the Act describes various circumstances where contributions to, or borrowing by, a partnership will not be considered to be substantial for the purpose of the grandfathering rule in subsection 40(3.15).

Generally, new subsection 40(3.16) applies after February 21, 1994.

ITA
40(3.17)

New subsection 40(3.15) of the Act sets out the meaning of "excluded interest" for the purposes of the exception from the rule in subsection 40(3.1) that deems a capital gain to have been realized in circumstances in which a partnership interest has a "negative" adjusted cost base. Pursuant to subsection 40(3.15), a partnership interest is an excluded interest only if the partnership has continuously since February 22, 1994 carried on the same business or earned income from the same property.

New subsection 40(3.17) provides that, for this purpose, a partnership in respect of which the transitional measures in paragraph (3.16)(a), (b) or (c) apply shall be considered to have actively carried on the business, or earned income from the property, contemplated by the documents referred to in those paragraphs continuously from

February 22, 1994 until the earlier of the closing date, if any, stipulated in the document and January 1, 1995.

Generally, new subsection 40(3.17) applies after February 21, 1994.

ITA
40(3.18)

New subsection 40(3.18) of the Act provides that a member of a partnership is considered to have held the member's partnership interest on February 22, 1994 where the member acquired the interest in certain circumstances. Where new subsection 40(3.18) applies, a member is considered to have held the partnership interest on February 22, 1994 for the purpose of new subsection 40(3.1) and may, therefore, be eligible for transitional relief from the effect of that subsection. With respect to whether the interest of such a member is also an "excluded interest", reference may be made to new subsections 40(3.15), (3.16) and (3.17).

Generally, new subsection 40(3.18) applies after February 21, 1994.

ITA
40(3.19)

New subsection 40(3.19) of the Act provides that subsection 40(3) does not apply in any case in which new subsection 40(3.1) applies.

Generally, this subsection applies after February 21, 1994.

ITA
40(3.2)

New subsection 40(3.2) of the Act provides that new subsection 40(3.1), which deems a member of a partnership to have a capital gain in certain circumstances, does not apply in any case in which paragraph 98(1)(c) or 98.1(1)(c) applies. Those latter paragraphs apply to deem a member of a partnership to have a capital gain equal to the "negative" adjusted cost base in the member's partnership interest where the partnership ceases to carry on business and where the member has a residual interest in a partnership. Generally, new subsection 40(3.2) applies after February 21, 1994.

Subclause 12(3)

ITA
40(6)(b)(ii)

Subsection 40(6) of the Act contains transitional rules that apply where more than one principal residence was owned by members of a family unit at the end of 1981. These rules were introduced when amendments were made to permit a family unit to treat only one residence as its principal residence for taxation years after 1981. Subparagraph 40(6)(b)(ii) is amended, consequential on the amendment to paragraph 40(2)(b), by changing the reference "subparagraph (2)(b)(i)" to "the description of B in paragraph (2)(b)".

Subclause 12(4)

ITA
40(7.1)

Where a taxpayer disposes of a property that was his or her principal residence at any time after the later of December 31, 1971 and the day on which the it was last acquired or reacquired by the taxpayer, existing paragraph 40(2)(b) of the Act reduces a capital gain otherwise determined by the principal residence portion thereof. Under paragraph 40(2)(b) as amended for dispositions occurring after February 22, 1994, the capital gain otherwise determined will be the gain determined ignoring not only paragraph 40(2)(b) but also any election made under subsection 110.6(19). Subsections 40(4) to (7) contain additional rules that are relevant in determining the principal residence portion of a gain under the formula in paragraph 40(2)(b).

New subsection 40(7.1) of the Act, which is effective for dispositions that occur after February 22, 1994, contains an interpretive rule for the purposes of paragraph 40(2)(b) and subsections 40(4) to (7). Where an election was made under subsection 110.6(19) in respect of a taxpayer's property that was the taxpayer's principal residence for the 1994 taxation year or that is designated, in the taxpayer's return of income for the year in which the property was disposed of or in which an option in respect of the property was granted, as the taxpayer's principal residence for any taxation year, the election is ignored in determining for the purposes of those provisions when the property was last acquired or reacquired by the taxpayer and the period throughout which it was owned by the taxpayer. As a result,

- the increase in the adjusted cost base of the property that resulted from the election will be ignored in computing the taxpayer's capital gain from the disposition, and

- the taxation years that ended before February 23, 1994 and during which the taxpayer owned the property will still be relevant in computing the principal residence portion of the gain.

Where the property is not the taxpayer's principal residence for the 1994 taxation year and is not designated as the taxpayer's principal residence in the taxpayer's return of income for the year in which the disposition occurs, the property will be considered to have last been reacquired immediately after the deemed disposition resulting from the election. Paragraph 40(2)(b) will not be relevant in determining the taxpayer's gain from the subsequent disposition.

Clause 13

Options

ITA
49(3.2)

Section 49 of the Act provides a number of rules that deal with the granting, expiry, exercise and renewal of options.

Where an option to acquire property is exercised, subsection 49(3) treats the previous granting of the option as not being a disposition of property by the grantor. Instead, the consideration received by the vendor for the granting of the option is added to the proceeds of disposition of the property disposed of as a result of the exercise of the option. Where the exercise of the option occurs in a taxation year subsequent to the year in which the option was granted and the grantor files an amended return for the earlier year, Revenue Canada is required by subsection 49(4) to reassess the earlier year.

New subsection 49(3.2) is added, consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, to allow the grantor of an option that was granted before February 23, 1994 and exercised after February 22, 1994 to elect not to have subsection 49(3) apply in respect of the option. The effect of such an election will be to treat the gain that arose on the granting of the option as a gain from a disposition that occurred before February 23, 1994. New subsection 49(3.2) applies to dispositions that occur after February 22, 1994.

Where a taxpayer elects under subsection 110.6(19) in respect of a property and the taxpayer previously granted to another person an option to acquire the property, the determination of the fair market value of the property at the end of February 22, 1994, for the purpose of determining the cost to the taxpayer of the property under subparagraph 110.6(19)(a)(ii), should take into account the existence of the option. Where a taxpayer designates in the election an amount greater than 11/10 of the fair market value of the property at that time, the cost to the taxpayer of the property is reduced below that fair market value by the amount of the excess. (See the commentary on new subsection 110.6(19) of the Act).

Clause 14

Adjustments to Cost Base

ITA
53

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

Subclause 14(1)

ITA
53(1)(e)(vi)

New subparagraph 53(1)(e)(vi) of the Act provides for an increase in the adjusted cost base ("ACB") of a taxpayer's partnership interest where the taxpayer has been required to report a gain under new subsection 40(3.1) in respect of a fiscal period of the partnership ending before the time the ACB is being computed. Generally, this subparagraph applies after February 21, 1994.

Subclause 14(2)

ITA
53(1)(e)(xii)

Paragraph 53(1)(e) of the Act requires certain amounts to be added in computing the adjusted cost base to a taxpayer of a partnership interest. New subparagraph 53(1)(e)(xii) is added as a consequence of the amendments to section 110.6 that permit individuals to recognize gains accrued to February 22, 1994. This subparagraph adds a reference to the addition required by new paragraph 110.6(23)(a). This addition is relevant only in computing an individual's capital gain from the deemed disposition of a partnership interest that results from a capital gains election made under subsection 110.6(19) in respect of the interest. A partner's share of a partnership's income for a fiscal period is not reflected in the adjusted cost base of the partner's interest until the end of that fiscal period. This addition requires an individual, for the purpose of computing his or her capital gain arising from a capital gains election in respect of a partnership interest, to take into account his or her share of the income of the partnership earned before February 23, 1994 and his or her share of the partnership's net taxable capital gains realized before that day. For this purpose, the income of a partnership for its fiscal period that includes February 22, 1994 is prorated. (See the commentary on new subsection 110.6(23)).

Subclause 14(3)

ITA
53(1)(p)

New paragraph 53(1)(p) is added consequential on the elimination of the $100,000 lifetime capital gains exemption for gains arising on dispositions that occur after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) for recognizing gains accrued to that day. Where an individual recognizes a capital gain accrued to that day on an interest in or a share of the capital stock of a flow-through entity (within the meaning assigned by subsection 39.1(1)), the amount of the gain is credited to a special account referred to as the individual's exempt capital gains balance in respect of the entity. Claims may be made against this account to reduce gains that are flowed out to the individual by the entity for taxation years before 2005 and gains realized on dispositions of interests in or shares of the entity in those years. If, at the end of 2004, an individual has not used up his or her exempt capital gains balance in respect of an entity in which he or she still holds an interest, the unused portion will thereafter be added to the adjusted cost base of the individual's remaining interest or interests therein.

Subclause 14(4)

ITA
53(2)(c)(i.2)

New subparagraph 53(2)(c)(i.2) of the Act provides a reduction in the adjusted cost base of a taxpayer's partnership interest equal to the amount of any capital loss reported by the taxpayer under new subsection 40(3.12) in respect of any preceding fiscal period of the partnership. Generally, this subparagraph applies after February 21, 1994.

ITA
53(2)(c)(i.3)

New subparagraph 53(2)(c)(i.3) of the Act provides for a decrease in the adjusted cost base of a taxpayer's interest in a partnership. The reduction, which applies only to taxpayers described in new subsection 40(3.1), is the amount of any limited-recourse debt of the taxpayer that can reasonably be considered to have been used to acquire the partnership interest. This new subparagraph applies to debts entered into by a taxpayer after September 26, 1994 other than such a debt entered into pursuant to an agreement in writing entered into by the taxpayer before September 27, 1994.

Subclause 14(5)

ITA
53(2)(c)(xi)

Paragraph 53(2)(c) of the Act requires certain amounts to be deducted in computing the adjusted cost base to a taxpayer of a partnership interest. New subparagraph 53(2)(c)(xi) is added as a consequence of the amendments to section 110.6 that permit individuals to recognize capital gains accrued to February 22, 1994. This subparagraph adds a reference to the deduction required by new paragraph 110.6(23)(b). This deduction is relevant only in computing an individual's capital gain from the deemed disposition of a partnership interest that results from a capital gains election made under subsection 110.6(19) in respect of the partnership interest. A partner's share of a partnership's loss for a fiscal period is not reflected in the adjusted cost base of its partners' interests until the end of that fiscal period. This deduction requires an individual, for the purpose of computing his or her capital gain on the deemed disposition of a partnership interest that results from a capital gains election under subsection 110.6(19), to take into account losses suffered by the partnership up to February 22, 1994. For this purpose, the losses of the partnership for its fiscal period that includes February 22, 1994 will be prorated for this purpose. (See the commentary on new subsection 110.6(23)).

Subclause 14(6)

ITA
53(2)(u) and (v)

New paragraph 53(2)(u) of the Act requires an amount to be deducted in computing the adjusted cost base to a taxpayer of a property that at the end of February 22, 1994 was a non-qualifying real property for the purposes of section 110.6. The amount to be deducted (determined under paragraph 110.6(21)(b)) represents the portion of the capital gain that resulted from an election under subsection 110.6(19) in respect of the property that is not an eligible real property gain (within the meaning assigned by subsection 110.6(1)). That portion of the gain is not reflected in the taxable capital gain of the elector that results from the election. The reduction in the adjusted cost base of the property required by paragraphs 110.6(21)(b) and 53(2)(u) ensures that the ineligible portion of the gain (that is, the post-February 1992 portion of the gain that was not eligible for the exemption and that, because of subsection 110.6(21), was not taxable) will be taxed on a subsequent taxable disposition of the property.

New paragraph 53(2)(v) of the Act requires a taxpayer to deduct an amount in computing the adjusted cost base to the taxpayer, at any time after February 22, 1994, of a property in respect of which an election was made under subsection 110.6(19). This provision will have an impact only where the amount designated in the election exceeds 11/10 of the fair market value of the property at the end of February 22, 1994 and only to the extent that the excess is greater than

- where the property is an interest in or a share of the capital stock of a flow-through entity for the purposes of section 39.1 (such as a mutual fund trust, or a partnership), the difference between its fair market value and its adjusted cost base to the taxpayer at the end of February 22, 1994, and

- in any other case, the adjusted cost base to the taxpayer of the property at the end of February 22, 1994.

The amount to be deducted is computed under new subsection 110.6(22).

Clause 15

Definitions - Adjusted Cost Base

ITA
54

Section 54 defines a number of expressions for the purpose of subdivision c of Division B of Part I of the Act. The definition "adjusted cost base" is relevant in computing a taxpayer's gain from the disposition of a property. This definition is amended effective for the 1994 and subsequent taxation years to ensure that, unless the Act specifically provides otherwise, the adjusted cost base to a taxpayer of a property can never be less than nil. It is also amended, consequential on the enactment of subsection 110.6(19), to ensure that adjustments required under section 53 in determining a taxpayer's adjusted cost base of an interest in or a share of the capital stock of a flow-through entity (within the meaning assigned by subsection 39.1(1)) before February 23, 1994 will still be relevant in determining the taxpayer's adjusted cost base of the property after the deemed reacquisition under subsection 110.6(19) of the property, as illustrated by the following example.

An individual elects under subsection 110.6(19) in respect of an interest in a partnership that has an original cost of $1,000, an adjusted cost base to the individual of $200 immediately before the disposition resulting from the election and a fair market value at that time of $2,000. The individual designates $2,000 in respect of the property, thereby realizing a capital gain of $1,800 which is reflected in the individual's exempt capital gains balance in respect of the partnership. The individual is considered to have reacquired the property at its original cost to the individual of $1,000, and the adjustments relevant to the determination of a taxpayer's adjusted cost base at any time before February 23, 1994 (other than the adjustment required by subsection 110.6(22)) will continue to be relevant in determining the individual's adjusted cost base of the partnership interest after February 22, 1994.

Clause 16

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:

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).

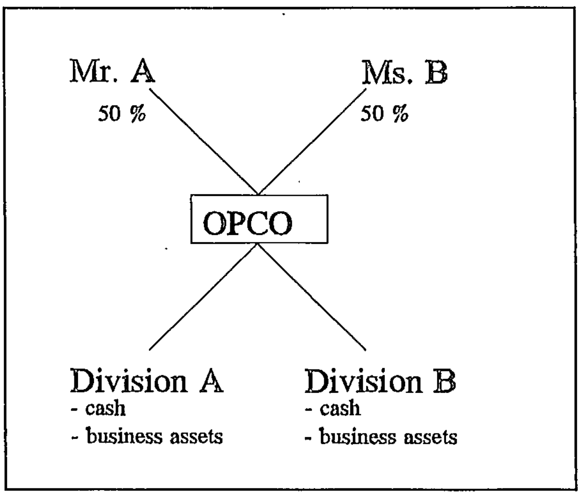

Figure 1: Pre-butterfly structure

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.

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 as 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).*

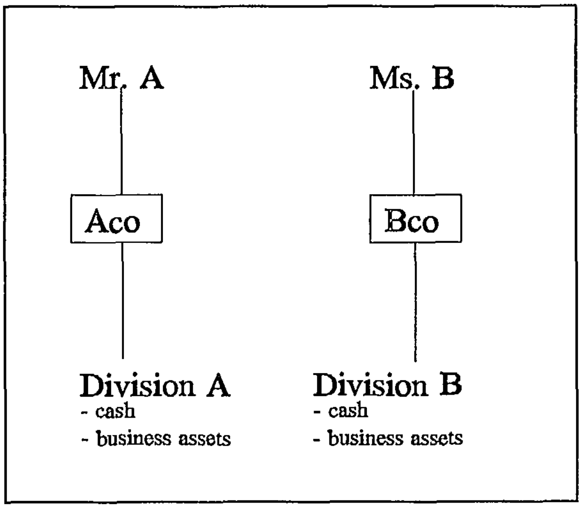

Figure 2: Post-butterfly structure

A number of changes are made to section 55. The main purpose of these changes is to limit the tax-deferred 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-deferred distribution will 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. More particularly, paragraph 55(3)(b) of the Act will accommodate the tax-deferred division of one corporation into two or more corporations the shares of which continue to be owned by the shareholders of the original corporation and the tax-deferred division of a corporation's assets among its corporate shareholders so as to enable them to carry on separately the businesses and activities that were previously carried on by them in common through the 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.

Subclause 16(1)

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) to (d) 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 A 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 clause 55(3.1)(c)(i)(B) 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 51(1) or 86(1) of the Act applies (or to which either of those subsections would apply if the shares were held as capital property) 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 another corporation (the acquiror) made in contemplation of the tax-deferred distribution of property by the distributing corporation to one or more of its corporate shareholders.

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 acquiror on the exchange and, immediately after the exchange, all of the issued shares of the capital stock of the acquiror 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 acquiror 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 before the exchange and none or all of the shares of that class are transferred on the exchange, the shares of that class will be ignored in determining whether the participants have participated in the exchange 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.

The requirements of the definition "permitted exchange" will have to be satisfied in every situation in which a person acquires a share of the capital stock of the distributing corporation in contemplation of the distribution from another person to whom the acquiror is not related. For this purpose, the acquiror will be considered not to be related to the other person unless

- the acquiror acquires all of the shares of the distributing corporation that are owned by the other person,

- the acquiror is related, after the reorganization that includes the distribution, to the distributing corporation (See new paragraph 55(3.2)(c) of the Act), or

- the acquiror acquired the share on a capital distribution by a personal trust (see new paragraph 55(3.2)(d) 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 a transferee corporation and a similar redemption or purchase for cancellation of all of the shares of the capital stock of a transferee corporation held by the distributing corporation. A permitted redemption also includes a preliminary redemption by the distributing corporation of all the shares of each of the specified classes of its capital stock that were issued in circumstances where the original owner's cost of the shares equalled the fair market value of the consideration for which they were issued. (See the commentary on the definition "specified class" below.)

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 lose the protection of the butterfly exemption. For this purpose, 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 paragraphs 55(3.2)(e) and (f) 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 another corporation constitutes a permitted exchange for the purposes of paragraph 55(3.1)(b) of the Act. It is also relevant in determining whether a preliminary redemption of shares by the distributing corporation is a permitted redemption.

A share of the capital stock of a distributing corporation will qualify as a share of a specified class only where

- the paid-up capital in respect of the class at the beginning of the series of transactions or events that includes a distribution by the distributing corporation 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) or shares of the capital stock of a transferee corporation, 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.

Subclause 16(2)

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. (See new subparagraphs 55(5)(e)(ii) and (iii) of the Act).

Where a beneficiary under a personal trust acquires property on a capital distribution by the trust, the beneficiary will be considered, in respect of that acquisition, to be related to the trust. (See new subparagraph 55(5)(e)(iii) of the Act).

Subclause 16(3)

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 is made by a distributing corporation. In order to qualify for the butterfly exemption, the dividend must also be received on a permitted redemption in relation to the distribution or on the winding-up of the distributing corporation. This is intended to clarify that other dividends that may be linked to the reorganization but do not result from the cross-redemptions of shares between the distributing corporation and the transferee corporations or from the winding-up of the distributing corporation do not qualify for the exemption.

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.

Subclause 16(4)

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 (d) 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) to (d) 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).

Paragraph 55(3.1)(a) does not allow for the acquisition of a partnership interest in contemplation of a butterfly distribution. This is consistent with new paragraphs 55(3.1)(c) and (d) which generally will deny the protection of the butterfly exemption where a significant portion of the property received by a transferee corporation on a distribution or retained by the distributing corporation following a distribution is acquired by a partnership.

Where a partnership interest is acquired in contemplation of a butterfly distribution, otherwise than as a result of one of the specifically permitted transactions, paragraph 55(3.1)(a) will deny the protection of the butterfly exemption for dividends received in the course of the butterfly reorganization.

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 a 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:

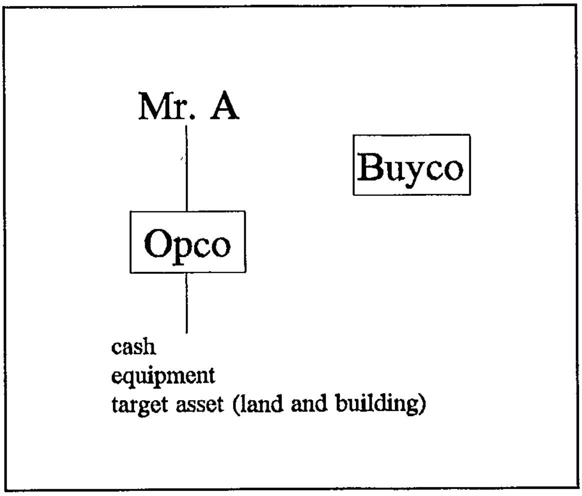

Figure 3: Pre-butterfly structure

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:

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.

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*

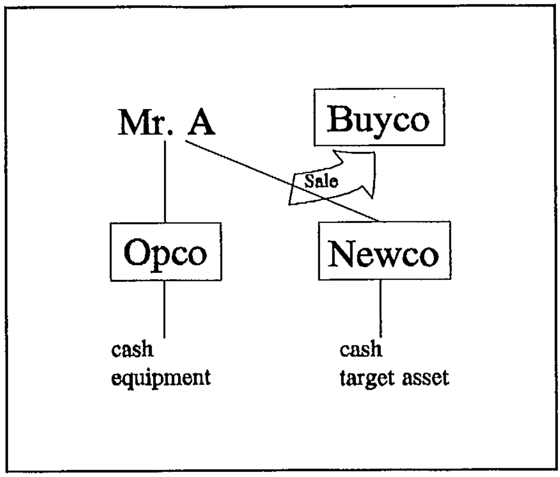

Figure 4: Post-butterfly structure

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 section 55. 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) and (d)

New paragraph 55(3.1)(c) of the Act denies the protection of the butterfly exemption for a dividend received by a transferee corporation in circumstances where, as part of the series of transactions or events that includes the receipt of the dividend, a significant portion of the property received by the transferee corporation on a distribution becomes property of a partnership or of a person who is not related to the transferee corporation.

New paragraph 55(3.1)(d) of the Act similarly denies the protection of the butterfly exemption for a dividend received by the distributing corporation in circumstances where, as part of the series of transactions or events that includes the receipt of the dividend, a significant portion of the property owned by it immediately before it made a distribution and not disposed of by it on the distribution is acquired by a partnership or a person who is not related to the distributing corporation.

These restrictions are 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. They also ensure 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.

Paragraphs 55(3.1)(c) and (d) do 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) or (d) 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. Insignificant sales of assets outside the ordinary course of business to non-related parties also will not taint the dividends received by the seller in the course of the butterfly reorganization. The transferee corporation is permitted to sell, outside the ordinary course of its business and to non-related parties, property having a total fair market value not greater than 10% of the fair market value, at the time of the distribution, of the property (other than money and non-convertible debt) received by it on the distribution. A similar provision in paragraph 55(3.1)(d) permits insignificant sales outside the ordinary course by the distributing corporation.

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. Aco wishes to withdraw from the business. A fourth corporation (Buyer) wishes to acquire a business asset (the target property) worth $40,000 that is owned by Opco.

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 (other than money and non-convertible debt) 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 dividend received by Aco on the redemption of its shares of Opco 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 June 23, 1994) treats a person (the acquiror) as not being related to another person from whom the acquiror acquired a share of the distributing corporation in contemplation of a distribution unless

- the acquiror acquired all of the shares of the distributing corporation owned by the other person,
- the acquiror and the distributing corporation are related immediately after the reorganization in the course of which the distributing corporation made a distribution, or
- the share is acquired from a personal trust on a capital distribution by the trust, in which case new paragraph 55(3.2)(d) deems the acquiror to be related, in respect of that acquisition, to the trust.

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, specified shareholders of the distributing corporation who dispose of shares of the distributing corporation to another person in anticipation of a distribution must either transfer all of their shares to that person or satisfy the requirements of a permitted exchange. This prevents shareholders of a corporation from effecting a partial split-up of their interests in a distributing corporation.

New paragraph 55(3.2)(e) of the Act (which also generally applies to dividends received after June 23, 1994) 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)(f) 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.

New paragraph 55(3.2)(g) treats control of a corporation as not having been acquired for the purposes of paragraph 55(3.1)(b) where it is acquired solely because of the incorporation of a corporation or the issuance of directors' qualifying shares.

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 June 23, 1994 (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 (d) and (3.2)(c) and (e). 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 received within that period not to qualify for the butterfly exemption.

Subclause 16(5)

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.

Subclause 16(6)

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 generally 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. Where a beneficiary under a personal trust (within the meaning assigned by subsection 248(1) of the Act) acquires property on a capital distribution by the trust, the beneficiary will be treated for the purposes of section 55, in respect of that acquisition, as being related to 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 17

Meals and Entertainment Expenses

ITA
67.1(1)

Subsection 67.1(1) of the Act provides that the amounts of meals and entertainment expenses that are recognized for the purposes of the Act are 80 per cent of the lesser of the actual expenses and the amounts that would be reasonable in the circumstances. This subsection is amended, applicable to expenses incurred after February 21, 1994 in respect of food and beverages consumed and entertainment enjoyed after February 1994, to reduce the portion of meals and entertainment expenses recognized for the purposes of the Act to 50 per cent.

Clause 18

Deceased Taxpayers - Eligible Capital Property

ITA
70(5.1)

Subsection 70(5.1) deals with the transfer of eligible capital property on the death of a taxpayer to a beneficiary. Where the beneficiary continues to carry on the business of the deceased, the beneficiary is deemed to have acquired an eligible capital property at 4/3 of the cumulative eligible capital of the deceased's business prorated using the fair market values of all eligible capital property.

Subparagraph 70(5.1)(d)(ii) is amended, consequential on the amendment to subparagraph 14(1)(a)(v), to ensure that there will not be an over-inclusion under subparagraph 14(1)(a)(v) in computing the beneficiary's income from the business because of amounts deducted under paragraph 20(1)(b) in computing the deceased's income from the business for a fiscal period that ended before the deceased's adjustment time (within the meaning assigned by subsection 14(5)) in respect of the business.

Clause 19

***Inter vivos* Transfers of Farm Property**

ITA
73(3)

Subsection 73(3) provides a tax deferral for an inter-vivos transfer of farm property by a taxpayer to a child of the taxpayer.
Subparagraph 73(3)(d.2)(ii) is amended, consequential on the amendment to subparagraph 14(1)(a)(v), to ensure that there will not be an over-inclusion under subparagraph 14(1)(a)(v) in computing the child's income from the business because of amounts deducted under paragraph 20(1)(b) in computing the taxpayer's income from the business for fiscal periods that ended before the taxpayer's adjustment time (within the meaning assigned by subsection 14(5)) in respect of the business.

Clause 20

Transfer of Property to Spouse

ITA
74.2(2)

Subsection 74.2(2) provides that taxable capital gains and allowable capital losses attributed to an individual in a taxation year under certain provisions of the Act will be treated, for the purposes of the lifetime capital gains exemption, as having arisen on a disposition in the year of property by the individual. Paragraph 74.2(2)(b) is amended, effective for the 1994 and subsequent taxation years, to treat the individual as having disposed of the property on the day on which the disposition that gave rise to the attributed gain or loss occurred. This amendment is consequential on the elimination of the $100,000 lifetime capital gains exemption for gains arising on dispositions that occur after February 22, 1994.

Clause 21

Attribution Rules

ITA
75(3)(c.1)

Subsection 75(3) of the Act exempts a number of trusts from the attribution rule in subsection 75(2), under which any income or loss from trust property held by certain reversionary trusts can be attributed for tax purposes to the persons from whom the property was received.

New paragraph 75(3)(c.1) exempts mining reclamation trusts from the attribution rule in subsection 75(2). The expression "mining reclamation trust" is defined in subsection 248(1).

This amendment applies to taxation years ending after February 22, 1994.

Clause 22

Transfer of Property to Corporation by Shareholders

ITA
85(1)(d.1)

Subsection 85(1) provides a tax deferral for the transfer of various types of property by a taxpayer to a corporation for consideration that includes shares of the corporation's capital stock.
Paragraph 85(1)(d.1) provides specific rules to ensure that the tax accounts relating to eligible capital property in respect of a business are carried through from the transferor to the transferee. This paragraph is amended, consequential on the amendment to subparagraph 14(1)(a)(v), to ensure that there will not be an over-inclusion under that subparagraph in computing the income of the transferee corporation from the business because of amounts deducted under paragraph 20(1)(b) in computing the transferor's income from the business for fiscal periods that ended before the transferor's adjustment time (within the meaning assigned by subsection 14(5)) in respect of the business.

Clause 23

Amalgamations

ITA
87(2)

Subsection 87(2) of the Act sets out rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation.

Subclause 23(1)

ITA
87(2)(j.2)

Paragraph 87(2)(j.2) of the Act provides that a corporation formed as the result of an amalgamation is considered to be a continuation of its predecessor corporations for the purposes of subsection 18(9) (prepaid expenses) and paragraph 20(1)(mm) (cost of injected substance used in recovery of petroleum, natural gas or related hydrocarbons). Paragraph 87(2)(j.2) is amended, effective for 1994 and subsequent taxation years, so that it also applies for the purpose of new subsection 18(9.01) of the Act. That subsection contains rules for the deduction of certain premiums paid under group term life insurance policies.

Subclause 23(2)

ITA
87(2)(j.92)

New paragraph 87(2)(j.92) of the Act is consequential on the introduction of subsection 125(5.1) of the Act, which enacts the February 1994 Budget proposal to restrict the benefit of the "small business deduction" for large Canadian-controlled private corporations. This paragraph ensures that subsection 125(5.1) will continue to apply to an amalgamated corporation as though it were a continuation of its predecessor corporations. The provisions of new paragraph 87(2)(j.92) also apply, pursuant to paragraph 88(1)(e.2), for the purposes of the rules relating to the winding-up of a subsidiary into its parent corporation.

ITA
87(2)(j.93)

Paragraph 87(2)(j.93) of the Act is introduced so that an amalgamated corporation is considered, for the purposes of provisions relating to mining reclamation trusts, to be the same corporation as, and a continuation of, each of its predecessor corporations. Because of existing cross-references in paragraph 88(1)(e.2) of the Act, this measure also applies to a winding-up of a taxable Canadian corporation in circumstances to which subsection 88(1) applies.

This amendment applies to amalgamations occurring and windings-up beginning after February 22, 1994.

Clause 24

Winding-up of a Corporation

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,

- two or more persons (other than specified persons) who, at any time during the series and before control of the subsidiary was last acquired by the parent, owned, in total, such number of shares as would, if they were owned by one person, make that person a specified shareholder of the subsidiary,

- a corporation (other than a specified person) of which any person who was a specified shareholder of the subsidiary is a specified shareholder, or

- a corporation (other than a specified person) where persons whose shares, if owned by one person, would have made the person a specified shareholder of the subsidiary before the acquisition of control owned, after the acquisition of control, such number of shares as would, if they were owned by one person, make that person a specified shareholder of the corporation that acquired the property.

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 paragraph 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 one or more persons (other than specified persons) who had a significant interest in the subsidiary before the parent last acquired control of the subsidiary acquire, 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.

Similarly, two or more persons will be considered to have had a significant interest in the subsidiary if they owned, in total, more than 10% of the shares of any class of the subsidiary's capital stock.

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.

Similarly, two or more persons who have a significant interest in the subsidiary will be considered to have acquired a significant interest in a property if they acquire the property or own, in total, more than 10% of the shares of any class of the capital stock of any corporation that acquired the property.

For these purposes, 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 December 1994, 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 25

Partnerships and Their Members

ITA
96(2.2)(c)

Subsection 96(2.2) of the Act defines the "at-risk amount" of a limited partner. The starting point in the calculation of a partner's at-risk amount is the adjusted cost base of the partner's interest. If the partner has used limited-recourse financing to acquire the interest, that amount will be deducted under new subparagraph 53(2)(c)(i.3) in computing the adjusted cost base of the interest and, consequently, will not be included in the partner's at-risk amount.
Paragraph 96(2.2)(c) is amended to ensure that this amount is not deducted a second time under that paragraph in computing the partner's at-risk amount. This amendment applies after September 26, 1994.

Clause 26

Dispositions of Partnership Property

ITA
98

Section 98 of the Act provides rules relating to the taxation of partnership properties and interests where a partnership has ceased to exist.

Subclause 26(1)

ITA
98(1)(c)

Paragraph 98(1)(c) applies to a partnership interest where, at the end of a fiscal period of the partnership, the total of amounts deducted under subsection 53(2) in respect of the interest exceeds the total of the cost of the interest and the amounts added under subsection 53(1) in respect of the interest. If the partnership has ceased to exist, the excess is treated as a gain of the holder from a disposition of that interest at the end of the fiscal period and, for the purposes of section 110.6, the disposition is considered to have occurred in the taxation year in which that fiscal period ends. Consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, this paragraph is amended, effective for the 1995 and subsequent taxation years, by deleting the reference to section 110.6. For the 1994 taxation year, a taxpayer's gain under paragraph 98(1)(c) will be considered to have arisen on a disposition that will be deemed for the purpose of section 110.6 to have occurred at the end of the fiscal period. This ensures that an individual's gain arising under that paragraph at the end of a fiscal period that ended before February 23, 1994 will still be taken into account in determining the individual's capital gains deduction for the 1994 taxation year.

Subclauses 26(2) and (3)

ITA
98(3)(g)(iii)(B) and 98(5)(h)(ii)(B)

Subsections 98(3) and (5) provide a tax deferral in certain circumstances where a partnership ceases to exist and the property is distributed to one or more of its members. Consequential to the amendment to subparagraph 14(1)(a)(v), these amendments ensure that there will not be an over-inclusion under that subparagraph (as a result of amounts having been deducted under paragraph 20(1)(b) in computing the partnership's income from the transferred business for fiscal periods that ended before the partnership's adjustment time in respect of the business) in computing the business income of a recipient of the distributed property.

Clause 27

Residual Interests in Partnerships

ITA
98.1(1)(c)

Paragraph 98.1(1)(c) applies where, at the end of a partnership's fiscal period, the total of amounts deducted under subsection 53(2) in respect of a taxpayer's residual interest in a partnership is greater than the total of the taxpayer's cost of the interest and the amounts added under subsection 53(1) in respect of the interest. The excess is treated as a gain of the taxpayer from a disposition of the interest at the end of the fiscal period and, for the purposes of section 110.6, the disposition is considered to have occurred in the taxation year in which that fiscal period ends. Consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, this paragraph is amended, effective for the 1995 and subsequent taxation years, by deleting the reference to section 110.6. For the 1994 taxation year, a taxpayer's gain under paragraph 98.1(1)(c) will be considered to have arisen on a disposition that will be deemed for the purpose of section 110.6 to have occurred at the end of the fiscal period. This ensures that an individual's gain arising under that paragraph at the end of a fiscal period that ended before February 23, 1994 will still be taken into account in determining the individual's capital gains deduction for the 1994 taxation year.

Clause 28

Taxable Capital Gains of Trusts

ITA
104(21.2)

Subsection 104(21.2) of the Act sets out the rules for allocating the net taxable capital gains of a trust to its beneficiaries for the purpose of section 110.6. The formulae in paragraph (b) determine the extent to which beneficiaries may be able to claim the capital gains exemption under subsection 110.6(2), (2.1) or (3) of the Act.

The preamble of subsection 104(21.2) is amended, consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, to restrict the ability to make designations under that subsection to trusts that are personal trusts. The only gains from dispositions that occur after that day that will continue to be eligible for the lifetime capital gains exemption will be gains that qualify for the $500,000 exemption. A trust that is not a personal trust will not realize such gains because the definitions "qualified farm property" and "qualified small business corporation share" require the relevant property to be owned by an individual other than a trust that is not a personal trust.

The formulae in paragraph 104(21.2)(b) are amended, effective for taxation years of trusts that begin after February 22, 1994, as a consequence of the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after that day. Where a trust designates an amount in respect of a beneficiary under subsection 104(21), it must also designate a portion of its eligible taxable capital gains (within the meaning assigned by subsection 108(1)) in respect of the beneficiary.

The letter A in the existing formulae is the eligible taxable capital gains of the trust for the year in which the designations are made under subsection 104(21). The description of A is amended to reflect only that portion of the trust's eligible taxable capital gains that is included in computing the income of its beneficiaries. Subsection 104(13.2) allows amounts that would otherwise be taxable capital gains of the beneficiaries under a trust because of subsection 104(21) to be taxed in the hands of the trust instead of the beneficiaries. In effect, amounts designated under subsection 104(13.2) will be considered to have been designated first from the trust's gains other than its eligible taxable capital gains.

The letter B in the formulae is the amount designated under subsection 104(21) in respect of the beneficiary in excess of the portion thereof that is designated in respect of the beneficiary under subsection 104(13.2). It represents the net taxable capital gain that is flowed out to the beneficiary in the year by the trust.

The letter C in the existing formulae is replaced by the letter D and its description is amended, consequential on the changes made to the description of the A, to reflect only the net taxable capital gains of the trust for the year that are flowed out to its beneficiaries for tax purposes. In the result, the lesser of the trust's eligible taxable capital gains and its net taxable capital gains that have been flowed out to its beneficiaries will be allocated among its beneficiaries in the same proportion as the net taxable capital gains are allocated to them under subsection 104(21).

The letters E and G in the existing formulae are replaced by the letters C and E, respectively.

Subparagraph 104(21.2)(b)(iii) is deleted consequential on the amendments to section 110.6 which eliminate the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994. Since the eligible taxable capital gains of a trust are determined with reference to the trust's annual gains limit (within the meaning assigned by subsection 110.6(1)) and the definition "annual gains limit" is amended to exclude gains realized on dispositions that occur after that day (other than gains from the disposition of property that qualifies for the $500,000 lifetime capital gains exemption), the eligible taxable capital gains of a trust for a taxation year that begins after February 22, 1994 will include only gains from the disposition of qualified farm property and qualified small business corporation shares.

In applying subsection 104(21.2) of the Act to a trust's taxation year that includes February 22, 1994, the descriptions of A, B and C are amended in the manner that the descriptions of A, B and D (C under the existing rules) are amended for taxation years that begin after February 22, 1994. See the above descriptions of these amendments. Further, a mutual fund trust will not be permitted to make a designation under subsection 104(21.2) for its 1994 taxation year. This means that an individual will not be able to claim the capital gains exemption in respect of a taxable capital gain flowed out to the individual by the mutual fund trust. The only way for the individual to shelter such a gain with the exemption is to elect under subsection 110.6(19) in respect of his or her units and then offset (under section 39.1) all or a portion of the taxable capital gain that resulted from the subsection 104(21) designation with the individual's exempt capital gains balance that resulted from the election. Finally, the concluding portion of paragraph 104(21.2)(b) is also amended to ensure that, for the purposes of section 110.6, the taxable capital gain of a beneficiary resulting from a designation made under subsection 104(21.2) is considered to arise from a disposition that occurred on February 22, 1994. (A trust's gain from a disposition after that day will not be reflected in its eligible taxable capital gains for its taxation year that includes that day). This will ensure that such a gain is reflected in the annual gains limit of the beneficiary for the beneficiary's taxation year in which the taxation year of the trust that includes February 22, 1994 ends.

Clause 29

Dispositions of Capital Interests by Trusts

ITA
107(2)(f)

Subsection 107(2) provides a tax deferral on certain capital distributions by a personal trust or a prescribed trust.
Clause 107(2)(f)(ii)(B) is amended, consequential on the amendment to subparagraph 14(1)(a)(v), to ensure that there will not be an over-inclusion under that subparagraph (as a result of amounts having been deducted under paragraph 20(1)(b) in computing the trust's income from a business for fiscal periods that ended before the trust's

adjustment time (within the meaning assigned by subsection 14(5)) in respect of the business.

Clause 30

Beneficiaries under Mining Reclamation Trusts

ITA
107.3

New section 107.3 of the Act sets out a number of rules dealing with the taxation of the beneficiaries of "mining reclamation trusts", as newly defined in subsection 248(1). Mining reclamation trusts are exempt from income tax under Part I of the Act, but are instead subject to tax under new Part XII.4 of the Act. However, as described in the commentary on new section 127.41, a beneficiary of a mining reclamation trust is entitled to a refundable tax credit with respect to the Part XII.4 tax payable by the trust.

Under paragraph 107.3(1)(a), any income or loss earned or realized at the trust level for a taxation year is also treated as having been earned or realized by a trust beneficiary. Where there is more than one beneficiary, the income or loss is required to be allocated to the various trust beneficiaries in a reasonable manner. In the case of a non-resident beneficiary under a mining reclamation trust, any income or loss that would not otherwise be included in computing the beneficiary's taxable income earned in Canada is considered under paragraph 107.3(1)(b) to be income or loss from the carrying on of business in Canada through a fixed place of business located in the province in which the mine relating to the trust is situated. Paragraph 107.3(1)(b) also applies to amounts included under new paragraphs 12(1)(z.1) and (z.2) in computing the income of a taxpayer not resident in Canada.

Subsection 107.3(2) provides that, where property is transferred to a beneficiary of a mining reclamation trust in satisfaction of the beneficiary's interest in the trust, the trust is considered to have disposed of the transferred property for its fair market value and the beneficiary to have acquired it for the same amount. Any income or loss resulting from this rule is flowed through to trust beneficiaries, as provided under subsection 107.3(1).

Subsection 107.3(3) applies if a trust ceases to be a mining reclamation trust. In this case, the trust is considered to have disposed of each of its properties that continued to be held after its change of status at fair market value and to have reacquired each property for the same amount. In addition, a beneficiary is deemed to have received as a distribution from the trust the amount that can reasonably be considered to be the beneficiary's share of the trust properties. The amount deemed to have been received by the beneficiary is also considered to be the cost of the beneficiary's interest in the continuing trust. At the time a trust ceases to be a mining reclamation trust, its taxation year is considered to end and a new taxation year is considered to start immediately afterwards.

Subsection 107.3(4) ensures that the general rules relating to ordinary trusts and their beneficiaries in subsection 104(13) and sections 105 to 107 of the Act do not apply while a trust is a mining reclamation trust.

These amendments apply to taxation years ending after February 22, 1994.

Clause 31

Trusts - Definitions

ITA
108(1)

Consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, the definitions "eligible real property gain", "eligible real property loss" and "non-qualifying real property" are repealed. In addition, because taxable capital gains of a trust (other than a personal trust) for a taxation year that begins after that day will not be relevant in computing the annual gains limit (within the meaning assigned by subsection 110.6(19)) of any taxpayer, the definition "eligible taxable capital gains" is amended to restrict its application to personal trusts. These amendments to subsection 108(1) are effective for trust taxation years that begin after February 22, 1994.

Clause 32

Capital Gains Exemption

ITA
110.6

Section 110.6 of the Act sets out the rules for calculating an individual's entitlement to the lifetime capital gains exemption. A number of amendments are made to this section as a consequence of the elimination of the $100,000 exemption for gains realized on dispositions that occur after February 22, 1994 and for gains from previous dispositions brought into income in the 1995 and subsequent taxation years under the capital gains reserve mechanism. As part of these amendments, new subsections 110.6(19) to (30) are added to provide for a special election, announced as part of the February 1994 federal budget, that allows individuals and personal trusts to recognize gains accrued to February 22, 1994 so as to obtain the benefit of the exemption in respect of those gains.

Subclauses 32(1) and (2)

ITA
110.6(1)

Subsection 110.6(1) of the Act sets out a number of definitions for the purposes of the capital gains exemption.

The annual gains limit of an individual for a taxation year is relevant in determining the individual's entitlement to the capital gains exemption for that year. It consists of the amount by which the lesser of

- the individual's net taxable capital gains for the year (other than those arising from pre-1985 dispositions), and

- the amount that would have been the individual's net taxable capital gains if, in respect of dispositions of non-qualifying real property, only the eligible real property gains and eligible real property losses were taken into account exceeds the total of the individual's net capital losses carried over from other years and the individual's allowable business investment losses for the year.

The description of A in the formula used in the definition "annual gains limit" is amended to exclude gains and losses other than those arising on dispositions after 1984 of qualified farm properties and dispositions after June 17, 1987 of qualified small business corporation shares. This amendment is effective for the 1994 and subsequent taxation years. However, for an individual's 1994 and 1995 taxation years, the annual gains limit of an individual will be the amount by which the lesser of

- the individual's net taxable capital gains for the year (other than those arising from pre-1985 dispositions), and

- the amount that would have been the individual's net taxable capital gains if

  - gains and losses from dispositions of property (other than qualified farm property and qualified small business corporation shares) that occurred after February 22, 1994 were excluded,

  - gains resulting from an election under subsection 110.6(19) by a trust were included only if the individual was a beneficiary under the trust on February 21, 1994 and only to the extent that they cannot reasonably be considered to have been included in computing the individual's income because of an interest in the trust that was acquired after February 22, 1994,

  - except for the purpose of determining the individual's share of a partnership's taxable capital gain for the partnership's fiscal period that includes February 22, 1994 or the individual's taxable capital gain resulting from a designation made under section 104 by a trust for its taxation year that includes that day, the individual's gains for 1995 excluded gains (other than gains from the disposition of qualified small business corporation shares or qualified farm property) that were included in computing the individual's income for 1995 because of the reserve mechanism in paragraph 40(1)(a) or 44(1)(e), and

- in respect of dispositions of non-qualifying real property that occurred before February 23, 1994, only the eligible real property gains and eligible real property losses were taken into account,

exceeds the total of the individual's net capital losses carried over from other years and the individual's allowable business investment losses for the year.

If an individual realizes a capital loss after February 22, 1994, it will not reduce the individual's annual gains limit except to the extent that the allowable capital loss exceeds the individual's taxable capital gains realized after that day. Where the allowable capital loss arises on a disposition in 1994 of qualified farm property or qualified small business corporation shares, it will reduce first the amount otherwise deductible under subsection 110.6(2) or (2.1), as the case may be, for the year. The balance of the allowable capital loss from such a disposition will reduce the individual's entitlement to the $100,000 exemption, but, where the disposition occurred after February 22, 1994, only to the extent that it exceeds the individual's taxable capital gains realized after that day from dispositions of other properties.

The definitions "eligible real property gain", "eligible real property loss" and "non-qualifying real property" will no longer be relevant after the elimination of the $100,000 capital gains exemption and are repealed effective after 1995.

Subclause 32(3)

ITA
110.6(3)

Subsection 110.6(3) of the Act provides a deduction (commonly referred to as the $100,000 lifetime capital gains exemption) in respect of net taxable capital gains from the disposition of properties other than qualified farm property and qualified small business corporation shares. This subsection is repealed for the 1996 and subsequent taxation years. In applying this subsection to the 1994 and 1995 taxation years, its preamble is amended to clarify that gains from the disposition of qualified farm property and qualified small business corporation shares that result from an election made under subsection 110.6(19) are included in determining the amount deductible under subsection 110.6(3). Such gains are not eligible for the $500,000 exemption under subsection 110.6(2) or (2.1).

Notwithstanding the fact that the deduction under subsection 110.6(3) continues to be available for the 1994 and 1995 taxation years, it will be available only in respect of gains realized from dispositions that occurred before February 23, 1994 because of amendments made to the definition "annual gains limit" in subsection 110.6(1). It is available for the 1995 taxation year of an individual in order to ensure that the individual's taxable capital gain for 1995 that

- arose from a designation made under subsection 104(21.2) in respect of the individual by a trust for its taxation year that ends in 1995 but includes February 22, 1994, or

- represents the individual's share of a partnership's taxable capital gain for its fiscal period that ends in 1995 but includes February 22, 1994 from a disposition that occurred before February 23, 1994

will continue to be eligible for the $100,000 lifetime capital gains exemption.

Subclauses 32(4) to (8)

ITA
110.6(4) to (8)

Subsections 110.6(4) to (8) of the Act are amended effective for the 1996 and subsequent taxation years by deleting the references therein to subsection 110.6(3). These amendments are strictly consequential on the repeal of subsection 110.6(3).

Subclause 32(9)

ITA
110.6(12)(b)

Subsection 110.6(12) of the Act allows spousal trusts described in paragraph 104(4)(a) or (a.1) (other than a trust that has elected under subsection 104(5.3)) to take advantage of any unused capital gains exemption of the beneficiary spouse after that spouse dies. Paragraph 110.6(12)(b) is amended, consequential on the elimination of the $100,000 lifetime capital gains exemption, to limit the deduction under subsection 110.6(12) to the spouse's unused $500,000 lifetime capital gains exemption in respect of qualified farm property and qualified small business corporation shares.

This amendment is effective for taxation years that end after February 22, 1994. However, for taxation years that end after that day and before 1997, paragraph 110.6(12)(b) is to be read in a manner that allows the trust to take advantage of not only the spouse's unused $500,000 exemption but also the spouse's unused $100,000 exemption in respect of net taxable capital gains realized from dispositions that occurred before February 23, 1994. This parallels the availability of the $100,000 exemption for individuals (other than trusts) for the 1994 and 1995 taxation years. (See the commentary on the amendments to the definition "annual gains limit" in subsection 110.6(1) of the Act for an explanation of the rules relating to gains realized as a consequence of elections made under subsection 110.6(19) and to gains brought into income under the capital gains reserve mechanisms).

The rules applicable to a spousal trust's taxation year that includes February 22, 1994 will permit the trust (where the spouse dies in the year) to claim the $100,000 exemption in respect of gains realized on the deemed disposition of its property on the death of the spouse where the spouse died before February 23, 1994. If the spouse dies after February 22, 1994, the trust must elect under subsection 110.6(19) in order for the gains accrued to that day on its properties other than qualified farm property and qualified small business corporation shares to be sheltered by the exemption under subsection 110.6(12).

Subclause 32(10)

ITA
110.6(17)

Subsection 110.6(17) of the Act is amended effective for the 1996 and subsequent taxation years by deleting the reference to clause 110.6(3)(a)(iii)(A). This amendment is consequential on the repeal of subsection 110.6(3).

Subclause 32(11)

ITA
110.6(18)

Subsection 110.6(18) of the Act provides special rules for determining a taxpayer's eligible real property gains and eligible real property losses with respect to dispositions of non-qualifying real property. This subsection is repealed for the 1996 and subsequent taxation years consequential on the elimination of the $100,000 capital gains exemption for gains realized on dispositions that occur after February 22, 1994.

Subclause 32(12)

ITA
110.6(19)

New subsection 110.6(19) of the Act provides a mechanism for individuals and personal trusts (each of which is referred to in subsections 110.6(19) to (30) as an "elector") to recognize capital gains accrued to February 22, 1994 in order that those gains may be sheltered by the $100,000 lifetime capital gains exemption which is being eliminated for gains realized on dispositions that occur after that day.

In order to recognize the accrued gain in respect of a property owned by an elector at the end of February 22, 1994, the elector is required to elect, in prescribed form and within the timeframe specified by subsection 110.6(24), to have the provisions of subsection 110.6(19) apply to the property. This election can be made in respect of any property the disposition of which would give rise to a capital gain, including qualified small business corporation shares and qualified farm property the gains from the disposition of which would ordinarily qualify for the $500,000 exemption rather than the $100,000 exemption. (See the commentary on the application of paragraphs 110.6(2)(d) and (2.1)(d) to the 1994 and 1995 taxation years).

The prescribed form will require the elector to identify the property in respect of which the election is made and to designate an amount in respect of the property.

The rules in paragraph 110.6(19)(a) apply where the property covered by the election is a capital property other than an interest in any of the following types of trusts:

- related segregated fund trusts,
- trusts governed by employees profit sharing plans,
- trusts created to hold shares of the capital stock of corporations for the benefit of their employees,
- certain trusts established for the benefit of creditors, and
- certain voting trusts where the purpose of the trust is to provide for the exercise of voting rights attached to shares held by the trust.

(Elections in respect of interests in these excluded types of trusts are dealt with under paragraph 110.6(19)(c)).

Subparagraph 110.6(19)(a)(i) provides that the property will be considered to have been disposed of by the elector at the end of February 22, 1994 for proceeds of disposition equal to the amount designated in the election less, where a disposition of the property would result in an income inclusion under section 7 or 35, the amount that would be so included. The election cannot be used to trigger a capital loss because that subparagraph provides that the proceeds of disposition cannot be less than the adjusted cost base of the property.

Subparagraph 110.6(19)(a)(ii) provides that the property will be considered to have been reacquired by the elector immediately after the deemed disposition at a cost equal to

- where the property is an interest in a flow-through entity (within the meaning assigned by new subsection 39.1(1)), the cost to the elector of the property immediately before the disposition,

- where a disposition of the property would result in an income inclusion under section 7 or 35, the elector's proceeds of disposition resulting from the election (unless the amount designated in the election is greater than the fair market value of the property at the end of February 22, 1994), and

- in any other case, the amount designated in the election (unless that amount is greater than the fair market value of the property at the end of February 22, 1994).

Although the gain realized as a result of an election in respect of an interest in a flow-through entity is not reflected in its adjusted cost base to the elector, the gain so realized will be reflected in an exempt gains pool (referred to in new section 39.1 as the elector's "exempt capital gains balance") in respect of the entity. This pool can be used to shelter capital gains flowed out after February 22, 1994 to the elector by the flow-through entity and capital gains realized on subsequent dispositions of interests in or shares of the capital stock of the entity.

Where the designated amount in respect of a property (other than an interest in a flow-through entity) is greater than its fair market value at the end of February 22, 1994, the cost to the elector of the property on the reacquisition will be what it would have been had the designated amount been equal to that fair market value less the amount by which the designated amount exceeds 11/10 of that fair market value. The purpose of this cost base reduction is to discourage taxpayers from designating amounts in excess of fair market value and thereby triggering gains in excess of the gains accrued to February 22, 1994.

Where an individual designates an amount in respect of his or her business (other than a business carried on in partnership with others), paragraph 110.6(19)(b) deems the individual to have a taxable capital gain equal to the amount that would have been the individual's taxable capital gain determined under subparagraph 14(1)(a)(v) if the fiscal period of the business had ended at the end of February 22, 1994 and the individual's eligible capital property in respect of the business had been disposed of immediately before that time for proceeds equal to the designated amount.

Subparagraph 110.6(19)(b)(ii) provides that the taxable capital gain resulting from an election in respect of a business is to be considered, for the purpose of paragraph 14(3)(b), to have been sheltered by the capital gains exemption available to a person who does not deal at arm's length with each person or partnership that does not deal at arm's length with the individual who made the election. This ensures that where the eligible capital property in respect of the business is subsequently disposed of to a person or partnership with whom the individual does not deal at arm's length, the taxable capital gain resulting from the election will not be reflected in any increase in the acquiror's cumulative eligible capital.

The rules in paragraph 110.6(19)(c) apply where the property covered by the election is an interest in a trust that is specifically excluded from the application of paragraph 110.6(19)(a). Where an election is made in respect of such an interest, there is no deemed disposition of the interest. Rather, the elector is deemed to have a capital gain from the disposition of property on February 22, 1994 equal to the amount designated in the election in respect of the interest. That capital gain cannot exceed what would have been the elector's net capital gains if the trust had disposed of all its capital properties and the capital gains and losses arising therefrom were allocated among the beneficiaries in a reasonable manner having regard to their interests. This capital gain is credited to the elector's exempt gains pool (referred to in section 39.1 as the elector's "exempt capital gains balance") in respect of the trust. This pool can be used to shelter capital gains allocated by the trust to the elector after February 22, 1994 and the elector's capital gain from a disposition after that day of an interest in the trust.

ITA
110.6(20)

New subsection 110.6(20) of the Act, which is effective for the 1994 and subsequent taxation years, is consequential on the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the introduction of the mechanism in subsection 110.6(19) for recognizing gains accrued to that day.

Subsection 110.6(20) limits the application of the capital gains election mechanism in subsection 110.6(19) to property in certain circumstances.

Where the elector is an individual (other than a trust), the election under subsection 110.6(19) will be effective only if one or more of the following conditions are met:

i) the application of that subsection to all the properties and businesses in respect of which elections made by the individual or a spouse of the individual

  - would result in an increase in the $100,000 capital gains exemption under subsection 110.6(3) that may be claimed by the person making the election or that person's spouse, and

  - would not result in the lesser of the annual gains limit and the cumulative gains limit (in excess of amounts deducted for the year under the $500,000 lifetime capital gains exemption) exceeding the balance of the $100,000 exemption (or $75,000 capital gains deduction) available to the elector or spouse,

ii) the amount designated in the election, if it is in respect of a property, is greater than 11/10 of the property's fair market value at the end of February 22, 1994, or

iii) the amount designated in the election, if it is in respect of a business, is $1.00 or is greater than 11/10 of the fair market value at the end of February 22, 1994 of all of the elector's eligible capital property in respect of the business.

The references to the spouse of an elector in subparagraph 110.6(2)(a)(i) are intended to ensure that an individual's election under subsection 110.6(19) is not rendered ineffective merely because the taxable capital gain that results from the election is attributed to a spouse of the elector. The references also ensure that the limit to the taxable capital gains that can be triggered through the elections cannot be avoided by electing in respect of properties the gains from the disposition of which are attributed to the elector's spouse. Where only part of a taxable capital gain resulting from an election in respect of a property is attributed to a spouse of the elector, clause 110.6(20)(a)(i)(B) will not render the election ineffective even though the resulting taxable capital gain of either the elector or the spouse cannot be sheltered by his or her capital gain exemption.

There are adverse tax consequences for an individual who over-estimates a property's fair market value as at the end of February 22, 1994 and designates in the election in respect of the property an amount greater than 11/10 of that fair market value. Subparagraphs 110.6(20)(a)(ii) and (iii) ensure that the individual cannot avoid the tax consequences of such an election by, for example, triggering additional gains that in total exceed his or her available exemption.

The reference in subparagraph 110.6(20)(a)(iii) to an individual designating $1.00 in respect of a business ensures that the benefit of the capital gains exemption will still be available to the individual in respect of gains included under paragraph 14(1)(a)(v) in computing the individual's income for the taxation year in which the fiscal period of the business that includes February 22, 1994 ends where those gains result from dispositions of eligible capital property that occurred before February 23, 1994.

Where the person making the election is a personal trust, the election under subsection 110.6(19) will be effective only if the application of that subsection to all the elections made by the trust

- would result in an increase in the eligible taxable capital gains of the trust that are flowed out under subsections 104(21) and (21.2) to an individual who was a beneficiary of the trust on February 22, 1994 and who was resident in Canada at any time in the individual's taxation year in which the trust's taxation year that includes February 22, 1994 ends, or

- would result in an increase in the amount deductible by the trust under subsection 110.6(12). This would be applicable where the election is made by a personal trust that is eligible for a capital gains exemption under subsection 110.6(12) for its taxation year that includes February 22, 1994, (that is, a spousal trust, other than one that has elected under subsection 104(5.3), whose beneficiary spouse has died during that taxation year).

Where an election is not effective because of subsection 110.6(20), the elector may have the opportunity to amend the election in accordance with the rules in subsections 110.6(27) and (28).

ITA
110.6(21)

Where an individual has elected under subsection 110.6(19) in respect of a capital property and paragraph 110.6(19)(a) applies to the property, the individual is deemed to have disposed of the property for proceeds of disposition equal to the amount designated in the election. Where that property is a non-qualifying real property (within the meaning assigned by subsection 110.6(1)), only a portion of the gain recognized as a consequence of the deemed disposition will be eligible for the capital gains exemption. New subsection 110.6(21) of the Act reduces the taxable capital gain otherwise determined by 3/4 of the portion of the gain that is not an eligible real property gain. It also reduces the individual's adjusted cost base or capital cost, as the case may be, of the property (except where the property is an interest in a flow-through entity within the meaning assigned by subsection 39.1(1)) by that ineligible portion of the gain. (See also new paragraph 53(2)(u)). These adjustments serve to ensure that the tax on that portion of the gain that is not an eligible real property gain will be deferred until a subsequent taxable disposition of the property.

Subsection 110.6(21) is effective for the 1994 and subsequent taxation years.

ITA
110.6(22)

Where the amount designated in an election under subsection 110.6(19) in respect of a capital property referred to in paragraph 110.6(19)(a) exceeds 11/10 of the property's fair market value at the end of February 22, 1994, the excess will reduce

- where the property is an interest in or a share of the capital stock of a flow-through entity (within the meaning assigned by subsection 39.1(1)) such as a mutual fund trust or a partnership, the exempt capital gains balance the elector might otherwise have had in respect of the entity had the designated amount not exceeded that fair market value, and

- in any other case, the cost at which the elector is deemed by paragraph 110.6(19)(a) to have reacquired the property.

Where the excess is greater than

- where the property is an interest in or a share of the capital stock of a flow-through entity, 4/3 of the maximum taxable capital gain that could have resulted from an election under subsection 110.6(19) in respect of the property, and

- in any other case, the fair market value of the property at that time,

the amount in excess thereof will be deducted in computing the adjusted cost base to the elector of the property at any time after February 22, 1994. (See also new paragraph 53(2)(v) of the Act). This is intended to discourage individuals from attempting to shelter post-February 1992 gains by triggering gains in excess of the gains accrued to February 22, 1994.

ITA
110.6(23)

Where an individual elects under subsection 110.6(19) in respect of an interest in a partnership, certain adjustments to the individual's adjusted cost base of the interest are required for the purpose of computing the individual's capital gain resulting from the election (which will be reflected in the individual's exempt capital gains balance in respect of the partnership). Paragraph 110.6(23)(a) requires an addition to the adjusted cost base of the interest equal to the total of

- the pre-February 23, 1994 portion of the individual's share of the partnership's net income for its fiscal period that includes February 22, 1994, and

- the individual's share of the partnership's net capital gains that arose from dispositions before February 23, 1994.

For this purpose, the income of the partnership for that fiscal period is prorated on a daily basis.

Where the partnership has net losses for that fiscal period and the prorated portion of the net loss is greater than the partnership's pre-February 23, 1994 net taxable capital gains, the excess is required to be deducted in computing the individual's adjusted cost base immediately before the deemed disposition.

These adjustments ensure that the income or loss of the partnership for the period up to February 22, 1994 that is reflected in the value of a partnership interest on that day but would otherwise not be reflected in the adjusted cost base of its members' interests until the end of the fiscal period will be reflected in the adjusted cost base of those interests for the purpose of determining the member's gains accrued to February 22, 1994 that can be recognized by means of the capital gains election mechanism in subsection 110.6(19). (See also the amendments to paragraphs 53(1)(e) and 53(2)(c) of the Act).

Subsection 110.6(23) is effective for the 1994 and subsequent taxation years.

ITA
110.6(24)

New subsection 110.6(24) of the Act sets out the time limits for the filing of elections made under subsection 110.6(19).

Where the election is made by an individual (other than a trust), the election must ordinarily be filed on or before the individual's balance-due day for the 1994 taxation year. Where the property covered by the election is eligible capital property in respect of a business of the individual, the election must be filed on or before the individual's balance-due day for the taxation year in which the fiscal period of the business that includes February 22, 1994 ends. An individual's balance-due day for a taxation year coincides with the normal filing deadline for the individual's tax return for the year. For most individuals, this will be April 30 of the following year. For deceased individuals, the filing deadline for the terminal return is April 30 of the following year unless the death occurred in the last 2 months of the year or before April 30 of the following year, in which case the filing deadline is 6 months after the date of death.

Where the election is made by a personal trust, the filing deadline for the election is March 31 of the calendar year following the calendar year in which the taxation year of the trust that includes February 22, 1994 ends. For example, where that taxation year of the trust ends February 28, 1994, the election must be filed on or before March 31, 1995. Where that taxation year ends January 31, 1995, the election must be filed on or before March 31, 1996.

ITA
110.6(25) to (30)

New subsections 110.6(25) to (30) of the Act deal with the revocation of elections made under subsection 110.6(19), the filing of late and amended elections under that subsection, and penalties payable in respect of late-filed and amended elections.

Subject to subsection 110.6(28), new subsection 110.6(25) permits an election made under subsection 110.6(19) in respect of a property to be revoked by the filing of a written notice of the revocation with the Minister of National Revenue before 1998.

Subsection 110.6(26) permits an election under subsection 110.6(19) in respect of a property to be filed within 2 years after the applicable filing deadline in subsection 110.6(24) if an estimate of the penalty in respect of the late filing is paid when the late election is filed.

Subject to subsection 110.6(28), subsection 110.6(27) permits an election under subsection 110.6(19) in respect of a property to be amended at any time before 1998 by the filing of an amended election in prescribed form accompanied by payment of an estimate of the penalty in respect of the amended election.

Subsection 110.6(28) prohibits the revocation or amendment of an election where the amount designated in the election in respect of the property is greater than 11/10 of its fair market value at the end of February 22, 1994. This is intended to ensure that an individual cannot, by revoking or amending an election, escape the consequences of having used an inflated value in an election in respect of a property.

The penalty in respect of a late-filed election is 1/3 of 1% of the taxable capital gain resulting from the election multiplied by the number of months that begin or end on or after the election filing deadline and on or before the day that the late election is filed.

The penalty in respect of an amended election is the number of months that begin or end after the election filing deadline and on or before the day that the amended election is filed multiplied by 1/3 of 1% of the increase, if any, in the taxable capital gain resulting from the amended election over the amount that would have been the taxable capital gain resulting from the original election if the limitations in subsection 110.6(20) had not applied. In other words, a penalty will be payable in respect of an amended election only where the amount designated in respect of the property in the amended election is greater than the amount designated in the original election in respect of the property.

The penalty in respect of late-filed or amended elections applies on a property-by-property basis. As a result, the penalty in respect of an increase in the designated amount in respect of one property will not be offset by a revocation of another election or a decrease in the designated amount in respect of another property.

Subsection 110.6(30) provides for the assessment of penalties in respect of late-filed and amended elections and the requirement of the elector to pay the penalties so assessed.

Subsections 110.6(25) to (30) are effective for the 1994 and subsequent taxation years.

Subclause 32(15)

ITA
110.6(2)(d) and (2.1)(d)

Subsection 110.6(2) of the Act provides a deduction in respect of net taxable capital gains from the disposition of qualified farm property. Subsection 110.6(2.1) provides a similar deduction in respect of net taxable capital gains from the disposition of qualified small business corporation shares. Together, these deductions compose the $500,000 lifetime capital gains exemption.

In applying these provisions to the 1994 and 1995 taxation years, paragraphs 110.6(2)(d) and (2.1)(d) are to be read as if gains from the disposition of qualified farm property and qualified small business corporation shares that resulted from an election made under subsection 110.6(19) were excluded. This will ensure that gains resulting from an election in respect of properties that would ordinarily qualify for the $500,000 exemption under subsection 110.6(2) or (2.1) will qualify for the exemption but only to the extent of the deduction available under subsection 110.6(3) – that is, the $100,000 exemption.

Clause 33

Age Tax Credit

ITA
118(2)

Subsection 118(2) of the Act provides an age tax credit for individuals who are over 65 years of age or who reach age 65 in the year. The credit is calculated as a percentage (17 per cent for 1994) of an indexed base amount ($3482 for 1994).

This amendment to subsection 118(2) provides that, for 1995 and subsequent years, the base amount upon which an individual's age tax credit is calculated will be reduced by 15 per cent of the amount by which the individual's income for the year exceeds $25,921. Like the base amount itself, this income threshold will be subject to indexation. For 1994, the reduction will be only one-half of the reduction otherwise determined. As a result, in 1994 the age tax credit will be reduced to half for seniors with incomes over $49,134, while in 1995 and subsequent years no age tax credit will be available to seniors with incomes over $49,134 (as indexed).

Clause 34

Charitable Donations Tax Credit

ITA
118.1(3)

Section 118.1 of the Act provides a tax credit to individuals for charitable gifts and gifts to the Crown and certain other entities. Under subsection 118.1(3), the credit is calculated as 17 percent of the first $250 of such gifts and 29 per cent of gifts above that amount. Subsection 118.1(3) is amended, effective for 1994 and subsequent years, to lower the threshold at which the 29 per cent credit rate applies from $250 to $200.

Clause 35

Small Business Deduction

ITA
125(5) and (5.1)

Section 125 of the Act establishes the special low rate of tax applicable to the income of a Canadian-controlled private corporation (CCPC) from an active business carried on in Canada. This preferential tax rate is provided by way of an annual tax credit, commonly referred to as the "small business deduction", which is calculated as 16 per cent of the least of: a corporation's active business income for a taxation year; its taxable income for the year; and its business limit for the year (which is generally $200,000).

The Large Corporations Tax (LCT) is a tax levied, under Part I.3 of the Act, at the rate of 0.2 per cent on a corporation's "taxable capital employed in Canada" in excess of $10 million. In general terms, taxable capital employed in Canada is the amount of a corporation's debt and equity, less the amount of its inter-corporate investments, that is considered to be used in connection with its activities carried on in Canada.

New subsection 125(5.1) of the Act is designed to phase out the small business deduction, on a straight-line basis, for corporations having taxable capital employed in Canada of between $10 and $15 million, and, therefore, to eliminate the small business deduction for CCPCs having more than $15 million of taxable capital.

New subsection 125(5.1) of the Act restricts a corporation's access to the small business deduction through the reduction of its annual business limit: in general, each $1 of a corporation's LCT liability for a given taxation year will reduce its business limit for the next taxation year by $20. Since the LCT is payable only upon taxable capital employed in Canada in excess of $10 million, section 125(5.1) will not affect small and medium-sized business corporations.

For purposes of new subsection 125(5.1), a corporation's LCT liability is determined without reference to the credit provided under Part I.3 for the corporate surtax. Moreover, in order to negate the effect of short taxation years on the amount of a corporation's business limit reduction, LCT payable for the preceding taxation year is to be calculated without reference to the pro-rated tax reduction that applies under the LCT to short taxation years.

In computing its business limit reduction, a CCPC that is associated with one or more other corporations, whether CCPCs or non-CCPCs, in a taxation year ending in a given calendar year, is required to take into account its own as well as the LCT liability of such associated corporations for their last taxation year ending in the preceding calendar year.

Finally, new subsection 125(5.1) of the Act applies to reduce a corporation's business limit "otherwise determined", that is, its business limit determined in accordance with the existing provisions of section 125 of the Act. More specifically, in computing its business limit, a taxpayer should apply the provisions of section 125 in the following order: subsections 125(2) to (4), then 125(5) and, finally, new 125(5.1). The amendment to subsection 125(5) of the Act is designed to achieve this ordering.

Amended subsection 125(5) and new subsection 125(5.1) of the Act apply to taxation years ending after June 30, 1994. However, transitional provisions prorate the business limit reduction in subsection 125(5.1) for taxation years that straddle July 1, 1994, on the basis of the number of days in a taxation year after that date.

Examples

The example below illustrates the calculation of the business limit for A Co., a Canadian-controlled private corporation that is not associated with any other corporation, for its taxation years ending December 31, 1994, August 31, 1995 and August 31, 1996. Assume that it has taxable capital employed in Canada and Large Corporations Tax (LCT) paid as follows:

Taxation year ending	Taxable capital employed in Canada	LCT paid
December 31, 1993	$12,000,000	$4,000
December 31, 1994	$12,000,000	$4,000
August 31, 1995	$13,000,000	$3,995

Calculation of business limit

Taxation year ending		31/12/94	31/08/95	31/08/96
LCT payable for preceding taxation year	A	$4,000	$4,000	$3,995
Number of days in taxation year	B	365	243	366
Number of days in taxation year after June 30, 1994[1]	C	184	n/a	n/a
LCT determined on a full year basis:	D	$4,000	$4,000	$6,000
Lesser of D and $10,000[1]	E	$4,000	n/a	n/a
Business limit otherwise determined (after the application of 125(5)(b)): \$200,000 x B/365	F	$200,000	$133,151	$200,000
Business limit reduction: For years beginning before July 1994: $F \times \frac{E}{\$10,000} \times \frac{C}{B}$		40,329	n/a	n/a
For later years: $F \times \frac{D}{\$10,000}$		n/a	53,260	120,000
Business limit		$159,671	79,891	80,000

[1] For taxation years beginning before July 1994.

This example illustrates the calculation of the business limit for two Canadian-controlled private corporations, A Co. and B Co., that are associated throughout the period. For A Co., the assumptions are the same as in the previous example. For B Co., assume that the taxation years and the Large Corporations Tax (LCT) paid are as follows:

Taxation year ending	LCT paid
August 31, 1993	$4,000
August 31, 1994	$4,500
August 31, 1995	$5,000

Calculation of business limit

Calendar year		1994	1995	1996
LCT payable for last fiscal year ending in preceding calendar year				
A Co.	A	$4,000	$4,000	$3,995
B Co.	B	$4,000	$4,500	$5,000
Number of days in previous taxation year				
A Co.	C	365	365	243
B Co.	D	365	365	365
Allocation of $200,000 Business Limit				
A Co.	E	$75,000	$75,000	$75,000
B Co.	F	125,000	125,000	125,000
		$200,000	$200,000	$200,000
LCT determined on a full year basis:				
A Co.		$4,000	$4,000	$6,000
B Co.		$4,000	$4,500	$5,000
Total	G	$8,000	$8,500	$11,000
Lesser of G and $10,000[1]	H	$80,000	n/a	n/a

[1] For taxation years beginning before July 1994.

A Co.

Taxation year ending		31/12/94	31/08/95	31/08/96
Number of days in taxation year	J	365	243	366
Number of days in taxation year after June 30, 1994[1]	K	184	n/a	n/a
Business limit otherwise determined (after the application of 125(5)(b)): $E \times J / 365$	L	75,000	49,932	75,000
Business limit reduction: For years beginning before July 1994: $L \times \frac{H}{\$10,000} \times \frac{K}{J}$		30,247	n/a	n/a
For later years: $L \times \frac{G}{\$10,000}$		n/a	42,442	82,500
Business Limit		44,753	7,490	0[2]

B Co.

Taxation year ending		31/08/94	31/08/95	31/08/96
Number of days in taxation year	M	365	365	366
Number of days in taxation year after June 30, 1994[1]	N	62	n/a	n/a
Business limit otherwise determined (after the application of 125(5)(b)): $F \times M / 365$	P	125,000	125,000	125,000
Business limit reduction: For years beginning before July 1994: $P \times \frac{H}{\$10,000} \times \frac{N}{M}$		16,986	n/a	n/a
For later years: $P \times \frac{G}{\$10,000}$		n/a	106,250	137,500
Business Limit		108,014	18,750	0[2]

(1) For taxation years beginning before July 1994.

(2) Business limit cannot be a negative amount or number.

Clause 36

Foreign Tax Credit

ITA
126

Section 126 of the Act provides rules under which a taxpayer may deduct amounts based on foreign taxes paid from tax otherwise payable under Part I of the Act.

Subclause 36(1)

ITA
126(7)

"tax for the year otherwise payable under this Part"

Under subsection 126(7) of the Act, for the purposes of computing the taxpayer's foreign tax credit, a taxpayer's "tax for the year otherwise payable" is determined without reference to a number of specified provisions.

This definition is amended to provide that the special tax credit provided to beneficiaries of mining reclamation trusts under new subsection 127.41(2) is also ignored for this purpose. Thus, the foreign tax credit limitation is determined by reference to tax payable under Part I of the Act before the deduction of this special credit. The definition is also amended to eliminate a reference to a provision of the Act that was previously repealed.

These amendments apply to taxation years ending after February 22, 1994.

Subclause 36(2)

ITA
126(7)

"non-business-income tax"

Subsection 126(7) of the Act defines several expressions, including the expression "non-business income tax", for the purpose of determining a taxpayer's foreign tax credit under section 126. Paragraph (g) of the definition "non-business income tax" reduces a taxpayer's non-business income tax for a year by an amount that can reasonably be regarded as being attributable to a taxable capital gain or portion thereof in respect of which the taxpayer has claimed the capital gains exemption for the year. This paragraph of the definition is amended to ensure that the non-business income tax will be reduced

- not only where the capital gains exemption was claimed in the year but also where it was claimed in a previous year (as might be the case, for example, where the capital gains exemption was previously claimed as a result of an election made under subsection 110.6(19) in respect of the property), and

- not only where the exemption in respect of the gain was claimed by the taxpayer but also where it was claimed by a spouse of the taxpayer (as might be the case where the gain is attributed to the spouse for Canadian income tax purposes).

These amendments are effective for the 1994 and subsequent taxation years.

Clause 37

Investment Tax Credits

ITA
127

Section 127 of the Act permits deductions in computing tax payable in respect of logging taxes, political contributions and investment tax credits.

Subclauses 37(1) to (4)

ITA
127(9)

Subsection 127(9) of the Act provides definitions for certain terms used in sections 127 and 127.1 of the Act.

"certified property"

The definition "certified property" is relevant for the purposes of determining the type of property qualifying for the special 30% investment tax credit. The certified property must be used in a prescribed region of Canada for manufacturing and processing as determined under the *Regional Development Incentives Act.* The definition "certified property" is amended to provide that the investment tax credit for certified property will no longer be available for property acquired after 1994 except in certain specified circumstances. The amendments to the definition "certified property" apply to property acquired after 1994.

"specified percentage"

The definition "specified percentage" in subsection 127(9) sets out the rates at which investment tax credits are earned in different circumstances.

Paragraph (a) of the definition "specified percentage" sets out the investment tax credit rates in respect of "qualified property". The rates for such property acquired for use in the Atlantic provinces, the

Gaspé Peninsula or a prescribed offshore region are set out in subparagraphs (a)(iii) and (v). Subparagraphs (a)(iii) and (v) are amended to reduce the rate from the current 15% to 10% for property acquired after 1994, except for property acquired in certain defined circumstances. The amendments to subparagraphs (a)(iii) and (v) of the definition "specified percentage" apply to property acquired after 1994.

Paragraph (e) of the definition "specified percentage" sets out the investment tax credit rates in respect of a "qualified expenditure". The rates for such expenditures incurred by a taxpayer after the taxpayer's 1984 taxation year are set out in subparagraph (e)(iv). The rate for the Atlantic Provinces and the Gaspé Peninsula is 30% and for elsewhere in Canada is 20%. Subparagraph (e)(iv) is amended, and new subparagraph (v) is added, to ensure that the current rate of 30% for the Atlantic Provinces and the Gaspé Peninsula is reduced to 20% for expenditures incurred after 1994 except in cases where the expenditures are incurred by a taxpayer pursuant to a written agreement entered into by the taxpayer prior to February 22, 1994.

Subclauses 37(5) and (6)

ITA
127(10.1), (10.2) and (10.6)

Subsection 127(10.1) of the Act provides an additional investment tax credit for qualifying scientific research and experimental development (SR&ED) expenditures incurred by certain Canadian-controlled private corporations (CCPCs). To qualify for the additional credit, the corporation must be a CCPC throughout the taxation year in which the expenditures were incurred and its taxable income for its preceding taxation year, together with the taxable incomes for the preceding taxation years of all corporations with which it was associated, must not exceed twice the business limit of the corporations (as determined under section 125 of the Act). Furthermore, the additional credit cannot be earned on expenditures in excess of the corporation's expenditure limit.

Subsection 127(10.1) is amended, effective for taxation years beginning after 1995, as a consequence of the amendments to the small business deduction in subsection 125 of the Act. This amendment to subsection 127(10.1) removes the reference to the condition that the corporation's taxable income for its preceding taxation year, together with its associated corporations' taxable income for their preceding taxation years, cannot exceed twice the business limit of the corporation and its associates for the preceding years. The determination of the expenditure limit in amended subsection 127(10.2) of the Act incorporates the new business limit determinations under amended section 125.

Subsection 127(10.2) of the Act defines a CCPC's expenditure limit for a taxation year for the purposes of determining SR&ED expenditures eligible for the additional credit under subsection 127(10.1). As the taxable income of the corporation or its associated corporations for the preceding taxation years increases from $200,000 to $400,000, the expenditure limit decreases from $2,000,000 to zero. In other words, for every $1 that the previous year's taxable income exceeds $200,000, the expenditure limit is reduced by $10. Where the CCPC is associated with another corporation in the year, the CCPC's expenditure limit is treated as nil unless the corporations share the expenditure limit as provided for in subsections 127(10.3) and (10.4).

Subsection 127(10.2) is amended, effective for taxation years that begin after 1995, as a consequence of the changes to the small business deduction in section 125 of the Act. Under amended subsection 127(10.2), a CCPC's expenditure limit for a particular taxation is multiplied by the ratio of the total of the business limits of the CCPC and its associates for the particular year as determined under section 125 to $200,000. In other words, the CCPC's expenditure limit will be reduced in accordance with the reduction in the CCPC's business limit under section 125 of the Act. Consequently, where the CCPC's business limit is zero, the CCPC's expenditure limit is also zero.

Subsection 127(10.6) of the Act is amended to provide, in determining a CCPC's expenditure limit for a taxation year under subsection 127(10.2), a gross-up of the CCPC's taxable income and business limit where the taxation is less than 51 weeks. Amended subsection 127(10.6) applies to taxation years that begin after 1995.

Subclause 37(7)

ITA
127(11.2)

Subsection 127(11.2) of the Act provides that, for the purposes of sections 127 and 127.1, a taxpayer will generally be treated as not having acquired a property or incurred an expenditure for scientific research and experimental development property (as described in subparagraph 37(1)(b)(i) of the Act), until the property is available for use by the taxpayer. Therefore, for example, in order for certified property (as defined in amended subsection 127(9) of the Act) to qualify for the 30% investment tax credit, it must generally be acquired by the taxpayer before 1995 and available for use by the taxpayer before that time.

Subsection 127(11.2) is amended, effective after February 21, 1994, to ensure that eligibility for an investment tax credit is not affected by the fact that, at the time of acquisition of the property by the taxpayer, the property may not be available for use by the taxpayer. Under amended subsection 127(11.2) the availability for use by the taxpayer will only affect the deduction and refundability of the investment tax credit.

Clause 38

Refundable Investment Tax Credits

ITA
127.1(2)

Section 127.1 of the Act provides for the refund of investment tax credits under certain circumstances. Subsection 127.1(2) of the Act sets out definitions relevant for the purposes of section 127.1. A "qualifying corporation" as defined in subsection 127.1(2) is, for a particular taxation year, a Canadian-controlled private corporation the taxable income of which for its preceding taxation year together with the taxable incomes of all associated corporations for their preceding taxation years does not exceed the total of the small business limits (as determined under section 125 of the Act) of the corporation and its associates for those preceding years. A qualifying corporation may be eligible for either a 40% or 100% refund for its investment tax credits depending on the type of expenditures.

The definition "qualifying corporation" in subsection 127.1(2) is amended, effective for taxation years ending after June 1994, as a consequence of the changes to the small business deduction in section 125 of the Act. The amendment ensures that the business limits of the corporation and its associated corporations, as determined under new section 125, apply only to taxation years that begin after 1995, and that for taxation years that begin before 1996, the business limits under section 125 will continue to be determined in the same manner as that used for taxation years ending before July 1994. This 2-year postponement of the consequential effect of the small business deduction changes on the refundability of investment tax credits is consistent with the effective date of the changes to subsection 127(10.1) and (10.2) of the Act.

Clause 39

Part XII.4 Tax Credit

ITA
127.41

New section 127.41 of the Act provides a refundable tax credit to beneficiaries of a mining reclamation trust, recognizing that income subject to the special tax at the trust level under Part XII.4 of the Act is also included in computing a beneficiary's income under new subsection 107.3(1). The refundable tax credit avoids the double taxation of the same income in the hands of a mining reclamation trust and its beneficiaries. (Note that this refundable tax credit need not be included in computing the recipient's income under paragraph 12(1)(x) or taken into account under any other provision of the Act.)

More specifically, where a taxpayer was the sole beneficiary of a mining reclamation trust in a taxation year of the trust that ends in a particular taxation year of the taxpayer, the taxpayer may deduct under subsection 127.41(2), in computing federal income tax for the particular year, the tax payable by the trust under Part XII.4. To the extent that the amount is not deducted by the taxpayer for a taxation year, it is deemed by subsection 127.41(3) to have been paid, on account of the taxpayer's tax for the year, where the taxpayer is an individual, on the individual's balance-due day for the year and, where the taxpayer is a corporation, on the day on or before which any balance of tax under Part I is required to be paid. For the purposes above, a taxpayer does not include a person (for example, certain Crown corporations) exempt from tax under Part I of the Act.

Section 127.41 also applies in the event that a beneficiary of a mining reclamation trust is a partnership. Where this is the case, members of the partnership are entitled to a pro-rata share of the Part XII.4 tax credit to which the partnership would be entitled if it were a person.

Section 127.41 applies to taxation years ending after February 22, 1994.

The following example illustrates the combined effect of the rules in sections 107.3 and 127.41 and Part XII.4 for mining reclamation trusts and their beneficiaries.

EXAMPLE

A mining reclamation trust has a single beneficiary in a taxation year. It earns $1,000 of investment income in the year. The beneficiary is a corporation the federal income tax payable of which (after taking into account subsection 107.3(1)) for its taxation year in which the trust's year ends is nil because of the various deductions to which it is entitled in calculating its income.

Results:

1. The $1,000 of income is treated as the trust's income for the purposes of Part XII.4 of the Act. The same $1,000 is treated as the corporation's income.

2. The mining reclamation trust is subject to $280 of federal tax under Part XII.4.

3. The corporation is considered to have paid an amount of $280 under subsection 127.41(3) on account of its tax payable under Part I. Since no tax is payable by the corporation, the corporation is *entitled to an income tax refund of the amount of the Part XII.4 tax paid by the trust - that is, $280.*

Clause 40

Mortgage Investment Corporations

ITA
130.1(4) and (9)

Section 130.1 of the Act sets out rules that apply to mortgage investment corporations and their shareholders. A mortgage investment corporation is essentially treated as a conduit in that its income (including capital gains) may be flowed through to its shareholders and taxed as such in their hands rather than in the corporation.

Subsection 130.1(4) allows a mortgage investment corporation to elect to treat a dividend paid to its shareholders in the period beginning 91 days after the beginning of a taxation year and ending 90 days after the end of the taxation year as a capital gains dividend to the extent of the amount of its undistributed capital gains for the year. Such a dividend is treated as a capital gain of the shareholder. This subsection was amended, applicable to the 1992 and subsequent taxation years, to provide that such an election must be made under either paragraph 130.1(4)(a) or (b). A capital gains dividend under paragraph (a) was treated as having been paid out of qualifying taxed capital gains and resulted in a capital gain in the hands of the shareholders that was eligible for the $100,000 lifetime capital gains exemption. A capital gains dividend under paragraph (b) was treated as having been paid out of non-qualifying taxed capital gains and did not result in capital gains eligible for the exemption in the hands of the shareholders.

As a result of the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, it is no longer necessary to treat capital gains of a mortgage investment corporation that are flowed through to its shareholders under 130.1(4) as capital gains that are eligible or ineligible for the exemption. Accordingly, subsection 130.1(4) is amended, effective for capital gains dividends paid after

February 22, 1994, simply to treat a capital gains dividend paid by the corporation as a capital gain in the hands of its shareholders.

Subsection 130.1(9) is also amended, effective after February 22, 1994, by deleting the definitions "non-qualifying real property", "non-qualifying taxed capital gains" and "qualifying taxed capital gains" and by adding the definition "taxed capital gains". The definition "taxed capital gains" references the meaning assigned to that expression in paragraph 130(3)(b) of the Act. Essentially, a corporation's taxed capital gains for a taxation year are its net taxable capital gains for the year less any net capital loss carryforward deducted under paragraph 111(1)(b) of the Act in computing the corporation's taxable income for the year.

Where an individual has elected under subsection 110.6(19) in respect of his or her shares of a mortgage investment corporation, the individual may be able to shelter from tax all or a portion of the capital gains dividends received by the individual from the corporation in a taxation year by claiming a reduction under new section 39.1. (See the commentary on new section 39.1).

Clause 41

Mutual Fund Corporations

ITA
131

Section 131 of the Act sets out rules relating to the taxation of mutual fund corporations and their shareholders.

Taxable capital gains of a mutual fund corporation are taxed at the full corporate tax rate. However, this tax (referred to as "refundable capital gains tax on hand") is refunded to the corporation when its taxable capital gains are distributed to its shareholders in the form of "capital gains dividends".

Subclause 41(1)

ITA
131(1)

Subsection 131(1) of the Act allows a mutual fund corporation to elect to treat a dividend payable to its shareholders as a capital gains dividend to the extent of its capital gains dividend account. Such a dividend is treated as a taxable capital gain of the shareholder in respect of which the shareholder may be entitled to claim the capital gains exemption. Alternatively, the corporation may elect under that subsection to treat a dividend payable to its shareholders as a capital gains dividend payable out of its non-qualifying real property capital gains dividend account. In that case, the dividend is treated as a capital gain in the hands of the shareholders that is not eligible for the capital gains exemption.

As a result of the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994, it is no longer necessary to treat capital gains of a mutual fund corporation that are flowed through to its shareholders under subsection 131(1) as capital gains that are either eligible or ineligible for the exemption. Accordingly, subsection 131(1) is amended, effective for capital gains dividends paid after February 22, 1994, simply to treat a capital gains dividend paid by the corporation as a capital gain in the hands of its shareholders. Such a gain will no longer be eligible for the exemption.

These amendments to subsection 131(1), as well as the amendments to subsection 131(6) of the Act, also apply, because of subsection 130(2) of the Act, for the purpose of capital gains dividends paid by investment corporations.

Where an individual has elected under subsection 110.6(19) in respect of his or her shares of a mutual fund corporation, the individual may be able to shelter from tax all or a portion of the capital gains dividends received by the individual from the corporation in a taxation year by claiming a reduction under new section 39.1. (See the commentary on new section 39.1).

Subclauses 41(2) and (3)

ITA
131(6)

Subsection 131(6) of the Act is amended, effective after February 22, 1994, by deleting the definitions "non-qualifying real property" and "non-qualifying real property capital gains dividend account" and amending the definition "capital gains dividend account". The amended definition "capital gains dividend account", which is relevant in determining the extent to which dividends can be treated as capital gains dividends which will give rise to a capital gains refund, represents the undistributed net capital gains of the corporation in respect of which the corporation has not obtained a capital gains refund.

Clause 42

Employee Profit Sharing Plans - Capital Gains

ITA
144(4)

A trust that is governed by an employees profit sharing plan is required to allocate all of its income and losses each year to employees who are beneficiaries under the plan. Subsection 144(4) provides that capital gains and capital losses that are so allocated to the beneficiaries retain their character as capital gains and capital losses in the hands of the beneficiaries to whom they are allocated. This subsection is amended, effective for the 1994 and subsequent taxation years, to clarify that capital gains so allocated are treated as capital gains in the hands of the employees for the purposes of the lifetime capital gains exemption. The properties disposed of by the trust that gave rise to the capital gains are considered to have been disposed of by the employees on the day on which they were disposed of by the trust.

This amendment will ensure that a capital gain of such a trust that arose from a disposition of property that occurred on or before February 22, 1994 and that would, but for the elimination of the $100,000 lifetime capital gains exemption effective for dispositions that occur after that day, be eligible for the exemption in the hands of the employee beneficiaries to continue to be so eligible.

Clause 43

Registered Retirement Savings Plans

ITA
146

Section 146 of the Act provides rules governing the treatment of registered retirement savings plans (RRSPs).

Subclause 43(1)

ITA
146(1)

"premium"

Subsection 146(1) of the Act defines the expression "premium" as a payment made by an individual to an RRSP in consideration for benefits provided under the RRSP. However, except for specified purposes, a "premium" does not include repayments made under the Home Buyers' Plan (HBP).

The English version of the definition is amended to ensure that, to the extent an amount paid to an RRSP has been designated under amended subsection 146.01(3) as a repayment with respect to the HBP, it will not be treated as a "premium" for most purposes. As a result, such repayments cannot be deducted in computing an individual's income. No corresponding change is made to the French version of the definition because it is already clear in this regard.

This amendment applies to the 1995 and subsequent taxation years.

Subclause 43(2)

ITA
146(5)(a)

Under subsection 146(5) of the Act, an individual may deduct in computing income for a taxation year an amount not exceeding the lesser of two amounts. The first amount is the individual's RRSP deduction limit for the year. The second amount, as determined under paragraph 146(5)(a), is the undeducted portion of the individual's pool of post-1990 RRSP contributions made on or before the 60th day of the following year to RRSPs under which the individual is the annuitant.

Paragraph 146(5)(a) is amended to provide that the second amount, described above, does not include contributions that are withdrawn as eligible amounts under the Home Buyers' Plan (HBP) less than 90 days after being contributed. For this purpose, it is assumed that RRSP withdrawals relate first to RRSP earnings and then, on a "first-in, first-out" basis to RRSP premiums previously paid. As a consequence, this restriction does not affect the deductibility of RRSP contributions made by an individual who withdraws a single eligible amount under the HBP from the individual's RRSP, where the eligible amount is no greater than the balance in the RRSP 90 days before the withdrawal and no other amounts were withdrawn from the RRSP in the 90-day period. In general, this restriction denies a deduction for a contribution by an individual to an RRSP made fewer than 90 days before a single withdrawal by the individual of an eligible amount from the RRSP only to the extent that the contribution is greater than the fair market value of the RRSP balance after the withdrawal.

This amendment applies to RRSP contributions made after March 1, 1994.

Subclause 43(3)

ITA
146(5.1)(a)

Under subsection 146(5.1) of the Act, an individual may deduct in computing income for a taxation year an amount not exceeding the lesser of two amounts. The first amount is the individual's RRSP deduction limit for the year, minus the amount deducted by the individual for the year under subsection 146(5) with respect to RRSPs under which the individual is the annuitant. The second amount, as determined under paragraph 146(5.1)(a), is the undeducted portion of the individual's pool of post-1990 RRSP contributions made on or before the 60th day of the following year to RRSPs under which the individual's spouse is the annuitant.

Paragraph 146(5.1)(a) is amended to provide that the second amount, described above, does not include contributions that are withdrawn as eligible amounts under the Home Buyers' Plan (HBP) less than 90 days after being contributed. For this purpose, it is assumed that RRSP withdrawals relate first to RRSP earnings and then, on a "first-in, first-out" basis to RRSP premiums previously paid. As a consequence, this restriction does not affect the deductibility of RRSP contributions made by an individual whose spouse withdraws a single eligible amount under the HBP from the RRSP, where the eligible amount is no greater than the balance in the RRSP 90 days before the withdrawal and no other amounts were withdrawn from the RRSP in the 90-day period. In general, this restriction denies a deduction for a contribution made by an individual to an RRSP fewer than 90 days before a single withdrawal of an eligible amount by the individual's spouse from the RRSP only to the extent that the contribution is greater than the fair market value of the RRSP balance after the withdrawal.

This amendment applies with respect to RRSP contributions made after March 1, 1994.

Clause 44

Home Buyers' Plan

ITA
146.01

The rules relating to the Home Buyers' Plan (HBP) are set out in section 146.01 of the Act. Under the existing rules, a home buyer may withdraw amounts (referred to in the section as "eligible amounts") from one or more or his or her RRSPs on a tax-free basis and repay the amounts on a non-deductible basis over 15 years from 1995 to 2009. The total eligible amounts withdrawn by an individual cannot exceed $20,000. Under the existing rules, requests to withdraw eligible amounts must be received before March 2, 1994 and eligible amounts must be withdrawn before April 1994.

The rules are being amended to extend the HBP to RRSP withdrawals made by qualifying participants after March 1, 1994. Under the amended program, as described in greater detail below, a qualifying participant generally includes an individual only where the individual (and the individual's spouse, where applicable) are first-time home buyers. Withdrawals made after March 1, 1994 and before 1995 are to be repaid over 15 years beginning in 1996. To the extent that a minimum repayment for a year is not made, the shortfall is required to be included in computing a participant's income for the year. Where the RRSP withdrawals are made after 1994, the 15-year repayment period commences in the second calendar year following the calendar year of the RRSP withdrawal. For this purpose, an individual has the option under amended subsection 146.01(3) of designating amounts paid in the first 60 days of a calendar year as repayments for the preceding calendar year. (In certain exceptional cases, the application of paragraphs 146.01(2)(e) and (f) will affect the time at which an eligible amount is considered to have been withdrawn for the purposes above.)

Subclauses 44(1) to (4)

ITA
146.01(1)

Subsection 146.01(1) of the Act defines certain expressions used for the purposes of the Home Buyers' Plan (HBP).

"completion date"

The "completion date" is generally the date before which a qualifying home must be acquired in order that an RRSP withdrawal be considered as an eligible amount under the HBP. For individuals who withdrew amounts under the HBP after March 1, 1993 and before March 2, 1994, the completion date is October 1, 1994.

As a consequence of the extension of the HBP, the definition is amended to provide that the completion date for amounts withdrawn under the revised HBP is October 1 of the calendar year following that in which the amount is withdrawn.

This amendment applies to the 1994 and subsequent taxation years.

"eligible amount"

An "eligible amount" received by an individual under the HBP also qualifies as an "excluded withdrawal" and as such is not included in computing the individual's income under subsection 146(8). Among the conditions that must presently be satisfied for an amount to qualify as an "eligible amount" are that:

- the amount was received before March 2, 1994 (or considered to have been received before that date under paragraph 146.01(2)(e)), and

- the individual's spouse did not receive any eligible amount before March 2, 1993.

Paragraph (a) of the definition of "eligible amount" is amended as a consequence of the extension of the HBP to provide that amounts received after March 1, 1994 can qualify as "eligible amounts".

Paragraph (g) of the definition is amended to provide that, for amounts received after March 1, 1994, the previous participation of an individual's spouse in the HBP does not, by itself, disqualify the individual from participating in the HBP.

The definition is further amended (in conjunction with the introduction of paragraph 146.01(2)(a.1)) to provide that the HBP now is generally restricted to first-time home buyers. More specifically, under new paragraph (d.1) of the definition "eligible amount" in subsection 146.01(1), an individual who receives an RRSP withdrawal after March 1, 1994 (other than an RRSP withdrawal deemed to have been received on that date under paragraph 146.01(2)(e)) cannot participate in the HBP if

- the individual owned a home that was the individual's principal place of residence at any time in the period beginning on the first day of the fourth calendar year preceding the year of the withdrawal and ending on the 31st day before the time of the withdrawal, or

- if the individual is married, the individual's spouse owned a home that was the spouse's principal place of residence and that was inhabited by the individual during the marriage at any time in that period.

The above rule also applies, because of the application of new paragraph 146.01(2)(a.1), to homes owned indirectly through the ownership of shares in cooperative housing corporations.

Paragraphs (h) and (i) of the definition are introduced so that a particular amount withdrawn by an individual after March 1, 1994 will not be considered to be an "eligible amount" if any eligible amount was withdrawn by the individual before March 2, 1994 or before the calendar year in which the particular amount was withdrawn. (However, there are relieving rules in this regard under amended paragraph 146.01(2)(e) and new paragraph 146.01(2)(f).) As a consequence, participation in the HBP is essentially limited to withdrawals for one acquisition of a qualifying home. This results in a single repayment schedule for each individual.

These amendments apply to the 1994 and subsequent taxation years.

Subclause 44(5)

ITA
146.01(2)(a.1)

New paragraph 146.01(2)(a.1) sets out the circumstances where an individual is considered to have an owner-occupied home. The effect of this provision is described in the commentary on the amendment to new paragraph (d.1) of the definition "eligible amount".

This amendment applies to the 1994 and subsequent taxation years.

Subclauses 44(6) and (7)

ITA
146.01(2)(d), (e) and (f)

Under the amended definition of "eligible amount", in order for one or more RRSP withdrawals made by an individual to qualify as eligible amounts under the Home Buyers' Plan (HBP), they must all be received by the individual in a single defined period. For this purpose, the defined periods are February 26, 1992 to March 1, 1993 (Phase I), March 2, 1993 to March 1, 1994 (Phase II), March 2, 1994 to December 31, 1994 (Phase III) and each calendar year commencing after 1994 (Phase IV and subsequent phases). Different restrictions (most importantly, the restriction with respect to prior home ownership) apply with respect to amounts received after March 1, 1994 than with respect to amounts received on or before that date.

Existing paragraph 146.01(2)(d) sets out a special rule for an RRSP withdrawal that is not an eligible amount under the HBP only because it was withdrawn by an individual in Phase II rather than in Phase I. In this case, the withdrawal is treated as being an eligible amount under the HBP that was withdrawn at the end of Phase I, where the individual withdrew another amount in Phase I that actually was an eligible amount, the request for the particular RRSP withdrawal was made by the end of Phase I and the particular RRSP withdrawal was received before April 1993.

Existing paragraph 146.01(2)(e) sets out a similar rule for an RRSP withdrawal that is not an eligible amount under the HBP only because it was withdrawn in Phase III rather than in Phase II. Such a withdrawal is deemed to be an eligible amount under the HBP that was withdrawn at the end of Phase II, where the request for the particular RRSP withdrawal was made by the end of Phase II and the particular RRSP withdrawal is received before April 1994.

The above rules, as well as the new rule in paragraph 146.01(2)(f), permit certain amounts actually received in one defined period to be treated as if they were received at the end of the immediately preceding period so that such amounts can qualify as "eligible amounts". The rules will typically be relevant where an individual has withdrawn an eligible amount in one defined period and wishes to have an RRSP withdrawal made in a subsequent defined period qualify as an eligible amount. In addition, as the rules governing the various phases of the HBP differ, paragraphs 146.01(2)(d) to (f) can be applied so that the rules and restrictions for one phase of the plan govern the RRSP withdrawal, notwithstanding it was made in the subsequent phase of the plan.

Paragraph 146.01(2)(d) is amended to provide the Minister of National Revenue with discretion to apply the provision to any particular RRSP withdrawal that is not an eligible amount under the HBP only because it was withdrawn by an individual in Phase II rather than in Phase I, where the individual withdrew another amount in Phase I that is an eligible amount and the particular withdrawal was made before the end of 1993. This amendment applies to the 1992 and subsequent taxation years.

Paragraph 146.01(2)(e) is amended to provide the Minister with discretion to apply the provision to any particular RRSP withdrawal that is not an eligible amount under the HBP only because it was withdrawn in Phase III rather than in Phase II, where an individual's withdrawal is received before the end of 1994 and the individual actually withdrew an eligible amount before March 2, 1994. This rule is also amended so it does not apply where the participant in the HBP so elects by notifying the Minister in writing before the end of 1995. A first-time home buyer may choose to make such an election in order to avoid the application of the income inclusion rule for Phase II participants in the HBP under subsection 146.01(10), but only where the individual did not actually receive any eligible amount before March 2, 1994. These amendments apply to the 1992 and subsequent taxation years.

Under new paragraph 146.01(2)(f), a particular RRSP withdrawal made in a calendar year after 1994 that is not an eligible amount under the HBP only because it was withdrawn after, rather than before, the end of that year is deemed to be an eligible amount under the HBP that was withdrawn before the end of that year. This measure applies only to RRSP withdrawals made in January of a calendar year (or a later time in the year that is acceptable to the Minister) pursuant to a request made before the end of the preceding year, where the individual actually withdrew an eligible amount in the preceding year. This amendment applies to the 1995 and subsequent taxation years.

Subclause 44(8)

ITA
146.01(3)

Existing subsection 146.01(3) of the Act provides that amounts contributed by individuals to their RRSPs be designated as non-deductible repayments under the Home Buyers' Plan (HBP) at the time of their contribution (or a later time acceptable to the Minister of National Revenue). Unlike the provisions for the deduction of RRSP contributions, the existing rule requires repayments for a taxation year to be made before the end of the year and does not permit contributions made in the first 60 days of the following year to be treated as repayments for the preceding year.

Subsection 146.01(3) is amended to provide that, instead of requiring the designation of each particular RRSP contribution as a repayment under the HBP, a single designation for a taxation year may be made by an individual for all or part of the individual's RRSP contributions in the year to RRSPs under which the individual is the annuitant. The designation by an individual for a taxation year is required to be made in prescribed form filed with the individual's personal income tax return for the year. Where an individual is not required to file a return of income for a taxation year, any designation for the year is required to be made by filing the form with the Minister of National

Revenue by April 30 of the following year. The amount so designated is treated as a repayment for the purposes of the HBP.

Subsection 146.01(3) is also amended to provide that RRSP contributions so designated for a taxation year can include not only those RRSP contributions made in a year, but also those contributions made in the first 60 days of the following year. Such contributions, to the extent they are designated by an individual as a repayments under subsection 146.01(3) for the year or are deducted in computing in the individual's income for the year, cannot be designated under subsection 146.01(3) as repayments for the following year.

These amendments apply to the 1995 and subsequent taxation years.

Subclauses 44(9) and (10)

ITA
146.01(4)

Subsection 146.01(4) of the Act provides that, for the 1995 taxation year, an individual is required to include in income 1/15 of all eligible amounts received by the individual minus repayments made under subsection 146.01(3) by the individual for the year and all preceding years. The amount of the repayment required to avoid an income inclusion for any subsequent taxation year is a fraction of the individual's "balance" under the Home Buyers' Plan (HBP) at the beginning of the year. This balance, at the beginning of a particular year, is equal to the total of all eligible amounts received by the individual in previous years minus the repayments for preceding years and shortfalls included in computing income for preceding years. The fraction is 1/14 for 1996, 1/13 for 1997, and so on until the fraction is 1 for 2009. Any balance remaining in 2009 must either be repaid to an RRSP or included in income for that year.

Subsection 146.01(4) of the Act is amended to provide that the repayment schedule for eligible amounts withdrawn after March 1, 1994 under the revised HBP begins in the second calendar year following the year of the withdrawal and ends in the sixteenth year following the year of withdrawal.

This amendment applies to the 1995 and subsequent taxation years.

Subclause 44(11)

ITA
146.01(5)(b)

Subsection 146.01(5) of the Act is a special rule that applies where an individual ceases to be resident in Canada after having withdrawn an "eligible amount" under the Home Buyers' Plan (HBP). The rule provides for an income inclusion for an individual in these circumstances equal to the total of all eligible amounts previously withdrawn by the individual minus the total of

- all previous income inclusions under subsection 146.01(4) required as a result of shortfalls in repayments, and

- all repayments under subsection 146.01(3) made before the individual files a return of income for the year in which he or she became non-resident and not more than 90 days after the date on which the individual ceased to reside in Canada.

Subsection 146.01(5) is amended to provide that a non-resident is required to make such repayments not more than 60 days after ceasing to reside in Canada. This amendment is consistent with changes to subsection 146.01(3), under which repayments made up to 60 days after the end of a calendar year can be designated as repayments for that year.

This amendment applies to the 1995 and subsequent taxation years.

Subclause 44(12)

ITA
146.01(7)

Subsection 146.01(6) of the Act provides rules in the event that an individual dies and has previously received excluded withdrawals (typically eligible amounts under the Home Buyers' Plan (HBP)) which have not been repaid to RRSPs. Where the total of such amounts exceeds the sum of designated amounts repaid under subsection 146.01(3) by the individual and income inclusions of the individual under subsections 146.01(4) and (5), the excess is included in computing the individual's income for the year of death. An exception to this rule is provided under subsection 146.01(7).

Under subsection 146.01(7), an election may be made jointly by the Canadian-resident spouse of a deceased individual and the legal representatives of the deceased individual so that there is no income inclusion for the deceased individual under subsection 146.01(6). Instead, the excess described above is treated as having been received as an eligible amount by the surviving spouse at the time of the death. As a consequence, beginning in the year following the year of death, the surviving spouse will be subject to the repayment and income inclusion rules in connection with the excess under amended subsections 146.01(3) and (4).

New paragraph 146.01(7)(c) provides that the election will only apply to a spouse on the death of an individual where

- the surviving spouse (or the deceased) had not previously received an eligible amount under the HBP, or

- the period for repayments under the HBP of any eligible amounts received by the surviving spouse coincides with corresponding period for the deceased.

New paragraph 146.01(7)(f) provides that a surviving spouse is, for the purposes of determining the spouse's own eligibility under the HBP, considered to have received eligible amounts at such times as they were received by the deceased. As a consequence, a surviving spouse electing under subsection 146.01(7) on the death of his or her spouse will generally be precluded from subsequently participating in the HBP after such death.

New paragraph 146.01(7)(g) provides that the "completion date" in respect of eligible amounts deemed by subsection 146.01(7) to have been received by a surviving spouse is the same "completion date" in respect of eligible amounts actually received by that spouse. Where no eligible amount has been previously received by the spouse, it is the completion date in respect of eligible amounts received by the deceased. (In the event that neither spouse had previously received an eligible amount, the completion date is deemed to be October 1 of the year of death.)

These amendments apply to the 1994 and subsequent taxation years.

Subclause 44(13)

ITA
146.01(9) to (13)

Subsections 146.01(9) to (13) of the Act contain income inclusion rules under the existing Home Buyers' Plan (HBP). The rules are relevant only for the 1992 and 1993 taxation years and, consequently, are repealed for the 1994 and subsequent taxation years.

Under the revised HBP, the new rule described in the amendments to subsections 146(5) and (5.1) will prevent certain RRSP contributions from being deducted, if those contributions are withdrawn under the HBP within 90 days of being contributed.

These amendments apply to the 1994 and subsequent taxation years.

Clause 45

Exemption from Tax

ITA
149(1)(z)

New paragraph 149(1)(z) of the Act exempts mining reclamation trusts (as defined in section 248) from income tax under Part I of the Act. Instead, the income of mining reclamation trusts is subject to tax under new Part XII.4.

This amendment applies to the 1994 and subsequent taxation years.

Clause 46

Assessments and Reassessments

ITA
152

Subsection 152(1) of the Act contains rules relating to assessments and reassessments of tax, interest and penalties payable by a taxpayer and to determinations and redeterminations of tax deemed to have been paid by a taxpayer. Subsection 152(4.2) gives the Minister of National Revenue discretion to make a reassessment or a redetermination beyond the normal reassessment period when so requested by an individual or a testamentary trust.

Paragraphs 152(1)(b) and (4.2)(d) are amended to add references to new subsection 127.41(3), under which beneficiaries of mining reclamation trusts are deemed to pay an amount on account of federal income tax.

These amendments apply to taxation years ending after February 22, 1994.

Clause 47

Corporations - Payment of Tax

ITA
157(3)

Subsection 157(3) of the Act provides rules that allow the monthly instalments of tax payable by corporations to be reduced proportionately by the corporation's dividend refund, capital gains refund and allowable refund. New paragraph 157(3)(e), which applies to taxation years ending after February 22, 1994, provides that the monthly instalment amount for a particular year is reduced by 1/12th of the amount deemed by new subsection 127.41(3) to have been paid on account of the corporation's Part I tax for the year.

Clause 48

False Statements

ITA
163(2)(e)

Subsection 163(2) imposes a penalty where a taxpayer, knowingly or in circumstances amounting to gross negligence, participates in the making of a false statement in a tax return. The penalty is determined with reference to the understatement of tax or the overstatement of various amounts deemed to be paid on account of tax.

Paragraph 163(2)(e) is introduced so that the penalty extends to overstatements of deemed payments of tax under new subsection 127.41(3), relating to the Part XII.4 tax credit for beneficiaries under mining reclamation trusts.

This amendment applies to taxation years ending after February 22, 1994.

Clause 49

Part X.1 Tax on RRSP Overcontributions

ITA
204.2(1.2)I(a)(vi)

Subsection 204.2(1.2) of the Act contains the formula determining the amount of an individual's "undeducted RRSP premiums". In general terms, it is equal to the individual's undeducted post-1990 RRSP premiums. The special penalty tax under Part X.1 on overcontributions to RRSPs is determined with reference to this amount.

New subparagraph 204.2(1.2)I(a)(vi) is introduced to provide that certain RRSP contributions that are withdrawn as eligible amounts under the Home Buyers' Plan are excluded from the individual's undeducted RRSP premiums. This provision applies to RRSP contributions only to the extent that they are not deductible in computing an individual's income because of new subparagraph 146(5)(a)(iv.1) or 146(5.1)(a)(iv).

This amendment applies to the 1994 and subsequent taxation years.

Clause 50

Tax on Mining Reclamation Trusts

ITA
211.6 - Part XII.4

Part XII.4 of the Act is introduced to impose a special tax on mining reclamation trusts, as newly defined under subsection 248(1). Mining reclamation trusts are exempt from Part I tax under new paragraph 149(1)(z) of the Act. Beneficiaries under a mining reclamation trust are generally entitled to a refund under new section 127.41 with respect to tax payable by the trust under Part XII.4. The interaction of section 127.41, Part XII.4 and new subsection 107.3(1) is illustrated in an example in the commentary on section 127.41.

There are two reasons for taxing mining reclamation trusts under a separate part of the Act. First, the rate of taxation corresponds to the general federal corporate income tax rate (net of the provincial abatement). This recognizes that the large majority of taxpayers involved with such trusts will be corporations. Second, it is anticipated that the provincial governments will establish similar taxes under their own legislation, with tax rates linked to provincial corporate income tax rates.

Subsection 211.6(1) is the charging provision of Part XII.4. It require a mining reclamation trust to pay a tax equal to 28% of its income for the year. Subsection 211.6(2) provides that, for this purpose, a trust's income is determined without regard to many of the normal trust taxation rules (i.e. subsections 104(4) to (31) and sections 105 to 107).

Subsection 211.6(3) provides that a trust liable under Part XII.4 for a taxation year must file a Part XII.4 tax return with Revenue Canada, within 90 days of the end of each taxation year. Under subsection 211.6(4), the entire amount of the Part XII.4 tax liability is due at the same time.

Under subsection 211.6(5), provisions with respect to assessments, objections, appeals and other procedural and administrative matters for the purposes of the tax under Part I will also apply for the purposes of the Part XII.4 tax.

These amendments apply to the 1994 and subsequent taxation years.

Clause 51

Provision of Information

ITA
241(4)(d)(vi.1)

Section 241 prohibits the use or communication by government officials of information obtained under the Act unless specifically authorized by one of the exceptions found in that section.

New subparagraph 241(d)(vi.1) of the Act authorizes the Minister of National Revenue to communicate information to the Department of Energy, Mines and Resources for the purpose of determining whether property is prescribed energy conservation property. For further information regarding prescribed energy conservation property, reference may be made to the note on new subsection 13(18.1) of the Act in this material. This amendment applies after February 21, 1994.

Clause 52

Interpretation

ITA
248

Section 248 of the Act defines a number of terms used in the Act, and also sets out various rules relating to the interpretation and application of various provisions of the Act.

Subclauses 52(1), (2) and (5)

ITA
248(1)

"group term life insurance policy"

Subsection 248(1) of the Act defines the expression "group term life insurance policy" with respect to a taxpayer to mean a group life insurance policy under which, before the death or disability of the taxpayer, no amount is payable to anyone other than the group policyholder as a result of premiums paid by the employer of the taxpayer.

The definition is amended to clarify it. As amended, the definition provides that a group term life insurance policy is a group life insurance policy under which the only amounts that may be payable are: (i) amounts payable on the death or disability of individuals who are insured as a result of their employment or former employment, and (ii) policy dividends or experience rating refunds.

The amendment to this definition applies with respect to insurance for periods after June 1994.

Subclause 52(3)

ITA
248(1)

"cost amount"

Subsection 248(1) of the Act defines "cost amount", which is used throughout the Act and is particularly relevant with respect to the transfer of properties to and from corporations, trusts and partnerships.

The definition "cost amount" is amended, effective after 1993, so that the cost amount of an interest of a beneficiary under a mining reclamation trust is considered to be nil.

Subclause 52(4)

ITA
248(1)

"mining reclamation trust"

A "mining reclamation trust" is generally defined as a trust maintained for the sole purpose of funding reclamation of a mine in the province in which the trust is resident, where the first contribution to the trust was made by a taxpayer after 1991. (However, trustees of a trust to which contributions were made before February 23, 1994 may elect before 1996 that the trust not be treated as a mining reclamation trust.)

In order for a trust to qualify as a mining reclamation trust, the maintenance of the trust must be required by a federal, provincial or territorial law or under the terms of a contract entered into with the federal or provincial Crown. For this purpose, it is sufficient that the trust be established in anticipation of the enactment of the law or the entering into of the contract, provided that the law is enacted (or the contract is entered into) by the later of January 1, 1996 and one year after the trust is created. In some cases, it is anticipated that such laws will provide for options other than trusts (e.g., letters of credit).

This is not intended to preclude a trust from being considered to be a mining reclamation trust.

However, a mining reclamation trust does not include a trust

- from which distributions were made before February 23, 1994,
- that relates to the reclamation of a mine that is a clay pit (other than a kaolin pit), a deposit of peat, a gravel pit, a peat bog, a sand pit, a shale pit, a stone quarry or that relates to the reclamation of a well,
- that is not maintained to secure the mining reclamation obligations of one or more persons or partnerships who are beneficiaries under the trust,
- that has acquired any property other than cash, a deposit or an obligation described in paragraph (a), (b) or (f) of the definition "qualified investment" in section 204,
- that has trustees other than Her Majesty in right of Canada or the province or a corporation resident in Canada that is licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as trustee,
- that has borrowed money, or
- that was at any previous time not a mining reclamation trust.

This definition is used in the provisions of the Act dealing with the taxation of mining reclamation trusts and their beneficiaries. These provisions are described in the commentary on paragraphs 12(1)(z.1) and (z.2), 20(1)(ss) and (tt) and 75(3)(c.1), sections 107.3 and 127.41 and subsection 250(7).

Under the definition, a trust can also no longer qualify as a mining reclamation trust if it fails to meet prescribed conditions. At the present time, it is not intended to prescribe any additional conditions for this purposes.

For commentary on the residence of mining reclamation trusts, see new subsection 250(7).

This amendment applies after 1993.

Clause 53

Fiscal Period

ITA
249(2)(b)

Paragraph 249(2)(b) provides that a reference in the Act to a fiscal period of a partnership ending in a taxation year includes a reference to a fiscal period of a partnership ending coincidentally with that year. This paragraph is amended effective for fiscal periods that end after 1993, by deleting the references to partnerships. As a result, this provision will apply to fiscal periods of sole proprietorships as well as partnerships.

Clause 54

Deemed Residence of Mining Reclamation Trust

ITA
250(7)

New subsection 250(7) of the Act applies for the purposes of determining the province in which certain trusts reside. It applies where a trust resident in Canada would be a "mining reclamation trust", as defined by subsection 248(1), if it were resident in the province in which the mine to which the trust relates is situated. Where this is the case, the trust is considered to be resident in that province and in no other province.

This amendment applies after 1993.

Clause 55

Acquisition of Control

ITA
256

Section 256 of the Act contains rules for determining if corporations are to be considered associated with one another, as well as rules concerning whether control of a corporation has been acquired for the purposes of the Act.

Subclause 55(1)

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.

Subclause 55(2)

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 June 23, 1994, so that it applies also in determining for the purpose of section 55 of the Act whether control of a corporation has been acquired.

Clause 56

Depreciable Property - Transitional Rules

ITAR
20(1)

Subsection 20(1) of the *Income Tax Application Rules* is designed to prevent the taxation of gains on depreciable property that accrued to December 31, 1971 (referred to as "valuation day") and to prevent taxpayers from converting that tax-free zone into a depreciable base through one or more non-arm's length transactions or events. This is achieved by reducing, for the purposes of section 13 and subdivision c of Division B of Part I of the *Income Tax Act* (the subdivision that deals with capital gains and losses), the proceeds of disposition otherwise determined to the capital cost of the property plus the excess of the proceeds of disposition otherwise determined over the fair market value of the property on valuation day. In order to prevent the conversion of the tax-free zone into a depreciable base, paragraph 20(1)(b) limits the capital cost to the acquiror of depreciable property that became vested in the acquiror by one or more transactions between persons not dealing at arm's length.

Subparagraph 20(1)(b)(i) of the Rules is amended, effective for acquisitions of property after May 22, 1985, to ensure that it does not apply for the purposes of paragraphs 8(1)(j) and (p) and sections 13 and 20 of the Act where paragraph 13(7)(e) applies for those purposes in determining the capital cost to the acquiror of the property. That paragraph also limits the capital cost to an acquiror of depreciable property in certain non-arm's length situations. This amendment to the Rules clarifies the application of paragraph 20(1)(b) of the rules and removes the potential conflict between the two different rules for the determination of the acquiror's capital cost in such situations.

New paragraph 20(1)(c) is added, applicable to the 1994 and subsequent taxation years, as a result of the elimination of the $100,000 lifetime capital gains exemption for gains realized on dispositions that occur after February 22, 1994 and the mechanism provided by subsection 110.6(19) of the Act for recognizing gains that accrued to that day. Paragraph 20(1)(c) provides rules similar to those found in paragraph 20(1)(b). Where a taxpayer elects under subsection 110.6(19) of the Act in respect of a depreciable property, the taxpayer is deemed by that subsection to have disposed of the property for proceeds of disposition equal to the amount designated in the election in respect of the property. If that property was owned by the taxpayer without interruption since before 1972, the proceeds so determined are reduced by paragraph 20(1)(a) of the Rules. The taxpayer is then considered for the purposes of the Act (other than, where paragraph 13(7)(e) of the Act applies in determining the taxpayer's capital cost of the property, for the purposes of paragraphs 8(1)(j) and (p) and sections 13 and 20 of the Act) to have reacquired the property at a capital cost equal to the taxpayer's proceeds of disposition determined under paragraph 20(1)(a). For greater certainty, the taxpayer is considered for the purpose of subsection 20(1) of the Rules to have owned the property without interruption from December 31, 1971 until such time after February 22, 1994 as the taxpayer actually disposes of it. This ensures that the proceeds of disposition otherwise determined in respect of a subsequent disposition of the property will be reduced under paragraph 20(1)(a) of the Rules.

The following example illustrates the interaction between the subsection 20(1) of the Rules and the provisions of the Act where an individual elects under subsection 110.6(19) of the Act in respect of a rental property and later disposes of it in 1995.

> *Assume that an individual owns a building (a rental property) at the end of February 22, 1994 that has a fair market value at that time of $150,000. The building is non-qualifying real property of the individual for the purpose of the lifetime capital gains exemption. The building was originally acquired by the individual in 1965 for $50,000 and is the individual's only property of its*

prescribed class of depreciable property. Its fair market value at the end of 1971 was $70,000. The individual's undepreciated capital cost in respect of the building at the end of 1993 was $20,000.

The individual elected under subsection 110.6(19) of the Act in respect of the building and designated $150,000. The individual is deemed by that subsection to have disposed of the building at the end of February 22, 1994 for proceeds of disposition of $150,000 and to have reacquired it immediately thereafter at a cost equal to those proceeds. However, the proceeds of disposition so determined are reduced under paragraph 20(1)(a) of the Rules to $130,000 (that is, $50,000 + ($150,000 - $70,000)). Under paragraph 20(1)(c) of the Rules, the individual is also considered for the purposes of the Act to have reacquired the property at a capital cost of $130,000.

Based on proceeds of $130,000, the individual's capital gain is $80,000 and his or her taxable capital gain is $60,000. However, because the building is a non-qualifying real property, only $72,782 (that is, 242/266($80,000)), of the individual's gain is an eligible real property gain. The individual's taxable capital gain of $60,000 is therefore reduced under subsection 110.6(21) of the Act to $54,586 (that is, $60,000 -.75($80,000 - $72,782)), an amount in respect of which the individual claims the capital gains exemption.

The determination of the individual's capital cost of the property for the purposes of sections 13 and 20 of the Act is governed by paragraph 13(7)(e) of the Act (which overrides paragraph 20(1)(b) of the Rules). Under subparagraph 13(7)(e)(i), that capital cost is $50,000 (that is, $50,000 + .75($130,000 - ($50,000 + 4/3($54,586) + $7,218))). In other words, there is no increase in the individual's depreciable base in respect of the property. There will also be no recapture of depreciation under subsection 13(1) of the Act as a result of the election because, at the end of the individual's 1994 taxation year, the amount included in the determination of F in the definition "undepreciated capital cost" in subsection 13(21) as a result of the disposition of the property will be the same as the amount included in the determination of A in that definition as a result of the reacquisition of the property.

The individual's capital cost of the property for the purpose of subdivision c of Division B of Part I of the Act is the capital cost determined under paragraph 20(1)(b) of the Rules less the amount deducted under subsection 110.6(21) of the Act in respect of the ineligible portion of the gain. That capital cost is $122,782 (that is, $130,000 - $7,218).

Assume that the building is sold at arm's length in March 1995 for a price of $154,782. If no other depreciable property of that prescribed class is acquired before the end of the individual's 1995 taxation year, there will be recapture of depreciation under subsection 13(1) of $30,000 plus any capital cost allowance claimed in respect of the building for the 1994 taxation year. The individual's proceeds of disposition will be reduced under paragraph 20(1)(a) of the Rules to $134,782 (that is $50,000 + ($154,782 - $70,000)). The individual's capital gain from the disposition is $12,000 (that is, $134,782 - $122,782), and his or her taxable capital gain from the disposition is $9,000.

Clause 57

Non-Depreciable Capital Property - Transitional Rules

ITAR
26(29)

Section 26 of the Rules sets out the method for computing the adjusted cost base to a taxpayer of certain capital property owned by the taxpayer at the end of 1971. The general purpose of the provisions in section 26 is to prevent gains that accrued before 1972 from being subject to tax. The adjustment to the adjusted cost base of a property under section 26 creates a tax-free zone.

Where a taxpayer elects under subsection 110.6(19) of the Act in respect of a capital property the adjusted cost base of which is determined under section 26 of the Rules, the taxpayer, in effect, crystallizes the gain represented by the tax-free zone. The taxpayer is deemed by that subsection to have disposed of the property for proceeds of disposition equal to the amount designated in the election and in most cases is considered to have reacquired it at a cost equal to those proceeds.

New subsection 26(29) of the Rules provides that where a taxpayer elects under subsection 110.6(19) in respect of a property, that property is considered, for the purpose of determining the cost or adjusted cost base of any property at any time after February 22, 1994, not to have been owned by any taxpayer at the end of 1971. This is intended to prevent a taxpayer from obtaining the benefit of the tax-free zone in respect of a disposition after February 22, 1994 of a property where that benefit has previously been obtained through an increase in the adjusted cost base resulting from an election under subsection 110.6(19).