Amendments to the Income Tax Act

Explanatory Notes

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

February 1995

Canada

Amendments to the Income Tax Act

Explanatory Notes

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

February 1995

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*, the *Income Tax Application Rules* and related statutes These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

For additional copies of this document
please contact:

Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa K1A 0G5

Tel: (613) 995-2855
Fax: (613) 996-0518

Cette publication est également disponible en français.

PREFACE

The legislation to which these explanatory notes relate contains amendments to the *Income Tax Act*, the *Income Tax Application Rules* and related statutes. These amendments are designed to implement a number of the income tax measures put forth in the budget of February 22, 1994, as well as other measures announced by the government in 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, P.C., M.P.
Minister of Finance

Table of Contents

Clause in Legis-lation	Section of the Income Tax Act	Topic	Page
PART I: DEBT FORGIVENESS AND FORECLOSURE			
1	6	Employment income	1
2	13	Depreciable property	3
3	14	Eligible capital property	5
4	15	Shareholder benefits	6
5	18	Prohibited deductions-business and property income	8
6	20	Deductions in computing income from business or property	9
7	28	Farming or fishing business	11
8	31	Loss from farming	12
9	37	Scientific research and experimental development	12
10	39	Capital gains and losses	13
11	40	Capital gains - special rules	14
12	44	Replacement property	17
13	47	Identical properties	17
14	49	Options	19
15	50	Bad debts and shares of bankrupt corporations	20
16	51	Convertible property	20
17	53	Adjustments to cost of property	22
18	54	Capital gains and losses - definitions	27

Clause in Legislation	Section of the Income Tax Act	Topic	Page
19	56.2 & 56.3	Add back of reserves for debt forgiveness	29
20	61.2-61.4	Reserves and deduction for debt forgiveness	29
21	66	Resource expenditures	37
22	66.1	Canadian exploration expenses	38
23	66.2	Canadian development expenses	38
24	66.4	Canadian oil and gas property expenses	39
25	66.7	Successor rules	40
26	79 & 79.1	Surrenders and seizures	41
27	80-80.04	Forgiveness of debt	53
28	85	Transfer of property to corporations by shareholders	118
29	86	Exchange of shares	120
30	87	Amalgamations	121
31	88	Windings-up	124
32	95	Foreign accrual property income	125
33	96	Partnership rules	127
34	97	Transfers to partnerships	128
35	107	Trust rules	129
36	111	Losses deductible	130
37	114	Part-year residents	130

Clause in Legis- lation	Section of the Income Tax Act	Topic	Page
38	115	Taxable income earned in Canada	131
39	138	Insurance corporations	131
40	160.4	Liability in respect of transfers by insolvent corporations	132
41	191.3	Part VI.1 tax	133
42	220	Minister's duty	134
43	248	Interpretation	134
44	256	Acquisition of control	136

PART II: FOREIGN AFFILIATES

45	20	Borrowed money	138
46	95	Foreign accrual property income	139
47	248	Definitions	185

PART III: SECURITIES HELD BY FINANCIAL INSTITUTIONS

48	18	Superficial loss	186
49	39	Capital gains and losses	187
50	51.1	Conversion of debt obligation	188
51	66.3	Exploration and development shares	189
52	77	Bond conversion	189
53	85	Transfer of property to corporation by shareholders	190
54	87	Amalgamations	191
55	88	Windings-up	195

Clause in Legis- lation	Section of the Income Tax Act	Topic	Page
56	112	Taxable dividends received by corporations	198
57	138	Insurance corporations	204
58	142.2 - 142.6	Financial institutions	213
59	248	Definitions	243
60	249	Year-end on change of control	244

PART IV: ELIGIBLE FUNERAL ARRANGEMENTS

61	108	Trusts-definitions	246
62	148.1	Eligible funeral arrangements	247
63	149	Exemption from tax	250
64	212	Non-resident withholding tax	250
65	248	Definitions	251

PART V: REAL ESTATE INVESTMENT TRUSTS

66	108	Definition of unit trust	252
67	131	Definition of mutual fund corporation	253
68	132	Definition of mutual fund trust	253

Clause in Legislation	Section of the Income Tax Act	Topic	Page
PART VI: MUTUAL FUND REORGANIZATIONS			
69	132.2	Mutual funds - qualifying exchanges	255
PART VII: OBJECTIONS AND APPEALS			
70	165	Objections to assessments and determinations	263
71	169	Appeals to Tax Court of Canada	266
PART VIII: SECURITIES LENDING			
72	181	Definition of "financial institution"	267
73	212	Non-resident withholding tax	267
74	248	Definitions	268
75	260	Securities lending arrangements	270
PART IX: GENERAL			
76	12	Business and property income	273
77	54	Superficial loss	274
78	95	Foreign accrual property income	275

Clause in Legis-lation	Section of the Income Tax Act	Topic	Page

AMENDMENTS TO THE INCOME TAX APPLICATION RULES AND OTHER ACTS

79	ITAR 26	Capital gains	277
80	S.C. 1990 c. 39	Securities lending	277
81	S.C. 1991 c. 49	Securities lending	278
82	S.C. 1994 c. 21	Securities lending	278

PART I:

Debt Forgiveness and Foreclosure

Part I of this bill, which is composed of clauses 1 to 44, contains amendments to the *Income Tax Act* relating to the measures on debt forgiveness and foreclosures announced in the budget of February 22, 1994.

Reference may also be made to clauses 76, 78 and 79 in the bill and the related explanatory notes, as these clauses also contain amendments pertaining to this measure.

Clause 1

Employment income

ITA
6(15) and (15.1)

Subsection 6(15) of the *Income Tax Act* provides that, for the purposes of paragraph 6(1)(a), the value of a benefit for a taxpayer arising on the settlement or extinguishment of a loan or other obligation is the amount of the outstanding obligation that was settled or extinguished, minus the amount paid by the taxpayer on the settlement or extinguishment of the obligation. Under paragraph 6(1)(a), the benefit is included in computing a taxpayer's employment income if it is received or enjoyed in respect of, in the course of or by virtue of, an office or employment.

Subsection 6(15) is amended to provide that the value of a benefit enjoyed by a taxpayer in connection with an obligation that is issued by a debtor (typically the taxpayer) and that is settled or extinguished is the "forgiven amount" in respect of the obligation, as defined by new subsection 6(15.1). Reference in this context should be made to new subsections 248(26) and (27), which clarify the circumstances in which an obligation is considered to be issued by a debtor and affect partial settlements of obligations.

Under subsection 80(1), the "forgiven amount" in respect of an obligation is essentially the lesser of the principal amount of the obligation and the amount for which it was issued minus any amount paid in satisfaction of the principal amount of the obligation and other adjustments which reflect the extent to which the unpaid amount of the obligation has otherwise been recognized for income tax purposes. Subsection 6(15.1) defines this expression in the same way, except that

- any amount included in computing income because of the obligation being settled or extinguished is not taken into account,
- the forgiven amount is not reduced to reflect the extent to which the obligation is taken into account under new subsection 79(3) in determining the proceeds of disposition of any property,
- interest payable on the principal amount of the obligation is not taken into account, and
- new paragraph 80(2)(q), dealing with debt forgiven after death, is not taken into account.

In the event that an obligation with respect to interest payable on such indebtedness is settled, subsection 6(15) does not have any effect because of paragraph 6(15.1)(d). Instead, the rules in section 79 or 80 will apply in the event that the obligation is a "commercial obligation" (as defined under amended subsection 80(1)).

A discussion of the interaction between subsections 6(15) and 15(1.2) and sections 78 to 80 is contained in the commentary on the amendments to section 80. In addition, new section 80.01 is relevant in determining whether an obligation is settled for the purposes of subsection 6(15).

These amendments apply to taxation years ending after February 21, 1994.

Clause 2

Depreciable property

Subclauses 2(1) to (3)

ITA
13(7.1)

Subsection 13(7.1) of the Act provides for reductions in the capital cost of a depreciable property equal to the amounts of deducted investment tax credits and certain other government assistance in respect of the property.

Subsection 13(7.1) is amended to provide for a reduction in the capital cost of a depreciable property, in the event that the reduction is required under section 80. The reduction under the new rules is generally provided only under subsection 80(5). However, for the purposes of determining capital cost (otherwise than for the purposes of paragraphs 8(1)(j) and (p), sections 13 and 20 and the capital cost allowance regulations), a further reduction in capital cost is provided under subsection 80(9) in certain cases.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 2(4)

ITA
13(21)

"proceeds of disposition"

The expression "proceeds of disposition" is defined under subsection 13(21) of the Act for the purposes of the income tax rules with respect to depreciable property. Where a taxpayer's property is acquired or reacquired by a creditor in consequence of the taxpayer's failure to pay a debt to the creditor (e.g., as a result of foreclosure proceedings), paragraph (h) of the definition provides that the proceeds of disposition of that property for the taxpayer include amounts determined under existing paragraph 79(c).

Paragraph (h) of the definition is amended to refer to section 79 generally, rather than a specific provision of it. This amendment is consequential on the amendments to section 79, described in the following commentary, under which proceeds of disposition for a debtor are determined under new subsection 79(3).

This amendment applies to taxation years ending after February 21, 1994.

Subclauses 2(5) and (6)

ITA
13(21)

"undepreciated capital cost" (description of E.1)

Subsection 13(21) of the Act defines the expression "undepreciated capital cost".

This definition is amended to provide a reduction in the undepreciated capital cost of depreciable property of a class to the extent that such reduction is required by reason of new subsection 80(5). The new rule does not apply, however, to the extent that such reduction results from the reduction under subsection 80(5) or (9) of the capital cost of depreciable property. Reductions in capital cost arising from section 80 are dealt with, instead, under amended subsection 13(7.1). The amendment to this definition is consequential on the amendments to section 80, as described in the following commentary.

This amendment applies to taxation years ending after February 21, 1994.

Clause 3

Eligible capital property

Subclauses 3(1) and (2)

ITA
14(5)

"cumulative eligible capital"

Subsection 14(1) of the Act provides that where, at the end of a taxation year, the amounts required to be deducted in computing a taxpayer's "cumulative eligible capital" (as defined under subsection 14(5)) exceed the amounts required to be added in computing that amount, the excess must be included in computing the taxpayer's income for the year as business income or as a taxable capital gain.

The definition "cumulative eligible capital" in subsection 14(5) is amended to provide that a new amount (P.1) is added in computing that excess. The amount determined for P.1 in respect of a business of a taxpayer is the total of all reductions of the taxpayer's cumulative eligible capital in respect of that business that are required under new subsection 80(7). Under that provision, a taxpayer is allowed to apply a portion of any amount forgiven on the settlement of a debt issued by the taxpayer to reduce the cumulative eligible capital in respect of a business of the taxpayer.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 3(3)

ITA
14(10) and (11)

Subsection 14(5) of the Act defines the expression "eligible capital expenditure" for the purposes of determining income inclusions and deductions with respect to eligible capital property. Under the existing law, there are no specific rules dealing with government assistance received or repaid with respect to eligible capital property.

To the extent that government assistance with respect to such property does not reduce the eligible capital expenditure with respect to such property, the existing rules provide for an income inclusion under paragraph 12(1)(x).

New subsections 14(10) and (11) provide that government assistance for eligible capital property in respect of a business carried on by a taxpayer, or a repayment of such assistance, results in a decrease or increase, as the case may be, in the eligible capital expenditure in respect of that property. This rule applies only to the extent that the entitlement to the assistance arises, or the repayment thereof is made, before the taxpayer ceases to carry on that business. (A deduction in computing income for repayments made after the taxpayer ceases to carry on business is provided under new paragraph 20(1)(hh.1).) Subsections 14(10) and (11) are similar to the rules with respect to depreciable property in subsections 13(7.1) and (7.2).

The new rules in subsections 14(10) and (11) are relevant not only for government assistance, but also for other amounts treated as government assistance for the purposes of the Act. In this regard reference may be made to new subsection 79(4), under which certain amounts are treated as payments or repayments of government assistance, and subsection 248(16) under which input tax credits with respect to the Goods and Services Tax are likewise treated as government assistance.

These amendments apply to assistance that a taxpayer receives or becomes entitled to receive after February 21, 1994 and repayments of such assistance.

Clause 4

Shareholder benefits

ITA
15(1.2) and (1.21)

Subsection 15(1.2) of the Act provides that the value of the benefit considered to be conferred on a shareholder in consequence of the settlement or extinguishment of a loan or other obligation is the amount of the outstanding obligation that was settled or extinguished, minus the sum of the amount paid by the shareholder on the settlement or extinguishment of the obligation and the amount included in the shareholder's income at the time the obligation arose. The value of such a benefit conferred on a shareholder by a corporation is included in computing the shareholder's income under subsection 15(1).

Subsection 15(1.2) is amended to provide that the value of a benefit in connection with an obligation issued by a debtor that is settled or extinguished is the "forgiven amount" in respect of the obligation, as defined by new subsection 15(1.21). Reference in this context should be made to new subsections 248(26) and (27), which clarify the circumstances in which an obligation is considered to be issued by a debtor and affect partial settlements of obligations.

Under subsection 80(1), the "forgiven amount" in respect of an obligation is essentially the lesser of the principal amount of the obligation and the amount for which it was issued minus any amount paid in satisfaction of the principal amount of the obligation and other adjustments which reflect the extent to which the unpaid amount of the obligation has otherwise been recognized for income tax purposes. Subsection 15(1.21) defines this expression in the same way, except that

- any amount included in computing income because of the obligation being settled or extinguished is not taken into account, except to the extent that the amount is included in income under paragraph 6(1)(a),

- the forgiven amount is not reduced to reflect the extent to which the obligation is taken into account under new subsection 79(3) in determining the proceeds of disposition of any property,

- interest payable on the principal amount of the obligation is not taken into account, and

- new paragraph 80(2)(q), dealing with debt forgiven after death, is not taken into account.

In the event an obligation with respect to interest payable on an obligation is settled, subsection 15(1.2) does not have any effect because of paragraph 15(1.21)(d). Instead, the rules in section 79 or 80 will apply in the event that the obligation is a "commercial obligation" (as defined under amended subsection 80(1)).

A discussion of the interaction between subsections 6(15) and 15(1.2) and sections 78 to 80 is contained in the commentary on the amendments to section 80. In addition, new section 80.01 is relevant in determining whether an obligation is settled for the purposes of subsection 15(1).

These amendments apply to taxation years ending after February 21, 1994.

Clause 5

Prohibited deductions - business and property income

ITA
18(9.3)

Subsection 18(9.3) of the Act applies in the event that a debtor prepaid interest in respect of a debt obligation and the amount that the debtor has deducted in respect of the prepayment is limited because of subsection 18(9.2). In these circumstances, the prepaid interest not deductible because of subsection 18(9.2) is effectively treated as a payment in satisfaction of the principal amount of the debt obligation, in the event that the debt obligation is settled or extinguished in circumstances to which section 79 or 80 applies. As a consequence, the impact of those sections on the debtor is reduced.

Subsection 18(9.3) is amended to provide that it applies in the event that section 79 applies to a debtor, whether or not the debt owed by the debtor is settled or extinguished. In addition, a reference to paragraph 79(c) is changed to section 79 in order that both the existing rules and the new rules in section 79 are referred to. These amendments apply to 1992 and subsequent taxation years.

Paragraph 18(9.3)(a) is amended to provide that pre-paid interest paid at the same time a debt obligation is settled or extinguished is likewise treated as a payment in satisfaction of the principal amount of the obligation. This amendment applies to taxation years ending after February 21, 1994 with respect to debts settled or extinguished in circumstances to which the new rules in section 80 apply.

Paragraph 18(9.3)(f) is amended to provide that the prepaid interest described above is to be deducted in computing the forgiven amount in respect of a debt at the time it is settled or extinguished. This deduction is provided in paragraph (c) of the description of B in the definition "forgiven amount" in amended subsection 80(1). This amendment applies to taxation years ending after February 21, 1994, with respect to debts settled or extinguished in circumstances to which the new rules in section 80 apply.

Clause 6

Deductions in computing income from business or property

Subclause 6(1)

ITA
20(1)(n)

Paragraph 20(1)(n) of the Act allows a taxpayer to claim a reserve in respect of the taxpayer's profit from the sale of property. The reserve may be claimed by a taxpayer for a taxation year only with respect to an amount that was included in computing the taxpayer's income from a business for the year or a preceding taxation year and that is not due until after the end of the year. (Unless the property is land, there is an additional requirement that all or part of the amount not be due until more than two years after the sale.) However, subsection 20(8) provides that no reserve may be claimed under paragraph 20(1)(n) for a taxation year in respect of the sale of property if the sale occurred more than 36 months before the end of the year.

Paragraph 20(1)(n) is amended to provide that, in the case of real property, a reserve in respect of a taxpayer's profit from the sale of property may be claimed by the taxpayer for a taxation year to the extent that proceeds from the sale of the property are payable after the end of the year. In the case of property other than real property, a reserve may be claimed on the same basis provided that all or part of the amount payable at the end of the year was, at the time of the sale, due at least two years after the time of the sale. The reserve is subject to the 36-month limit in subsection 20(8).

The purpose of this amendment is to avoid penalizing creditors who exercise "acceleration" clauses pursuant to an agreement under which the creditor sold property and received, as part of the consideration, a note payable by the purchaser of the property. The acceleration clause would typically only be exercised where the purchaser defaulted on its obligations to a creditor. Similar amendments are proposed to subsections 40(1) and 44(1).

This amendment applies to taxation years ending after February 21, 1994.

Subclause 6(2)

ITA
20(1)(hh.1)

New paragraph 20(1)(hh.1) of the Act allows a deduction for the repayment, after February 21, 1994, of assistance received by a taxpayer in respect of eligible capital property related to a business carried on by the taxpayer. The deduction (equal to 3/4 of the amount so repaid) applies only where the taxpayer ceases to carry on the business prior to the repayment. Repayments of assistance prior to that time are added under new paragraph 14(10)(b) in computing the eligible capital expenditure of the taxpayer.

Subclause 6(3)

ITA
20(1)(uu)

New paragraph 20(1)(uu) of the Act provides a deduction in computing a taxpayer's income in certain cases where the debt forgiveness rules under subsection 80(15) apply to a partnership of which the taxpayer is a member. A deduction is also provided for up to 3/4 of any payment to which subsection 80.01(10) applies.

Subsection 80.01(10) concerns payments made in satisfaction of a debt after it is considered to have become "parked" for the purposes of the debt forgiveness rules in section 80. For further discussion, see the commentary on those subsections.

This amendment applies to taxation years ending after February 21, 1994.

Clause 7

Farming or fishing business

ITA
28(1)(d) and (g)

Section 28 of the Act provides rules concerning the computation of income for taxpayers who use the cash-basis method of accounting in respect of farming or fishing businesses for income tax purposes.

Paragraphs 28(1)(d) and (g) are amended so that income inclusions under subsections 80(13) and (17) (net of any deduction under new paragraph 20(1)(uu)) are recognized as income from a farming or fishing business, in the event that an obligation in respect of the business is settled or extinguished in circumstances to which section 80 applies. Many obligations in respect of such businesses will, however, not be subject to sections 79 and 80 because of paragraph (b) of the definition of "excluded obligation" in subsection 80(1). This definition is used in the definition of "forgiven amount" in subsection 80(1) and in the description of F in subsection 79(3). The non-recognition for cash-basis taxpayers of interest payable until it is actually paid also minimizes the effect of the rules in both sections 79 and 80. (See subparagraph (b)(v) of the description of F in subsection 79(3) and paragraph 80(2)(b).)

These amendments apply to taxation years ending after February 21, 1994.

Clause 8

Loss from farming

ITA
31(1) and (1.1)

Subsection 31(1) of the Act restricts the losses from farming deductible against other sources of income by farmers whose chief source of income is neither farming nor a combination of farming and some other source of income. The unrestricted portion of such losses is limited to $2,500 plus one-half of the next $12,500 of losses. The remainder of such a loss is defined, for the purposes of the Act, as a "restricted farm loss". A restricted farm loss for a taxation year is deductible under paragraph 111(1)(c) in computing taxable income for the 3 preceding taxation years or the 10 following taxation years to the extent of the taxpayer's income from farming in those years.

Section 31 is amended so that the definition of "restricted farm loss" is provided under new subsection 31(1.1) rather than subsection 31(1).

New subsection 31(1.1) expressly provides that a "restricted farm loss" is reduced as required by section 80.

These amendments apply to taxation years ending after February 21, 1994.

Clause 9

Scientific research and experimental development

ITA
37(1)(f.1)

Section 37 of the Act sets out the rules for the deductibility of expenditures incurred by a taxpayer for scientific research and experimental development (SR&ED).

New paragraph 37(1)(f.1) provides that a taxpayer's SR&ED balance for a taxation year must be reduced to take into account each deduction claimed by the taxpayer under new section 61.3 for a preceding taxation year. That section provides a deduction to corporations and non-residents in certain circumstances to offset amounts included in income under section 80 as a result of the forgiveness of debt issued those persons. The amount of the reduction under paragraph 37(1)(f.1) is equal to the lesser of:

- the amount deducted under section 61.3 in computing the taxpayer's income for that preceding year, and

- any amount that the taxpayer was entitled to deduct, but did not claim, under subsection 37(1) for that preceding taxation year.

This amendment applies to taxation years ending after February 21, 1994.

Clause 10

Capital gains and losses

ITA
39(3)

Subsection 39(3) of the Act provides rules that apply where a taxpayer purchases in the open market any obligation earlier issued by the taxpayer. In these circumstances, the taxpayer will be considered to have realized a capital gain to the extent that the amount for which the obligation was issued by the taxpayer exceeds the purchase price for the obligation. A capital loss arises to the extent that the purchase price exceeds the greater of the principal amount of the obligation and the amount for which it was issued. However, these provisions do not apply to the extent that the gain or loss is otherwise recognized under the Act as income or a loss.

Subsection 39(3) is amended to ensure that a capital gain may arise pursuant to paragraph 39(3)(a), notwithstanding that the application of new subsection 80(12) or (13) could result in an income inclusion for the taxpayer if subsection 39(3) did not apply. Paragraph (d) of the description of B in the definition "forgiven amount" in subsection 80(1) ensures that an obligation extinguished in circumstances to which subsection 39(3) applies does not give rise to the application of section 80.

Reference should also be made to new subsection 248(27), which clarifies that the open market purchase of any portion of an obligation under subsection 39(3) is treated on the same basis as the purchase of the entire obligation.

This amendment applies to taxation years ending after February 21, 1994.

Clause 11

Capital gains - special rules

Subclause 11(1)

ITA
40(1)(a)(iii)(C)

Where a taxpayer disposes of capital property in a taxation year, the gain otherwise determined may be reduced under subparagraph 40(1)(a)(iii) of the Act by a reasonable reserve in respect of proceeds of disposition that are not due to the taxpayer until after the end of the year. However, the gain from the disposition is fully recognized over the first five (or, in some cases, ten) taxation years of the taxpayer ending after the time of disposition.

Clause 40(1)(a)(iii)(C) is amended to provide that a reserve for a taxation year is based on amounts that are payable to the creditor after the end of the year, whether or not the amounts became due to the creditor before the end of the year. The purpose of this amendment is to avoid penalizing creditors who exercise "acceleration" clauses pursuant to an agreement under which the creditor sold capital property and received as part of the consideration a note payable by the purchaser of the property. The acceleration clause would typically be exercised only if the purchaser defaulted on its obligations to a creditor. Similar amendments are proposed to paragraph 20(1)(n) and subsection 44(1).

This amendment applies to taxation years ending after February 21, 1994.

Subclause 11(2)

ITA
40(2)(e.1)

New paragraph 40(2)(e.1) of the Act (in conjunction with amended subsections 85(4) and 97(3)) provides that the loss from the disposition by a taxpayer of certain indebtedness is considered to be nil. Instead, the transferee is generally entitled to increase its adjusted cost base of the property under amended paragraph 53(1)(f.1) or new paragraph 53(1)(f.11).

New paragraph 40(2)(e.1) applies where the transferor and the transferee of the indebtedness and the debtor are related to each other. New paragraph 80(2)(j), described in the following commentary, may apply in determining whether or not a transferor, a transferee and a debtor are related to each other for the purpose of this rule.

The purpose of new paragraph 40(2)(e.1) (in conjunction with amended subsections 85(4) and 97(3)) is to provide balanced treatment for debtors and creditors under the debt parking rule in subsection 80.01(8) and the stop-loss rules in subsections 40(2), 85(4) and 97(3). For further details, see the commentary on the amendment to subsection 85(4).

This amendment applies to dispositions after July 12, 1994, other than dispositions pursuant to agreements in writing entered into before July 13, 1994.

ITA
40(2)(e.2)

New paragraph 40(2)(e.2) of the Act applies where a taxpayer disposes of one commercial obligation (as defined by subsection 80(1)) issued by a person or partnership in exchange for another commercial obligation issued by the same person or partnership. In these circumstances, any loss from the disposition is reduced and the amount of the reduction is added under new paragraph 53(1)(f.12) in computing the adjusted cost base of the new obligation. More specifically, the loss determined under new paragraph 40(2)(e.2) from the disposition of a particular commercial obligation is equal to the loss otherwise determined multiplied by a proration factor. The proration factor is equal to the fair market value of the consideration that is not a commercial obligation divided by the fair market value of the total consideration received for the obligation disposed of.

This amendment applies to dispositions after December 20, 1994, other than dispositions pursuant to agreements in writing entered into before December 21, 1994.

EXAMPLE

Assume a $100,000 commercial debt obligation issued by Debtco to a taxpayer is now worth only $10,000. As part of a restructuring, the taxpayer accepts two commercial debt obligations issued by Debtco (having principal amounts of $45,000 and $15,000) and $4,000 of cash in settlement of the $100,000 obligation. The total value of this consideration is $10,000.

Results:

1. As a consequence of new paragraph 80(2)(h), the full principal amount of the new obligations is considered to have been paid in satisfaction of the first debt. The "forgiven amount" in respect of the first obligation is therefore equal to $36,000 ($100,000 - 60,000 - 4,000).

2. The capital loss otherwise determined is equal to $90,000 ($100,000 - 10,000). As a consequence of paragraph 40(2)(e.2), the capital loss is also equal to $36,000 ($90,000 X (4,000/10,000)).

3. The $54,000 reduction in the capital loss is added under new paragraph 53(1)(f.12) in computing the adjusted cost base of the new obligations in proportion to the principal amounts of those obligations. Consequently, $40,500 (three-quarters of the $54,000 *reduction) is allocated to the $45,000 obligation and $13,500 (one-quarter of the $54,000 reduction) is allocated to the $15,000 obligation.*

Clause 12

Replacement property

ITA
44(1)(e)(iii)(C)

Paragraph 44(1)(e) of the Act governs the computation of a taxpayer's gain from the disposition of a capital property when another capital property is acquired by the taxpayer as a replacement property. Under subparagraph 44(1)(e)(iii), a reserve may be claimed with respect to the computed gain on the same basis as a reserve may be claimed under subparagraph 40(1)(c)(iii) (described in the commentary above).

Clause 44(1)(e)(iii)(C) is amended in the same manner as clause 40(1)(a)(iii)(C). The amendment to the latter clause is described in the commentary above.

This amendment applies to taxation years ending after February 21, 1994.

Clause 13

Identical properties

ITA
47(1)

Section 47 of the Act requires a taxpayer to average the cost of identical properties acquired after 1971. Where a taxpayer acquires a property identical to a property or properties already owned by the taxpayer, the taxpayer is considered under subsection 47(1) to have disposed of each of the previously-acquired properties for proceeds equal to its adjusted cost base to the taxpayer and to have acquired each of the identical properties for a cost equal to

- the total of the adjusted cost bases to the taxpayer of all of the previously-acquired identical properties and the cost to the taxpayer of the newly-acquired identical property

divided by

- the number of identical properties owned by the taxpayer after the acquisition of the newly-acquired identical property.

Subsection 47(1) is designed so that the cost of each identical property of a taxpayer is the same after the acquisition of a new identical property by the taxpayer. As a consequence, the order of any subsequent dispositions of such properties by a taxpayer generally does not need to be identified.

Subsection 47(1) is amended to provide that, where previously-acquired identical properties have been subject to a deduction in computing their adjusted cost bases under new paragraph 53(2)(g.1), the adjusted cost base of each identical property after a new acquisition of such property is reduced pro-rata under that paragraph. The amendment effectively preserves the history of deductions in computing the adjusted cost base of property under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of the amendment is with respect to the potential future application of new section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 49(3.01), 51(1), 53(4) to (6), 86(4) and 87(5.1) and (6.1).

The amount deducted under paragraph 47(1)(c) in computing the adjusted cost base of a property to a taxpayer is added in computing that adjusted cost base under paragraph 47(1)(d) so that these provisions will maintain the same net amount as the adjusted cost base to the taxpayer of the property.

This amendment applies to taxation years ending after February 21, 1994.

Clause 14

Options

ITA
49(3.01)

Subsection 49(3) of the Act applies when an option to acquire property is exercised by a taxpayer. In computing the adjusted cost base to the taxpayer of such property, there is generally added the adjusted cost base to the taxpayer of the related option.

New subsection 49(3.01) provides that, where the adjusted cost base of an option to acquire "specified property" has been subject to a deduction in computing its adjusted cost base under new paragraph 53(2)(g.1), the adjusted cost base of the specified property acquired on the exercise of the option will also be reduced under that paragraph. A corresponding increase in the adjusted cost base is also provided, so that there is no net effect on the amount of the adjusted cost base of the specified property. For this purpose, "specified property" is defined under section 54 as a capital property of a taxpayer that is a share, a capital interest in a trust, a partnership interest or an option to acquire such property.

Subsection 49(3.01) effectively preserves the history of deductions in computing the adjusted cost base of an option under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of subsection 49(3.01) is with respect to the potential future application of new section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 47(1), 51(1), 53(4) to (6), 86(4) and 87(5.1) and (6.1).

This amendment applies to taxation years ending after February 21, 1994.

Clause 15

Bad debts and shares of bankrupt corporations

ITA
50(1)

Subsection 50(1) of the Act provides that certain debt owed to a taxpayer is deemed to be disposed of by the taxpayer for no proceeds and to have been reacquired by the taxpayer at a cost of nil. This rule applies to debts established to have become bad debts by a taxpayer. Subsection 50(1) also applies to certain shares owned by a taxpayer, where the taxpayer so elects.

Subsection 50(1) is amended to provide that it also only applies, in the case of a debt payable to a taxpayer, where the taxpayer so elects. A taxpayer may decide not to elect under subsection 50(1) if that election would result in the application of new subsection 80.01(8) to a debtor with whom the taxpayer does not deal at arm's length or in which the taxpayer has a "significant interest" (as defined under subsection 80.01(2)). For further discussion, see the commentary on new subsections 80.01(6) to (8).

These amendments apply to taxation years ending after February 21, 1994.

Clause 16

Convertible property

ITA
51(1)(d.1) and (d.2)

Subsection 51(1) of the Act applies where a share of the capital stock of a corporation is acquired under the terms of certain convertible securities issued by the corporation. In these circumstances, the convertible security is treated as if it had not been disposed of. The cost of the new share is determined with reference to the adjusted cost base of the convertible security.

New paragraphs 51(1)(d.1) and (d.2) provide that, where the adjusted cost base of a convertible security has been subject to a deduction in computing its adjusted cost base under new paragraph 53(2)(g.1), the adjusted cost base of the new share is likewise reduced under paragraph 53(2)(g.1). This measure effectively preserves the history of deductions in computing the adjusted cost base of a convertible security under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of paragraphs 51(1)(d.1) and (d.2) is with respect to the potential future application of new section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 47(1), 49(3.01), 53(4) to (6), 86(4) and 87(5.1) and (6.1).

More specifically, paragraph 51(1)(d.1) provides for a deduction in computing the adjusted cost base of a share acquired in exchange for a convertible security. The deduction, which is taken into account at the time of the exchange, is equal to a specified proportion of the total amounts previously deducted under paragraph 53(2)(g.1) in computing the adjusted cost base of the convertible property. The specified proportion is equal to the fair market value of the new share acquired by a taxpayer divided by the fair market value of all new shares acquired by the taxpayer on the exchange.

Under paragraph 51(1)(d.2), the amount determined under paragraph 51(1)(d.1) in respect of a new share acquired by a taxpayer is added in computing the adjusted cost base to the taxpayer of the share so that there is no net effect on the amount of its adjusted cost base.

This amendment applies to taxation years ending after February 21, 1994.

Clause 17

Adjustments to cost of property

Subclause 17(1)

ITA
53(1)(f.1) to (f.12)

Paragraph 53(1)(f.1) of the Act provides for an increase in computing the adjusted cost base to a taxable Canadian corporation of property transferred to the corporation, equal to a capital loss denied to the transferor because of paragraph 40(2)(e) or subsection 85(4). It applies only where:

- the transferor was another taxable Canadian corporation, and
- the transferor was not allowed under paragraph 85(4)(b) to increase the adjusted cost base of shares owned by it as a consequence of the transfer of the property.

Paragraph 53(1)(f.1) is amended to provide that capital losses denied under new paragraph 40(2)(e.1) are, for the purposes of paragraph 53(1)(f.1), treated in the same way as capital losses denied under paragraph 40(2)(e).

New paragraph 53(1)(f.11) is introduced so that a capital loss denied under paragraph 40(2)(e.1) (to the extent not reflected under amended paragraph 53(1)(f.1) or paragraph 85(4)(b)) on the transfer of a property is similarly added to the adjusted cost base to the transferee of the property. This measure does not apply where the transferor is non-resident or tax-exempt or is a partnership (other than an eligible Canadian partnership, within the meaning assigned by subsection 80(1)).

New paragraph 53(1)(f.12) is introduced so that the amount by which a capital loss has been reduced under paragraph 40(2)(e.2) on the exchange of one commercial obligation for one or more other commercial obligations is added in computing the adjusted cost base of the other obligation or obligations. For further detail, see the commentary on new paragraph 40(2)(e.2) and the definition "commercial obligation" in subsection 80(1).

These amendments apply to taxation years ending after February 21, 1994.

Subclause 17(2)

ITA
53(1)(q)

New paragraph 53(1)(q) of the Act provides for an increase in the adjusted cost base to a taxpayer of property, to the extent allowed by any of new paragraphs 47(1)(d), 49(3.01)(b), 51(1)(d.2), 53(4)(b), (5)(b) and (6)(b), 86(4)(b) and 87(5.1)(b) and (6.1)(b). For further detail, see the commentary on those provisions and new section 80.03.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 17(3)

ITA
53(2)(g.1)

New paragraph 53(2)(g.1) of the Act provides for deductions in computing the adjusted cost base to a taxpayer of property, to the extent required by any of new subsections 80(9) to (11) and paragraphs 47(1)(c), 49(3.01)(a), 51(1)(d.1), 53(4)(a), (5)(a) and (6)(a), 86(4)(a) and 87(5.1)(a) and (6.1)(a). For further detail, see the commentary on those provisions and new section 80.03.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 17(4)

ITA
53(4) to (6)

New subsections 53(4) to (6) of the Act provide rules that affect the computation of the adjusted cost base to a taxpayer of any "specified property".

The only significance of subsections 53(4) to (6) is with respect to the potential application of new section 80.03, which recognizes all or a portion of the reduction in the adjusted cost base of specified property under paragraph 53(2)(g.1), on certain dispositions of such property. Paragraph 53(2)(g.1) provides reductions in the adjusted cost bases of property which result, directly or indirectly, from the operation of the debt forgiveness rules in section 80. Similar amendments are provided under subsections 47(1), 49(3.01), 51(1), 86(4) and 87(5.1) and (6.1). As defined under section 54, "specified property" is capital property that is a share, a capital interest in a trust, a partnership interest or an option to acquire such property.

Subsection 53(4) of the Act applies only where the proceeds of disposition of a specified property are determined under any one of a number of provisions in the Act. Where this is the case, and the adjusted cost base of the specified property was reduced under paragraph 53(2)(g.1), subsection 53(4) provides for the adjusted cost base to continue to be reduced under that paragraph.

The provisions set out in subsection 53(4) are as follows:

- paragraph 48.1(1)(c) (which provides for the deemed disposition and reacquisition of a share of the capital stock of a small business corporation that becomes a public corporation),

- sections 70 and 73 (which provide for the deemed disposition of certain property on the death of an individual and, in certain cases, for rollovers of property to qualifying recipients),

- subsection 85(1) (under which is determined proceeds of disposition of property transferred to a corporation in exchange for a share issued by the corporation),

- paragraph 85.1(1)(a) (under which is determined proceeds of disposition of shares of the capital stock of a corporation that are exchanged by a taxpayer for shares of the capital stock of another corporation),

- paragraphs 87(4)(a) and (c) (under each of which is determined the proceeds of disposition of shares of the capital stock of a corporation on the amalgamation of that corporation with another corporation),

- paragraph 88(1)(a) (under which is determined the proceeds of disposition for a subsidiary of assets transferred to a parent on a winding-up),

- subsection 97(2) (under which is determined proceeds of disposition of property transferred to a partnership in exchange for an interest in the partnership),

- subsection 98(2) and paragraphs 98(3)(f) and (5)(f) (under each of which is determined proceeds of disposition for a partnership of partnership assets distributed to members of the partnership),

- subsection 104(4) (which provides for the deemed disposition by a trust of capital property),

- paragraphs 107(2)(a), (2.1)(a), (4)(d) and (5)(a) (under each of which is determined proceeds of disposition for a trust of trust assets distributed to beneficiaries under the trust),

- paragraph 111(4)(e) (under which is determined the proceeds of disposition of certain capital property of a corporation on an acquisition of control of the corporation), and

- section 128.1 (which provides for the deemed disposition and reacquisition of property where taxpayers immigrate to, or emigrate from, Canada).

Where the proceeds of disposition at any time for a specified property are determined under any one of the above provisions, there is deducted under paragraph 53(4)(a) in computing the adjusted cost base to a transferee (including a person or partnership deemed to reacquire such property under that provision), the amount, if any, by which

- the total of amounts previously deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the person who actually disposed of, or is deemed by any of the provisions to have disposed of, that property

exceeds

- the capital gain from the disposition of that property, determined without reference to subsection 100(2) (dealing with dispositions of partnership interests which have "negative" adjusted cost bases) and any reserves claimed by that person.

Any amount deducted under paragraph 53(4)(a) in computing the adjusted cost base of a property is also added at the same time under paragraph 53(4)(b) in computing that adjusted cost base so that there is no net effect on the amount of the adjusted cost base of the property.

Subsection 53(5) applies where specified property is disposed of by a person (referred to below as the "vendor") to another person or partnership with whom the vendor does not deal at arm's length, or with whom the vendor would not deal at arm's length if the assumptions set out in new paragraph 80(2)(j) were made. Where this is the case, and subsection 53(4) does not apply to the disposition, there is deducted under paragraph 53(5)(a) in computing the adjusted cost base to the other person or partnership, the amount, if any, by which

- the total of amounts previously deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the vendor of that property

exceeds

- the capital gain from the disposition of that property, determined without reference to subsection 100(2) and any reserves claimed by the vendor.

Any amount deducted under paragraph 53(5)(a) in computing the adjusted cost base of a property is also added at the same time under paragraph 53(5)(b) in computing that adjusted cost base.

Subsection 53(6) applies where 2 or more corporations amalgamate or merge to form a new corporate entity and specified property is acquired on the formation of the new entity. Where this is the case, any amount previously deducted by a predecessor corporation under paragraph 53(2)(g.1) in computing its adjusted cost base of such property is deducted under paragraph 53(6)(a) after the time of the acquisition, unless those amounts are otherwise deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the new entity of the specified property.

Any amount deducted under paragraph 53(6)(a) in computing the adjusted cost base of a property is also added at the same time under paragraph 53(6)(b) in computing that adjusted cost base.

These amendments apply to taxation years ending after February 21, 1994.

Clause 18

Capital gains and losses - definitions

Subclause 18(1)

ITA
54

"proceeds of disposition"

The expression "proceeds of disposition", which is relevant for the purposes of determining a taxpayer's capital gain or loss from the disposition of property, is contained in section 54 of the Act. Included in the "proceeds of disposition" of property under existing paragraph (h) of the definition are proceeds deemed to arise in consequence of paragraph 79(c).

Paragraph (h) of the definition is amended to refer to section 79, rather than paragraph 79(c). This amendment is consequential on the amendments to section 79, described in the following commentary, under which proceeds of disposition for a debtor are determined under new subsection 79(3).

This amendment applies to taxation years ending after February 21, 1994.

Subclause 18(2)

ITA
54

"superficial loss"

Section 54 of the Act defines "superficial loss". Pursuant to paragraph 40(2)(g), a taxpayer's loss from the disposition of property is nil, if the loss is a superficial loss. The loss denied to a transferor may be added in computing the adjusted cost base to the transferee of the property, to the extent provided under paragraph 53(1)(f).

The definition of "superficial loss" is amended to provide that it does not apply in respect of losses deemed to be nil by new paragraph 40(2)(e.1). Thus, a loss denied under paragraph 40(2)(e.1) is added under amended paragraph 53(1)(f.1) or new paragraph 53(1)(f.11), rather than paragraph 53(1)(f), in computing the adjusted cost base to the transferee of the property.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 18(3)

ITA
54

"specified property"

The new definition "specified property" is described in the commentary to new subsections 53(4) to (6) of the Act. It is used in those subsections, as well as in new subsection 49(3.01).

This amendment applies to taxation years ending after February 21, 1994.

Clause 19

Add back of reserves for debt forgiveness

ITA
56.2 and 56.3

New section 56.2 of the Act is discussed in the commentary on new section 61.2.

New section 56.3 provides that a reserve deducted by a taxpayer under new section 61.4 for a taxation year is added back in computing the taxpayer's income for the following taxation year. For further discussion, see the commentary on section 61.4. Section 61.4, in conjunction with section 56.3, permits non-residents carrying on business in Canada and resident corporations and trusts to have amounts included in income under section 80 (debt forgiveness) spread over a five-year period. It should be noted, however, that section 56.3 does not apply to require an income inclusion in a taxation year during which a taxpayer is a bankrupt.

These amendments apply to taxation years ending after February 21, 1994.

Clause 20

Reserve for debt forgiveness

ITA
61.2

New section 61.2 of the Act provides relief to individuals resident in Canada who might otherwise face financial hardship as a consequence of an income inclusion under new subsection 80(13), which in certain circumstances includes an amount in the income of an individual whose indebtedness has been forgiven. A related amendment, discussed in the commentary on section 61.4, applies to non-residents, corporations and trusts. It should be noted, however, that the Minister of National Revenue is authorized under new subsection 80(16) to reduce an individual's tax attributes and, as a consequence, the income inclusion of the individual under subsection 80(13), in the event that the individual has failed under section 80 to apply forgiven amounts of debts to the maximum extent possible against those tax attributes.

The deduction under section 61.2 is equal to:

- the total of all such income inclusions for the year (including the individual's share of such income inclusions as a member of a partnership for fiscal periods that end in the year),

MINUS the total of

- deductions claimed under paragraph 80(15)(a) for the year in the individual's capacity as a member of a partnership, and

- if the individual's income for the year exceeds $40,000, 20% of the excess.

For these purposes, an individual's income is computed without regard to subsection 80(13), new section 56.2, paragraph 60(w) (deduction for tax under Part I.2 on old age security) and section 61.2 itself. The reference to paragraph 60(w) is required to prevent a circular calculation between section 180.2 (under which Part I.2 tax is computed) and section 61.2. The effect of these references is that a deduction under section 61.2 is claimed before the computation of Part I.2 tax.

The amount deducted under section 61.2 in computing an individual's income for a taxation year is added back under section 56.2 in computing the individual's income for the following year, but a deduction in respect of the resulting income inclusion is available under section 61.2 on the same basis for the following year. As a consequence, the income inclusion for an individual resulting from section 80 is, in effect, deferred until a later taxation year in which the individual has sufficient other income to support the inclusion of all or part of an income inclusion under subsection 80(13). However, it is intended that a deduction can be claimed under section 61.2 for the taxation year in which an individual dies. There is no requirement that the reserve be added in computing the income of the individual's estate or beneficiaries. In addition, the add-back of a reserve for an individual will not apply to any taxation year during which the individual is a bankrupt.

This amendment applies to taxation years ending after February 21, 1994.

The operation of sections 56.2 and 61.2 in these circumstances is illustrated in the following examples.

EXAMPLE 1

In 1995, individual A included $20,000 in income under subsection 80(13) as a result of a forgiveness of debt. The individual's income, determined without reference to subsection 80(13) and sections 56.2 and 61.2, is $30,000 in 1995 and 1996 and $50,000 in 1997. Assume A claims deductions under section 61.2 to the maximum extent possible.

Results:

1. The amount included in income for 1995 under subsection 80(13) will be completely offset by a deduction under section 61.2 of $20,000 so that A's income for tax purposes for 1995 will remain $30,000.

2. For 1996, A will be required under section 56.2 to bring into income the $20,000 claimed in 1995 under section 61.2. This inclusion will be completely offset by a deduction under section 61.2 of $20,000 so that A's income for tax purposes for 1996 will remain $30,000.

3. For 1997, A will be required under section 56.2 to bring into income the $20,000 claimed in 1996 under section 61.2. Because A's income otherwise determined for 1997 exceeds $40,000, A is not entitled to completely offset the $20,000 income inclusion with a further claim under section 61.2. Rather, the potential reserve is reduced by 20% of A's income in excess of $40,000, i.e., $2,000 (.2 x ($50,000 - 40,000)). Thus, A may claim a deduction of $18,000 under section 61.2 and A's income for tax purposes for 1997 will be $52,000 ($50,000 + $20,000 - $18,000).

4. The $18,000 reserve claimed for 1997 will be added to A's income for 1998. A reserve for that year and subsequent years may be available, depending on the amount of A's income in those years.

EXAMPLE 2

In 1995, individual B included an amount in income under subsection 80(13) of $10,000 in respect of one debt, against which the individual was able to claim a reserve under section 61.2 of $3,000. In 1996, a further amount of $6,000 is included in computing the individual's income under subsection 80(13) in respect of another debt. The individual's income for 1996, without taking into account subsection 80(13) and sections 56.2 and 61.2, is $62,000.

Results:

1. The deduction that may be claimed under section 61.2 for 1996 is $4,600. This is equal to $6,000 (forgiven amount in respect of the other debt), plus $3,000 (income inclusion under section 56.2) minus 20% of ($62,000 - $40,000).

2. To the extent that a deduction is claimed for 1996 under section 61.2, it is added back under section 56.2 in computing the individual's income for 1997.

Deduction for debt forgiveness

ITA
61.3

New subsection 61.3(1) of the Act provides a deduction for corporations resident in Canada (other than corporations exempt from tax under Part I of the Act) with respect to amounts included in income under subsection 80(13) because of the application of the debt forgiveness rules. In general terms, section 61.3 requires a debtor corporation to compute the amount of its net assets (i.e., the fair market value of its assets, net of its liabilities) at the end of a taxation year. Subsection 61.3(1) allows an offset against the income inclusion under subsection 80(13) equal to the amount of that income inclusion minus two times the net asset amount. Thus, the effect of the offset is that a corporation will be required to recognize income as a consequence of subsection 80(13) only to the extent of twice the corporation's net assets. As a consequence, on the assumption that the combined federal/provincial income tax rate of a corporation does not exceed 50%, the income inclusion for the corporation under subsection 80(13) will not result in the corporation's liabilities exceeding the fair market value of its assets.

More specifically, the amount deducted under subsection 61.3(1) in respect of a corporation for a taxation year is equal to the lesser of two amounts. The first amount (referred to below as the "net forgiveness amount") is equal to the total of amounts added in computing the corporation's income because of the application of subsection 80(13), net of any deductions in respect of that total under paragraph 80(15)(a).

The second amount in respect of a corporation for a taxation year is determined as follows:

- ADD the corporation's net forgiveness amount;

- SUBTRACT 2 times the total of

  - the fair market value of the corporation's assets at the end of the year,

  - the amounts paid by the corporation before the end of the year on account of federal and provincial taxes for the year that are specified below, and

  - all amounts paid in the 12-month period preceding the end of the year by the corporation to a person with whom the corporation does not deal at arm's length

    - as a dividend (other than a stock dividend),

    - on a reduction of paid-up capital,

    - on a redemption, acquisition or cancellation of its shares, or

- as a distribution or appropriation in any manner whatever to or for the benefit of the shareholders of any class of its capital stock (to the extent that the distribution or appropriation cannot reasonably be considered to have resulted in a reduction in the corporation's liabilities);

- ADD 2 times the corporation's liabilities at the end of the year, determined in the manner specified below;

- ADD 2 times the total of the principal amounts of all distress preferred shares issued by the corporation as of the end of the year, as determined under new section 80.02; and

- ADD the amount, if any, by which the income of the corporation for the year (determined without reference to sections 61.3 and 61.4 and subsection 80(17)) exceeds the corporation's net forgiveness amount.

For the purposes of subsection 61.3(1), the liabilities of a corporation at the end of a taxation year are determined without regard to specified federal and provincial taxes payable for the year. Otherwise, generally accepted accounting principles must be used for the purposes of determining such liabilities. In the event that a balance sheet reflecting the liabilities of a corporate debtor has been shown to its shareholders or, in the case of a bank or insurance corporation, to the appropriate federal or provincial regulator, the liabilities will generally be those reflected on the balance sheet with an adjustment for the specified federal and provincial taxes. (For this purpose, the specified federal taxes for a taxation year are the taxes payable for the year under Part I or any of Parts I.3, II, VI and XIV of the Act. Specified provincial taxes are any corresponding provincial taxes.)

Subsection 61.3(2) provides for a deduction, parallel to the deduction referred to above, for a non-resident corporation in computing the non-resident corporation's income.

Subsection 61.3(3) provides that the deductions under subsections 61.3(1) and (2) are not available to a corporation for a taxation year if property was transferred (or the corporation became indebted) in 12-month period preceding the end of the year and one of the reasons for the transaction was to increase the amount that the corporation would be entitled to deduct under subsection 61.3(1) or (2). Reference should also be made in this context to the joint liability rule in new section 160.4.

The Minister of National Revenue is authorized under new subsection 80(16) to increase the amount of a corporation's forgiven amounts that are applied under subsections 80(5) to (11) against the corporation's tax attributes, in the event that there is a deduction under section 61.3 in computing the corporation's income. In addition, a deduction under section 61.3 by a corporation can result in a recapture of up to 50% of the deduction under new subsection 80(17) and an adjustment under new paragraph 37(1)(f.1) with respect to the corporation's balance of scientific research expenditures. An adjustment with respect to a deduction under section 61.3 is also provided with respect to payments of debts deemed to be settled under subsection 80.01(8) (debt parking) or (9) (statutory limitation periods).

These amendments apply to taxation years ending after February 21, 1994.

The following example illustrates the operation of subsection 61.3(1).

EXAMPLE

The following information applies to Debtco at the end of the 1994 taxation year:

Net forgiveness amount	*$100,000*
Fair market value of assets at end of year	*$ 70,000*
Liabilities at the end of year, determined without regard to specified tax liabilities for the year	*$ 67,000*
Income for the year, determined without reference to sections 61.3 and 61.4 and subsection 80(17)	*$101,000*

Payments on account of specified tax liabilities for the year . . . . $ nil

Results:

1. The deduction that Debtco claims under section 61.3 for the taxation year is equal to $95,000, which is the lesser of

- *$100,000, and*
- *$95,000 ($100,000 - 2(70,000) + 2(67,000) + (101,000-100,000)).*

2. Under section 61.4, the $5,000 remaining income inclusion can be spread over 5 years.

Reserve for debt forgiveness

ITA
61.4

New section 61.4 of the Act allows a taxpayer to deduct an amount as a reserve with respect to an income inclusion under new subsection 80(13) on the settlement of a commercial obligation (within the meaning assigned by subsection 80(1)) issued by the taxpayer. In conjunction with new section 56.3, section 61.4 allows such an income inclusion for a taxpayer to be spread over 5 years if the taxpayer is a non-resident person that carries on business through a fixed place of business in Canada or a corporation or trust resident in Canada. No reserve is allowed for partnerships because of the special rules for members of partnerships described in the commentary to new subsection 80(15). A reserve is also not allowed under section 61.4 for corporations that are winding-up in circumstances to which subsection 88(1) does not apply. (Individuals resident in Canada are allowed to claim a reserve under new section 61.2. Corporations are also permitted, in certain cases, to claim a deduction under new section 61.3.)

More specifically, where an income inclusion under subsection 80(13) arises for a qualifying taxpayer, up to 4/5 of the income inclusion may be deducted under section 61.4 in computing the taxpayer's income for the year. The amount deducted by a taxpayer under section 61.4 for a taxation year is added back under section 56.3 in computing the taxpayer's income for the following year. For the following year, a taxpayer may deduct up to 3/5 of the original income inclusion for the year (subject to a limit equal to the original income inclusion minus the amount by which the original inclusion exceeds the amount deducted under section 61.4 for the preceding year in respect of that income inclusion). For the next two years, up to 2/5 and 1/5 of the original income inclusion may be deducted, subject to the same limit.

Section 61.4 is structured so that it takes into account debts settled in different taxation years. However, the effect of section 61.4 is to group debts according to the taxation year in which they were settled so that the income inclusion with respect to such debts can be determined in the manner described above.

For the purposes of section 61.4, the original income inclusion referred to above is determined net of deductions claimed by the taxpayer under new paragraph 80(15)(a) and section 61.3 in respect of the income inclusion. The reference to paragraph 80(15)(a) is relevant only where a taxpayer is a member of a partnership to which section 80 applied.

This amendment applies to taxation years ending after February 21, 1994.

Clause 21

Resource expenditures

ITA
66(4)

Subsection 66(4) of the Act sets out the deduction that may be claimed for foreign exploration and development expenses (FEDE). Under paragraph 66(4)(a), the amount that may be deducted by a taxpayer for a taxation year is determined with reference to the portion of the total of those expenses incurred before the end of the year that was not deductible in computing the taxpayer's income for a preceding taxation year.

Paragraph 66(4)(a) is amended to provide that the deduction for FEDE takes into account reductions in the FEDE balance required by new subsection 80(8), which applies in certain circumstances when debt is forgiven.

This amendment applies to taxation years ending after February 21, 1994.

Clause 22

Canadian exploration expenses

ITA
66.1(6)

Subsection 66.1(6) of the Act sets out the definition of "cumulative Canadian exploration expense" (CCEE). New subsection 80(8) requires a taxpayer's resource expenditure pools to be reduced in certain cases where debt issued by the taxpayer is settled.

The new description of J.1 in that definition provides that the computation of CCEE takes into account reductions required by new subsection 80(8).

This amendment applies to taxation years ending after February 21, 1994.

Clause 23

Canadian development expenses

ITA
66.2(5)

"cumulative Canadian development expense"

Subsection 66.2(5) of the Act sets out the definition of "cumulative Canadian development expense" (CCDE). Under the description of F in that definition, a taxpayer's CCDE is reduced to take into account proceeds from the dispositions of Canadian mining properties to the extent that those proceeds have not reduced the taxpayer's pools arising as a consequence of a transaction to which the successor rules in section 66.7 apply. New subsection 80(8) requires a taxpayer's resource expenditure pools to be reduced in certain cases where debt issued by the taxpayer is settled.

The description of F in that definition is amended to provide that, in determining the amount of successor pools against which such proceeds of disposition have been applied, no reduction under subsection 80(8) at or after the time of the disposition is taken into account.

The new description of M.1 in that definition provides that the computation of CCDE takes into account reductions required by new subsection 80(8).

These amendments apply to taxation years ending after February 21, 1994.

Clause 24

Canadian oil and gas property expenses

ITA
66.4(5)

"cumulative Canadian oil and gas property expense"

Subsection 66.4(5) of the Act sets out the definition of "cumulative Canadian oil and gas property expense" (CCOGPE). Under the description of F in that definition, a taxpayer's CCOGPE is reduced to take into account proceeds from the dispositions of Canadian oil and gas properties to the extent that those proceeds have not reduced the taxpayer's pools arising as a consequence of a transaction to which the successor rules in section 66.7 apply. New subsection 80(8) requires a taxpayer's resource expenditure pools to be reduced in certain cases where debt issued by the taxpayer is settled.

The description of F in that definition is amended to provide that, in determining the amount of successor pools against which such proceeds of disposition have been applied, no reduction under subsection 80(8) at or after the time of the disposition is taken into account.

The new description of I.1 in that definition provides that the computation of CCOGPE takes into account reductions required by subsection 80(8).

These amendments apply to taxation years ending after February 21, 1994.

Clause 25

Successor rules

ITA
66.7(1) to (5) and (9)(f)

Subsections 66.7(1) to (5) of the Act allow a corporation to claim deductions with respect to Canadian exploration and development expenses, foreign exploration and development expenses, Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses incurred by one or more other taxpayers, where property has been acquired by the corporation in circumstances to which the successor rules apply. The deductions claimed under these subsections are limited to specified resource income (commonly called "streamed income") from the property to which the expenses relate. New subsection 80(8) requires a taxpayer's resource expenditure pools to be reduced in certain cases where a commercial obligation (within the meaning assigned by subsection 80(1)) issued by the taxpayer is settled. In certain cases, new subsections 80(13) and (17) require a taxpayer to include in computing income certain amounts arising in respect of the settlement of a commercial obligation (as defined in subsection 80(1)).

Paragraphs 66.7(1)(b), (2)(b), (3)(b), (4)(b) and (5)(b) are amended to ensure that amounts included in computing income under subsections 80(13) or (17) are excluded from a taxpayer's streamed income for the purposes of these rules.

Paragraphs 66.7(2)(a), (3)(a), (4)(a) and (5)(a) are amended to provide that the successor pools thereunder are reduced as required by new subsection 80(8).

A cross reference in paragraph 66.7(9)(f) is changed to reflect amended paragraph 66.7(3)(a).

These amendments apply to taxation years ending after February 21, 1994.

Clause 26

Surrender of property by debtor

ITA
79

Section 79 of the Act sets out rules governing the tax consequences for a debtor and creditor where the creditor has acquired property held by the debtor in consequence of the debtor's failure to pay an amount to the creditor. The existing rules are intended principally to ensure that such amounts, as well as other debt related to the acquired property, are recognized in computing the debtor's proceeds of disposition with respect to the property. In addition, the existing rules generally provide that a creditor acquires such property at a cost equal to the cost to the creditor of the creditor's claim with respect to such property and that the creditor may not subsequently claim any loss or deduction in respect of the creditor's claim.

The existing rules are structured so that income tax consequences do not depend on the fair market value (at the time of an acquisition or reacquisition) of such property, although if the property consists of more than one type of property for income tax purposes, the fair market value of a particular property may be relevant in determining the proceeds of disposition of the particular property for the debtor and the cost to the creditor of the same property. Where the creditor reacquires such property, the rules allow a gain of the creditor from the previous disposition of the property not to be recognized until the seized property is subsequently disposed of by the creditor, to the extent that the creditor claimed a reserve in respect of the gain for the taxation year preceding the year in which the seized property is reacquired by the creditor.

More specifically, the income tax consequences under the existing rules for a debtor and a creditor where the creditor acquires a property held by the debtor in consequence of the debtor's failure to pay an amount to the creditor may be summarized as follows:

- the debtor's proceeds of disposition of the property include the sum of the principal amounts of the creditor's claim plus the principal amounts of other debts extinguished by reason of the acquisition (paragraph 79(c));

- a loss may be claimed by the debtor in the event that any amounts are subsequently paid by the debtor in satisfaction of an obligation to pay any of the creditor's claim (paragraph 79(d));

- where the property has been reacquired by the creditor after a disposition of the property in a previous year by the creditor, a reserve claimed by the creditor under paragraph 20(1)(n) or subparagraph 40(1)(a)(iii) or 44(1)(e)(iii) for the first taxation year ending before the reacquisition is not added back for the purposes of determining the creditor's income or capital gain for the year of reacquisition (paragraph 79(e));

- the property is considered to have been acquired or reacquired by the creditor at a cost equal to the cost to the creditor of the creditor's claim, minus the reserve described above (paragraph 79(f));

- the creditor's adjusted cost base of the creditor's claim is nil, which prevents the creditor from subsequently claiming a capital loss in respect of the claim (paragraph 79(g)); and

- the creditor is not subsequently entitled to deduct any amount in respect of the creditor's claim as a doubtful or bad debt under paragraph 20(1)(l) or (p).

The following commentary discusses the amendments to section 79 and new section 79.1. Amended section 79 deals only with debtors. New section 79.1 deals with creditors. For an overview of the interaction between subsections 6(15) and 15(1.2) and sections 78 to 80, see the commentary on the amendments to section 80.

The new rules in sections 79 and 79.1 apply with respect to property acquired after February 21, 1994, other than property acquired or reacquired pursuant to a court order made before February 22, 1994.

ITA
79(1)

Amended section 79 of the Act provides the income tax consequences for debtors in connection with foreclosures, conditional sale repossessions and similar transactions. Definitions are provided in this respect under subsection 79(1). Under subsection 79.1(1), these definitions also apply for the purposes of new section 79.1.

The definition of "creditor" ensures that a mortgagee of property is considered to be a "creditor", irrespective of the applicable law governing mortgages. The definition also provides that the seller under a conditional sales agreement (and any assignee with respect to the agreement) is considered to be a creditor with respect to the property that is subject to the agreement. This definition is consistent with the existing law and ensures that the rules in sections 79 and 79.1 operate with respect to mortgage foreclosures and conditional sale repossessions.

"Debt" is defined to include an obligation to pay an amount under a mortgage or similar obligation or under a conditional sales agreement.

The definition of "person" ensures that sections 79 and 79.1 apply where the creditor or debtor is a partnership.

The definition of "property" ensures that sections 79 and 79.1 do not apply by reason of the acquisition of money or government debt (including government-guaranteed debt) by a creditor.

A "specified amount" of a debt owed or assumed by a person means the unpaid principal amount of the debt and unpaid interest that has accrued with respect to the debt. The reference to unpaid interest allows unpaid interest to be taken into account in determining a debtor's proceeds of disposition of property that is acquired by a creditor. The reference to debt that is assumed is relevant, under new subsection 79.1(6), only for the purposes of determining the cost to a creditor of property acquired from the debtor.

ITA
79(2)

New subsection 79(2) of the Act sets out the circumstances in which property is considered to be "surrendered" by a person to another person. The operative rules in section 79 only apply in the event that property is surrendered by a debtor to a creditor.

Property is surrendered by a debtor to a creditor where the beneficial ownership of the property is acquired or reacquired from the debtor by the creditor and the acquisition or reacquisition was in consequence of the debtor's failure to pay debt owing by the debtor to the creditor. Thus, where a creditor acquires or reacquires property from a third party to whom property was previously transferred by a debtor of the creditor, section 79 will not apply unless the third party has become liable directly to the creditor and the property is acquired or reacquired in consequence of the third party's failure to pay an amount to the creditor.

ITA
79(3)

Where a particular property is surrendered at any time (referred to below as the "surrender time") by a debtor to a creditor, the debtor's proceeds of disposition of the particular property are determined under new subsection 79(3) of the Act by the formula:

$$(A + B + C + D + E - F) \times G/H$$

The amount determined for A is the total of all debts owing by a debtor to a creditor in connection with the surrender of properties by the debtor to the creditor. The only difference from the existing rules in this respect is the inclusion of unpaid interest.

If property is surrendered to a creditor as a consequence of the failure to pay a debt while other property remains as security for the same debt, it is intended that a reasonable portion of that debt be included in the amount determined under A and that the portion of the debt so included not be included in the event that further property is surrendered by the debtor with respect to the same debt. One method .of making such a reasonable allocation would to base it on the fair market value of the surrendered property compared to the fair market value of all property that was security for the debt immediately before the surrender of the property.

The amount determined for B is the total of all debts owing immediately before the surrender time by a debtor to someone other than the creditor to whom properties are surrendered, to the extent that such amounts cease to be owing by the debtor as a consequence of that surrender. Unlike the existing rules, the amount determined for B includes unpaid interest. In addition, the amount determined for B includes debt that ceases to be owed by the debtor (whether or not the debt is actually extinguished) as a consequence of a surrender of property by the debtor.

The amount determined for C is the total of all debts owing by a debtor immediately before the surrender time that is not included in the amount determined for A or B, where any property surrendered by the debtor was security for such debt and such property was also security for a subordinate debt owing by the debtor immediately before the surrender time to the creditor to whom such property was surrendered. The description of C (in conjunction with the description of B) ensures, for example, that a debt under a first mortgage in respect of property is included in computing a debtor's proceeds of disposition if a debtor surrenders the property to the second mortgagee in respect of the property.

An amount is determined for D only if a debt is owing by the debtor immediately before the surrender time to a creditor (other than the creditor to whom property is surrendered) and, as a consequence of the surrender, the debt ceases to be secured by all the debtor's properties. Where this is the case, the portion of the total amount of such unsecured debts that is not taken into account in the amount determined for B or C is added in computing the debtor's proceeds of disposition of property that is surrendered. However, the amount determined for D is limited to the amount by which the total cost amount of all surrendered properties exceeds the proceeds for those properties (determined without reference to the amounts determined for D and F).

The description of D recognizes that, in some cases, a debtor may be insulated from liability from either a legal or practical perspective with respect to a debt formerly secured by a surrendered property. The new provision is designed to prevent an overall loss for a debtor that would otherwise result from not taking into account such debt in determining proceeds of disposition with respect to surrendered properties. In the event that payment is subsequently made by a debtor in satisfaction of a debt included in the amount determined for D, new subsection 79(4) provides for recognition of such a payment.

The description of E applies where a creditor and a debtor do not deal with each other at arm's length and the total fair market value of a surrendered property exceeds the total amounts of debts added in computing the proceeds of disposition determined on the surrender. In these circumstances, the excess is also taken into account in determining the debtor's proceeds of disposition. This measure is consistent with the existing wording in section 79.

The description of F results in a reduction of a debtor's proceeds of disposition of surrendered property to reflect the extent to which the obligations taken into account in determining the proceeds are, or have already been, taken into account under other provisions of the Act. This will occur where such an obligation is an "excluded obligation" (defined under subsection 80(1)), which includes a forgivable loan that is treated as assistance for income tax purposes. In addition, the proceeds under section 79 are reduced to reflect income arising from the settlement, or deemed settlement, of employee or shareholder indebtedness to which paragraph 6(1)(a) or subsection 15(1) applies and accrued interest payable that has been included under section 80.4 in computing the debtor's income. The proceeds under section 79 are also reduced to take into account accrued interest on the debtor's debt, if the debtor would be entitled to deduct such interest in computing income on a cash basis if it were actually paid. The proceeds under section 79 are further reduced, where a debtor is a joint exploration corporation, to reflect renunciations of resource expenditures under section 66 in respect of debt that is taken into account in determining proceeds of surrendered property for the debtor. Finally, the proceeds under section 79 are also reduced to reflect deemed settlements of obligations under subsection 80.01(8) before the year in which a debtor surrenders property in circumstances to which section 79 applies.

The descriptions of G and H in subsection 79(3) provide for the pro-ration of a debtor's proceeds of disposition with respect to surrendered property, in the event that the surrendered property consists of more than one type of property for income tax purposes. The proration factor is equal to the fair market value of the relevant part of the surrendered property divided by the fair market value of all the surrendered property.

ITA
79(4)

New subsection 79(4) of the Act provides a new rule in the event that a debtor subsequently pays a debt included in the debtor's proceeds of disposition of surrendered property. The existing rule in paragraph 79(d) provides that such amounts were considered to be losses from the disposition of property, but did not expressly characterize the nature of such a loss.

Under subsection 79(4), such a payment is treated as a capital loss under subsection 39(13) to the extent that it relates to non-depreciable capital property. To the extent that the payment relates to property the cost of which to the debtor was a Canadian exploration expense, Canadian development expense or Canadian oil and gas property expense, the amount of the payment is added to the resource pool to which such expense relates. In all other cases, the amount of the payment (or three-quarters of the payment where it relates to eligible capital property) is deductible under paragraph 20(1)(hh) or (hh.1).

ITA
79(5)

New subsection 79(5) of the Act is a special rule which applies in the event that an employee or shareholder indebtedness is settled or extinguished in a taxation year after having been recognized in computing a taxpayer's proceeds of disposition of property surrendered in a preceding year. In these circumstances, an amount equal to the employee's or shareholder's income inclusion (determined with reference to amended subsections 6(15) or 15(1.2)) is treated as a repayment of assistance to which subsection 79(4) applies.

Subsection 79(5), in conjunction with the description of F in subsection 79(3), ensures that the rules in subsection 6(15) and 15(1.2) have priority over the rules in section 79.

ITA
79(6)

New subsection 79(6) of the Act ensures that a debtor is not considered to have paid or repaid any amount as a consequence of the acquisition or reacquisition of surrendered properties. This measure is relevant, for example, where a surrender of property by a debtor relates to a forgivable loan that was considered to be assistance for the purposes of subsection 13(7.1). Such assistance is not considered to be repaid in these circumstances. Instead, the amount of such assistance is recognized under the description of F in subsection 79(3) as a deduction in computing the debtor's proceeds of disposition of surrendered properties.

ITA
79(7)

New subsection 79(7) of the Act provides that, where a debt is denominated in a foreign currency, the proceeds of disposition for property surrendered by a debtor are determined with reference to the historical foreign exchange rate at the time the debt was issued. This is consistent with the rule provided for debt forgiveness under paragraph 80(2)(k).

Seizure of property by creditor

ITA
79.1(1)

New section 79.1 of the Act provides the income tax consequences for creditors in connection with acquisitions and reacquisitions of property from debtors. Definitions used in this section are provided under subsection 79.1(1).

Subsection 79.1(1) defines "creditor", "debt", "person", "property" and "specified amount" in the same manner as those expressions are defined under subsection 79(1). The expression "specified cost" is also defined. This definition is discussed in the commentary on subsection 79.1(6).

ITA
79.1(2)

New subsection 79.1(2) of the Act sets out the circumstances in which property is considered to be "seized" by a person in respect of a debt. The operative rules in section 79.1 only apply where property is seized by a creditor in respect of a debt.

Property is seized by a creditor in respect of a debt where the beneficial ownership of the property is acquired or reacquired by the creditor and the acquisition or reacquisition was in consequence of another person's failure to pay to the creditor all or part of the debt. It should be noted that, unlike subsection 79(2), subsection 79.1(2) can apply to a creditor where the original debtor transfers secured property to a third party and there is no debtor/creditor relationship between the third party and the creditor.

In the event that the same debt is secured by more than one property and these properties are seized at different times by a creditor, it is intended that a reasonable portion of the debt be considered to relate to a particular property. The reasonable portion of the debt can be determined with reference to the fair market value of properties seized.

ITA
79.1(3) and (4)

Subsections 79.1(3) and (4) of the Act, which are similar to existing rules in paragraph 79(e), provide that a reserve claimed in the first taxation year ending before a reacquisition of a creditor's seized property is not added back in computing the creditor's income for the year of the seizure. Instead, the cost to the creditor of the seized property is reduced in a corresponding manner under subsection 79.1(6). However, if the prior year reserve in respect of a seized property exceeds its cost (determined under subsection 79.1(6), without reference to the reserve), the excess is added back into income for the year of the seizure.

ITA
79.1(5)

New subsection 79.1(5) of the Act provides relief for a creditor who seizes capital property during a taxation year in which it was previously disposed of by the creditor. Under subsection 79.1(5), a creditor's proceeds of disposition with respect to such a previous disposition are generally reduced by the unpaid portion of those proceeds at the time of the reacquisition of the property by the creditor. The amount of such reduction is taken into account by a reduction under subsection 79.1(6) in the cost to the creditor of the seized property. More specifically, the redetermined proceeds of disposition in respect of a previous disposition by the creditor of the seized property in these circumstances are considered to be equal to the lesser of the actual proceeds of disposition of the property to the creditor and the amount that is the greater of:

- the amount, if any, by which the actual proceeds of disposition of the property to the creditor exceed the portion of those proceeds represented by unpaid principal amounts of debt immediately before the time of the seizure, and

- the cost amount to the creditor of the property immediately before the previous disposition.

A special transitional rule allows this relief to apply retroactively where a taxpayer elects in writing filed with the Minister of National Revenue. This transitional rule applies to property that is reacquired by a creditor after 1991.

ITA
79.1(6)

New subsection 79.1(6) of the Act provides that the cost of a particular seized property to a creditor that is acquired in consequence of the failure to pay debt is treated as being the sum of two amounts minus a third amount.

The first amount added is the "specified cost" of the debt, multiplied by a proration factor (described below). The second amount added is the total outlays and expenses made or incurred by the creditor before the acquisition or reacquisition, or the amount of debt assumed by the creditor, to protect the creditor's interest in that property, other than outlays and expenses otherwise taken into account for income tax purposes. The third amount, which is subtracted, is any reserve claimed for the preceding taxation year with respect to that property, or the proceeds reduction determined under subsection 79.1(5), in the event that the property is being reacquired by the creditor.

As defined under subsection 79.1(1), the "specified cost" of a debt is, if the debt is capital property of a creditor, its adjusted cost base to the creditor. In other cases, the specified cost of the debt is simply its cost amount minus such portion of the cost amount that represents unpaid interest and that would be deductible in computing the creditor's income if the debt became a bad debt or became uncollectible. The reference to adjusted cost base (rather than cost) is of relevance, for example, where a corporate creditor has undergone an acquisition of control to which subsection 111(4) applies or where the adjusted cost base to the creditor of the debt is increased under paragraph 53(1)(f.1), or (f.11) on an acquisition of the debt from a person related to the creditor.

The proration factor, with respect to a particular property seized by a creditor, is its fair market value at the time of its acquisition or reacquisition by the creditor divided by the fair market value at that time of all the property seized by the creditor.

In the event that further costs are incurred by a creditor with respect to a property after its acquisition, subsection 79(6) is not intended to preclude such costs from being taken into account. For example, a creditor may make payments to a security holder with respect to seized property without having legally assumed the responsibility to make such payments.

ITA
79.1(7)

New subsection 79.1(7) of the Act provides that, if a creditor seizes property in respect of a debt, the amount received on account of the debt as a consequence of the seizure is deemed to be equal to the adjusted cost base to the creditor of the debt or, if the debt is not capital property, its cost amount. The debt is considered to have been disposed of at the time of seizure and, if any portion of it is still outstanding, it is deemed to have been reacquired. The cost of the reacquired debt is considered to be nil for capital property or, if the debt is not capital property, its cost amount minus its "specified cost" (as described in the commentary to subsection 79.1(6)). In the event that no part of a debt remains outstanding after a seizure by a creditor, this excess may be deducted by the creditor as a bad debt in computing the creditor's income.

This measure replaces the existing rule in paragraph 79(g) and ensures that there will be no income or loss resulting from any recovery in respect of a debt where a creditor seizes property in respect of the debt, unless the creditor recovers further amounts in respect of the debt. The amount received as a consequence of the seizure is considered to be received at the time of the seizure. Any further recovered amounts would be income or a capital gain of the creditor, depending on whether or not the debt is capital property of the creditor.

EXAMPLE

A creditor acquires debt from another person at a cost of $100,000. The debt is capital property. Part of the debt consists of unpaid interest of $15,000 that becomes payable after the acquisition. Subsequently, the creditor seizes land from the debtor in circumstances to which section 79.1 applies. The debt is still outstanding and the creditor collects a further $7,000 on account of the unpaid interest.

Results:

1. The creditor is considered to acquire the land for $100,000.

2. The debt is deemed to have been reacquired by the creditor for nil under subsection 79.1(7).

3. The further $7,000 collected is included in computing the creditor's income under paragraph 12(1)(c). However, the creditor is entitled to a corresponding deduction under paragraph 20(14)(b).

4. As a consequence of the deduction under paragraph 20(14)(b) and the application of subsection 40(3) and paragraph 53(2)(l), the creditor has a capital gain of $7,000. This capital gain is *added to the adjusted cost base under paragraph 53(1)(a) so that no further capital gain is realized.*

ITA
79.1(8)

New subsection 79.1(8) of the Act prohibits any deductions by a creditor in respect of the principal amount of a debtor's debt on account of bad or doubtful debts, where property was seized by the creditor in respect of that debt in circumstances to which section 79.1 applies.

The prohibition extends to bad debt expenses claimed directly (e.g., paragraph 20(1)(p) and subsections 20(4) to (4.2)) or claimed indirectly through an addition to a resource expenditure pool under subsection 66.1(6), 66.2(5) or 66.4(5).

Subsection 79.1(8) does not, however, prevent a creditor from claiming a bad or doubtful debt with respect to unpaid interest.

Clause 27

Forgiveness of debt

ITA
80

Section 80 of the Act (in conjunction with Part LIV of the *Income Tax Regulations*) sets out the existing rules that apply where an obligation of a debtor to pay an amount is settled or extinguished for less than its principal amount and the amount for which it was issued. In most circumstances, the current rules provide that the resulting economic gain is not immediately taxable but rather reduces, in turn, the amount of the debtor's deductible loss carry forwards from preceding taxation years, the capital cost of the debtor's depreciable property and the adjusted cost base of any other capital property.

There are a number of circumstances set out in existing paragraphs 80(1)(c) to (h) in which section 80 does not apply in respect of an obligation issued by a debtor. These exemptions from the application of section 80, which are also provided under the new provisions noted, apply where:

- the debtor is a bankrupt (paragraph (i) of the description of B in the definition of "forgiven amount" in subsection 80(1)),
- the obligation is one on which any interest payable may neither be deducted nor capitalized for tax purposes (definition of "commercial debt obligation" in subsection 80(1)),
- section 79 applies in respect of the obligation (paragraph (f) of the description of B in the definition of "forgiven amount" in subsection 80(1)),
- the amount of the obligation settled or extinguished is already recognized for tax purposes as income, a reduction in the capital cost or adjusted cost base of property or a capital gain under subsection 39(3) (paragraph (d) of the description of B in the definition of "forgiven amount" and the definition of "excluded obligation" in subsection 80(1)), or
- the obligation is settled or extinguished by way of bequest or inheritance (paragraph 80(2)(a)).

As described in detail below, the rules in existing section 80 are being substantially modified. The amendments to section 80 and related new provisions are organized as follows:

- Amended subsection 80(1) sets out a number of definitions relevant for the purposes of the new rules, including the key definition of "forgiven amount" that is referred to above.
- Amended subsection 80(2) contains a number of rules of application, including the rule contained in existing subsection 80(4) concerning the forgiveness of interest owing on a debt.
- The operative rules are now provided under new subsections 80(3) to (18).

- Rules for the deemed settlement of debt (including rules formerly contained in subsections 80(2) and (3)) are contained in new section 80.01.

- New section 80.02 provides special rules dealing with distress preferred shares.

- New section 80.03 provides for the recognition of a capital gain (or a forgiven amount) in certain cases after the adjusted cost base of a share, convertible debt, partnership interest, trust interest or option is reduced under new subsection 80(9), (10) or (11) and the property (or related property) is subsequently disposed of.

- New section 80.04 is a mechanism whereby unapplied portions of forgiven amounts may, in effect, be transferred by a debtor to eligible corporations and partnerships.

The new rules for debt forgiveness are entirely contained in the Act. As a consequence, Part LIV of the Regulations is no longer relevant, except in the cases where grandfathering applies.

The amendments to subsections 6(15) and 15(1.2) and sections 79 and 80 have been structured to provide that the income tax provisions for a debtor with respect to debt forgiveness and unpaid amounts apply in the following order:

- section 78, as per note 1,

- subsections 6(1) and (15), as per note 2,

- subsections 15(1) and (1.2), as per note 2,

- section 9, to the extent that a debt settlement results in an income inclusion apart from an express statutory rule, as per note 3,

- section 79, as per note 4, and

- section 80, as per note 5.

Notes:

[1] Section 80 does not apply to the settlement of a debt to the extent that section 78 applies in respect of the debt, because of

paragraph (c) of the definition of "excluded obligation" in subsection 80(1). The effect of section 79 is reduced because of the description of F in subsection 79(3).

2 In the event that subsection 79(3) applies to a debt in a taxation year following, or coinciding with, a taxation year in which subsection 6(15) or 15(1.2) applies to the same debt, the amount determined for F in subsection 79(3) limits the application of section 79. In the event that subsection 6(15) or 15(1.2) applies to a debt in a taxation year after the year for which subsection 79(3) applies to the same debt, subsection 79(5) effectively provides for a reversal of the application of section 79. Section 80 cannot apply concurrently with subsection 6(15) or 15(1.2) because of paragraph (b) of the description of B in the definition of "forgiven amount" in subsection 80(1).

3 To the extent that income is recognized on the settlement of an obligation (e.g., a trade account payable) apart from sections 79 and 80, sections 79 and 80 will not apply. (See the amount determined for F in subsection 79(3) and the definition of "excluded obligation" in subsection 80(1).) In the event that section 78 has previously applied with respect to such an obligation, subsection 4(4) will ensure that there is no further income inclusion.

4 Notwithstanding the general rule, the rules in section 80 rather than section 79 prevail in the event that subsection 80.01(8) (deemed settlement on debt parking) had applied to a debt in a taxation year before the taxation year in which section 79 applies to the debt. The amount determined for F in subsection 79(3) reflects the income tax consequences of a deemed settlement from the earlier taxation year. In the event that a surrender of property under section 79 occurs in the same year as a deemed settlement of debt under subsection 80.01(8), the rules in section 79 prevail because of paragraph (f) of the description of B in the definition of "forgiven amount" in subsection 80(1).

5 In the event that subsection 80.01(8) or (9) applies on a deemed settlement of debt before the subsequent operation of section 80, paragraph (g) of the description of B in the

definition of "forgiven amount" in subsection 80(1) will result in the subsequent operation of section 80 being limited.

The amendments to section 80 generally apply to taxation years ending after February 21, 1994. However, except for the purposes of the employee and shareholder indebtedness provisions and section 79, these amendments do not apply to any obligation settled or extinguished

- before February 22, 1994,

- after February 21, 1994, under the terms of a written agreement entered into on or before that date,

- after February 21, 1994, under the terms of any amendment to a written agreement entered into on or before February 21, 1994, where that amendment was entered into in writing before July 12, 1994 and the amount of the settlement or extinguishment was not substantially greater than the settlement or extinguishment provided under the terms of the agreement,

- before 1996, pursuant to a restructuring of debt in connection with a proceeding commenced in a court in Canada before February 22, 1994,

- before 1996, in connection with a proposal (or notice of intention to make a proposal) that was filed under the *Bankruptcy and Insolvency Act*, or similar legislation under a foreign country, before February 22, 1994, or

- before 1996, in connection with a written offer that was made by, or communicated to, the holder of the obligation before February 22, 1994.

These exceptions do not apply to cases of deemed settlements under subsections 80.01(8) and (9), for which separate grandfathering provisions are provided.

In addition, paragraph 80(2)(i) and subsections 80(5), (7), (8), (9), (10) and (11) refer to designations filed in prescribed forms with the income tax return of the debtor. A designation referred to in any of those provisions will be considered to have been filed, as required under those provisions, if it is filed with the Minister of National Revenue before 1996.

ITA
80(1)

The new definitions in subsection 80(1) of the Act are set out below.

"commercial debt obligation"

A "commercial debt obligation" includes an obligation on which interest payable is deductible in computing income or would, if interest had been payable in respect of the obligation and certain assumptions were made, have been so deductible. As is the case with the existing rules, the limitations on interest deductibility under subsections 18(2) and (3.1) (interest on debt related to building construction and land acquisition or ownership), subsection 18(4) (thin capitalization) and section 21 (capitalization of interest) are assumed not to apply for the purposes of the definition.

In determining whether an obligation is a "commercial debt obligation", the limitations on the deduction of interest under subsection 15.1(2) (small business development bonds), subsection 15.2(2) (small business bonds) and paragraph 18(1)(g) (income bonds) are also ignored. Under these provisions, interest paid by debtors is not deductible and is treated by the creditor as a dividend.

An obligation may also be a "commercial debt obligation" if interest on it is deductible in computing the debtor's taxable income earned in Canada or taxable income. The reference to "taxable income earned in Canada" and "taxable income" apply to businesses carried on by a debtor in a taxation year, where the debtor was not resident in Canada during all or part of that year. (For a discussion of the application of section 80 in connection with the computation of foreign accrual property income and surplus pools of foreign affiliates, see the commentary on the amendments to section 95 and to draft clause 5907(1)(a)(i)(C) of the Regulations.)

The expression "commercial debt obligation" is used in the definition "commercial obligation", described below, and in new paragraphs 80(2)(h), (n) to (q), subsection 80(15) and sections 80.01

to 80.04. Reference in this context should be made to new subsections 248(26) and (27), which clarify the circumstances in which an obligation is considered to be issued by a debtor and affect partial settlements of obligations.

A "commercial debt obligation" does not include an obligation to pay interest, except to the extent that new paragraph 80(2)(b) applies. For further detail, see the commentary on that paragraph.

"commercial obligation"

A "commercial obligation" issued by a debtor is a "commercial debt obligation" or "distress preferred share" issued by the debtor. For the rules in amended section 80 to apply, it is required that a "commercial obligation" be settled or extinguished. The application of these rules to distress preferred shares is an extension of the existing rules. Special rules for distress preferred shares are contained in new section 80.02.

"debtor"

A debtor is defined to include any corporation that has issued a distress preferred share and any partnership.

"directed person"

This expression is discussed in the commentary to new subsection 80(14).

"distress preferred share"

A "distress preferred share" issued by a corporation is defined as a share issued by the corporation after February 21, 1994 (other than a share issued pursuant to an agreement in writing entered into on or before that date) that is described in paragraph (e) of the definition of "term preferred share" in subsection 248(1) and would be a "term preferred share" under that subsection if that definition were read without reference to paragraphs (e) and (f) of the definition. The definition of "distress preferred share" is used in the expressions "commercial obligation", "debtor" and "excluded security", in the special rules for distress preferred shares contained in section 80.02 and for the purposes of new sections 80.01 and 80.03. Once a share ceases to be a distress preferred share, subsection 80.02(7) provides for a deemed settlement for the purposes of section 80.

"eligible Canadian partnership"

This definition is discussed in the commentary to new subsection 80(14).

"excluded obligation"

An "excluded obligation" is essentially an obligation (or a part of an obligation) not taken into account for the purposes of applying section 80 because it is taken into account for the purposes of the Act, apart from the rules in section 79 and 80.

An "excluded obligation" includes a loan that has been recognized as assistance for income tax purposes under any one of a number of provisions (e.g., paragraph 12(1)(x) or subsection 13(7.1)) or would have been so recognized if it were not for the exclusion of prescribed amounts under paragraph 12(1)(x). It also includes amounts payable that have been otherwise included in computing the debtor's income (e.g., subsection 15(2)) or amounts payable that resulted in a deduction in computing the adjusted cost base of property (e.g., subparagraph 53(2)(c)(i.3)). In addition, an "excluded obligation" includes an obligation related to an amount unpaid by a cash basis taxpayer that is recognized for income tax purposes only when it is paid.

An "excluded obligation" also includes an obligation to which the rules in section 78 apply and obligations (e.g., certain trade payables) the settlement of which result in income to a debtor, apart from the application of sections 79 and 80.

"excluded property"

An "excluded property" at any time in respect of a non-resident debtor is property that would not qualify as "taxable Canadian property" under paragraph 115(1)(b) if it were disposed of at that time.

The adjusted cost base of excluded property, as well as capital losses from the disposition of such property, are not taken into account under subsections 80(9) to (11). This is consistent with existing subsection 111(9), which provides that capital losses and business investment losses from the disposition by a non-resident taxpayer of such property are not taken into account in determining the taxpayer's non-capital loss or net capital loss for a taxation year.

"excluded security"

This expression is used only in paragraphs 80(2)(a) and (g). For discussion, see the commentary on those paragraphs.

"forgiven amount"

The key definition in section 80 is "forgiven amount". The forgiven amount in respect of a commercial obligation issued by a debtor is required to be applied as provided under subsections 80(3) to (12). In general, 3/4 of any remaining unapplied amount is added in computing the debtor's income under subsection 80(13).

The "forgiven amount" at any time in respect of a commercial obligation issued by a debtor is defined as the lesser of the principal amount of the obligation and the amount for which it was issued minus the total of the following amounts:

- any amount paid at that time in satisfaction of the principal amount of the obligation,

- any amount included in respect of employee or shareholder indebtedness in computing the income of any person because of the settlement of the obligation at that time,

- any amount reducing the forgiven amount in respect of the obligation at that time under amended paragraph 18(9.3)(f),

- any capital gain recognized under subsection 39(3) on the open market purchase by a debtor of the obligation,

- such portion of the principal amount of the obligation as relates to an amount renounced under subsection 66(10), (10.1), (10.2) or (10.3) by the debtor,

- any portion of the principal amount of the obligation that has been included in computing a debtor's proceeds of disposition under subsection 79(3) with respect to property surrendered by the debtor,

- all forgiven amounts determined in respect of the obligation at previous times at which the obligation was deemed by subsection 80.01(8) or (9) to have been settled,

- consideration previously given by the debtor to another person for the assumption by the other person of the obligation, and

- any portion of the principal amount of the obligation representing accrued interest that was included under section 80.4 in computing the debtor's income. (This measure is relevant only to the extent that unpaid amounts of interest are considered to represent a principal amount of debt because of paragraph 80(2)(b).)

In addition, the forgiven amount is nullified in the event that a debtor is a bankrupt or reduced to the extent that the obligation in connection with which the forgiven amount is determined is an "excluded obligation". The expression "excluded obligation" is defined in subsection 80(1) and discussed in the commentary above.

The "forgiven amount" definition is also nullified in the event that a debtor is an "active" member of a partnership and the obligation has always been payable to an "active" member of the partnership. For this purpose, an "active" member of a partnership is a member of the partnership actively engaged, on a regular, continuous and substantial basis, in partnership activities (other than the financing of the partnership business).

Reference in this context should also be made to new subsections 248(26) and (27), which clarify the circumstances in which an obligation is considered to be issued by a debtor and affect partial settlements of obligations originally issued by the debtor (e.g., the settlement of an obligation still outstanding after amounts have been paid in satisfaction of the original obligation).

"person"

A "person" is defined to include a partnership.

"relevant loss balance"

This expression is discussed in the commentary to new subsections 80(3) and (4).

"successor pool"

This expression is discussed in the commentary to new subsection 80(8).

"unrecognized loss"

This expression is discussed in the commentary to new subsection 80(13).

ITA
80(2)

New subsection 80(2) of the Act provides a number of rules of application for the purposes of section 80. Broader rules of application for the purposes of section 80 and other provisions in the Act are provided under new subsections 248(26) and (27). Rules relating to distress preferred shares are provided under new section 80.02.

ITA
80(2)(a) to (i)

New paragraph 80(2)(a) of the Act provides that an obligation issued by a debtor is considered to be settled when the obligation is settled or extinguished (otherwise than by way of a bequest or inheritance or as consideration for the issue of a share described in paragraph (b) of the definition "excluded security" in subsection 80(1)).

New paragraph 80(2)(b) treats interest payable by a debtor as having a principal amount equal to the portion of the interest that is deductible or that may be capitalized for income tax purposes. It also provides that such interest is also considered to be an obligation issued by the debtor for the same amount. This provision is a restatement of the rule contained in existing subsection 80(4).

New paragraph 80(2)(c) provides that subsections 80(3) to (13) apply in numerical order to the forgiven amount in respect of a commercial obligation.

New paragraphs 80(2)(d) and (e) provide rules that take into account the fraction of capital losses (including business investment losses) for a taxation year that are included in determining net capital losses and non-capital losses for the year. For taxation years ending after 1989, the applicable fraction is 3/4. For taxation years ending before 1988, the applicable fraction is 1/2. For taxation years ending in 1988 or 1989, the applicable fraction is between 1/2 and 3/4, as determined under section 38. Only the applicable fraction for a taxation year of the unapplied portion of the forgiven amount is applied under subsection 80(4) to reduce a loss for that year. However, the portion of the forgiven amount so applied under subsection 80(4) is considered to have been the amount of the reduction of a loss for a year divided by the applicable fraction for the year.

EXAMPLE

The forgiven amount at a relevant time in respect of an obligation issued by a debtor is $100. The debtor's undeducted net capital loss carryforward from the 1990 taxation year is $60.

Results:

1. As a consequence of subsection 80(4) and paragraph 80(2)(d), no more than 3/4 of the forgiven amount (i.e. 3/4 X 100) will be applied to reduce a net capital loss for 1990.

2. While the amount required to eliminate the loss is $60, as a consequence of paragraph 80(2)(e), the portion of the forgiven amount considered to have been applied in these circumstances is $80 (i.e. 4/3 X 60). Thus, the remaining unapplied portion of the forgiven amount is $20.

New paragraph 80(2)(f) is a rule that takes into account the fact that only 3/4 of a debtor's eligible capital expenditures are added in computing a debtor's cumulative eligible capital. As a consequence, under new subsection 80(7), only 3/4 of the unapplied forgiven amount in respect of an obligation is applied to reduce cumulative eligible capital. Under paragraph 80(2)(f), the portion of the forgiven amount applied in this respect is considered to be 4/3 of the reduction of the cumulative eligible capital. This rule is parallel to the rule for capital losses, illustrated in the example above.

New paragraph 80(2)(g) provides that the amount paid in satisfaction of a debt issued by a corporation and payable to a person shall be deemed to include the increase, resulting from the settlement of the debt, in the value of shares of the capital stock of the corporation owned by that person. Where a share of the capital stock of a corporation (other than an excluded security) is issued by the corporation to a person as full or partial consideration for the cancellation of a debt issued by the corporation, the debt is considered to be settled for an amount equal to the total of the fair market value of the share and the increase, resulting from the settlement of the debt, in the value of other shares of the capital stock of the corporation owned by that person. For this purpose, an "excluded security" issued by a corporation to a person in consideration for the cancellation of a debt is defined under subsection 80(1) as:

- a distress preferred share issued by the corporation to the person, or

- a share issued by the corporation to the person under the terms of the debt, where the debt was a bond, debenture or note listed on a prescribed stock exchange in Canada and the terms for the conversion to the share were not established or substantially modified after the later of February 22, 1994 and the time that the bond, debenture or note was issued.

Note that new paragraph 80(2)(a) provides that the cancellation of a publicly-traded debt described above will not give rise to the application of section 80.

New paragraph 80(2)(h) applies where any part of the consideration given by a debtor to another person for the settlement at any time of a particular commercial debt obligation issued by the debtor and payable to the other person consists of a new commercial debt obligation issued by the debtor to the other person. Where this is the case,

- an amount equal to the principal amount of the new obligation is deemed to be paid by the debtor at that time, because of the issue of the new obligation, in satisfaction of the principal amount of the particular obligation, and

- the new obligation is considered to have been issued for an amount equal to the amount, if any, by which the principal amount of the new obligation exceeds the amount, if any, by which

    - the principal amount of the new obligation exceeds

    - the amount for which the particular obligation was issued.

In applying paragraph 80(2)(h), consideration must be given to the existing definition of "principal amount" in subsection 248(1). In particular, the principal amount of an obligation issued by a debtor does not include amounts that are considered to be payable on account of interest.

New paragraph 80(2)(i) is a rule that clarifies the application of the debt forgiveness rules where the rules would otherwise apply simultaneously to obligations issued by a debtor that are settled at the same time. Where this is the case, the obligations are treated as having been settled at different times, in whatever order designated by the debtor in a prescribed form filed with the debtor's income tax return. If the debtor fails to designate an order, the order is designated by the Minister of National Revenue.

EXAMPLE

A debtor has two outstanding commercial debt obligations, owing to C1 (principal amount of $1,000) and C2 (principal amount of $5,000). The obligations are settled at the same time on the payment of $2,400 (of which $400 is for the obligation owing to C1 and $2,000 is for the obligation owing to C2). The debt owing to C1 is designated as having been settled before the debt owing to C2.

Result:

1. The forgiven amount determined with respect to the obligation owed to C1 is $600. This amount is applied, as required under subsections 80(3) to (12), immediately before the time at which it is actually settled.

2. The forgiven amount determined with respect to the obligation owed to C2 is $3,000, which is applied at the time of the actual settlement.

In many cases, the order in which obligations are settled as a consequence of new paragraph 80(2)(i) should not make any difference to the tax treatment of debtors. However, if two obligations were issued in different circumstances, the operation of the rules in subsections 80(3) to (12) is affected in certain cases. For example, the loss carryforwards and resource expenditure pools against which a forgiven amount can be applied under subsections 80(3) and (8) depend, in part, on when an obligation was issued. In addition, the nature of any income inclusion under subsection 80(13) or (17) depends on the source in connection with which an obligation was issued.

ITA
80(2)(j)

Paragraph 80(2)(j) of the Act introduces a number of assumptions that are relevant for the purposes of determining whether two or more persons (including partnerships and trusts) are related to each other. The assumptions are also relevant for the purposes of determining whether any person controls another person.

Paragraph 80(2)(j) provides that each partnership and trust is, for the purposes of section 80, treated as a corporation having a single class of capital of 100 voting shares. The members of the partnership, or the beneficiaries under the trust, are treated as owning such shares in accordance with their proportionate interests in the partnership or trust. The proportionate interest of a partner or a beneficiary is based on the fair market value of the partner's or beneficiary's interest in the partnership or trust.

In the case of a discretionary trust, the fair market value of a beneficiary's interest is treated as nil if the beneficiary is not entitled to any of the income or capital of the trust until after the death of one or more other beneficiaries under the trust. (Other beneficiaries under a discretionary trust will, in effect, each be considered to own the 100 voting shares jointly because the fair market value of their interest is considered to be the fair market value of all interests in the trust.)

The following example illustrates the operation of paragraph 80(2)(j).

EXAMPLE

Assume that individual A owns all the shares of the capital stock of Corporation A1. Corporation A1 is a 70% partner in Partnership A. Partnership A owns 60% of the shares in Corporation A2. Partnership A is the debtor to which the rules in section 80 apply.

Results:

1. Corporation A1 controls Partnership A, as Corporation A1 is deemed to own over 50% of the voting shares with respect to Partnership A.

2. Partnership A controls Corporation A2, as Partnership A is deemed to own over 50% of the voting shares with respect to Corporation A2.

3. As a consequence of the application of section 251, the individual is related to the partnership and the two corporations. In addition, the two corporations and the partnership are all related to each other.

ITA
80(2)(k)

Paragraph 80(2)(k) of the Act clarifies the treatment under section 80 of an obligation that is settled in the event that the obligation is denominated in a foreign currency. It provides that foreign currency fluctuations after the time an obligation is issued are ignored for the purposes of section 80 and that forgiven amounts are determined with reference to the exchange rate at the time that a debt was issued.

EXAMPLE

A debtor borrowed U.S. $10,000 on a long-term basis, at a time when the Canadian dollar and the U.S. dollar are trading at par. Subsequently, the creditor forgives the obligation on payment of U.S. $3,000. At the subsequent time, the exchange rate is Cdn. $1 = U.S. $.80. The foreign currency gains and losses for the debtor and creditor are assumed to be on account of capital.

Results:

1. At the subsequent time, the capital loss sustained by the debtor because of the depreciation of the Canadian dollar is Cdn. $750 ($3,000/.8 - $3,000). (The lender has a corresponding gain.)

2. Under new paragraph 80(2)(k), the forgiven amount is determined with reference to the exchange rate at the time the debt was issued. As a consequence, the forgiven amount is equal to Cdn. $7,000 (10,000 - 3,000).

Further rules dealing with fluctuations in foreign currency are provided under new subsections 79(7) and 80.01(11).

ITA
80(2)(l)

Paragraph 80(2)(l) of the Act applies where an amount is paid in satisfaction of the principal amount of a particular commercial obligation issued by a debtor and, as a consequence of the payment, the debtor is legally obliged to pay that amount to another person. Typically, this would arise where a guarantor is obliged to make payments under the terms of a guarantee to a creditor.

Where this is the case, the obligation to pay that amount to the other person is considered to be a commercial obligation that was issued by the debtor at the same time and in the same circumstances as the particular obligation. This amendment should be read with new subsection 248(27), which clarifies the circumstances in which a person will be regarded as having issued an obligation.

ITA
80(2)(m)

Paragraph 80(2)(m) of the Act ensures that, if a "forgiven amount" is applied under section 80 to reduce another amount, the amount of the reduction cannot exceed that other amount. As a consequence, the application of the forgiven amount will not result in negative amounts.

ITA
80(2)(n) and (o)

Paragraph 80(2)(n) of the Act applies where a commercial debt obligation issued by a partner is settled and the debt was treated as debt owed by the partnership. Paragraph 80(2)(n) ensures that, in these circumstances, the obligation is considered, for the purposes of section 80, to have been issued by the partnership and not by the debtor.

Paragraph 80(2)(o) applies, within or outside the partnership context, where a commercial debt obligation for which a debtor is jointly liable is settled at any time in respect of the debtor but not in respect of all the other persons jointly liable to pay the debt. In these circumstances, notwithstanding paragraph 80(2)(n), a reasonable share of the obligation is considered to have been issued by the debtor and to have been settled at such time and not at any subsequent time.

ITA
80(2)(p) and (q)

Paragraphs 80(2)(p) and (q) apply in the event that a commercial debt obligation issued by an individual is settled after the individual's death. Paragraph 80(2)(p) clarifies that the obligation is considered to have been issued by the estate of the individual at the same time and in the same circumstances as the obligation was issued by the individual, assuming that the estate was liable for the obligation immediately before it was settled. However, paragraph 80(2)(q) provides that the obligation is considered to have been settled at the beginning of the day of the individual's death where it is settled within the period ending 6 months after the death (or a longer period acceptable to the Minister of National Revenue and the deceased's legal representatives). Any amount paid by the estate on the settlement of the obligation is, together with any consideration given by the estate for the assumption by another person of the obligation, likewise considered to have been paid or given at the beginning of the day of the individual's death. Paragraph 80(2)(q) also provides that, in these circumstances, interest accruing after the individual's death is ignored for the purposes of computing the forgiven amount in respect of the obligation that is deemed to have been settled. However, paragraph 80(2)(q) does not apply where any amount is included because of the settlement under paragraph 6(1)(a) or subsection 15(1) in computing the income of any person or where section 79 applies in respect of the obligation.

The purpose of paragraph 80(2)(q) is to allow forgiven amounts in respect of commercial debt obligations issued by a deceased individual to be applied against the individual's tax attributes under subsections 80(3) to (12). In the event that an income inclusion arises under subsection 80(13), a deduction can be claimed under new section 61.2 in the terminal return of the deceased.

ITA
80(3) and (4)

New subsections 80(3) and (4) of the Act provide that a forgiven amount in respect of debt issued by a debtor is applied at the time that the debt is settled to reduce the debtor's loss carryforwards, as described in greater detail below. As under the existing rules, there is no requirement that the debt settled was used in generating such losses.

The forgiven amount in respect of a commercial obligation is applied under subsection 80(3)to reduce, in the following order:

- the debtor's non-capital loss carryforwards (apart from allowable business investment losses, which are provided more generous treatment under subsection 80(4)),

- the debtor's farm loss carryforwards, and

- the debtor's restricted farm loss carryforwards.

Within each of the above categories of losses, a loss for an earlier taxation year is reduced before a loss for a later taxation year. In addition, the amount by which a loss for a year may be reduced is limited to the "relevant loss balance" for the relevant obligation and in respect of that loss. The "relevant loss balance" of a debtor for an obligation and in respect of a loss for a previous taxation year is defined in subsection 80(1) as the amount of such loss that would be deductible in computing the debtor's taxable income or taxable income earned in Canada if:

- the debtor had sufficient income and taxable capital gains,
- the amount of such loss were not reduced under subsection 80(3) or (4) at or after the time that the obligation was settled, and
- there were no restrictions under subsections 111(4) and (5) after the acquisition of control of the debtor with respect to the deduction of losses.

The relevant loss balance of a corporate debtor for an obligation and in respect of a net capital loss, non-capital loss, farm loss or restricted farm loss for a previous year is deemed to be nil after an acquisition of control of the debtor that occurred after that previous year unless

- the obligation was issued before, and not in contemplation of, that acquisition of control, or
- all or substantially all of the proceeds from issuing that obligation were (directly or indirectly) used to refinance an obligation that is described immediately above.

Under subsection 80(4), the remaining unapplied portion of a debtor's forgiven amount is multiplied by the applicable fraction for a taxation year (as described in the commentary to subsection 80(2)) and applied to reduce, subject to the same restrictions as described above, in the following order:

- the debtor's non-capital losses, to the extent that they are allowable business investment losses, of each previous year, and
- the debtor's net capital losses of each previous year.

Within each of these categories of losses, a loss for an earlier taxation year is reduced before the loss for a later taxation year. In addition, the amount by which a loss for a year may be reduced is limited to the "relevant loss balance" for the relevant obligation and in respect of that loss.

Under paragraph 80(2)(e), the portion of the forgiven amount applied under subsection 80(4) in respect of a loss for a taxation year is considered to be equal to the reduction of the loss for that year multiplied by the reciprocal of the applicable fraction for that year. For further discussion, see the commentary on that paragraph.

The following example illustrates the operation of subsections 80(3) and (4).

EXAMPLE

Debtco has $10,000 of non-capital losses from the 1992 taxation year. This amount consists of $4,800 of allowable business investment losses and $5,200 of other losses. Debtco deducted $2,000 in respect of these losses in computing its 1993 income. In 1995, $20,000 of commercial debt issued by Debtco is settled without any payment being made by Debtco.

Results:

1. Under subsection 80(3), the "ordinary non-capital loss" is $3,200 ($10,000 - 2,000 - 4,800). As a consequence, the non-capital loss for the 1992 year is reduced under subsection 80(3) by $3,200. The remaining unapplied portion of the forgiven amount is $16,800.

2. Under subsection 80(4), the portion of the forgiven amount that is applied is $4,800, which is the "relevant loss balance" in respect of the non-capital loss of $8,000 ($10,000 - 2,000) minus the "ordinary non-capital loss" balance of $3,200.

3. As a consequence, the non-capital loss for the 1992 year is reduced to $2,000 (10,000 - 3,200 - 4,800). However, the remaining $2,000 cannot be deducted because it was previously claimed as a deduction.

4. The remaining unapplied forgiven amount is $10,400 ($20,000 - 3,200 - (4/3 X 4,800)).

ITA
80(5) and (6)

New subsection 80(5) of the Act (which, in conjunction with subsection 80(6), effectively replaces the rules in Part LIV of the Regulations) provides that the remaining unapplied portion of a debtor's forgiven amount in respect of an obligation settled at any time may, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, be applied to reduce immediately after that time the following amounts:

- capital costs of depreciable properties that are owned by the debtor immediately after that time, and

- the undepreciated capital costs to the debtor of a prescribed class of depreciable property immediately after that time.

Subsection 80(6) provides that an amount may be applied under subsection 80(5) to reduce the capital cost to the debtor of a depreciable property of a prescribed class only to the extent that the undepreciated capital cost to the debtor of the depreciable property exceeds the total of all other reductions at that time to that undepreciated capital cost. In other words, a reduction under subsection 80(5) to the capital cost of a property in a prescribed class cannot be made to the extent that it would result in a negative balance in the undepreciated capital cost of the class.

Subsection 80(6) also provides that an amount may be applied under subsection 80(5) to reduce the capital cost to a debtor of a depreciable property that is not in a prescribed class, to the extent that the capital cost to the debtor of that property exceeds the amount that was allowed to the debtor under Part XVII of the Regulations in respect of the property. This measure is relevant only for property acquired before 1972 to which Part XVII of the Regulations applies.

ITA
80(7)

New subsection 80(7) of the Act provides that the remaining unapplied portion of a debtor's forgiven amount is multiplied by 3/4 and then applied, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, to reduce the debtor's cumulative eligible capital. As noted in the commentary on paragraph 80(2)(f), the portion of a forgiven amount that is considered to have been applied under subsection 80(7) is equal to 4/3 of the reduction.

ITA
80(8)

New subsection 80(8) of the Act provides that the remaining unapplied portion of a debtor's forgiven amount in respect of an obligation settled at any time may, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, be applied to reduce immediately after that time the following amounts:

- undeducted resource expenditure balances that are deductible or potentially deductible under subsection 66.7(2), (3), (4) or (5) as a consequence of the acquisition of control of the debtor by a person or group of persons, the debtor ceasing to be exempt from tax under Part I on its taxable income or the acquisition of properties by the debtor by way of an amalgamation or merger, subject to the limitation described below,

- the debtor's cumulative Canadian exploration expense, cumulative Canadian development expense and cumulative Canadian oil and gas property expense, and

- where the debtor is resident in Canada, the portion of the debtor's foreign exploration and development expenses that would be deductible in computing the debtor's income for the year if the debtor had sufficient foreign resource income and if the year ended at that time.

The reduction in a resource expenditure balance under any of subsections 66.7(2) to (5) as a consequence of the settlement of an obligation at any time is limited to the "successor pool" immediately after that time for the obligation, as defined under subsection 80(1). The "successor pool" at any time for an obligation is the balance of an amount determined under any of those subsections that would be deductible in computing the debtor's income for the taxation year that includes that time if

- the debtor had sufficient "streamed" income from resource properties,
- the balance were not reduced as a consequence of the application of subsection 80(8) at that time,
- the year ended immediately after that time (i.e. there were no future transactions or events that reduced the balance), and
- there were no annual percentage limits with respect to the deduction of "successor" Canadian development expenses or "successor" Canadian oil and gas property expenses.

However, the successor pool at any time for an obligation is deemed to be nil unless

- the obligation was issued before, and not in contemplation of, the event (e.g., acquisition of control) that gave rise to the deduction of the resource expenditure balance under subsection 66.7(2), (3), (4), or (5), or
- all or substantially all of the proceeds from issuing that obligation were (directly or indirectly) used to refinance an obligation described immediately above.

ITA
80(9)

New subsection 80(9) of the Act provides that the remaining unapplied portion of a debtor's forgiven amount in respect of an obligation settled at any time may, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, be applied to reduce immediately after that time the adjusted cost bases to the debtor of capital properties, other than the following properties:

- depreciable properties, except to the extent provided under paragraph 80(9)(b) (described below),
- excluded properties (as defined under subsection 80(1)),
- personal-use properties (as defined under section 54),

- shares of the capital stock of corporations of which the debtor is a "specified shareholder" (as defined under subsection 248(1)),

- debt issued by corporations of which the debtor is a "specified shareholder" (as defined under subsection 248(1)), and

- interests in partnerships that are related to the debtor (as determined with reference to the assumptions in paragraph 80(2)(j)).

In order to take advantage of subsection 80(9) with respect to a settlement of an obligation, a debtor must designate to the maximum extent permitted under subsections 80(5), (7) and (8) in respect of the settlement. Subsections 80(10) and (11) provide for reductions in the adjusted cost base of shares, debts and partnership interests, in the event that a forgiven amount is not fully applied after the operation of subsection 80(9).

In the majority of cases, the application of a forgiven amount in respect of depreciable properties is dealt with exclusively under subsection 80(5). Paragraph 80(9)(b) applies only where the capital cost of depreciable property of a prescribed class is, for the purposes of paragraphs 8(1)(j) and (p), sections 13 and 20 and regulations under paragraph 20(1)(a), less than its capital cost for other purposes. This difference can arise because special rules for changes of use and non-arm's length transfers are provided under subsection 13(7) to determine the capital cost of a depreciable property only for the purposes of paragraphs 8(1)(j) and (p), sections 13 and 20 and regulations under paragraph 20(1)(a). In these circumstances, a debtor is allowed under subsection 80(9) to reduce the capital cost of depreciable property only to the extent that the capital cost is not reflected in the undepreciated capital cost of a prescribed class of depreciable property.

Paragraph 80(9)(c) provides that the reduction of the capital cost of depreciable property under subsection 80(9) is not relevant for the purposes of paragraphs 8(1)(j) and (p), sections 13 and 20 and regulations under paragraph 20(1)(a). The reduction would, for example, be relevant for the purposes of computing any capital gain from the disposition of the property.

In some cases, reductions under subsection 80(9) to the adjusted cost bases of shares, convertible debts, partnership interests, trust interests and options with respect to such property may ultimately be relevant for the purposes of new section 80.03. For further detail, see the commentary on that section.

New subsection 80(18) restricts the designations that may be made under subsection 80(9) by a partnership. For further detail, see the following commentary.

ITA
80(10)

New subsection 80(10) of the Act provides that the remaining unapplied portion of a debtor's forgiven amount in respect of an obligation may be applied to reduce the adjusted cost bases to the debtor of capital properties that are shares of the capital stock of corporations of which the debtor is a specified shareholder or debts issued by such corporations, other than the following properties:

- shares of the capital stock of corporations related to the debtor,
- debts issued by corporations related to the debtor, and
- excluded properties (as defined under subsection 80(1)).

In order to take advantage of subsection 80(10) with respect to a settlement of an obligation, a debtor must designate to the maximum extent permitted under subsections 80(5) to (9) in respect of the settlement. Subsection 80(11) provides for reductions in the adjusted cost base of shares and debts, in the event that a forgiven amount is not fully applied after the operation of subsection 80(10).

In some cases, reductions under subsection 80(10) to the adjusted cost bases of shares or convertible debts may ultimately be relevant for the purposes of new section 80.03. For further detail, see the commentary on that section.

New subsection 80(18) restricts the designations that may be made under subsection 80(10) by a partnership. For further detail, see the following commentary.

ITA
80(11)

New subsection 80(11) of the Act provides that the remaining unapplied portion of a debtor's forgiven amount in respect of an obligation may, to the extent designated by the debtor in a prescribed form filed with the debtor's income tax return, be applied to reduce the adjusted cost bases to the debtor of capital properties that are shares of the capital stock of related corporations, debts issued by related corporations or interests in related partnerships and that are not excluded properties (as defined under subsection 80(1)). For this purpose, paragraph 80(2)(j) may assist in determining whether a debtor is related to a corporation or partnership.

In order to take advantage of subsection 80(11) with respect to a settlement of an obligation, a debtor must designate to the maximum extent permitted under subsections 80(5) to (10) in respect of the settlement. As discussed in the following commentary, the amount designated by a debtor under subsection 80(11) may be constrained because of the new income inclusion rule in subsection 80(13). Excessive reductions in the adjusted cost base of property under subsection 80(11) can result in an income inclusion under subsection 80(13).

In some cases, reductions under subsection 80(11) to the adjusted cost bases of shares, convertible debts and partnership interests may ultimately be relevant for the purposes of new section 80.03. For further detail, see the commentary on that section.

New subsection 80(18) restricts the designations that may be made under subsection 80(11) by a partnership. For further detail, see the following commentary.

ITA
80(12)

New subsection 80(12) of the Act provides a mechanism whereby a debtor can effectively apply a forgiven amount against current year capital losses or, where the debtor is a corporation, any net capital losses of its former subsidiary that are potentially deductible in computing the debtor's taxable income as a consequence of the application of subsection 88(1.2). In the absence of this provision, the unapplied forgiven amount would be included in computing the debtor's income to the extent provided under subsection 80(13) and such capital losses could not be used to offset the resulting income.

Subsection 80(12) applies where amounts have been designated by a debtor under subsections 80(5) to (9) in respect of the settlement of an obligation to the maximum extent permitted. Where this is the case, the lesser of two amounts is treated as a capital gain of the debtor. The forgiven amount in respect of an obligation is considered to have been applied to the extent of the capital gain for the debtor under subsection 80(12).

The first amount relevant for the purposes of determining a debtor's capital gain is the portion of the forgiven amount that remains unapplied after the application of subsections 80(3) to (11).

The second amount is, in general terms, the debtor's capital losses for the taxation year that includes the time of the settlement, net of the debtor's capital gains for the year. More specifically, the second amount (determined in respect of any obligation settled at any time) is the amount, if any, by which the total of

- the total capital losses for the year that includes that time from the disposition of properties (other than excluded properties, as defined under subsection 80(1), and listed personal properties), and

- where the debtor is a corporation into which a subsidiary has been wound-up under subsection 88(1), 4/3 of the amount, if any, that would be deductible under paragraph 111(1)(b) as a net capital loss for the year with respect to the subsidiary's capital losses, as a consequence of the application of subsection 88(1.2), if the debtor had sufficient income and taxable capital gains for the year

exceeds the total of

- the debtor's total capital gains for the year (determined without reference to the application of subsection 80(12)), and

- all amounts deemed by subsection 80(12) to be a capital gain of the debtor for the year as a consequence of the application of subsection 80(12) to obligations settled before that time.

ITA
80(13)

Where a commercial obligation issued by a debtor is settled, 75% (or, where the debtor is a partnership, 100%) of the portion of the debtor's forgiven amount that remains unapplied after the application of subsections 80(3) to (12) of the Act, is added in computing the debtor's income. The source of that income is deemed to be the source in connection with which the obligation was issued. However, as discussed below, two adjustments apply for the purposes of calculating the income inclusion under subsection 80(13).

Under new sections 56.2, 56.3, 61.2 and 61.4, any income inclusion under subsection 80(13) can be spread over a number of years, depending on the circumstances of the debtor. Reference should be made to the commentary on those provisions. A special rule is also provided under new subsection 80(15) to deal with cases where debtors are partnerships. Finally, new section 61.3 provides for a deduction with respect to insolvent corporations where there is an income inclusion under subsection 80(13).

The following example illustrates the effect of subsections 80(3) to (13), without reference to the two adjustments referred to above.

EXAMPLE

A debt issued by Debtco for $50,000 has a principal amount equal to the same amount and is settled in 1995 with no payment by Debtco in satisfaction of the principal amount. At the time the debt is settled, Debtco has a cumulative Canadian development expense of $1,200, cumulative eligible capital in respect of a business of $600 and an undepreciated capital cost of a prescribed class of $30,000. (The properties currently owned by the debtor in the prescribed class are Asset A, which has a capital cost of $8,000 and Asset B, which has a capital cost of $12,000.) Debtco also has land with an adjusted cost base of $16,000. Debtco has no loss carryforwards. What are the tax consequences to Debtco assuming that the forgiven amount of $50,000 is applied to the maximum extent permitted under subsections 80(5) to (9)?

Results:

1. The forgiven amount of $50,000 may first be applied under subsection 80(5) to reduce the capital costs of Assets A and B to nil. The unapplied balance of the forgiven amount is thus $30,000 ($50,000 - $8,000 - $12,000). The $30,000 balance may then be applied against the undepreciated capital cost of the prescribed class, which is $10,000 ($30,000 net of the reductions thereto caused by the reduction of the capital costs of Assets A and B). After the undepreciated capital cost is reduced to nil the unapplied balance of the forgiven amount is $20,000.

2. The $20,000 balance is then multiplied under subsection 80(7) by 3/4. The resulting product ($15,000) may be applied under that subsection to reduce the cumulative eligible capital to nil. By reason of paragraph 80(2)(f), the balance of the forgiven amount after the application of subsection 80(7) is $19,200 ($20,000 minus 4/3 ($600)).

3. The $19,200 balance may then be applied under subsection 80(8) to reduce the cumulative Canadian development expense to nil. The resulting balance is $18,000 ($19,200 - 1,200).

4. The $18,000 balance may then be applied under subsection 80(9) to reduce the adjusted cost base of the land to nil. The resulting balance is $2,000 ($18,000 - 16,000).

5. The $2,000 still remaining is multiplied by 3/4. The product ($1,500) is included under subsection 80(13) in computing the debtor's income.

As mentioned above, two adjustments are made in calculating the income inclusion under subsection 80(13). The purpose of the first adjustment is to provide an incentive for debtors to enter into agreements with related parties under new section 80.04 to reduce the tax attributes of related parties to nil, before the debtor designates amounts under subsection 80(11) to reduce the adjusted cost base of certain property owned by the debtor. In general, the debtor is provided with an incentive to reduce the amount otherwise designated under subsection 80(11) by an amount up to the specified tax attributes of specified persons related to the debtor. The amount stipulated in such an agreement is deducted in computing the income inclusion otherwise arising for a debtor under subsection 80(13).

The first adjustment (equal to "B" minus "C") under subsection 80(13) can occur where a debtor has applied any amount under subsection 80(11) to reduce the adjusted cost base of a share of the capital stock of a related corporation, debt issued by a related corporation or an interest in a related partnership. This adjustment can also occur where a debtor has filed one or more agreements under section 80.04 that, in effect, transfer some or all of the remaining unapplied forgiven amount, to related corporations or partnerships. (For the purposes of section 80, the relatedness of corporations and partnerships is determined with reference to new paragraph 80(2)(j).)

In each case, the amount of this adjustment in respect of the settlement of an obligation at any time is equal to

- the lesser of

  - the total of all amounts designated under subsection 80(11) by the debtor in respect of that settlement, and

  - the total of the "residual balance" at that time in respect of that settlement (as described in the commentary on subsection 80(14)) and the amount, if any, by which the total of all amounts specified in an agreement under section 80.04 in respect of that settlement exceeds the unapplied forgiven amount in respect of the obligation.

MINUS

- the total of all amounts specified in an agreement filed under section 80.04 in respect of that settlement (for further detail see the commentary on that section).

If the amount of this adjustment is a positive number, it is added in the calculation of the debtor's income inclusion under subsection 80(13) because of the amounts determined for B and C in subsection 80(13). Where the amount of the adjustment is negative, the debtor's income under subsection 80(13) is reduced accordingly. For further commentary on the first adjustment, see the commentary on subsection 80(14).

The second adjustment (equal to minus "D") in the calculation of a debtor's income inclusion applies in the event that the debtor has disposed of a debt owing to the debtor or another right to receive an amount, but a capital loss was denied with respect to the disposition because of subparagraph 40(2)(g)(ii). In these circumstances, the debtor's income inclusion under subsection 80(13) can generally be reduced to reflect the portion of such loss (which is defined in subsection 80(1) as the debtor's "unrecognized loss") that has not already reduced the income inclusion of the debtor under subsection 80(13) in respect of previous settlements of obligations issued by the debtor. This adjustment is, however, not available unless the debtor has designated to the maximum extent permitted under subsections 80(5) to (10). Moreover, in the event that the debtor is a corporation the control of which was acquired after the unrecognized loss was realized, the unrecognized loss at any subsequent time is deemed to be nil unless

- the obligation settled at the subsequent time was issued by the debtor before, and not in contemplation of, the acquisition of control, or

- all or substantially all of the proceeds from issuing that obligation were (directly or indirectly) used to refinance an obligation described immediately above.

It should be noted, however, that Part XII of the Regulations will be amended to ensure that subsection 80(13) does not result in any increase of a taxpayer's resource allowance or depletion deductions.

ITA
80(14)

Subsection 80(14) of the Act defines the expression "residual balance". In general terms, it is defined as the total of income tax attributes (other than those described in subsection 80(11)) of certain corporations and partnerships related to a debtor (referred to as "directed persons") remaining after the settlement of an obligation, after taking into account the application of section 80.04 in respect of that settlement. Where a commercial debt obligation issued by a debtor (other than a partnership) is settled at any time, the debtor is required under subsection 80(13) to add in computing income an amount equal to 75% of the lesser of the residual balance at that time and total amounts applied at that time under subsection 80(11) of the Act to reduce the adjusted cost base of the debtor's capital property.

More specifically, the residual balance at any time in a taxation year in respect of the settlement of a particular obligation issued by a debtor is the amount, if any, by which

- the total of all amounts that would be applied under any of subsections 80(3) to (10) and (12) in respect of the settlements of notional separate commercial obligations issued by each "directed person" at that time in respect of the debtor if

  - those notional obligations were issued at that time by those directed persons and were settled <u>immediately after</u> that time,

  - an amount equal to the forgiven amount at that time in respect of the actual settled obligation were the forgiven amount immediately after that time in respect of each of those notional obligations,

  - amounts were designated by those directed persons under subsections 80(5) to (10) to the maximum extent permitted in respect of the settlement of each of those notional obligations, and

  - no amounts were designated by any of those directed persons under subsection 80(11) in respect of the settlement of any of those notional obligations

exceeds the total of

- 4/3 of the total amount that would be included under subsection 80(13) in computing the debtor's income for the year in respect of settlements at or before that time of commercial obligations issued by the debtor if the residual balance and the second adjustment in the income inclusion calculation under subsection 80(13) (described in the commentary on that subsection) were nil at the times of those settlements,

- 4/3 of the total amount that would, without regard to the second adjustment, be included under subsection 80(13) in computing the income of any of those directed persons in respect of settlements of the obligations that are deemed by paragraph 80.04(4)(e) to have been issued by the directed person because of the filing of an agreement under section 80.04 in respect of settlements at or before that time and in the year of commercial obligations issued by the debtor,

- all amounts specified in an agreement (other than an agreement with any of those directed persons) filed under section 80.04 in respect of settlements at or before that time and in the year of commercial obligations issued by the debtor, and

- the total of all amounts designated under subsection 80(11) in respect of a settlement before that time and in the year of a commercial obligation issued by the debtor, to the extent of the residual balance of the debtor at that previous time.

Where the debtor is a partnership, an amount is added under paragraph 80(14)(b) in computing the residual balance of the partnership. The effect of this adjustment is that the references to "4/3 of" in the above description are ignored, reflecting the different treatment of partnerships under subsection 80(13).

For the purposes of computing the "residual balance", a "directed person" in respect of a debtor is defined under subsection 80(1) as:

- a taxable Canadian corporation or an eligible Canadian partnership by which the debtor is controlled, or

- a taxable Canadian corporation or an eligible Canadian partnership that is controlled at that time by

    - the debtor,

    - the debtor and one or more persons related to the debtor, or

    - a person or group of persons by which the debtor is controlled.

Under subsection 102(1), a "Canadian partnership" is defined as a partnership all the members of which are resident in Canada. An "eligible Canadian partnership" is defined under subsection 80(1) as a Canadian partnership none of the members of which are:

- non-resident owned investment corporations,
- persons exempt because of subsection 149(1) from tax under Part I of the Act on their taxable income,
- other partnerships, other than eligible Canadian partnerships, or
- trusts, other than trusts in which no non-resident persons and no persons described immediately above are beneficially interested (within the meaning assigned by subsection 248(25)).

Several points may be helpful in understanding the residual balance definition:

- As mentioned above, the residual balance does take into account agreements under section 80.04 that have the effect of reducing the tax attributes of a directed person. The technical basis for this is that a notional obligation referred to above is deemed by subparagraph 80(14)(a)(i) to have been settled immediately after an agreement under section 80.04 is effective. As a consequence, the reduction of tax attributes because of section 80.04 is taken into account for the purposes of determining the residual balance.
- In some cases, a directed person may rather have an income inclusion than reduce tax attributes pursuant to an agreement under section 80.04. Where this is the case, the residual balance is still reduced under paragraph 80(14)(d).
- In the event that a debtor chooses to apply any amount under subsection 80(11), it will generally be to the debtor's advantage to arrange to have a residual balance of nil in order to avoid the double counting of a portion of the forgiven amount among the debtor and directed persons of the debtor. The residual balance can be reduced either by entering into agreements under section 80.04 with persons related to the debtor or reducing the

amount that is applied under subsection 80(11). A reduction of the amount applied under subsection 80(11) will reduce the residual balance under paragraph 80(14)(c).

The following examples illustrate the operation of subsections 80(13) and (14) and section 80.04.

EXAMPLE 1

Debtco issued a commercial obligation to a bank for $21,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $22,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $16,000. The full $21,000 of debt is forgiven.

Results:

1. The effect of subsection 80(13) in this case is that Debtco will have an income inclusion, unless at least $16,000 is transferred under section 80.04 to Opco. Assume, for the purposes below, that $16,000 is specified in an agreement filed under section 80.04 between Debtco and Opco.

2. Assuming that Opco uses the $16,000 specified in the agreement to reduce its UCC, the residual balance is nil because Opco has no relevant tax attributes as a consequence of the agreement under section 80.04. (Even if Opco does not use the $16,000 to grind its tax attributes, the residual balance would still be reduced to nil because of paragraph 80(14)(d).)

3. To the extent that Opco does not reduce its UCC to nil under subsection 80(5), subsection 80(13) would require that $12,000 (3/4 of $16,000) be included in computing Opco's income. Opco would not be permitted to claim any reserve under section 61.3 or 61.4 because of paragraph 80.04(4)(j).

4. Typically, Debtco will wish to reduce the adjusted cost base of the Opco shares by $5,000 under subsection 80(11). Debtco's income inclusion under subsection 80(13) is nil as a result of the $16,000 transfer. This amount is computed as follows:

- *add $16,000 under the description of A in subsection 80(13), which is the remaining unapplied amount ($21,000 - 5,000),*

- *add nil under the description of B in subsection 80(13), which is the lesser of the residual balance ($0) and the designation under subsection 80(11) ($5,000), and*

- *subtract $16,000 under the description of C in subsection 80(13), which is the amount specified in agreement under section 80.04.*

EXAMPLE 2

Debtco issued a commercial obligation to a bank for $150,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $120,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $70,000. The full $150,000 of debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $20,000 and designates $80,000 under subsection 80(11) as a reduction in the ACB of the Opco shares. Opco uses the $20,000 to reduce its UCC from $70,000 to $50,000.

Results:

1. The residual balance at the time of the settlement is nil, determined as follows:

- *Add $50,000, which is the $70,000 UCC minus the $20,000 amount specified in the agreement under section 80.04, and*

- *Subtract $50,000 under paragraph 80(14)(c), which is the $150,000 forgiven amount, minus the $80,000 designated under subsection 80(11) and the $20,000 specified in the agreement under section 80.04.*

2. As a consequence, the amount included under subsection 80(13) in computing Debtco's income is equal to $37,500, determined as follows:

- *Add $70,000 under the description of A in subsection 80(13), which is the remaining unapplied forgiven amount ($150,000 - 80,000),*

- *Add nil under the description of B in subsection 80(13), as the residual balance is nil,*

- *Subtract the $20,000 specified amount under the description of C in subsection 80(13), and*

- *Multiply the remainder ($50,000) by 3/4.*

EXAMPLE 3

Same as example 2, except that the amount designated under subsection 80(11) is $100,000 rather than $80,000.

Results:

1. The residual balance at the time of the settlement is $20,000, determined as follows:

- *Add $50,000, which is the $70,000 UCC minus the $20,000 amount specified in the agreement under section 80.04, and*

- *Subtract $30,000 under paragraph 80(14)(c), which is the $150,000 forgiven amount, minus the $100,000 designated under subsection 80(11) and the $20,000 specified in the agreement under section 80.04.*

2. As a consequence, the amount included under subsection 80(13) in computing Debtco's income is equal to $37,500, determined as follows:

- *Add $50,000 under the description of A in subsection 80(13), which is the remaining unapplied forgiven amount ($150,000 - 100,000),*

- *Add the $20,000 residual balance under the description of B in subsection 80(13),*

- *Subtract the $20,000 specified amount under the description of C in subsection 80(13), and*

- *Multiply the remainder ($50,000) by 3/4.*

EXAMPLE 4

Debtco issued two commercial obligations to a bank for $90,000 and $60,000. Debtco's only asset is the shares of the capital stock of Opco (a wholly-owned subsidiary that is a taxable Canadian corporation), which have an adjusted cost base (ACB) to Debtco of $120,000. Opco's only asset is depreciable property of a prescribed class having an undepreciated capital cost (UCC) of $70,000. The $90,000 debt is fully forgiven. Subsequently, in the same taxation year, the $60,000 debt is forgiven. Debtco enters into an agreement with Opco under section 80.04 in which the amount specified is $20,000 with respect to the first settlement. In addition, an amount of $20,000 is designated under subsection 80(11) with respect to the first settlement. Subsequently, an amount of $60,000 is designated under subsection 80(11) with respect to the second settlement. (Note: this example is, in substance, the same as example 2.)

Results:

1. As in example 2, the residual balance at the time of the first settlement is nil. This is computed as follows:

- *Add $50,000, which is the $70,000 UCC minus the $20,000 amount specified in the agreement under section 80.04, and*

- *Subtract $50,000 under paragraph 80(14)(c), which is the $90,000 forgiven amount, minus the $20,000 designated under subsection 80(11) and the $20,000 specified in the agreement under section 80.04.*

2. The residual balance at the time of the second settlement is also nil, as there are no further additions to the residual balance set out in the facts.

3. Given the residual balance in each case is equal to nil, the income inclusion under subsection 80(13) is equal to $37,500 with respect to the first settlement (3/4 X ($90,000 - $20,000 - $20,000)) and $0 with respect to the second settlement. This is consistent with example 2. In the event that a higher total amount is designated under subsection 80(11), the results will be consistent with example 3.

ITA
80(15)

Under new subsection 80(15) of the Act a member of a partnership is allowed a deduction not exceeding the amount that would, if the partnership had designated amounts to the maximum extent permitted under subsections 80(5) to (10) in respect of the forgiven amount of an obligation issued by it, have been included as the member's share of any income resulting from the application of subsection 80(13). For this purpose, income resulting from subsection 80(13) is considered to arise from a separate source so that current year partnership expenses do not have any impact on the computation of the deduction.

However, where a member of a partnership does deduct such an amount, the member is deemed to have issued a commercial obligation that was settled at the end of the fiscal period of the partnership in which the partnership's obligation was settled. The amount of such deduction claimed by the partner is treated as if it were the forgiven amount in respect of the deemed obligation.

Under subsection 80(15), a deemed obligation is generally treated as having been issued at the same time and in the same circumstances as the partnership obligation that gives rise to the application of subsection 80(13). (This is relevant for the purposes of applying the definitions "relevant loss balance", "successor pool" and "unrecognized loss", which are discussed in the commentary on subsections 80(3), (8) and (13).) In addition, for the purposes of applying subsection 80(13) in respect of the deemed obligation, the source in connection with which the deemed obligation was issued is deemed to be the source in connection with which the partnership obligation was issued.

Where a member of a partnership is a corporation the control of which was acquired after the time that an obligation is deemed by subsection 80(15) to be issued and before the corporation became a member of the partnership, the obligation will be considered under paragraph 80(15)(c) to have been issued after the time of the acquisition of control (or after a later acquisition of control, where relevant). As a consequence, the corporation will not be able to apply the deemed forgiven amount under subsection 80(15) against losses arising before an acquisition of control in these circumstances.

The purpose of subsection 80(15) is to provide for relief for members of a partnership, in recognition of the fact that a partner may well have undeducted loss carryforwards and resource expenditure pools that are attributable to activities of the partnership. The forgiveness of an obligation that is deemed to arise for a partner is treated in the same manner as a forgiven amount in respect of an obligation issued by the debtor would be treated. Further relief with respect to certain partnership obligations is provided under paragraph (k) of the description of B in the definition "forgiven amount" in subsection 80(1). In addition, special rules are provided with respect to partnership obligations under new paragraphs 80(2)(n) and (o) and subsection 80(18).

EXAMPLE

A and B are members of a partnership. The adjusted cost base of A's interest in the partnership on October 1, 1994 is $10,000. The adjusted cost base of B's interest in the partnership on that date is "negative" $8,000. Debt of $30,000 owing by the partnership is settled for nil, with a resulting $30,000 forgiven amount. There are no relevant expenditures or costs against which the forgiven amount may be applied. A and B are 50/50 partners. The fiscal period of the partnership, as well as the taxation years of A and B, are all based on the calendar year.

Results:

1. As a consequence of section 96, A and B each have a share of partnership income equal to $15,000. As a result, the adjusted cost base of A's interest in the partnership on January 1, 1995 is $25,000. The adjusted cost base of B's interest in the partnership on that date is $7,000.

2. Under paragraph 80(15)(a), A and B may each deduct up to $15,000 in computing their income. This completely offsets the income inclusion referred to above, but does not have any effect on the adjusted cost base of their partnership interests.

3. If A deducts $15,000 under paragraph 80(15)(a), the amount is treated as a forgiven amount for A. If A does not have any tax attributes that can be reduced under subsections 80(3) to (8), A may apply the $15,000 to reduce the adjusted cost base of its partnership interest from $25,000 to $10,000 under subsection 80(9). (Note: If A were related to the partnership for the purposes of section 80, the adjusted cost base of the partnership interest could only be reduced in accordance with subsections 80(11) and (13).)

4. If B deducts $15,000 under paragraph 80(15)(a), the amount is likewise treated as a forgiven amount for B. If B does not have any tax attributes that can be reduced under subsections 80(3) to (8), B may apply $7,000 of the forgiven amount to reduce the adjusted cost base of its partnership interest from $7,000 to nil under subsection 80(9). An amount of $6,000 (3/4 X $8,000) would be included under subsection 80(13) in computing B's income for the 1994 taxation year. However, B would generally be allowed to claim a reserve under section 61.2 or 61.4 or may be entitled to a deduction under new section 61.3.

ITA
80(16)

New subsection 80(16) of the Act allows the Minister of National Revenue to designate amounts under any of subsections 80(5) to (11), to the extent that the debtor would have been permitted to have designated those amounts. However, this authority is provided only in the event that an amount would otherwise be deducted under new section 61.2 or 61.3. It should be noted that, in these circumstances, the Minister can designate an amount under new subsection 80(11) even where that increase also results in an increase in the amount added in computing the debtor's income under subsection 80(13) and, as a consequence, an increase in an offsetting amount deducted under section 61.3.

ITA
80(17)

New subsection 80(17) of the Act applies only if a deduction is claimed under new section 61.3 in computing the income of a corporation. New subsection 80(17) is designed to provide an insolvent corporation with an incentive to enter into agreements with related corporations and partnerships under section 80.04 in order to have the tax attributes of those corporations or partnerships reduced.

New subsection 80(17) provides that, if a commercial obligation issued by a corporation is settled at any time in a taxation year and the corporation claims a deduction under section 61.3 in computing income for that year, there is added in computing the corporation's income for that year from the source in connection with which the obligation was issued 50% of the lesser of:

- the total amounts designated under subsection 80(11) by the corporation in respect of the settlement of the obligation, and

- the amount, if any, by which the lesser of

  - the residual balance (within the meaning assigned by subsection 80(14)) at that time in respect of the settlement of the obligation, and

  - the amount deducted under section 61.3 in computing the debtor's income for the year (net of any part of that deduction applied to reduce the corporation's balance of scientific research expenditures under new paragraph 37(1)(f.1))

  exceeds the total of all other amounts included because of subsection 80(17) in computing the debtor's income for the year in respect of a settlement before that time of a commercial obligation issued by the corporation.

Subsection 80(17) does not, however, apply to a corporation for a taxation year if it begins to wind up on or before the day that is 12 months after the end of the year.

EXAMPLE

A commercial obligation issued by Debtco is settled. Assume the following facts apply to Debtco:

Amounts designated under subsection 80(11) $10,000

Deduction claimed under section 61.3 . . . . $25,000

Residual balance at the time of settlement . . . . $ 4,000

Result:

As a consequence of subsection 80(17), $2,000 (i.e. 50% of $4,000) is added in computing Debtco's income.

ITA
80(18)

New subsection 80(18) of the Act applies only where a commercial obligation issued by a partnership is settled at any time after December 20, 1994. Where this is the case, a partnership cannot designate amounts under subsection 80(9), (10) or (11) so that the adjusted cost base of a property at the time of the settlement becomes less than its fair market value at that time.

The purpose of this measure is to prevent partnerships from acquiring capital properties in order to minimize the impact of section 80. The measure is limited to partnerships because many tax attributes (e.g. loss carryforwards and resource expenditures) are allocated to partnership members and the forgiveness of a commercial obligation that is considered to have been issued by a partnership does not result in a reduction of those attributes, subject to the application of subsection 80(15). For further detail on the treatment of partnerships and their members, see the commentary on subsection 80(15).

Deemed settlement of debt

ITA
80.01

New section 80.01 of the Act provides that obligations issued by debtors are deemed to be settled in a number of cases.

Subsection 80.01(1) defines "commercial debt obligation", "commercial obligation", "debtor", "distress preferred share" and "person", for the purposes of section 80.01, as those terms are defined under new subsection 80(1).

Subsection 80.01(1) also provides that "forgiven amount" is generally defined in the same way as it is defined under subsection 80(1). However, in the event that employee or shareholder indebtedness has been forgiven in circumstances to which subsection 6(1) or 15(1) applies, the "forgiven amount" in respect of such indebtedness is given the meaning assigned by new subsection 6(15.1) or 15(1.21), as the case may be. This definition is relevant for the purposes of subsections 80.01(8) and (10), described in the following commentary.

Subsection 80.01(1) also defines the "specified cost" of an obligation for the purposes of new subsection 80.01(8). For further detail, see the following commentary.

Subsection 80.01(2) provides that the following provisions apply for the purposes of section 80.01:

- paragraph 80(2)(a) (which sets out the circumstances in which debt is considered to be settled),

- paragraph 80(2)(b) (which provides that interest payable by a debtor is considered to be an obligation issued by the debtor),

- paragraph 80(2)(j) (which provides assumptions relevant for the purposes of determining whether two or more persons are related to each other),

- paragraph 80(2)(l) (which ensures that an obligation created on a payment on account of an obligation by a guarantor is treated as if it were the guaranteed obligation), and

- paragraph 80(2)(n) (which ensures that debt of a partnership is treated as having been issued by the partnership).

Subsection 80.01(2) also provides that, for the purposes of section 80.01, a person has a "significant interest" in a debtor corporation if the person (and other non-arm's length persons) own shares of the capital stock of the debtor corporation to which 25% or more of the votes or value are attributable. The expression "significant interest" is relevant for the purposes of new subsections 80.01(6) to (8), described below.

The rule in new subsection 80.01(3) was contained in existing subsection 80(2). Under either provision, a debt settled on the amalgamation or merger of a debtor corporation and a creditor corporation is deemed to have been settled for its cost amount. The main substantive difference between existing subsection 80(2) and new subsection 80.01(3) is that subsection 80.01(3) applies to distress preferred shares "settled" on an amalgamation or merger. Under paragraph 80.02(2)(c), a distress preferred share is considered to be settled when it is redeemed, acquired or cancelled by its issuer. In addition, new subsection 80.01(3) provides that amounts of unpaid interest in respect of the debt that have been added in computing the creditor's income are likewise added, for the purposes of subsection 80.01(3), in computing the cost amount of the debt to the extent that those amounts have not been deducted as bad debts in computing the creditor's income.

The rule in new subsection 80.01(4) was contained in existing subsection 80(3). Under existing subsection 80(3) and new subsection 80.01(4), where a debt owed between a parent corporation and its subsidiary is settled on the winding-up of the subsidiary under 88(1) for less than both the principal amount of the debt and its cost amount to the creditor, an election may be filed by the parent corporation to treat the debt as having been settled for its cost amount (as determined above).

New subsection 80.01(4) also provides that unpaid interest is treated in the same manner as described above in the commentary on subsection 80.01(3).

New paragraph 80.01(4)(d) also provides a rule that applies whenever a subsidiary's obligation is settled on a distribution of property in the course of a winding-up to which subsection 88(1) applies. Where this is the case, the time at which the debt is settled is deemed to be the time that is immediately before the time that is immediately before the time of the distribution. This rule ensures that there is an appropriate reduction under section 80 in the cost amount of distributed property. It is consequential on the new rules in section 80 providing for the reductions of tax attributes under subsections 80(5) to (11) immediately after the settlement of an obligation and only with respect to property that is owned after the settlement.

Subsection 80.01(5) applies where a subsidiary is wound-up into a parent corporation in circumstances to which subsection 88(1) applies and, as a consequence, distress preferred shares issued by the subsidiary and owned by the parent are "settled" (i.e., redeemed, acquired or cancelled, as provided under paragraph 80.02(2)(c)) by the subsidiary. Subsection 80.01(5) provides that, for the purposes of applying the provisions of the Act only to the subsidiary, the share is considered to have been settled for an amount equal to its adjusted cost base. (The proceeds of disposition for the parent corporation of the share are determined under paragraph 88(1)(b).)
Subsection 80.01(5) applies in the same manner in the unusual case of distress preferred shares of the capital stock of a parent that are owned by the parent's subsidiary.

New subsection 80.01(5), like subsection 80.01(4), also provides a rule that applies whenever a distress preferred share issued by a subsidiary is settled on a distribution of property in the course of a winding-up to which subsection 88(1) applies. Where this is the case, the time at which the share is settled is deemed to be the time that is immediately before the time that is immediately before the time of the distribution.

Subsections 80.01(6) to (8) contain provisions that are designed to counter the "parking" of a commercial debt obligation. In general terms, they can apply where an obligation issued by a debtor to one creditor is transferred, directly or indirectly to another creditor who is related to the debtor or has a "significant interest" (as defined in subsection 80.01(2)) in the debtor. They can also apply after an obligation owed to a creditor is deemed to have been reacquired by the creditor under amended subsection 50(1).

In order for the "debt parking" rules to apply at any time to a debt, subject to transitional rules each of the following conditions (referred to below as the "debt parking conditions") must apply:

- under subsection 80.01(6), the debt must be a "specified obligation" (as described below),

- under subsection 80.01(7), the specified obligation must be a "parked obligation" (i.e., the current holder of the debt does not deal at arm's length with the debtor or, where the debtor is a corporation, the current holder of the corporation has a "significant interest" in the corporation (as defined by new subsection 80.01(2)),

- under subsection 80.01(8), but subject to paragraph 80.01(7)(b), the "parked obligation" must become a "parked obligation at that time (i.e., either of the above debt parking conditions did not apply immediately before that time), and

- under subsection 80.01(8), the specified cost (as defined in subsection 80.01(1)) to the current creditor of the obligation is less than 80% of its principal amount.

These conditions are described more fully below.

Under subsection 80.01(6), a "specified obligation" of a debtor is, at a particular time, an obligation issued by the debtor where any of the following three tests are satisfied:

- at any previous time

  - a person who owned the obligation dealt at arm's length with the debtor and, where the debtor is a corporation, did not have a "significant interest" (as defined in subsection 80.01(2)) in the debtor, or

- the obligation was acquired by the holder of the obligation from another person who was, at the time of that acquisition, not related to the holder or related to the holder only because of paragraph 251(5)(b), or

• the obligation is a bad debt that is deemed by subsection 50(1) to be reacquired at the particular time.

Note, however, that an obligation is not considered to become a "specified obligation" at any time because either of the first two tests above was satisfied before any previous time that the obligation became a "parked obligation". Consequently, once debt has become to the debt parking rules, any previous arm's length relationship or sale is irrelevant for the purposes of determining whether the debt is subject to a further application of the debt parking rules.

The second debt parking condition is satisfied under paragraph 80.01(7)(a) where the current holder of a "specified obligation" does not deal at arm's length with the debtor. In addition, where the debtor is a corporation and the current holder has a "significant interest" in debtor (as defined in subsection 80.01(2)), the second condition is also satisfied unless the current holder acquired the obligation before July 13, 1994 or pursuant to an agreement in writing entered into before that date.

The third debt parking condition necessary for the debt parking rules to apply to an obligation at any time is that an obligation must <u>become</u> a "parked obligation" at that time. In other words, the debt parking rules under subsection 80.01(8) will only apply once there is a change of status with respect to the debt. However, for this purpose, an obligation acquired or reacquired in circumstances to which subparagraph 80.01(6)(a)(ii) (acquisition from unrelated person) or paragraph 80.01(6)(b) (deemed reacquisition under subsection 50(1)) applies is, if the obligation is a parked obligation immediately after the acquisition or reacquisition, considered under paragraph 80.01(7)(b) to have <u>become</u> a parked obligation at the time of the acquisition or reacquisition. This rule applies whether or not the obligation was a parked obligation immediately before the acquisition or reacquisition.

Paragraph 80.01(7)(b) applies in relatively narrow circumstances. For example, assume that a commercial debt obligation issued by a corporation is acquired at time 1 by a related corporation from a financial institution and, as a consequence, becomes a parked obligation at time 1. Further assume that the debt purchaser disposes of the obligation and all the shares of the capital stock of the debtor at time 2 to a corporation that is unrelated to the debt purchaser. In these circumstances, paragraph 80.01(7)(b) provides that the obligation though it was also a parked obligation immediately before time 2.

Subject to a transitional rule described below, where all four debt parking conditions apply in respect of a commercial debt obligation, paragraphs 80.01(8)(a) and (b) provide that:

- for the purposes of applying the provisions of the Act to the debtor, the obligation is considered to have been settled at that time, and

- the forgiven amount at that time in respect of the obligation shall be determined as if the debtor had paid an amount at that time in satisfaction of the obligation equal to its "specified cost" (i.e. as defined in subsection 80.01(1), its adjusted cost base or, where the debt is not capital property, its cost amount) to the current holder of the obligation.

These consequences do not, however, apply with respect to debt that becomes a parked obligation after February 21, 1994 (otherwise than pursuant to an agreement in writing entered into before February 22, 1994). In applying the income tax law to acquisitions of debt to which subsection 80.01(8) does not apply, one of the issues that will be considered is the application of the general anti-avoidance rule.

The following examples illustrate the effect of subsections 80.01(6) to (8).

EXAMPLE 1

The relevant obligation (having a principal amount of $16,000) was issued by Debtco to a financial institution. The debt was acquired in 1995 for $12,000 by a corporation (C2) related to Debtco. Subsequently, the debt was disposed of by C2 to another corporation (C3) related to C2.

Results:

1. At the time of the acquisition by C2, the obligation becomes a parked obligation. This is because C2 is related to Debtco and because the obligation is a specified obligation, as described above. Consequently, the obligation is deemed to have been settled for $12,000. This generally results in a forgiven amount to Debtco of $4,000.

2. At the time of the acquisition by C3, the obligation does not become a parked obligation, since the obligation has been a "parked obligation" since the time of the acquisition by C2.

EXAMPLE 2

In June 1994, Purchaseco acquires, from a financial institution, debt that was issued by Debtco. The adjusted cost base of the debt is $10,000 and the principal amount of the debt (as well as the amount for which it was issued) is $40,000. In 1995, Purchaseco acquires all the shares of the capital stock of Debtco.

Result:

In 1995 the obligation becomes a parked obligation since it is held by a non-arm's length person and it is a specified obligation. The forgiven amount is equal to $30,000 (40,000 - 10,000), which is applied as described in the commentary to section 80.

EXAMPLE 3

Same as example 2, except that the adjusted cost base of the debt is $33,000.

Result:

There are no income tax consequences under subsection 80.01(8) at the time of the acquisition of the Debtco shares because of the de minimis rule in subsection 80.01(8). This rule allows debt to be acquired at a 20% discount (or less) without the application of subsection 80.01(8).

Subsection 80.01(9) applies where a commercial debt obligation issued by a debtor that is payable at any time to an unrelated creditor becomes unenforceable after February 21, 1994 because of a statutory limitation period. Where this is the case, the obligation is deemed to have been settled at that time. The treatment of subsequent payments with respect to the liability are dealt with in subsection 80.01(10).

Subsection 80.01(10) applies in the event that a recovery is made on account of the principal amount of a commercial debt obligation in excess of the amount for which the obligation was considered to be settled under subsection 80.01(8) or (9). Where this is the case, the debtor is generally permitted to deduct 3/4 of the amount, if any, by which the payment exceeds the amount, if any, by which

- the principal amount of the obligation

exceeds the total of

- all forgiven amounts previously determined in respect of the portions of the obligation at times such portions were previously deemed to be settled, and

- all previous payments made in satisfaction of the principal amount of the obligation.

The deduction under subsection 80.01(10) for a payment in satisfaction of an obligation is, however, denied if it can reasonably be considered that one of the reasons for the obligation becoming a parked obligation or becoming unenforceable, as the case may be, before the time of the payment was to have subsection 80.01(10) apply to the payment. In addition, any deduction under subsection 80.01(10) is reduced to reflect any deductions claimed by a debtor under new section 61.3 that have not resulted in a reduction of the debtor's scientific research expenditure balance pursuant to new paragraph 37(1)(f.1). A deduction under subsection 80.01(10) is also reduced to reflect income inclusions for a debtor under subsection 80(13) in respect of deemed settlements occurring when the debtor is non-resident or exempt from tax under Part I of the Act, except the portion of those income inclusions added in computing a non-resident's taxable income or taxable income earned in Canada.

The following examples illustrate the operation of subsection 80.01(10).

EXAMPLE 4

Same as example 2, except that Debtco repays $18,000 of the debt in 1997.

Results:

1. As described in example 2, the forgiven amount in 1995 is equal to $30,000.

2. Debtco may deduct $6,000 (3/4 X (18,000 - (40,000 - 30,000))) in computing its income for the 1997 taxation year.

EXAMPLE 5

In July 1994, Purchaseco acquires debt that was issued by Debtco from a financial institution and, in 1995, acquires all the shares of the capital stock of Debtco. The adjusted cost base of the debt was $60,000 and the principal amount of the debt (as well as the amount for which it was issued) is $100,000. In 1996, all the shares and one-half of the debt are acquired by an arm's length purchaser. The adjusted cost base to the arm's length purchaser (Newco) of the one-half of the debt is $12,000. In 1997, Debtco pays Purchaseco $44,000 in full satisfaction of the outstanding debt to Purchaseco. In 1998, Debtco pays Newco $30,000 in full satisfaction of the debt payable to Newco.

Results:

1. The forgiven amount for 1995 in respect of the whole obligation is $40,000 ($100,000 - 60,000), which is applied as described in commentary to section 80.

2. The forgiven amount for 1996 in respect of the acquired half of the obligation is $18,000. ($50,000 - 12,000 - (.5 x 40,000)), which is also applied as described in the commentary to section 80.

3. The deduction for Debtco with respect to the $44,000 payment is equal to $1,500. This is 3/4 X ($44,000 - ($100,000 - 40,000 - 18,000 - 0)). The zero in the computation reflects the fact that nothing was previously paid in satisfaction of the principal amount of the obligation.

4. The deduction for Debtco with respect to the $30,000 payment is equal to $22,500. This is 3/4 X ($30,000 - ($100,000 - 40,000 - 18,000 - 44,000)). Note: the negative number determined in the interior brackets is considered to be zero.

Subsection 80.01(11) provides that the deemed settlement of an obligation under subsection 80.01(8) or (9) will not trigger the recognition of any foreign currency gain or loss. Instead, any such gains or losses would typically arise on the actual settlement of the obligation in accordance with subsection 39(2). For further discussion on foreign currency gains and losses, see the commentary on paragraph 80(2)(k).

Section 80.01 applies to taxation years ending after February 21, 1994.

Rules for distress preferred shares

ITA
80.02

New section 80.02 of the Act sets out special rules dealing with distress preferred shares. Some of the rules have the effect of confirming Revenue Canada's existing interpretations of the law in this context.

Subsection 80.02(1) defines "commercial debt obligation", "commercial obligation", "distress preferred share" and "person" as those expressions are defined under subsection 80(1).

Subsection 80.02(2) sets out a number of rules that apply for the purposes of applying the provisions of the Act to issuers of distress preferred shares.

Paragraph 80.02(2)(a) provides that the "principal amount" of a distress preferred share is considered to be the amount for which it was issued.

Paragraph 80.02(2)(b) provides that the amount for which a distress preferred share is considered to be issued is, at any time, equal to the total of

- the amount for which the share was issued (otherwise determined), and

- any increase in the paid-up capital of the share before that time

MINUS

- any amounts paid before that time on a reduction of the paid-up capital of the share, except to the extent that the amount is deemed by section 84 to have been paid as a dividend.

Paragraph 80.02(2)(c) provides that a distress preferred share is considered to be settled when it is redeemed, acquired or cancelled by its issuer.

Paragraph 80.02(2)(d) provides that a payment in satisfaction of the principal amount of a distress preferred share is any payment made on a reduction of the paid-up capital in respect of the share, to the extent that the payment would constitute proceeds of disposition of the share if the exclusion for deemed dividends under paragraph (j) of the definition of "proceeds of disposition" in section 54 were ignored.

Subsection 80.02(3) applies where a commercial debt obligation issued by a corporation is settled and there is a direct substitution of a distress preferred share for the obligation. If there is a direct transfer of this nature, there is essentially a "rollover" of the principal amount of the obligation for the purposes of section 80. More specifically, an obligation directly substituted by distress preferred shares is deemed to have been settled for the lesser of:

- the principal amount of the obligation, and

- the amount by which the paid-up capital of shares of that class increases because of the issue of those shares.

Under paragraph 80.02(3)(b), the distress preferred share is considered to have been issued for the same amount, subject to subsequent reductions in respect of the issued amount that are determined under paragraph 80.02(2)(b).

Subsection 80.02(4) applies where a distress preferred share issued by a corporation is settled and there is a direct substitution of the share by a commercial debt obligation issued by the corporation. Where this is the case, the share is deemed to have been settled for an amount equal to the principal amount of the obligation. The substitute obligation is considered to have been issued for the same amount. Under subsection 80.02(5), a similar rule applies in the unusual case that the substitute obligation is another distress preferred share. However, in this case, the amount paid in satisfaction of the original distress preferred share is considered to be the increase in paid-up capital associated with the issue of the substitute share.

Subsections 80.02(3) to (5) do not apply to arrangements where exchanges involving distress preferred shares are made on a more indirect basis. If similar income tax results are achieved by such transactions as are achieved with direct substitutions and exchanges described in those subsections, such transactions will not be viewed as offensive in tax policy terms.

Subsection 80.02(6) applies where a distress preferred share issued by a corporation is settled and there is a direct substitution of the share by another share (other than another distress preferred share) or by an obligation (other than a commercial obligation) that is issued by the corporation. Where this is the case, the amount paid in satisfaction of the principal amount of the distress preferred share on its settlement is considered to be the fair market value of the other share or the obligation.

Subsection 80.02(7) applies where a share no longer qualifies as a distress preferred share. Where this is the case, the share is deemed to have been settled immediately before the time it ceases to qualify. A payment equal to the fair market value of the share at that time is deemed to have been made immediately before that time in satisfaction of the principal amount of the share. Pursuant to the definition of "distress preferred share" in subsection 80(1), a share ceases to be a distress preferred share 5 years after its date of issue.

Section 80.02 applies to taxation years ending after February 21, 1994.

Gains on subsequent dispositions

ITA
80.03

New section 80.03 of the Act sets out rules that are designed to preserve the effectiveness of the debt forgiveness rules under section 80, in the event that section 80 has resulted in a reduction of the adjusted cost base of a share, partnership interest or trust interest. The operative rules in section 80.03 are contained in subsections 80.03(2) and (4).

Subsection 80.03(1) defines a number of expressions used in the section. "Commercial debt obligation", "commercial obligation", "distress preferred share", "forgiven amount" and "person" have the meanings assigned by subsection 80(1). In addition, as is the case under subsection 112(6), "taxable dividend" does not include a capital gains dividend that is issued by a mutual fund corporation.

Subsection 80.03(2) applies where capital property that is a share (other than a distress preferred share), partnership interest or trust interest is "surrendered" (as determined under subsection 80.03(3)). In general terms, such property is surrendered when it is cancelled, redeemed or extinguished and the underlying property of the corporation, partnership or trust that is acquired on such a surrender is based on the cost to the corporation, partnership or trust. More specifically, the surrender of a share, a partnership interest or a trust interest, as the case may be, by a person occurs where:

- the share is of the capital stock of a subsidiary and the share is disposed of in the course of a winding-up to which subsection 88(1) applies,
- the person is a corporation and the share is of the capital stock of another corporation with which the corporation amalgamates or merges,
- the trust interest is disposed of on a rollover basis under subsection 107(2), or

- the partnership interest is disposed of on a rollover basis under subsection 98(3) or (5).

Where such property is surrendered by a person, subsection 80.03(2) provides that the person is treated as having realized a capital gain from the disposition of another notional property. The amount of this capital gain is equal to the amount, by which

- the total reductions in the adjusted cost base of the surrendered property resulting directly from the application of any of subsections 80(9) to (11) or that, as a consequence of the application of subsection 47(1), 49(3.01), 51(1), 53(4) to (6), 86(4) or 87(5.1) or (6.1) (referred to below as the "history preservation rules"), resulted indirectly from the application of subsections 80(9) to (11)

exceeds the total of

- the person's capital gain from the disposition of the surrendered property (determined without reference to the capital gain arising under subsection 100(2) from the disposition of a partnership interest with a "negative" adjusted cost base), and

- where, at the end of the taxation year that included the time of the surrender of the property, the person is resident in Canada or is a non-resident person who carries on business in Canada through a fixed place of business, the amount designated under subsection 80.03(7) by the person in respect of the surrendered property.

The history preservation rules effectively maintain the record of deductions in computing the adjusted cost base of property resulting from the application of subsections 80(9) to (11), in the event that such property is

- transferred or deemed to have been acquired or reacquired under subsection 47(1) (identical properties) or a number of the provisions referred to in subsection 53(4),

- transferred to any person on a non-arm's length basis in circumstances to which subsection 53(5) applies,

- acquired on an amalgamation or merger, or

- substituted for other property in circumstances to which subsection 49(3.01), 51(1), 86(4) or 87(5.1) or (6.1) applies.

Subsection 80.03(4) applies where a corporation disposes of capital property that is a share or a partnership or trust interest. Where this is the case, and neither subsection 80.03(2) nor the history preservation rules apply, the corporation is deemed to have a capital gain from the disposition of another capital property. The capital gain determined as a consequence of a disposition at any time of a share or a partnership or trust interest is equal to the amount by which the lesser of

- the total of all amounts deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the transferor of that property immediately before that time, and

- where that property is a share, the total of taxable dividends on the share (to the extent deductible in computing taxable income) in the specified period relating to the disposition, as described below, and capital dividends received on the share in the same period

exceeds the sum of the capital gain recognized by the transferor from the disposition of that property and any amount designated in respect of the disposition under subsection 80.03(7). Subsection 80.03(4) also applies where such property is transferred to an individual or a partnership in circumstances to which subsection 53(5) applies or where the property is transferred by a corporation to a partnership in circumstances to which subsection 97(2) applies.

Where the property is an interest in a partnership or a trust, the second amount referred to above is equal to the total of

- the partner's share of taxable dividends relating to the partnership interest (to the extent deductible in computing taxable income) that were received by the partnership after July 12, 1994 and in a fiscal period ending in the specified period relating to the disposition of the partnership interest, and

- the partner's share of capital dividends received by the partnership in respect of that interest in such a fiscal period.

Where the property is a capital interest in a trust, the second amount referred to above is equal to the amounts deemed by subsection 104(19) to have been received as taxable dividends in respect of the capital interest (to the extent deductible in computing taxable income) in the specified period in respect of the disposition of the capital interest.

For the purposes of subsection 80.03(4), the specified period relating to a disposition of property by a person is generally the period during which the property is held by the person. More specifically, a specified period relating to a property disposed of by a person at any time is defined under subsection 80.03(5) as the period

- beginning at or on the later of July 12, 1994 and the last previous time the person acquired the property, and

- ending at the time of the disposition.

Subsection 80.03(6) provides a special rule for determining the "specified period" relating to the disposition of a property, in the event that any of the history preservation rules applied on acquisition of the property. Where this is the case, the beginning of the specified period is determined with respect to the first preceding acquisition to which none of the history preservation rules applied.

Subsection 80.03(7) allows a person to treat a capital gain that would otherwise arise under subsection 80.03(2) or (4) as a forgiven amount for the purposes of section 80, to the extent that the person so designates. The designation is made in a prescribed form filed with a person's income tax return for the taxation year that includes the time of the disposition that gave rise to the application of subsection 80.03(2) or (4). Where a person makes a designation, for the purposes of section 80

- the person is considered to have issued a commercial debt obligation at that time that is settled immediately after that time,

- the amount designated (to the extent of the deemed capital gain otherwise determined) is treated as if it were the forgiven amount immediately after that time in respect of the deemed obligation,

- the source in connection with which the deemed obligation was issued is any business carried on by the person at the end of the year, and

- if the person does not carry on a business at the end of the year, the person is deemed to carry on an active business at the end of the year and the source in connection with which the obligation was issued shall be deemed to be the business deemed to be carried on.

Subsection 80.03(8) applies where, as a consequence of the disposition by an individual of property that qualifies for the lifetime capital gains exemption, the individual realizes a capital gain under subsection 80.03(2). Where this is the case, the capital gain so determined will be eligible for the lifetime capital gains exemption under section 110.6.

Section 80.03 applies to taxation years ending after February 21, 1994. However, the prescribed form referred to in subsection 80.03(7) is considered to have been filed on a timely basis if it is filed with the Minister of National Revenue before 1996.

Transfers of forgiven amounts

ITA
80.04

New section 80.04 of the Act contains a mechanism which applies where a commercial obligation issued by a debtor has been settled, but the forgiven amount is not fully applied under subsections 80(3) to (12). Where this is the case, and the debtor has designated amounts to the maximum extent permitted under subsection 80(5) to (10), the debtor may transfer the unapplied portion of the forgiven amount to certain corporations and partnerships to which the debtor is related. The transferee is then permitted to apply the transferred amount under subsection 80(3) to (10) and (12) and include any unapplied portion of the transferred amount in its income. The advantage to the debtor is that the transferred amount, as described in the commentary to subsections 80(13) and (14), reduces the amount otherwise included in computing the debtor's income under subsections 80(13) and (17). The mechanism provided under section 80.04 is similar to existing section 191.3 of the Act, which allows for the transfer of liability under Part VI.1 of the Act from one corporation to another.

Subsection 80.04(1) defines "commercial debt obligation", "commercial obligation", "debtor", "eligible Canadian partnership", "forgiven amount" and "person" in the same manner as those expressions are defined under subsection 80(1).

Subsection 80.04(2) defines an "eligible transferee" of a debtor at any time as a corporation or partnership that is a "directed person" at that time in respect of the debtor (as described in the commentary to subsection 80(14)) or a taxable Canadian corporation or eligible Canadian partnership related to the debtor. For this purpose, relatedness arising because of a right referred to in paragraph 251(5)(b) is ignored.

Subsection 80.04(3) provides that the rules of application under subsection 80(2) apply, to the extent relevant, for the purposes of section 80.04. For example, paragraph 80(2)(j) provides rules which are relevant for the purposes of determining whether a debtor is related to a partnership.

Subsection 80.04(4) sets out the detail of the circumstances in which the mechanism in section 80.04 applies. The mechanism applies where:

- a commercial obligation issued by a debtor (other than an obligation deemed by section 80.04 itself to have been issued) is settled,

- amounts were designated by the debtor under subsections 80(5) to (10) to the maximum extent permitted in respect of the settlement of the obligation time,

- the debtor and an eligible transferee of the debtor (described above) file an agreement under section 80.04 between them in respect of that settlement, and

- an amount is specified in that agreement.

Where the above circumstances apply in respect of the settlement at any time of a commercial obligation, the following rules apply:

- except for the purposes of subsection 80(11), the transferee is deemed to have issued a commercial debt obligation that was settled at that time;

- the specified amount under the agreement is treated as the forgiven amount at that time in respect of the deemed obligation;

- the deemed obligation is generally treated as having been issued at the same time (referred to below as the "time of issue") at which, and in the same circumstances in which, the particular obligation was issued;

- where the transferee is a corporation the control of which was acquired after the time of issue and the transferee corporation and the debtor were not related to each other immediately before that acquisition of control, the deemed obligation is treated as having been issued after that acquisition of control so that the transferee will not be able to apply the forgiven amount against losses arising before the acquisition of control;

- the source in connection with which the deemed obligation was issued is considered to be the source in connection with which the particular obligation was issued; and

- the transferee is, however, not entitled to claim any amount under section 61.3 or 61.4 with respect to the deemed obligation.

Subsection 80.04(5) provides rules that apply where property is acquired by an eligible transferee as consideration for entering into an agreement that is filed under section 80.04. If the property is owned by the debtor immediately before the transfer, the debtor is deemed to have disposed of the property at its fair market value but is not entitled to deduct any amount in respect of the transfer except any loss resulting from the deemed disposition. The cost at which the property was acquired by the eligible transferee is considered to be equal to its fair market value. Neither the eligible transferee nor the debtor is required to add any amount or benefit in computing income only because of the acquisition of the property or because of the entering into of the agreement under section 80.04.

Subsection 80.04(6) sets out the mechanics of filing an agreement under section 80.04 that are required for the agreement to be a valid agreement. The agreement is not valid unless it is filed in a prescribed form

- by the later of
  - the due date for the debtor's income tax return for the taxation year or fiscal period that includes the time at which the debtor's obligation was settled, and
  - the due date for the transferee's income tax return for the taxation year or fiscal period that includes that time, or
- within the period within which the debtor or the transferee may serve a notice of objection to an assessment of Part I tax for either of the two applicable taxation years described above.

For the purposes above, a partnership is treated by subsection 80.04(7) as being required to file an income tax return for its fiscal period that is due by the latest income tax return due date for any of its partners for the taxation year in which that period ends. Likewise, it is assumed a partnership can file a notice of objection for a fiscal period during each period within which any member of the partnership may serve a notice of objection to an assessment of Part I tax payable for a taxation year in which the fiscal period ends. For further detail with respect to agreements by partnerships, see amended subsection 96(3).

Subsection 80.04(6) also provides that, where the debtor or transferee is a corporation, agreement under section 80.04 must be accompanied by the resolution of the corporation's directors, or the document of the corporation's legal administrators, authorizing the agreement to be made.

Subsection 80.04(6) also provides that an agreement between a debtor and an eligible transferee is invalid if it is superseded by a subsequent valid agreement. However, the earlier agreement remains valid for the purposes of section 80.04 if it is one to which subsection 80.04(8) applies.

Subsection 80.04(8) applies where it can reasonably be considered that the main purpose of a corporation becoming related to another corporation was to enable the corporations to file an agreement under section 80.04. If this is the case, the amount specified under that agreement is considered to be nil for the purposes applying subsection 80(13) to the debtor. As a consequence, no relief under subsection 80(13) would be available in connection with such agreement.

Subsection 80.04(9) requires the Minister of National Revenue to assess or reassess any taxpayers (including partners of the debtor or transferee) to take into account an agreement filed under section 80.04, even where the assessment or reassessment would otherwise be statute-barred.

Subsection 80.04(10) provides that a debtor is liable to pay all or part of its eligible transferee's taxes, interest and penalties for taxation years ending in the 10 calendar years ending after the settlement of the debt that is the subject of an agreement under section 80.04. Where the transferee is a partnership, the liability is based on the total taxes, interest and penalties of the transferee's partners. The liability is limited, however, to 30% of the amount specified in the agreement. Subsection 80.04(11) clarifies that the debtor and the transferee (or, where the transferee is a partnership, the members of the partnership) are jointly and severally liable for such amounts.

Subsections 80.04(12) and (13) permit the Minister to assess a debtor for a liability arising under subsection 80.04(10) in the same manner in which a liability for the debtor's own taxes is assessed. If the debtor is a partnership, the assessments may be made with respect to the members of the partnership. However, the Minister may assess a member of such a partnership only with respect to taxation years of an eligible transferee (or, where the eligible transferee is another partnership, members of the other partnership) that end at or after the time that member entered the debtor partnership. If a person was no longer a member of a partnership at the time an obligation is deemed to be settled under section 80.04, the Minister cannot assess that person in connection with the deemed settlement except if the person re-enters the partnership.

Subsection 80.04(14) provides that, where there are two or more tiers of partnerships, the rules in subsections 80.04(10) and (12) look through any such tiers. For example, if one partnership is a member of another partnership, the first partnership's members will be treated as members of the other partnership for the purposes of subsections 80.04(10) and (12).

Section 80.04 applies to taxation years ending after February 21, 1994. However, the prescribed form referred to in subsection 80.04(6) is considered to have been filed on a timely basis if it is filed with the Minister before 1996.

Clause 28

Transfer of property to corporations by shareholders

ITA
85(4)

Subsection 85(4) of the Act applies where a taxpayer disposes of capital property or eligible capital property to a transferee corporation controlled by the taxpayer, by the taxpayer's spouse or by a person or group of persons by whom the taxpayer was controlled. In these circumstances, any capital loss (or deduction under paragraph 24(1)(a)) is denied. Instead, where the transferor owns shares of the capital stock of the transferee, all or part of the denied loss is added under paragraph 85(4)(b) in computing the adjusted cost base of those shares.

Paragraph 85(4)(b) is amended to provide that it does not apply in the event that the property disposed of is debt that, after the transfer, is payable to the transferee by another related corporation or a related partnership. In these circumstances, the denied capital loss would be added under paragraph 53(1)(f.1) or (f.11) in computing the adjusted cost base to the transferee corporation of the debt. New paragraph 80(2)(j), described in the commentary above, assists in determining whether or not a transferee is related to a debtor for the purpose of paragraph 85(4)(b).

The purpose of this amendment is to ensure balance between the rules in subsection 85(4) for creditors and the debt parking rules for debtors in new section 80.01.

This amendment applies to property disposed of after July 12, 1994, other than property disposed of pursuant to an agreement in writing entered before July 13, 1994.

EXAMPLE

Assume that Purchaseco is planning to acquire all the assets of Holdco, a corporation with which it deals at arm's length. Holdco's assets consist of shares of the capital stock of Opco 1 and debt owed to Holdco by a corporation (Opco 2) which is a wholly-owned subsidiary of Opco 1. The fair market value of the debt is well below its principal amount.

Results:

1. If Purchaseco acquires the debt and the shares, the debt parking rules will apply and reduce Opco 2's tax attributes. Conversely, Holdco should be able to realize a loss for income tax purposes.

2. In the absence of this amendment, a transfer of the debt to Opco 1 would increase the adjusted cost base of the shares of the capital stock of Opco 1. A loss would be realized on the disposition of shares, with no corresponding reduction of tax attributes.

3. As a consequence of this amendment, no loss is realized by Holdco.

Clause 29

Exchange of shares

ITA
86(4)

Section 86 of the Act applies where a corporation reorganizes its capital structure by issuing shares to a taxpayer as full or partial consideration for the surrender of all the taxpayer's shares in a class of shares of the capital stock of the corporation. Where this is the case, the cost of the new shares is determined with reference to the adjusted cost base of the surrendered shares.

New subsection 86(4) provides that, where the adjusted cost base of a surrendered share has been subject to a deduction in computing its adjusted cost base under paragraph 53(2)(g.1), the adjusted cost base of a new share to which section 86 applies is also reduced under that paragraph. This measure effectively preserves the history of deductions in computing the adjusted cost base of the surrendered share under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of subsection 86(4) is with respect to the potential future application of section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 47(1), 49(3.01), 51(1), 53(4) to (6) and 87(5.1) and (6.1).

More specifically, in computing the adjusted cost base to a taxpayer of any new share acquired in circumstances to which section 86 applies, paragraph 86(4)(a) provides for the deduction in computing the adjusted cost base to the taxpayer of the new share. The deduction is equal to a specified percentage of the amount, if any, by which

- the total amounts that were deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to a taxpayer of the old shares

exceeds

- the taxpayer's capital gain from the disposition of the old shares (determined without reference to the capital gains reserve).

The specified percentage for a particular new share is the percentage of the fair market value of all the new shares that is attributable to the particular new share.

Under paragraph 86(4)(b), the amount determined under paragraph 86(4)(a) in respect of a new share is added in computing the adjusted cost base to the taxpayer of the new share. As a consequence, there is no net effect on the amount of its adjusted cost base.

This amendment applies to taxation years ending after February 21, 1994.

Clause 30

Amalgamations

Subclause 30(1)

ITA
87(2)(h.1)

New paragraph 87(2)(h.1) of the Act provides that specified provisions relating to the settlement of debt apply to an amalgamated corporation as if the amalgamated corporation were the same corporation as, and a continuation of, each of the predecessor corporations. Because of the reference to paragraph 87(2)(h.1) in paragraph 88(1)(e.2), the new measure also applies to windings-up to which subsection 88(1) applies. The provisions specified are:

- section 61.4 (which allows an amalgamated corporation to claim a reserve under section 61.4 on the same basis as its predecessor corporations),

- the description of F in subsection 79(3) (which ensures that, if an amalgamated corporation surrenders property on a foreclosure, that the proceeds of disposition of the property do not include amounts that a predecessor corporation had already recognized for income tax purposes),

- the definition of "forgiven amount" in subsection 80(1) (which, in conjunction with subsection 87(7), ensures that any forgiven amount in respect of an obligation issued by a predecessor corporation and settled after the amalgamation is determined in the same manner as if it had been settled before the amalgamation),

- subsection 80.03(7) (which ensures that a designation may be made under subsection 80.03(7) by a corporation to reduce a deemed capital gain otherwise arising for a predecessor corporation under section 80.01), and

- section 80.04 (which ensures that an agreement to transfer a forgiven amount from a debtor to a transferee under section 80.04 is effective whether or not there has been an amalgamation involving either the debtor or the transferee).

New section 56.3 is not referred to in paragraph 87(2)(h.1). This is because existing paragraph 87(2)(g) already provides for reserves claimed by a predecessor corporation (including reserves under section 61.4) to be added back in computing the income of a corporation formed on the amalgamation of the predecessor corporation and other corporations.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 30(2)

ITA
87(2)(l.21)

New paragraph 87(2)(l.21) of the Act provides that section 61.3 and subsection 80.01(10) apply to an amalgamated corporation as if the amalgamated corporation were the same corporation as, and a continuation of, each of the predecessor corporations. For further detail on these provisions, see the commentary above.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 30(3)

ITA
87(5.1)

Subsection 87(5) of the Act applies where a taxpayer has an outstanding option to acquire shares of the capital stock of a corporation at the time the corporation amalgamates with one or more other corporations. In the event that the taxpayer acquires an option to acquire shares of the capital stock of the amalgamated corporation as consideration for the outstanding option, the new option is deemed to have been acquired at a cost equal to the adjusted cost base of the outstanding option.

New subsection 87(5.1) provides that, where the adjusted cost base of such an outstanding option has been subject to a deduction in computing its adjusted cost base under new paragraph 53(2)(g.1), the adjusted cost base of the new option is likewise reduced under that paragraph. A corresponding increase in the adjusted cost base is also provided, so that there is no net effect on the adjusted cost base of the new option.

Subsection 87(5.1) effectively preserves the history of deductions in computing the adjusted cost base of the option under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of subsection 87(5.1) is with respect to the potential future application of new section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 47(1), 49(3.01), 51(1), 53(4) to (6), 86(4) and 87(6.1).

This amendment applies to taxation years ending after February 21, 1994.

Subclause 30(4)

ITA
87(6.1)

Subsection 87(6) of the Act applies where a taxpayer owns a capital property that is an outstanding bond, debenture, note or other obligation of a corporation at the time the corporation amalgamates with one or more other corporations. In the event that the taxpayer acquires such an obligation of the amalgamated corporation as consideration for the outstanding obligation, the new obligation is deemed to have been acquired at a cost equal to the adjusted cost base of the outstanding obligation.

New subsection 87(6.1) applies only where such a new obligation is convertible to shares on a rollover basis under subsection 51(1). Where this is the case and the adjusted cost base of the outstanding obligation for which the new obligation was substituted has been subject to a deduction in computing its adjusted cost base under new paragraph 53(2)(g.1), the adjusted cost base of the new obligation is likewise reduced under that paragraph. A corresponding increase in the adjusted cost base is also provided, so that there is no net effect on the adjusted cost base of the new obligation.

Subsection 87(6.1) effectively preserves the history of deductions in computing the adjusted cost base of the obligation under paragraph 53(2)(g.1), which relates to reductions in the adjusted cost base arising from the operation of the debt forgiveness rules in section 80. The only relevance of subsection 87(6.1) is with respect to the potential future application of new section 80.03, as described in the commentary on that section. Similar amendments are provided under subsections 47(1), 49(3.01), 51(1), 53(4) to (6), 86(4) and 87(5.1).

This amendment applies to taxation years ending after February 21, 1994.

Clause 31

Windings-up

ITA
88(1)(c)(ii)

Subsection 88(1) of the Act provides rules which apply where a subsidiary has been wound-up into its parent. The proceeds for a subsidiary and the cost to the parent corporation of property owned by its subsidiary before the winding-up are generally equal to the cost amount to the subsidiary immediately before the winding-up. However, under clause 88(1)(c)(ii)(B), the cost of such property also reflects any required reductions under existing paragraph 80(1)(b) to the cost amount of the property on the winding-up brought about by the settlement or extinguishment of an obligation owing to the parent corporation by the subsidiary.

Clause 88(1)(c)(ii)(B) is amended to refer to required reductions under section 80 rather than paragraph 80(1)(b). This amendment is consequential on the amendments to section 80 that are described above.

This amendment applies to windings-up beginning after July 13, 1990.

Clause 32

Foreign accrual property income

Subclauses 32(1) to (3)

ITA
95(1)

"foreign accrual property income"

The foreign accrual property income (FAPI) of a controlled foreign affiliate of a taxpayer resident in Canada is taken into account under section 91 of the Act in computing the taxpayer's income for the year in which it is earned by the affiliate, rather than the year in which it is distributed. Under subsection 95(1), one of the components of FAPI is certain income from property and business, other than active business. However, certain losses and loss carryforwards of the affiliate reduce the affiliate's FAPI.

The new description of A.1 in the FAPI definition requires that an amount be added in computing FAPI. The amount that is added is 4/3 of the amount required to be added because of subsection 80(13). However, in the event that this amount exceeds the losses deductible under the descriptions of D to F in computing FAPI, the excess for a taxation year is deducted under the new description of G in computing FAPI for the year and added under the new description of A.2 in computing FAPI for the subsequent year. In effect, the excess is taken into account only once the affiliate realizes further losses that are relevant for the purposes of computing its FAPI.

Consequential amendments to Part LIX of the Regulations will be made to reflect the new descriptions of A.1, A.2 and G in the FAPI definition.

It should also be noted that the description of A in the FAPI definition is being amended so that the application of section 80 is ignored, except to the extent described in the preceding paragraph. This amendment can be found in subclause 78(1) of this bill. As well, reference may be made to the commentary on new paragraph 95(2)(g.1).

These amendments apply to taxation years ending after February 21, 1994.

As illustrated in the following example, the effect of these amendments is to negate an affiliate's losses for the purposes of computing its FAPI.

EXAMPLE

A foreign affiliate borrows $20,000 in year 1. It uses the borrowed money to purchase a property the income from which is included in computing the affiliate's FAPI. The affiliate initially has net losses totalling $2,900 in years 1 and 2, which are carried forward to year 3. In year 3, $3,600 of the debt is forgiven.

Results:

1. For year 3, the amount added in computing FAPI under the description of A.1 is $3,600 (i.e., 4/3 X $3,600 X .75). The amount subtracted under the description of G is $700 ($3,600-2,900).

2. The amount subtracted under the description of G is added back in computing the FAPI of the affiliate under the description of A.2 for the following year. It will be taken into account only once further losses are realized.

Subclause 32(4)

ITA
95(2)(g.1)

Subsection 95(2) of the Act sets out certain rules that apply in determining components of the foreign accrual property income (FAPI) of a foreign affiliate.

New paragraph 95(2)(g.1) clarifies that, for the purposes of computing FAPI, the rules in section 80 will apply with respect to obligations settled or extinguished that relate to FAPI. An obligation will be considered to relate to FAPI for this purpose if interest on the obligation is relevant (or would be relevant, if charged) in determining an affiliate's FAPI. However, many of the debt forgiveness rules (specifically, subsections 80(3) to (12), (15) and (17), subsections 80.01(5) to (11) and sections 80.02 to 80.04) are ignored for this purpose. In addition, adjustments are made under the amended FAPI definition in subsection 95(1) so that, in effect, the application of section 80 for FAPI purposes results only in a reduction of FAPI-related losses.

This amendment applies to taxation years ending after February 21, 1994.

Clause 33

Partnership rules

ITA
96(3)

Subsection 96(3) of the Act provides rules that apply where a member of a partnership makes an election under, or in respect of the application of, certain provisions of the Act for a purpose that is relevant to the computation of the member's income from the partnership. In such case, the election will be valid only if it is made on behalf of all the members of the partnership and the member had authority to act for the partnership.

Subsection 96(3) is amended so that designations under subsections 80(5) and (9) to (11) in respect of a partnership are treated in the same way as an election referred to in subsection 96(3).

Subsection 96(3) is also amended to treat an agreement filed by a partnership under section 80.04 in the same way as an election referred to in subsection 96(3). For further discussion, see the commentary on that section.

These amendments apply to fiscal periods ending after February 21, 1994.

Clause 34

Transfers to partnerships

ITA
97(3)(b)

Subsection 97(3) of the Act applies where a taxpayer disposes of capital property to a transferee partnership of which the taxpayer is a majority interest partner. In these circumstances, any capital loss from the disposition is denied. Instead, the denied loss is added under paragraph 97(3)(b) in computing the adjusted cost base of the transferor's interest in the transferee partnership.

Paragraph 97(3)(b) is amended to provide that it does not apply in the event that the property disposed of is debt that, after the transfer, is payable to the transferee partnership by a corporation or a partnership related to the transferor. In these circumstances, the denied capital loss would be added under paragraph 53(1)(f.11) in computing the adjusted cost base to the transferee partnership of the debt. New paragraph 80(2)(j), described in the commentary above, assists in determining whether or not a transferor is related to a debtor for the purpose of paragraph 97(3)(b).

The purpose of this amendment is to ensure balance between the rules in subsection 97(3) for creditors and the debt parking rules for debtors in new section 80. For further detail, see the commentary on a related amendment to subsection 85(4).

This amendment applies to property disposed of after July 12, 1994, other than property disposed of pursuant to an agreement in writing entered into before July 13, 1994.

Clause 35

Trust rules

ITA
107(1)(a)

Paragraph 107(1)(a) of the Act is relevant for the purpose of computing a beneficiary's taxable capital gain from the disposition of a capital interest in a personal trust. The effect of the provision is that a beneficiary will not realize a gain from the disposition of an interest in a personal trust (or a trust prescribed under section 4800.1 of the Regulations), except to the extent that the proceeds of disposition exceed the greater of two amounts. The first amount is the adjusted cost base to the beneficiary of that interest. The second amount is the "cost amount" of that interest. "Cost amount" for this purpose is, under subsection 108(1), determined with reference to the cost amount to a trust of the trust's assets.

Paragraph 107(1)(a) is amended so that, in computing the second amount, there are deducted amounts that are deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the beneficiary of the interest in the trust.

This amendment applies to taxation years ending after February 21, 1994.

Clause 36

Losses deductible

ITA
111(8)

"farm loss", "net capital loss" and "non-capital loss"

Subsection 111(8) of the Act defines the "farm loss", "net capital loss" and "non-capital loss" of a taxpayer. The definitions are amended to clarify that such losses are to be reduced as required by section 80. Section 80 requires such reductions under both the existing and new rules.

These amendments apply to taxation years ending after February 21, 1994, including the computation of loss carryforwards from years ending on or before that date.

Clause 37

Part-year residents

ITA
114(a)

Section 114 of the Act provides the rules with respect to deductions allowed in computing the taxable income of an individual residing in Canada during only part of a taxation year.

Paragraph 114(a) is amended to ensure that, in these cases, an individual cannot claim a deduction under new section 61.2 in computing the individual's income for a taxation year.

This amendment applies to taxation years ending after February 21, 1994.

Clause 38

Taxable income earned in Canada

ITA
115(1)(a)(iii.21)

Subsection 115(1) of the Act determines the taxable income earned in Canada on which a non-resident is subject to taxation under Part I of the Act.

New subparagraph 115(1)(a)(iii.21) provides that amounts required to be included in computing a non-resident corporation's income under section 56.3 of the Act are included in computing the corporation's taxable income earned in Canada.

This amendment applies to taxation years ending after February 21, 1994.

Clause 39

Insurance corporations

ITA
138(11.93)

Subsection 139(11.93) of the Act provides rules, overriding those in section 79, which apply where an insurer acquires or reacquires property as a result of a debtor's failure to pay an amount in respect of a bond, debenture, mortgage, hypothec, agreement of sale or other form of indebtedness. In this case, the insurer is treated as having acquired or reacquired the property at its fair market value and to have disposed of the bond or other form of indebtedness for proceeds equal to that fair market value. In addition, the insurer's unpaid claim is treated as having a cost amount of nil and to be a bond or other form of indebtedness. The insurer is denied any further reserves for doubtful debts in respect of the claim. The debtor, on the other hand, treats the property has having been disposed of for the amount of the insurer's claim and may treat any further payments on the debt as a loss from the disposition of property.

Subsection 138(11.93) is amended to provide that it applies in the circumstances described above only to an insurer and not to a debtor of the insurer. The debtor will be subject to the rules in section 79.

Subsection 138(11.93) is also amended to clarify the income tax rules that apply in the event that an amount is still owing to an insurer after the acquisition or reacquisition by the insurer of property. In this case,

- the remaining right is considered to have been reacquired by the insurer at a cost of nil, and
- the remaining right shall continue to be treated as if it is in respect of a bond, debenture, mortgage, hypothec, agreement of sale or other form of indebtedness.

These amendments apply with respect to property acquired or reacquired after February 21, 1994, other than acquisitions or reacquisitions pursuant to a court order made before February 22, 1994.

Clause 40

Liability in respect of transfers by insolvent corporations

ITA
160.4

New section 160.4 of the Act applies where a transfer of property has been made by a corporation and, as a consequence of the transfer (or the transfer combined with other transactions), the corporation is precluded under subsection 61.3(3) from deducting an amount under section 61.3. Where this is the case, the transferee is jointly liable with the transferor under subsection 160.4(1) for the transferor's tax under Part I of the Act for the first taxation year of the transferor ending after the time of the transfer and for preceding taxation years. The liability of the transferee applies up to the amount, if any, by which the fair market value of the property at the time of the transfer exceeds the fair market value of the consideration given for the property transferred.

In addition, should a transferee make a further non-arm's length transfer and one of the reasons that the transfer was made was to prevent the enforcement of section 160.4, subsection 160.4(2) provides for joint liability on the part of subsequent non-arm's length transferees for the original transferor's Part I tax referred to above. The liability is limited to the lesser of the outstanding amount of the original transferor's tax liability remaining at the time of the subsequent transfer and the amount, if any, by which the fair market value of the property transferred exceeds the fair market value of the consideration given for the property.

This amendment applies to transfers made after December 20, 1994.

Clause 41

Part VI.1 tax

ITA
191.3(1.1)

Section 191.3 of the Act, relating to the special Part VI.1 tax on corporations paying dividends on taxable preferred shares, allows a transferor corporation to transfer its liability for this tax to a related transferee corporation.

New subsection 191.3(1.1) provides rules that apply where property is acquired by a transferee corporation as consideration for entering into an agreement that is filed under section 191.3. If the property is owned by the transferor corporation immediately before the transfer, the corporation is deemed to have disposed of the property at its fair market value but is not entitled to deduct any amount in respect of the transfer except any loss resulting from the deemed disposition. The cost at which the property was acquired by the transferee corporation is considered to be equal to its fair market value. Neither the transferor corporation nor the transferee corporation is required to add any amount or benefit in computing income only because of the acquisition of the property or because of the entering into of the agreement under section 191.3. This provision is similar to new subsection 80.04(5), discussed in the commentary above.

This amendment applies to the 1988 and subsequent taxation years.

Clause 42

Minister's duty

ITA
220

Subsections 220(3.2) to (3.7) of the Act allow for the late filing, amendment and revocation of certain elections made by taxpayers or partnerships.

Subsection 220(3.21) is introduced so that these measures apply to designations in forms prescribed for the purposes of section 80 and subsection 80.03(7).

This amendment applies on Royal Assent.

Clause 43

Interpretation

Subclause 43(1)

ITA
248(1)

"restricted farm loss"

The definition "restricted farm loss" is amended to change a cross-reference to subsection 31(1) to subsection 31(1.1). This amendment is consequential on the splitting of existing subsection 31(1) into two subsections.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 43(2)

ITA
248(1)
"bankrupt"
"estate of the bankrupt"

"Bankrupt" and "estate of the bankrupt" are defined as having the meanings assigned by the *Bankruptcy and Insolvency Act.* This amendment eliminates the need to add cross-references to subsection 128(3) whenever the expressions are used.

This amendment applies to taxation years ending after February 21, 1994.

Subclause 43(3)

ITA
248(26)

New subsection 248(26) of the Act clarifies the circumstances in which an obligation of a person will be regarded as having been issued for the purposes of section 80 and other provisions.

Subsection 248(26) applies where a debtor becomes liable to repay borrowed money. It also applies where a debtor becomes liable to pay an amount (other than interest) as consideration for any property acquired or services rendered or that is deductible in computing the income of the debtor. Subsection 248(26) ensures that such liabilities are treated as obligations issued for a principal amount equal to the amount of the liability. This measure is relevant for the purposes of applying the provisions of the Act relating to the treatment of the debtor in respect of such liabilities.

Subsection 248(26) does not apply to a liability of a person or partnership under a guarantee or similar undertaking given by the person or partnership.

This amendment applies to taxation years ending after February 21, 1994.

ITA
248(27)

New subsection 248(27) of the Act clarifies the treatment of obligations issued by a debtor that are or were part of a larger obligation issued by the debtor. Unless the context otherwise requires, any portion of that obligation is treated as an obligation in its own right. The principal amount, and the amount for which the obligation is issued, are pro-rated accordingly.

For example, assume a debtor issued an obligation for $196,000 that had a principal amount of $200,000 and that the debtor has paid $100,000 on account of the principal amount of the obligation. The obligation still remaining would be considered to have a principal amount of $100,000 and to have been issued for $98,000.

This amendment applies to taxation years ending after February 21, 1994.

Clause 44

Acquisition of control

ITA
256(7) and (8)

Paragraph 256(7)(a) of the Act identifies circumstances in which control of a corporation (or a corporation controlled by that corporation) will not be considered to have been acquired for the purposes of certain provisions in the Act. Paragraph 256(7)(b) provides that a person or group of persons will, in certain circumstances, be considered for the purposes of the same provisions to have acquired control of a corporation immediately before the amalgamation of that corporation with another corporation. Subsection 256(8) extends the circumstances in which control of a corporation is considered to have been acquired for the purposes of many of the same provisions in certain cases where a taxpayer has acquired a right to acquire shares, to control the voting rights of shares or to cause the corporation to redeem, cancel or acquire shares owned by other shareholders.

Subsection 256(7) is amended so that it also applies for the purposes of section 80, in which there are references to acquisitions of control in the definitions of "relevant loss balance", "successor pool" and "unrecognized loss" in subsection 80(1) and in subsection 80(15). It is also amended so that it applies for the purposes of paragraph 80.04(4)(h). For further detail, see the commentary above on those provisions. This amendment applies to amalgamations, acquisitions, redemptions and cancellations that occur after February 21, 1994.

Subsection 256(8) is amended so that control of a corporation is (for the purposes of section 80 and paragraph 80.04(4)(h)) considered to be acquired, in the event that a right referred to above in respect of the corporation is acquired and it can reasonably be concluded that one of the main purposes of the acquisition of the right was to affect the application of section 80. This amendment applies to acquisitions that occur after February 21, 1994.

PART II

Foreign Affiliates

Part II of this bill, which is composed of clauses 45 to 47, contains amendments to the *Income Tax Act* relating to the measures on foreign affiliates, which were announced by the Minister of Finance in the budget of February 22, 1994.

Reference may also be made to subclause 78(2) of Part IX of the bill and the related explanatory note, as that subclause also contains an amendment pertaining to this measure.

Clause 45

Borrowed money

ITA
20(3)

Subsection 20(3) of the Act provides a rule that applies when a taxpayer uses borrowed money to repay an existing debt. For the purposes of the provisions of the Act set out therein, the borrowed money is treated as having been used for the same purpose as that of the money previously borrowed but repaid. The amendment to this subsection simply makes the provision apply also for the purposes of new subparagraph 95(2)(a)(ii) of the Act. That provision deals with foreign affiliates and the definition of foreign accrual property income which is discussed in the explanatory notes relating to subsection 95(2) of the Act.

The amendment is applicable for expenses incurred in taxation years that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendment will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the amendment will remain applicable to taxation years that begin after 1994. Thus, where a foreign affiliate of a taxpayer borrows money to repay a loan, the funds are considered to have been used for the same purpose as the use made of the funds that were derived from the repaid loan.

Clause 46

Foreign accrual property income

ITA
95

Subclause 46(1)

ITA
95(1)

"foreign affiliate"

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

The definition is amended applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendment will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the amendment will remain applicable to taxation years that begin after 1994.

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

EXAMPLE 1

<u>*Facts*</u>

Corporation A which is resident in Canada owns an 82% interest in the outstanding shares of a foreign corporation.

Corporations B and C which are related to corporation A and are resident in Canada each own a 9% interest in the outstanding shares of the same foreign corporation.

<u>*Results Under Current Definition*</u>

Under the existing definition of a foreign affiliate of a taxpayer resident in Canada in subsection 95(1) of the Act, the foreign corporation would be a foreign affiliate of corporation A but not of corporation B or C since the equity percentage of each of those corporations in the foreign corporation is less than 10%.

Since corporation A controls the foreign corporation, the foreign corporation is a controlled foreign affiliate of corporation A. Corporation A would then report as *income 82% of the foreign accrual property income of that controlled foreign affiliate.*

<u>*Results Under Amended Definition*</u>

The amended definition of a foreign affiliate of a taxpayer resident in Canada would treat the foreign corporation as a foreign affiliate of corporations B and C since each have an equity percentage in the foreign corporation that is not less than 1% and the total of the equity percentages of the three related corporations in the foreign corporation is not less than 10%.

Since the foreign corporation is controlled by corporation A which is related to corporations B and C, it is also a controlled foreign affiliate of corporations B and C (see the definition of a "controlled foreign affiliate" in subsection 95(1) of the Act). Therefore, 100% of the foreign accrual property income of the controlled foreign affiliate will be included in the income of the Canadian shareholders - corporation A (82%), corporation B (9%) and corporation C (9%).

Subclause 46(2)

ITA
95(1)

"foreign accrual property income"

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

It should be noted that the description for the letter A in this definition is also being amended. That amendment is contained in subclause 78(2) of this bill. Reference should therefore be made to the commentary on subclause 78(2) in these notes.

The description for the letter D and the formula in the definition deducts from foreign accrual property income of an affiliate its losses from property and businesses other than active businesses. The amendment to the description for the letter D provides that those losses are also to be determined without reference to those expenses of the affiliate referred to in new clause 95(2)(a)(ii)(D) of the Act where an amount in respect of the income derived from those amounts of expense payments was included in computing the income from an active business of another foreign affiliate of the taxpayer or a foreign affiliate of a person with which the taxpayer does not deal at arm's length.

The amendments are applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendments will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the amendments will remain applicable to taxation years that begin after 1994.

Subclause 46(3)

ITA
95(1)

"active business"
"foreign bank"
"income from an active business"
"income from property"
"investment business"
"investment property"
"lease obligation"
"lending of money"
"licensing of property"

The new definitions in subsection 95(1) of the Act are applicable to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the new definitions will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new definitions will remain applicable for taxation years that begin after 1994.

The new definitions add the terms "active business", "foreign bank", "income from an active business", "income from property" and "investment business" as well as other terms relevant in determining the foreign accrual property income of a foreign affiliate.

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

"Foreign bank" means an entity that would be a foreign bank as that expression is defined in section 2 of the Bank Act if that definition were read without its postamble and no entity had been exempt from being a foreign bank under section 12 of the Bank Act.

"Income from an active business" of a foreign affiliate of a taxpayer for a taxation year includes, for greater certainty, any income of the affiliate for the year that pertains to or is incident to that active business but does not include other income that is income from property of the affiliate for the year and does not include income of the affiliate for the year from a business that is deemed by subsection 95(2) of the Act to be a business other than an active business of the affiliate.

"Income from property" of a foreign affiliate of a taxpayer for a taxation year includes its income for the year from an investment business and its income for the year from an adventure or concern in the nature of trade but, for greater certainty, does not include its income for the year that is treated by subsection 95(2) of the Act as its income from a business.

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

However, an "investment business" will not include a business carried on by a foreign affiliate in a taxation year where it is established that, throughout the period in the year during which the business was carried on, the following conditions are satisfied.

First, it must be established that the business was carried on principally with arm's length persons and was either

- carried on by the affiliate as a foreign bank, trust company, credit union, insurance corporation or a trader or dealer in securities or commodities the activities of which are regulated in the country in which the business is principally carried on, or

- the development of real estate for sale, the lending of money, the leasing or licensing of property or the insurance or reinsurance of risks.

Second, it must be established that the affiliate or, where the affiliate carries on the business as a member of a partnership (other than where the affiliate was a specified member of the partnership in a fiscal period of the partnership ending in the year), the partnership either

- employed more than five employees full time in the active conduct of the business, or

- employed the equivalent of more than 5 employees full-time in the active conduct of the business taking into consideration only the services provided by its employees and the services provided outside Canada by employees of a corporation related to the affiliate or employees of members of the partnership (other than a partner that was a specified member of the partnership in a fiscal period of the partnership ending in the year). This test is satisfied only where such employers received compensation from the affiliate in exchange for the services performed by their employees in an amount that is at least equal to the cost of the employee compensation paid or accruing to the employees while the services were performed by them.

For this purpose, the term "specified member" of a partnership is defined in subsection 248(1) of the Act and refers to limited partners and to certain members who are not actively engaged in the partnership business.

A financial institution regulated as a bank or other regulated financial institution on a consolidated basis by a regulatory authority located in a member state of the European community, other than the member state in which the business of the financial institution is principally carried on, in accordance with the Consolidated Supervision Directive will be considered to be a financial institution whose activities are regulated in the member state in which the business is principally carried on where the European regulatory law has been incorporated into the local regulatory law of that member state.

The term "investment property" is relevant for the definition "investment business". The investment property of a foreign affiliate of a taxpayer is defined to include

- a share in a corporation and an interest in a partnership or trust other than any such property that is excluded property of the affiliate,

- indebtedness and annuities,

- commodities or commodities futures purchased or sold, directly or indirectly in any manner whatever, on a commodities or commodities futures exchange (except where the commodities were manufactured, produced, grown, extracted or processed by the affiliate or a person to which the affiliate was related, otherwise than by reason of a right referred to in paragraph 251(5)(b) of the Act, or the commodities futures were in respect of such commodities),

- currency,

- real estate,
- Canadian and foreign resource properties,
- interests in funds and entities other than corporations, partnerships and trusts, and
- interests and options in respect of any such property.

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

"Lending of money" by a person (the lender) is defined to include

- the acquisition of trade accounts receivable of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such trade accounts receivable,
- the acquisition of loans made by and lending assets of another person (the borrower) owing by persons that deal at arm's length with the lender or of interests in such loans or lending assets,
- the acquisition of foreign resource properties of other persons (the borrower) other than resource properties that are rents or royalties payable by persons that do not deal at arm's length with the lender, and
- the sale by the lender of loans or lending assets or an interest in loans or lending assets where the loans or lending assets were owing by persons that deal at arm's length with the lender.

The definition "lending of money" is relevant for the purpose of the definition "investment business".

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

The approach for determining the income of a foreign affiliate of a taxpayer for a year that is its income from an active business, its income from property, its income from a business that is deemed under subsection 95(2) to be a business other than an active business and its foreign accrual property income is as follows.

- Determine if the affiliate carries on income earning activities that are deemed to be a separate business other than an active business carried on by the affiliate under subsection 95(2) of the Act (such as under new paragraphs (a.1) to (a.4) thereof). Income from such separate business including any income from assets at risk in or essential to that business (such as interest from the investment of temporarily surplus funds) is income from a business other than an active business. As such, the income is excluded from the affiliate's income from property and its income from an active business because of the definitions of those terms in subsection 95(1).

- Determine if the affiliate carries on other income earning activities that constitute separate businesses and apply the investment business definition in subsection 95(1) to each such separate business to determine if an investment business exists. Income from an investment business of the affiliate is included in the income from property of the affiliate. Where a business is not an investment business, it will qualify as an active business subject to the application of paragraph 95(2)(l). Income from the active business including any income derived from assets at risk in or essential to the active business (such as interest from the investment of temporarily surplus funds) is income of the affiliate from an active business because of the definition of that income in subsection 95(1).

- Determine if the affiliate carries on any income earning activities that do not constitute a separate business. An adventure or concern in the nature of trade would not constitute a separate business and would be included in these types of activities because of the amendment to the definition "business" in subsection 248(1) of the Act. The definition "income from property" in subsection 95(1) includes the income of the affiliate from an investment business and its income from an adventure or concern in the nature of trade in income from property of the affiliate.

- Determine the extent to which paragraph 95(2)(a) applies to treat income from property of the affiliate as active business income of the affiliate. Include such income in the active business income of the affiliate. The balance of the income from property remains as income from property of the affiliate.

- Determine the foreign accrual property income of the affiliate by including the income from property of the affiliate and the income from a business other than an active business of the affiliate as well as the other amounts included under the Act.

EXAMPLE 2

Facts

A corporation resident in Canada has three foreign affiliates that it controls - FA1, FA2 and FA3.

FA1 and FA2 are resident in and carry on a manufacturing business in a designated treaty country.

FA3 is a financing affiliate that carries on a non-arms length financing business and makes interest-bearing loans to FA1 and FA2 and the interest cost in respect of such loans are deductible in computing the amount prescribed to be the earnings or loss from an active business carried on in the designated treaty country by FA1 and FA2.

The manufacturing income of FA1 is $1915 which includes $15 of interest income from the short term investment of funds that are at risk in the manufacturing business (income pertaining to or incident to the active manufacturing business).

FA2 has manufacturing income of $1500.

FA3 has interest income from loans made to FA1 and FA2 of $160 and interest income from the investment of funds derived from its operating surpluses of $60.

<u>Application of definitions</u>

FA1 carries on a manufacturing business that is an active business and has income from an active business of $1915.

FA2 carries on a manufacturing business that is an active business and has income from an active business of $1500 because of the definition "active business" and "income from an active business" in subsection 95(1).

FA3 carries on a non-arm's length financing business that is an investment business and includes the $220 of income from the investment business in its income from property because of the definitions "investment business" and "income from property" in subsection 95(1).

FA3 will include $160 of its income from property in its income from an active business under subparagraph 95(2)(a)(ii) (the income FA3 derived from the interest payments made to it by FA1 and FA2) and the remaining $60 of its income from property will remain as income from property of FA3.

FA3 will have $60 of income from property (the $60 of income from the investment of funds derived from operating surpluses) that will be included in its foreign accrual property income.

EXAMPLE 3

<u>Facts</u>

A corporation resident in Canada has a number of foreign affiliates which it controls each of which is resident in and carries on a manufacturing business in a designated treaty country. It also has another foreign affiliate which it controls which carries on the non-arm's length insurance business of insuring the risks of the Canadian corporation and its manufacturing affiliates.

The insurance affiliate derives $1000 of premium income (net premiums minus claims and related expenses etc.) from insuring the Canadian corporation's risks (the "Canadian *insurance business") and $300 of premium income derived from the insurance of the foreign affiliates' risks (the "Foreign insurance business"). As well, the investment of the Canadian business net premiums and capital earns $50 of interest income while the investment of foreign business net premiums and capital earns $15 of interest income. There is no income derived from assets not employed in the businesses.*

<u>Applications of the definitions</u>

The insurance affiliate is deemed to carry on a separate business other than an active business under subsection 95(2) (paragraph (a.2)) of the Act in respect of the insurance of the Canadian risks. The $1000 of premium income derived from the insurance of the Canadian risks and the $50 of interest derived from the investment of the funds at risk in that separate business is included in the affiliate's income from a business other than an active business.

The insurance affiliate carries on a non-arm's length insurance business insuring the risks of related affiliates. That business is an investment business and the $300 of premium income and the $15 of interest derived from the investment of funds at risk in that business is income from the investment business that is included in its income from property because of the definition "income from property" in subsection 95(1). However, because of the application of subparagraphs 95(2)(a)(i) and (ii), the insurance affiliate will include in computing its active business income, the $315 of income derived from the business of the insurance of the risks of the related foreign affiliates. The income from property of the affiliate will then be nil.

EXAMPLE 4

<u>Facts</u>

A corporation resident in Canada has three foreign affiliates that it controls - FA5, FA6 and FA7.

FA5 and FA6 are resident in and carry on a manufacturing business in a designated treaty country.

FA7 is a financing affiliate that carries on a non-arm's length financing business and makes interest-bearing loans to FA5 and FA6 and the interest cost in respect of such loans are deductible in computing the amount prescribed to be the earnings or loss from an active business carried on in the designated treaty country by FA5 and FA6. FA7 earns $440 of interest in respect of these loans.

FA7 also receives, as part of that non-arm's length financing business, advances of funds from FA5 and FA6 that are at risk in their manufacturing businesses but are temporarily available for investment. The funds are returned to FA5 and FA6 for use in their manufacturing business as required. FA7 earns $10 of income on the investments of such funds.

<u>*Application of definitions*</u>

FA7 carries on a non-arm's length financing business that is an investment business and the $450 of income from the investment business is included in its income from property because of the definition "income from property" in subsection 95(1). However, because of the application of subparagraphs 95(2)(a)(i) and (ii), FA7 will include the $450 in computing its active business income (the $10 of income derived from the investment of funds at risk in the manufacturing businesses of FA5 and FA6 and the $440 of income derived from the interest paid to it by FA5 and FA6). The income from property of FA7 will then be nil.

Subclause 46(4)

Determination of foreign accrual property income

ITA
95(2)

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

ITA
95(2)(a)

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

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

- the income is derived from amounts paid or payable to the affiliate or a partnership of which the affiliate is a member by another affiliate of the taxpayer or by a non-resident corporation with which the taxpayer does not deal at arm's length where the amounts paid or payable reduce (or would reduce, if the non-resident corporation were a foreign affiliate of the taxpayer) the amounts prescribed to be the active business earnings of the payer from a business carried on in a country other than Canada.

That paragraph is being replaced applicable to taxation years of foreign affiliates that begin after 1994 except that, where there has been a change to a taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of the affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

The wording of the existing paragraph causes some uncertainty particularly as it relates to the determination of what income of one affiliate pertains to or is incident to the active business carried on by another corporation. The new definitions "income from an active business" and "income from property" of a foreign affiliate in subsection 95(1) of the Act as well as new subparagraph 95(2)(a)(i) deal with this issue. As well, because of the new definition "income from property" in subsection 95(1), only income that would otherwise be income from property needs to be dealt with in paragraph 95(2)(a). Finally, the scope of new subparagraphs 95(2)(a)(i) and (ii) have been altered as discussed below.

New subparagraph 95(2)(a)(i) defines situations where income for the year that would otherwise be the income from property of a foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year will be treated as active business income for the year of the affiliate.

Income from property for a taxation year of a particular foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year will be considered to be income from an active business of the particular affiliate for the year to the extent that it is derived by it from activities that could reasonably be considered to be directly related to active business activities carried on outside Canada either by any other non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year, or by the taxpayer in those circumstances where the taxpayer is a life insurance corporation resident in Canada throughout the year. The income must be of the type that, if earned by the non-resident corporation or the taxpayer that is the life insurance corporation, would be included in computing the amount prescribed to be its earnings or loss from an active business carried on outside Canada if it were a foreign affiliate of the taxpayer. Rules are provided in new paragraph 95(2)(m) for determining when a taxpayer has a qualifying interest in a foreign affiliate of the taxpayer.

Subparagraph 95(2)(a)(i) is directed at cases where the business activities of a single foreign active business are conducted in more than one related corporation. It also deals with the situation where income of one foreign corporation is derived from assets that are at risk in a foreign active business carried on by a related foreign corporation. Assets will be considered to be at risk in a business where the permanent removal of such assets would have a destabilizing effect on the business.

There must be a link between the foreign active business activities conducted by the related foreign corporation and the activities conducted by the other foreign corporation that produces income from property. The activities resulting in the income from property must be dependent upon and would not have taken place but for the active business activities taking place. The fact that activities are similar is not enough to demonstrate a link.

EXAMPLE 5

<u>Facts</u>

A corporation resident in Canada has two foreign affiliates which it controls throughout the year - FA1 and FA2.

FA1 carries on the active business of leasing property at arm's length and has 20 employees.

FA2 is a wholly owned subsidiary of FA1 with no employees and was formed by FA1 for business reasons to hold a single high risk lease that was negotiated and executed by the employees of FA1 in the conduct of the business of FA1.

FA2 earns leasing income of $100 which would otherwise qualify as income from property.

<u>Application of Subparagraph 95(2)(a)(i)</u>

The leasing activity of FA2 is directly linked to the active business activities of FA1 since it was negotiated by the employees of FA1 in the conduct of the business of FA1 and can be considered to be an extension of the business of FA1. The leasing activities of FA2 resulting in the property income are dependent upon the active business activities of FA1 and *would not have taken place but for the active business activities of FA1.*

If FA1 had earned the leasing income of FA2, the income would be income from the active leasing business of FA1.

The corporation resident in Canada, FA1 and FA2 are related throughout the year.

The $100 of FA2's income derived from the leasing activities is included in its income from an active business rather than its income from property.

FA2 has no property income and $100 of active business income.

EXAMPLE 6

Facts

A corporation resident in Canada has two foreign affiliates which it controls throughout the year - FA3 and FA4.

FA3 carries on the active business of developing real estate for sale and has 30 employees.

FA4 is a wholly owned subsidiary of FA3 and is used by FA3 to develop and sell a real estate property that but for the risk involved would have been developed and sold by FA3. The activities of FA4 are managed by employees of FA3. FA4 carries on no other activities and earns a profit of $200 on the sale of the property.

Application of Subparagraph 95(2)(a)(i)

The development and sale of the real estate property by FA4 is an activity that is directly linked to the active business activities of FA3 and can be considered to be an extension of the active business of FA3.

If FA3 had earned the income of FA4, the income would be income from the active business of FA3.

The corporation resident in Canada, FA3 and FA4 are related throughout the year.

The $200 of income derived by FA4 from the development and sale of the real estate property is included in its income from an active business rather than its income from property.

FA4 has no property income and $200 of active business income.

EXAMPLE 7

Facts

A corporation resident in Canada has three foreign affiliates which it controls throughout the year - FA5, FA6 and FA7.

FA5 and FA6 carry on active manufacturing businesses in foreign countries and advance funds that are at risk in their active businesses but are also available for temporary investment to FA7 for investment. The funds are returned to FA5 and FA6 for use in their active businesses as required.

FA7 earns $100 of income from investing the funds of FA5 and FA6. As well, it earns $200 of income from investing funds derived from its surplus. FA7 has fewer than 5 employees and carries on an investment business as defined in subsection 95(1).

Application of Subparagraph 95(2)(a)(i)

The activities involving the investment of the funds provided by FA5 and FA6 are directly linked to the active business activities of FA5 and FA6 since FA7 is performing a treasury function in respect of funds at risk in the businesses of FA5 and FA6.

If FA5 and FA6 had earned the $100 of income that was derived by FA7 from the investment of these funds, the income would be income from their active businesses since the funds were at risk in their businesses.

The corporation resident in Canada, FA5, FA6 and FA7 are related throughout the year.

The $100 of income from property of FA7 derived from the investment of funds provided by FA5 and FA6 would be included in its income from an active business. The remaining $200 of property income of FA7 would remain income from property.

New subparagraph 95(2)(a)(ii) of the Act is similar to existing subparagraph 95(2)(a)(ii) of the Act. However, the scope of the provision has been altered in two ways. First, the scope has been expanded to accommodate the use of holding corporations by certain groups of foreign affiliates of a taxpayer. Second, its application has been restricted to income from property derived from certain transactions involving members of groups of related non-resident corporations or groups of foreign affiliates of the taxpayer in respect of which the taxpayer has a qualifying interest as defined in new paragraph 95(2)(m) of the Act.

Income that would otherwise be income from property for a taxation year of a foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest will be included in its income from an active business for the year to the extent that the income is derived from amounts paid or payable, directly or indirectly, to the affiliate or a partnership of which it is a member

- under clause (A), by a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year or by a partnership of which such a non-resident corporation is a member (other than where it is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would, if the non-resident corporation or the partnership were a foreign affiliate of the taxpayer, be deductible in the year or a subsequent taxation year by it in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,

- under clause (B), by another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year or by a partnership of which such other foreign affiliate of the taxpayer is a member (other than where the other affiliate is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that are or would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent taxation year by the other affiliate or the partnership in computing the amounts prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada,

- under clause (C), by a partnership where the particular affiliate is a member of the partnership (other than where it is a specified member of the partnership at any time in a fiscal period of the partnership ending in the year) to the extent that those amounts paid or payable are for expenditures (either an expenditure of a current nature or an expenditure in respect of which an allowance is claimed) that would be, if the partnership were a foreign affiliate of the taxpayer, deductible in the year or a subsequent taxation year in computing the amounts prescribed to be its earnings or loss from an active business carried on by it outside Canada, or

- under clause (D), by another foreign affiliate of the taxpayer that is related to the particular affiliate and the taxpayer throughout the year (second affiliate) pursuant to a legal obligation to pay interest on borrowed money used to acquire, or on an amount payable for the acquisition of, property, where

    - the property is excluded property of the second affiliate that is shares of another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year (third affiliate),

    - the second affiliate and third affiliate are resident and subject to income taxation in the same country, and

- the amounts paid or payable are relevant in computing the liability for taxes of the members of a corporate group composed of the second affiliate and one or more other foreign affiliates of the taxpayer which are resident and subject to income taxation in the same country as the second affiliate and in respect of which the taxpayer has a qualifying interest throughout the year.

- under clause (E), by the taxpayer, where the taxpayer is a life insurance corporation resident in Canada, to the extent that those amounts paid or payable are for expenditures that are deductible in the year or a subsequent taxation year by the insurer in computing its income or loss from carrying on its insurance business outside Canada and not in Canada.

EXAMPLE 8

Facts

A foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year loaned funds to another foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year.

The interest on the loan would otherwise qualify as income from property of the lending affiliate.

The interest expense of the borrowing affiliate is deductible in computing the amount prescribed to be its earnings or loss from an active business, other than an active business carried on in Canada.

Application of Subparagraph 95(2)(a)(ii)

New clause 95(2)(a)(ii)(B) of the Act would include the income of the lending affiliate derived from the interest paid by the borrowing affiliate in the active business income of the lending affiliate. The active business earnings or loss of the group of affiliates is then unaffected by the inter-affiliate interest payments.

Where foreign income tax rules such as the rules dealing with earnings stripping in the United States defer an expense deduction, subparagraph 95(2)(a)(ii) still applies since the interest is considered to be deductible in computing the amount prescribed to be the borrower's earnings or loss from an active business carried on outside Canada.

Proposed new subsection 5907(2.7) of the Income Tax Regulations (released by the Minister of Finance on January 23, 1995) provides that the interest paid or payable by the borrower is to be deducted in computing the active business earnings or loss of the borrower in the year of the borrower that includes the earlier of the day on which the interest is paid or the day on which the interest becomes payable.

Proposed subclause 5907(1)(b)(iv)(B)(V) of the Income Tax Regulations (released by the Minister of Finance on January 23, 1995) includes the income that is deemed to be active business income of the affiliate in computing the lender's exempt earnings or loss to the extent that the interest paid or payable are deductible in computing the borrowing affiliate's exempt earnings or loss.

EXAMPLE 9

Facts

A foreign affiliate of a taxpayer in respect of which the taxpayer has a qualifying interest throughout the year carries on an active business as a member of a partnership.

The affiliate makes a loan to the partnership and the interest on the loan is deductible in computing the amount that would be, if the partnership were a foreign affiliate of the taxpayer, its earnings or loss from an active business carried on by it.

The income of the affiliate derived from the interest on the loan would otherwise be income from property of the affiliate.

Application of Subparagraph 95(2)(a)(ii)

New clause 95(2)(a)(ii)(C) would treat the income of the affiliate as active business income of the affiliate to the extent that the interest paid or payable to the affiliate would be, if the partnership were a foreign affiliate of the taxpayer, deductible in computing the amount prescribed to be its earnings or loss from an active business carried on in a country other than Canada.

New subsection 5907(2.7) of the Income Tax Regulations (released by the Minister of Finance on January 23, 1995) requires the affiliate to deduct the interest paid to the affiliate in computing its active business earnings or loss from the partnership in the year of the partnership that includes the earlier of the day on which the interest is paid and the day on which the interest becomes payable.

Where the affiliate is resident in a designated treaty country, proposed subclause 5907(1)(b)(iv)(B)(VII) of the Income Tax Regulations (released by the Minister of Finance on January 23, 1995) includes the income deemed to be active business income of the affiliate in computing the lenders exempt earnings or loss to the extent that the interest paid or payable by the partnership would be, if the partnership were a foreign affiliate of a corporation, deductible in computing its exempt earnings or loss.

EXAMPLE 10

Facts

A foreign affiliate of a taxpayer (the "first affiliate") in respect of which the taxpayer has a qualifying interest throughout the year loaned funds to another foreign affiliate of the taxpayer (the "second affiliate") to which the particular affiliate and the taxpayer are related throughout the year.

The second affiliate used the funds to purchase excluded property that is shares of yet another affiliate of the taxpayer (the "third affiliate") in respect of which the taxpayer has a qualifying interest throughout the year.

The interest paid to the first affiliate by the second affiliate would otherwise be income from property of the first affiliate.

The second affiliate did not carry on an active business and did not deduct the interest in computing the amount prescribed to be its earnings or loss from that active business carried on outside Canada.

The second and third affiliates are resident and subject to income taxation in the same country.

The interest paid or payable by the second affiliate to the first affiliate is relevant in computing the liability for income taxes of the members of a group of corporations composed of the second affiliate and one or more other affiliates of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year that are resident and subject to income taxation in the same country as the second affiliate.

Tax consolidation is used by the group of foreign affiliates of the taxpayer.

Application of Subparagraph 95(2)(a)(ii)

New clause 95(2)(a)(ii)(D) will treat the income of the first affiliate derived from the interest paid to it by the second affiliate as active business income.

Proposed new subsection 5907(2.8) of the Income Tax Regulations (released by the Minister of Finance on January 23, 1995) requires the second affiliate to deduct the interest paid to the first affiliate in computing its active business earnings or loss from an active business in the year that includes the earlier of the day on which the interest is paid and the day on which the interest becomes payable and will deem the second affiliate to be carrying on an active business in the country in which it is resident if it does not do so.

Where the first affiliate is resident in a designated treaty country, proposed subclause 5907(1)(b)(iv)(B)(VIII) of the Income Tax Regulations (released by the Minister of Finance *on January 23, 1995) includes the income deemed to be active business income in computing its exempt earnings or loss provided that conditions set out therein are satisfied.*

New subparagraph 95(2)(a)(iii) of the Act includes in the income from an active business for a taxation year of a particular foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year its income for the year derived from the factoring of accounts receivable acquired by it or by a partnership of which it was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year. The accounts receivable must have arisen in the course of an active business carried on outside Canada by the non-resident corporation.

New subparagraph 95(2)(a)(iv) of the Act includes in the income from an active business for a taxation year of a particular foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest throughout the year its income for the year derived from loans or lending assets acquired by the particular affiliate or a partnership of which it was a member from a non-resident corporation to which the particular affiliate and the taxpayer are related throughout the year. The loans and lending assets must have arisen in the course of an active business carried on outside Canada by the non-resident corporation.

ITA
95(2)(a.1)

New paragraph 95(2)(a.1) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(a.1) includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the sale of property (including the income derived from services as agent provided in relation to a purchase or sale of property) where

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

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

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

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

EXAMPLE 11

Facts

Canco is a corporation resident in Canada that carries on a manufacturing business in Canada.

Canco purchases raw materials for its manufacturing business from suppliers in foreign country "X".

Canco is able to negotiate a bargain purchase price for its raw materials which is less than the price paid by its competitors.

Canco establishes a wholly-owned purchasing and sales subsidiary (F) in a foreign country "Y" with favourable tax rates for the purpose of purchasing the raw materials and selling them to Canco at a profit.

F makes a profit for the year from the purchase of the raw materials from the foreign supplier and the sale of the raw materials to Canco of $1,000,000.

Application of paragraph 95(2)(a.1)

The sale of the raw materials by F to Canco is deemed to be a separate business other than an active business of F.

The $1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA
95(2)(a.2)

New paragraph 95(2)(a.2) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before

February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(a.2) includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate from the insurance of risks (including income from the reinsurance of risk) where the risks insured were in respect of

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

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

The purpose of this new rule is to protect the Canadian tax base from erosion through the use of foreign affiliates by Canadian corporations to insure risks in Canada.

EXAMPLE 12

<u>*Facts*</u>

Canco is a corporation resident in Canada that carries on the business of a financial institution.

Canco sells insurance to or arranges for insurance for its customers as part of its business carried on in Canada.

Canco incorporates a wholly-owned subsidiary F in a foreign country with favourable tax rates for the purposes of insuring risks in respect of its Canadian customers.

Canco directs the insurance premiums and business to F.

F has income of $1,000,000 from the insurance of risks of persons resident in Canada.

Application of paragraph 95(2)(a.2)

The insurance of the risks of persons resident in Canada by F is deemed to be a separate business other than an active business of F.

The $1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA
95(2)(a.3)

New paragraph 95(2)(a.3) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(a.3) includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, the income of the affiliate derived directly or indirectly from indebtedness (other than specified deposits with a prescribed financial institution) or lease obligations (including any income of the affiliate derived from the purchase or sale of indebtedness and lease obligations on its own account) of persons resident in Canada or in respect of businesses carried on in Canada. The word "indirectly" is intended to refer to transactions designed to avoid the rule, for example, back-to-back arrangements where risks and rewards of a particular Canadian indebtedness or lease obligation rest with the foreign affiliate. Lease obligation is defined in a new definition in subsection 95(1) of the Act to include an obligation under a license. "Specified deposit" is defined in new subsection 95(2.5) of the Act. Prescribed financial institutions are set out in section 7900 of the *Income Tax Regulations.*

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

The purpose of this new rule is to protect the Canadian tax base from erosion, for example, through the use of foreign affiliates by Canadian corporations in the financing and leasing and licensing business to acquire debt and lease obligations of persons resident in Canada.

EXAMPLE 13

<u>*Facts*</u>

Canco is a corporation resident in Canada that carries on the business of a financial institution.

Canco makes loans to or arranges for loans for its customers as part of its business carried on in Canada.

Canco incorporates a wholly owned subsidiary F in a foreign country with favourable tax rates for the purposes of making loans to or purchasing loans made to its Canadian customers.

Canco directs the lending business and sells loans to F.

F has income of $1,000,000 derived from loans made to persons resident in Canada.

<u>*Application of paragraph 95(2)(a.3)*</u>

The lending of money to or the acquisition of loans of persons resident in Canada by F is deemed to be a separate business other than an active business of F.

The $1,000,000 of income of F derived from the separate business is income from a business other than an active business of F and is included in the foreign accrual property income of F. Canco must include the foreign accrual property income of F in its income.

ITA
95(2)(a.4)

New paragraph 95(2)(a.4) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(a.4) includes in the income from a business other than an active business and thus the foreign accrual property income of a foreign affiliate of a taxpayer resident in Canada, a portion of the income of the affiliate for a year derived directly or indirectly from indebtedness or lease obligations (including any income of the affiliate derived from the purchase or sale of indebtedness and lease obligations on its own account) in respect of businesses carried on outside Canada by a partnership where the taxpayer or a person resident in Canada with whom the taxpayer does not deal at arm's length (the non-arm's length persons) includes any income or loss of the partnership in computing its income or loss either directly or indirectly. It does not apply to income of the affiliate included in the affiliate's income from a business other than an active business under paragraph (a.3).

It applies to that proportion of such income of the affiliate that the total of the taxpayer's and the non-arm's length persons' shares of the income or loss of the partnership is of the total income or loss of the partnership for fiscal periods of the partnership ending in the year. Where the partnership does not have an income or loss for a fiscal period, it is assumed to have income of $1,000,000 for the purpose of calculating the proportion of the affiliate's income derived directly or indirectly from indebtedness or lease obligations in respect of businesses carried on outside Canada by the partnership that is to be included in the affiliate's income from a business other than an active business.

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

This rule protects the Canadian tax base where a foreign affiliate of a taxpayer loans funds to a partnership (such as a limited partnership) and non-arm's length persons resident in Canada share in the partnership income or loss. The income of the affiliate derived from the indebtedness and lease obligations of the partnership is to be included in the income of the affiliate from a business other than an active business and foreign accrual property income to the extent of the non-arm's length persons' proportionate shares of the partnership's income or loss. In this way, any Canadian tax base erosion through the use of affiliate loans to a partnership is eliminated.

EXAMPLE 14

<u>*Facts*</u>

Canco is a member of a partnership that carries on a business in a foreign country. Canco has a 90% share of the partnership income or loss. The only other partner is X, a wholly-owned foreign affiliate of Canco.

Canco incorporates a wholly-owned subsidiary (F) in a foreign country with favourable tax rates to serve as a financing affiliate and invests $10,000,000 in its capital.

F loans at 10% interest the $10,000,000 to the partnership for use in its business. F derives income of $1,000,000 from the loan.

The partnership incurs a loss of $700,000 in the conduct of its active business which is carried on in a designated treaty country. Canco's share of the loss is $630,000 and X's share of the loss is $70,000.

<u>*Application of paragraph 95(2)(a.4)*</u>

F must include $900,000 of its income derived from the loan to the partnership in its income from a business other than an active business and its foreign accrual property income. The remaining $100,000 of income of F derived from the loan to the partnership is income from property to which the rule in clause 95(2)(a)(ii)(B) would apply.

Canco would report a foreign business loss of $630,000 as its share of the partnership loss of $700,000. Canco has, in effect, realized, directly or indirectly, a profit of $370,000 with respect to the activities of the partnership – that is $1,000,000 of income derived by its financing affiliate setoff by $630,000 of the partnership loss. Only $100,000 (that portion of F's income to which the rule in clause 95(2)(a)(ii)(B) applies) is recognized as income from an active business, the remaining

$900,000 would be included in F's foreign accrual property income.

Subclause 46(5)

ITA
95(2)(k)

New paragraph 95(2)(k) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(k) provides a start-up rule that is to apply to a foreign affiliate of a taxpayer in respect of a business (foreign business) that is to be considered to be an investment business as defined in subsection 95(1) of the Act or a separate business other than an active business under paragraphs 95(2)(a.1), (a.2), (a.3) or (a.4) of the Act. It provides rules for computing the income of the affiliate from the foreign business for the first and subsequent taxation years in which such business is considered to be carried on.

For the purposes of computing the income of the affiliate from the foreign business for the first taxation year and each subsequent taxation year in which the foreign business is carried on, the following rules are provided.

- The affiliate is deemed to have commenced to carry on the foreign business in Canada at the later of the commencement of the first taxation year and the time it commenced to carry on the business and to have carried on the foreign business in Canada throughout that part of the first year or any subsequent taxation year in which the affiliate carried on the foreign business.

- Where the foreign business is a business in respect of which the affiliate would, if the foreign business were carried on in Canada, be required by law to report to a regulating authority such as the Superintendent of Financial Institutions or a similar authority of a province, the affiliate shall be deemed to have been subject to the supervision of such regulating authority.

- Paragraphs 138(11.91)(c) to (f) of the Act are to apply to the affiliate in respect of the foreign business as if the affiliate were the insurer referred to in subsection 138(11.91), the first year were the particular year referred to therein and the foreign business were the business of the insurer referred to therein.

The purpose of these rules is to ensure that the income of the affiliate from the foreign business is calculated appropriately using Canadian tax rules. For example, in the first year the affiliate is assumed to have claimed maximum reserves in the immediately preceding year. As well, there is a deemed disposition and reacquisition of property used or held in the foreign business immediately before the commencement of the first taxation year. Other rules exist in subsection 138(11.91). These fresh start rules are to apply to all affiliates and are designed to ensure that income or losses accruing in prior periods do not enter into the income calculations for the foreign business in the first or subsequent taxation years. The rule deeming the affiliate to be subject to the supervision of a regulating authority is to permit the affiliate to claim certain insurance reserves.

EXAMPLE 15

Facts

F is a wholly owned foreign affiliate of Canco which is deemed to carry on a separate business other than an active business under paragraph 95(2)(a.2). The separate business is the insurance of Canadian risks.

F has accrued gains on property used or held in the business of $1,000,000 and was entitled to claim reserves of $2,000,000 as at the end of its taxation year ending on December 31, 1994.

The first taxation year of F in respect of which paragraph 95(2)(k) applies to the separate business is the year ended December 31, 1995.

Application of Paragraph 95(2)(k)

F is deemed to have a taxation year ending December 31, 1994 and to have claimed maximum reserves for that year of $2,000,000. As well, F is deemed to have disposed of and reacquired the property used or held in the foreign business at its fair market value as at December 31, 1994 recognizing the accrued gain of $1,000,000 in its 1994 taxation year.

For its 1995 taxation year, F calculates its income from the foreign business using Canadian income tax rules, as if it had claimed maximum reserves in the immediately preceding taxation year and as if the cost of the property used or held in the foreign business was its fair market value as at December 31, 1994.

ITA
95(2)(l)

New paragraph 95(2)(l) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(l) includes certain business income of a foreign affiliate of a taxpayer in its income from property. It applies to the affiliate in respect of its income from a business (other than an investment business) the principal purpose of which is to derive income from the trading or dealing in indebtedness (which, for this purpose, includes interest on indebtedness). This rule does not apply with respect to indebtedness of arm's length persons resident in the country in which the affiliate was formed or continued and is governed and exists and in which its business is principally carried on nor with respect to accounts receivable owing by arm's length persons.

The rule does not apply where the taxpayer is a regulated financial institution in Canada, a subsidiary wholly-owned corporation of a regulated financial institution in Canada or a corporation of which a regulated financial institution in Canada is a subsidiary wholly-owned corporation and the business is carried on by its foreign affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the activities of which are regulated in the jurisdiction in which it was formed or continued and exists and in which the business was principally carried on. A regulated financial institution is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority.

ITA
95(2)(m)

New paragraph 95(2)(m) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new paragraph will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new paragraph will remain applicable to taxation years that begin after 1994.

New paragraph 95(2)(m) defines when a taxpayer has a qualifying interest in a foreign affiliate of the taxpayer and is relevant for the purposes of the amended paragraph 95(2)(a) of the Act. A taxpayer will have a qualifying interest in a foreign affiliate of a taxpayer at any time the taxpayer owned

- not less than 10% of the issued and outstanding shares having full voting rights under all circumstances of the affiliate, and

- shares of the affiliate having a fair market value of not less than 10% of the fair market value of all the issued and outstanding shares of the affiliate.

It also provides special rules for the purposes of this ownership test.

- Shares of one corporation held by another corporation are deemed to be held by the shareholders of the holding corporation in a proportion determined by reference to the shareholder's percentage fair market value interest in the corporation.

- Shares of a corporation held by a partnership are deemed to be held by the partners in a proportion based on the partners' percentage share of the income or loss of the partnership. The partnership is assumed for this purpose to have $1,000,000 of income where it has no income or loss.

- A taxpayer that holds convertible property issued by the affiliate and outstanding at June 23, 1994 can elect to treat all such property as having been converted into shares as provided for under the terms and conditions of the convertible property.

Subclause 46(6)

ITA
95(2.1)

New subsection 95(2.1) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new subsection will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new subsection will remain applicable to taxation years that begin after 1994.

New subsection 95(2.1) provides a rule for the purposes of the new definition "investment business" in subsection 95(1). It provides that a foreign affiliate of a taxpayer, the taxpayer and, in certain circumstances, a regulated financial institution in Canada of which the taxpayer is a subsidiary wholly-owned corporation, will be considered to be dealing with each other at arm's length in respect of the entering into and the execution of agreements providing for a purchase or sale or exchange of currency where

- the taxpayer is, or is a corporation all of the issued shares of which are owned by a corporation that is, a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority,

- the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, options or rights agreements or similar agreements,

- the agreements are entered into by the foreign affiliate in the course of a business carried on principally with arm's length persons in the country in which the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it, and

- the terms and conditions of the sale or exchange are arm's length terms and conditions.

This rule will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

ITA
95(2.2)

New subsection 95(2.2) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new subsection will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new subsection will remain applicable to taxation years that begin after 1994.

New subsection 95(2.2) provides rules for the purposes of paragraph 95(2)(a) of the Act. New paragraph 95(2.2)(a) provides that a non-resident corporation that was not a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout a particular year shall be deemed to be a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest throughout that year where

- a person has, in that year, acquired or disposed of shares of that non-resident corporation or any other corporation, and because of that acquisition or disposition, the non-resident corporation became or ceased to be a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest, and

- at the commencement of that year or at the end of that year, the non-resident corporation was a foreign affiliate of the taxpayer in respect of which the taxpayer had a qualifying interest.

New paragraph 95(2.2)(b) provides that a non-resident corporation that was not related to a foreign affiliate of the taxpayer and the taxpayer throughout a particular year shall be deemed to be related both to the foreign affiliate of the taxpayer and to the taxpayer throughout that year where

- a person has, in that year, acquired or disposed of shares of that non-resident corporation or any other corporation, and because of that acquisition or disposition, the non-resident corporation became or ceased to be a non-resident corporation that was related to the foreign affiliate of the taxpayer and the taxpayer, and

- at the commencement of that year or at the end of that year, the non-resident corporation was related to the foreign affiliate of the taxpayer and the taxpayer.

ITA
95(2.3)

New subsection 95(2.3) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new subsection will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new subsection will remain applicable to taxation years that begin after 1994.

New subsection 95(2.3) provides a rule for the purposes of new paragraph 95(2)(a.1). It provides that paragraph 95(2)(a.1) will not apply to a foreign affiliate of a taxpayer in the respect of a sale or exchange of currency or a right to sell or exchange currency where

- the taxpayer is, or is a subsidiary wholly-owned corporation of, a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority,

- the sale or exchange was made by the foreign affiliate in the course of a business carried on principally with arm's length persons in the country in which the affiliate was formed or continued and exists and is governed and in which the business is principally carried on by it, and

- the terms and conditions of the sale or exchange are arm's length terms and conditions.

This rule will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

ITA
95(2.4)

New subsection 95(2.4) of the Act applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new subsection will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new subsection will remain applicable to taxation years that begin after 1994.

New subsection 95(2.4) provides a rule for the purposes of new paragraph 95(2)(a.3) of the Act. It provides that paragraph 95(2)(a.3) will not apply in respect of income derived by a foreign affiliate of a taxpayer directly or indirectly from indebtedness to the extent that

- such income was derived by the affiliate in the course of a business carried on by it as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the activities of which are regulated in the jurisdiction in which it was formed or continued and exists and is governed and in which the business was principally carried on, and

- such income was derived from the trading or dealing in such indebtedness with persons resident in a country other than Canada in which the affiliate and its similarly regulated competitors compete and have a substantial market presence (foreign business).

For this purpose, income from trading and dealing includes interest income from indebtedness acquired for trading and dealing. As well, the acquisition of indebtedness by the affiliate from the taxpayer for trading and dealing in the affiliate's foreign business is considered to be a foreign business transaction where the terms and conditions of the acquisition and sale are arm's length terms and conditions.

ITA
95(2.5)

The new definitions in subsection 95(2.5) of the Act apply to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the new definitions will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the new definitions will remain applicable to taxation years that begin after 1994.

"indebtedness"

The new definition of indebtedness applies for the purposes of new paragraph 95(2)(a.3) of the Act. It provides that indebtedness shall not include any obligations of a taxpayer under agreements with non-resident corporations providing for the purchase, sale or exchange of currency where:

- the agreements are swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements or options or rights agreements or similar agreements,

- the taxpayer is a bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities, the business activities of which are by law subject to the supervision of a regulating authority in Canada such as the Superintendent of Financial Institutions or a similar provincial authority,

- the agreements are entered into by the non-resident corporation in the course of a business carried on principally with arm's length persons in the country in which the non-resident corporation was formed or continued and exists and is governed and in which the business is principally carried on by it, and

- the terms and conditions of the agreements are arm's length terms and conditions.

This definition will permit foreign affiliates of Canadian taxpayers to deal with the foreign branches of Canadian financial institutions with respect to the currency needs of their foreign businesses. Such currency transactions of the affiliates will be afforded the same tax treatment given similar transactions conducted with foreign financial institutions.

"specified deposit"

New subsection 95(2.5) also defines "specified deposit" for the purposes of new paragraph 95(2)(a.3) of the Act. A specified deposit is a deposit of a foreign affiliate of a taxpayer with a prescribed financial institution (prescribed in section 7900 of the *Income Tax Regulations*) where

- the income of the affiliate from the deposit is income that would, but for paragraph 95(2)(a.3), be income from an active business other than a business the principal purpose of which is to derive income from property including interest, dividends, rents, royalties or similar returns or substitutes therefore or profits from the disposition of investment property, or

- the income is derived from a deposit of funds derived in the ordinary course of carrying on business activities with arm's length persons in the course of a business that, but for paragraph 95(2)(a.3), would be an active business conducted principally with arm's length persons.

The purpose of this definition is to treat bank deposits of foreign affiliates with foreign branches of Canadian deposit taking financial institutions the same as deposits with foreign financial institutions.

Subclause 46(7)

Where rights or shares are acquired or disposed of to avoid tax

ITA
95(6)

Subsection 95(6) of the Act is an anti-avoidance rule designed to prevent the avoidance of tax through the use of rights to acquire shares or the issuance of shares. It applies for the purposes of subdivision i of the Act.

The subsection has been amended in a number of ways and is consequential to the amendments to paragraph 95(2)(a) of the Act and the general concern with respect to tax avoidance. The amended subsection applies to taxation years of foreign affiliates that begin after 1994, except that, where there has been a change to the taxation year of a foreign affiliate in 1994 and after February 22, 1994, the amended subsection will apply to taxation years of such foreign affiliate that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the amended subsection will remain applicable to taxation years that begin after 1994.

The amendment to the preamble of subsection 95(6) provides that the rule does not apply for the purposes of section 90 of the Act. Section 90 simply includes in the income of a taxpayer resident in Canada a dividend received by the taxpayer on a share of a non-resident corporation owned by the taxpayer.

Paragraph 95(6)(a) has been amended in a number of ways. First, the "one of the main reasons test" is replaced by a "principal purpose" test consistent with the test in new paragraph (b). Second, it has been made to apply to persons and partnerships. Finally, it has been made to apply where the principal purpose for the existence of any right is to make two or more corporations related for the purposes of paragraph 95(2)(a) or to avoid, defer or reduce any amounts payable under the Act. In the first case, the corporations are deemed not to be related for the purposes of paragraph 95(2)(a) and, in any other case, the shares that could be acquired under the right are deemed to be owned.

Paragraph 95(6)(b) has been rewritten and applies to an acquisition or disposition of shares where the principal purpose for such acquisition or disposition was the avoidance, reduction or deferral of amounts payable under the Act. If the principal purpose exists, the shares are deemed not to have been acquired or disposed of and previously unissued shares are deemed not to have been issued.

EXAMPLE 16

<u>*Facts*</u>

Canco is a corporation resident in Canada that has a wholly owned foreign subsidiary (FC) which carries on an active business in a designated treaty country. Only one class of shares of FC are outstanding.

XCo is another corporation resident in Canada that is not related to Canco that is to lend money to FC for use in its foreign business. XCo forms a wholly-owned subsidiary (FX) in a designated treaty country for the purpose of making the loan to FC. FX does not carry on a business.

To take advantage of the rules in paragraph 95(2)(a) of the Act (which would permit FX to include its income from property derived from the loan in its active business income), XCo acquires a 11% interest in the outstanding shares of FC from Canco which are to be sold back to Canco when the loan is repaid. Canco has a right of first refusal at an agreed price in the event that XCo is to sell the shares.

FX includes the income derived from the loan in its active business income under subparagraph 95(2)(a)(ii) of the Act.

Application of subsection 95(6) of the Act

The shares of FC acquired by XCo shall be deemed not to have been disposed of by Canco or acquired by Xco since the principal purpose for the acquisition was the avoidance of Canadian tax on the foreign accrual property income of FX derived from the loan to FC.

The income of FX derived from the loan to FC will be property income of FX and will be included in its foreign accrual property income (FAPI). Xco will include the FAPI in its income for Canadian income tax purposes.

Clause 47

Definitions

ITA
248(1)

"business"

Subsection 248(1) of the Act provides definitions for the purposes of the Act. The definition of "business" includes an adventure or concern in the nature of trade except for certain purposes. That definition is being amended to ensure that it does not include an adventure or concern in the nature of trade for the purposes of the new definitions in subsection 95(1) of the Act. Any income of a foreign affiliate arising from an adventure or concern in the nature of trade is included in the affiliate's "income from property" as that expression is defined.

The amendment is applicable to taxation years that end after 1994.

PART III

Securities Held by Financial Institutions

Part III of this bill, which is composed of clauses 48 to 60, contains amendments to the *Income Tax Act* relating to the measures on securities held by financial institutions announced in the budget of February 22, 1994.

Reference may also be made to clause 77 of Part IX of the bill and the related explanatory note, as this clause also contains an amendment pertaining to this measure.

Clause 48

Superficial loss

ITA
18(13)

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

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

The amendments to subsection 18(13) apply to dispositions of property after October 30, 1994. However, because of the grandfathering that is provided for subsection 142.6(7), subsection 18(13) will continue to apply to the disposition of certain specified debt obligations after October 30, 1994 and before July 1995.

Clause 49

Capital gains and losses

Subclause 49(1)

ITA
39(1)(a)(ii.2)

Paragraph 39(1)(a) of the Act defines a taxpayer's capital gain for a taxation year from the disposition of property. Certain property is excluded from the definition, with the consequence that there is no capital gain from its disposition. New subparagraph 39(1)(a)(ii.2) provides an exclusion for specified debt obligations where new subsection 142.4(4) or (5) applies to the disposition, and for mark-to-market properties where new subsection 142.5(1) applies to the disposition. ("Specified debt obligation" and "mark-to-market property" are defined in new subsection 142.2(1).) These exclusions are required in case the gain that is determined under subdivision c of the Act exceeds the profit or gain determined for the purpose of the new rules for financial institutions.

Subclause 49(2)

ITA
39(1)(b)(ii)

Paragraph 39(1)(b) of the Act defines a taxpayer's capital loss for a taxation year from the disposition of property. Certain property is excluded from the definition, with the consequence that there is no capital loss from its disposition. Subparagraph 39(1)(b)(ii) is amended so that it excludes property referred to in new subparagraph 39(1)(a)(ii.2). For further information, see the commentary on that provision.

Subclause 49(3)

ITA
39(5)

Subsection 39(4) of the Act allows taxpayers to elect to treat all their Canadian securities as capital property. This election is not available to any taxpayer listed in subsection 39(5). Subsection 39(5) is amended to add to the list a financial institution (as defined in new subsection 142.2(1)). Also, the amendment removes from the list banks, trust companies, credit unions and insurance corporations, since those entities are included in the definition of a financial institution.

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

Clause 50

Conversion of debt obligation

ITA
51.1

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

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

New section 51.1 applies to exchanges occurring after October 1994.

Clause 51

Exploration and development shares

ITA
66.3(1)(a)

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

The amendment to paragraph 66.3(1)(a) applies to taxation years that commence after October 1994.

Clause 52

Bond conversion

ITA
77

Section 77 of the Act provides a tax-free rollover where a taxpayer exchanges a bond for another bond of the same debtor pursuant to a conversion right in the exchanged bond. With the introduction of new rules for debt obligations held by financial institutions, this rollover is being restricted to capital properties. Consequently, the rollover is moved to new section 51.1, and section 77 is repealed. The repeal applies to exchanges occurring after October 1994.

Clause 53

Transfer of property to corporation by shareholders

Subclause 53(1)

ITA
85(1)(c.1)

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

Paragraph 85(1)(c.1) deems the amount designated in respect of certain property to be the lesser of the fair market value of the property and the property's cost amount at the time of disposition, where the amount actually designated is less. This paragraph is amended to alter the properties to which it applies. The amendment is consequential on amendments to subsection 85(1.1), which specifies the types of property that are eligible for rollover treatment. The amendment to paragraph 85(1)(c.1) replaces the reference to property that is a security or debt obligation used by the taxpayer in an insurance or money-lending business with a reference to property described in paragraphs 85(1.1)(g) and (g.1). This amendment applies to dispositions of property after February 22, 1994.

Subclauses 53(2) and (3)

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

Subsection 85(1.1) defines "eligible property" for the purpose of the rollover provided by subsection 85(1). Paragraph 85(1.1)(g) includes as eligible property a security or debt obligation used by the taxpayer in the business of insurance or lending money, where the property is neither capital property nor inventory. This paragraph is amended to exclude, where the taxpayer is a financial institution, property that is mark-to-market property. ("Financial institution" and "mark-to-market property" are defined in new subsection 142.2(1).) A rollover is not permitted for mark-to-market property of a financial institution because such property is required to be revalued to fair market value on a regular basis for tax purposes. This amendment applies with respect to dispositions in taxation years that begin after October 1994.

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

Subclause 53(4)

ITA
85(1.4)

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

Clause 54

Amalgamations

ITA
87

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

Subclause 54(1)

Definitions

ITA
87(1.5)

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

Subclause 54(2)

Capital property

ITA
87(2)(e)

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

Subclause 54(3)

Security or debt obligation

ITA
87(2)(e.2)

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

Financial institutions - specified debt obligation

ITA
87(2)(e.3)

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

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

Financial institutions - mark-to-market property

ITA
87(2)(e.4)

New paragraph 87(2)(e.4) applies with respect to a property that the new corporation has acquired from a predecessor corporation on an amalgamation where either (i) the new corporation is a financial institution and the property is a mark-to-market property for the new corporation, or (ii) the predecessor corporation was a financial institution and the property was a mark-to-market property for the predecessor corporation. Paragraph 87(2)(e.4) provides that the cost of the property to the new corporation is equal to its fair market value immediately before the amalgamation. Paragraph 87(2)(e.4) applies with respect to amalgamations occurring after October 1994.

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

Financial institutions - mark-to-market property

ITA
87(2)(e.5)

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

Subsections 112(5) to (5.2) and (5.4) contain a stop-loss rule applicable where a financial institution has losses from the disposition of shares on which dividends have been received.
Paragraph 87(2)(e.5) ensures that the stop-loss rule applies in the same way to the new corporation as it would have applied to each predecessor corporation had the amalgamation not occurred. In particular, the new corporation is considered to have acquired shares when they were acquired by a predecessor corporation, and the predecessor corporations are not considered to have disposed of the shares that have become property of the new corporation. This has a number of consequences. For example, dividends received by a predecessor corporation are taken into account in applying the stop-loss rule to the new corporation. Another example is that in determining whether the new corporation has held a share for 365 days, the period during which the share was held by a predecessor corporation is included.

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

Subclause 54(4)

Financial institution rules

ITA
87(2)(g.2)

New paragraph 87(2)(g.2) provides that, for the purposes of a number of the new rules for financial institutions in sections 142.4 to 142.6, the new corporation formed on an amalgamation is deemed to be the same corporation as, and a continuation of, each predecessor corporation. This continuity rule applies for the purposes of paragraphs 142.4(4)(c) and (d) (amortization of gain or loss on disposition of specified debt obligation), subsections 142.5(5) and (7) (transition rules for the mark-to-market requirement) and subsection 142.6(1) (taxpayer becoming or ceasing to be a financial institution). With respect to subsection 142.6(1), the effect of paragraph 87(2)(g.2) is that the rules in that subsection will apply with respect to a predecessor corporation where that corporation is a financial institution and the new corporation is not, or vice versa.

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

Clause 55

Windings-up

ITA
88(1)

Subsection 88(1) contains rules that apply where a subsidiary has been wound up into its parent if both corporations are taxable Canadian corporations and the parent holds at least 90% of the issued shares of each class of the subsidiary's capital stock.

Subclauses 55(1) and (2)

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

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

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

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

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

Subclause 55(3)

ITA
88(1)(c)

Paragraph 88(1)(c) determines the cost to the parent corporation of property that it receives from its subsidiary corporation on a winding-up. Paragraph 88(1)(c) is amended to make it subject to new paragraph 87(2)(e.3), as that paragraph applies to windings-up. This amendment is made for the same reason as the amendment adding new paragraph 88(1)(a.3). The amendment to paragraph 88(1)(c) applies with respect to windings-up beginning after February 22, 1994.

Subclause 55(4)

ITA
88(1)(e.2)

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

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

Subclause 55(5)

ITA
88(1)(h)

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

ITA
88(1)(i)

New paragraph 88(1)(i) provides that, for the purpose of subsection 142.5(2) (mark-to-market requirement for financial institutions), the taxation year of a subsidiary in which its assets were distributed to its parent on a winding-up shall be deemed to have ended immediately before the distribution of the assets. Consequently, if the subsidiary is a financial institution, subsection 142.5(2) will deem it to have disposed of its mark-to-market property just before the distribution for proceeds equal to fair market value. Paragraph 88(1)(i) applies to windings-up beginning after October 1994.

Clause 56

Taxable dividends received by corporations

ITA
112

Subclauses 56(1) to (6)

Loss on share

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

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

These subsections are amended, with respect to dispositions after October 30, 1994, to provide that they are subject to new subsections 112(5.5) and (5.6). Those new subsections limit the circumstances in which the existing stop-loss rules apply. One reason for the restriction is that a new stop-loss rule has been added in subsection 112(5.2) for shares held by financial institutions. Another reason is that it is inappropriate for the existing stop-loss rules to apply where a share that has been held for less than 365 days is deemed to be disposed of under the mark-to-market requirement for financial institutions. For further information on the restrictions to the existing stop-loss rules, see the commentary on new subsections 112(5.5) and (5.6).

Subclause 56(7)

Adjustment to proceeds of disposition

ITA
112(5) to (5.3)

New subsection 112(5.2) contains a rule that may adjust a taxpayer's proceeds from the disposition of a share if the taxpayer has received dividends on the share. This subsection applies in the circumstances set out in new subsections 112(5) and (5.1). Subsection 112(5.3) provides that the adjustment does not apply for the purpose referred to in that subsection. Subsections 112(5) to (5.3) apply to dispositions in taxation years beginning after October 1994.

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

Subsection 112(5.1) provides that subsection 112(5.2) applies where a taxpayer disposes of a share that it held for less than 365 days if (i) the disposition was an actual disposition, i.e., not a deemed disposition, and (ii) the share was a mark-to-market property of the taxpayer for any taxation year beginning after October 1994 in which the taxpayer was a financial institution.

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

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

where

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

B = the lesser of two amounts:

- the loss (if any) from the disposition that would be determined before the application of subsection 112(5.2) if the cost of the share were determined without regard to certain provisions that specify the cost of property to a taxpayer, and

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

C = the sum of

- amounts by which subsection 112(5.2) increased the taxpayer's proceeds on deemed dispositions of the share before the current disposition,

- where the taxpayer is a corporation or trust, amounts by which losses of the taxpayer on deemed dispositions of the share before the current disposition were reduced by the stop-loss rule in subsection 112(3), (3.2), (4) or (4.3), and

- where the taxpayer is a partnership, amounts by which losses of members of the taxpayer on deemed dispositions of the share before the current disposition were reduced by the stop-loss rule in subsection 112(3.1) or (4.2); and

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

Generally, the effect of the requirement that the taxpayer's loss be determined (for amount B) without regard to certain provisions relating to cost is that the loss is measured using the original cost of the share. In particular, the mark-to-market rule in subsection 142.5(2) does not affect the loss that is used in the above formula. Where the taxpayer has acquired the share pursuant to an amalgamation (or certain other business reorganizations) the cost to the previous holder is used to measure the taxpayer's loss.

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

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

New subsection 112(5.3) provides that the adjustment made by subsection 112(5.2) to a taxpayer's proceeds of disposition of a share does not apply for the purpose of determining the cost of the share to the taxpayer on a deemed reacquisition of the share after a deemed disposition. This rule is relevant for those provisions that deem a taxpayer to have reacquired property at a cost equal to the taxpayer's proceeds of disposition on a deemed disposition of the property.

Deemed dispositions

ITA
112(5.4)

Generally, where a taxpayer is deemed to have disposed of a property and then reacquired it, the Act applies after the reacquisition as if the taxpayer had not previously owned the property. New subsection 112(5.4) contains certain exceptions to this principle for the purposes of subsections 112(5) to (5.2). Paragraph 112(5.4)(a) provides that the conditions in subsections 112(5) and (5.1) for determining whether the new stop-loss rule in subsection 112(5.2) applies to a disposition are to be applied without regard to any deemed dispositions and reacquisitions of the share before the disposition. Paragraph 112(5.4)(b) provides that the total amounts determined for the purpose of the formula in subsection 112(5.2) are to be measured from the time when the taxpayer actually acquired the share.

Stop-loss rules not applicable

ITA
112(5.5)

New subsection 112(5.5) provides that the existing stop-loss rules in subsections 112(3) to (4), (4.2) and (4.3) do not apply to a disposition of a mark-to-market property by a financial institution, nor to a disposition to which subsection 112(5.2) applies. The reason for the exclusion for dispositions to which subsection 112(5.2) applies is that the subsection can, in narrow circumstances, apply to dispositions by taxpayers that are not financial institutions. Subsection 112(5.5) applies to dispositions in taxation years beginning after October 1994.

Stop-loss rules restricted

ITA
112(5.6)

New subsection 112(5.6) provides that, in the case of certain dispositions, the holding of a share for less than 365 days does not cause the existing stop-loss rules in subsections 112(3) to (4), (4.2) and (4.3) to apply. Thus, the rules will apply only by virtue of the 5% share-ownership test.

Subsection 112(5.6) applies to the disposition of a share by a taxpayer in any of the following circumstances:

- the share is deemed by new subsection 142.5(2) (mark-to-market requirement) to be disposed of in a taxation year that includes October 31, 1994 - deemed dispositions in subsequent taxation years are excluded from the existing stop-loss rules by new subsection 112(5.5);

- the share is deemed by new paragraph 142.6(1)(b) to be disposed of as a result of the taxpayer becoming a financial institution after October 30, 1994; or

- the share was a mark-to-market property of the taxpayer for a taxation year beginning after October 1994 in which the taxpayer was a financial institution - the new rule in subsection 112(5.2) applies where a taxpayer that has ceased to be a financial institution disposes of a share that it held for less than 365 days if it held the share when it was a financial institution.

Subclause 56(8)

Definitions

ITA
112(6)

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

Clause 57

Insurance Corporations

ITA
138

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

Subclauses 57(1) and (2)

ITA
138(3)(b) and (d)

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

Paragraph 138(3)(b) is amended as it applies to taxation years that include February 22, 1994 to provide that it does not apply to dispositions after that date. In addition, the paragraph is repealed for taxation years beginning after February 22, 1994.
Paragraph 138(3)(d) is repealed for taxation years ending after February 22, 1994. New section 142.3 contains rules for determining the income to be recognized while a debt obligation is held, and new section 142.4 provides for the tax treatment of dispositions.

Subclauses 57(3) and (4)

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

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

Paragraph 138(4)(b) is amended as it applies to taxation years that include February 22, 1994 to provide that it does not apply to dispositions after that date. In addition, the paragraph is repealed for taxation years beginning after February 22, 1994. Paragraph 138(4)(c) is repealed for taxation years ending after February 22, 1994. New section 142.3 contains rules for determining the income to be recognized while a debt obligation is held, and new section 142.4 provides for the tax treatment of dispositions.

Subclause 57(5)

ITA
138(5.2)

Subsection 138(5.2) denies an insurer a deduction for a "superficial loss" sustained on the sale of a share or debt obligation that is not capital property. This subsection is repealed for dispositions occurring after October 30, 1994, except for the disposition of a debt obligation before July 1995 where the following conditions are satisfied:

- the disposition is part of a series of transactions or events that began before October 31, 1994,

- as part of that series, the taxpayer who acquired the obligation disposed of property before October 31, 1994, and

- the taxpayer's purpose in acquiring the obligation was to obtain a deduction because of income it has from the disposition of the property or because of a reduction in a balance of undeducted expenditures (such as its resource expenditure pools) resulting from the disposition.

Subclause 57(6)

ITA
138(10)

New subsection 138(10) applies to a resident multinational life insurer or a non-resident insurer. It provides that, in computing the income of such an insurer from carrying on an insurance business in Canada, the new financial institution rules in sections 142.3 and 142.5 apply to "property used by it in the year in, or held by it in the year in the course of" carrying on the business. Section 2400 of the Regulations contains rules for determining which properties are so used or held (the "designated properties"). Subsection 138(10) also provides that the rules in new section 142.4 for determining the tax consequences on the disposition of a debt obligation apply to debt obligations that were designated properties for the taxation year of disposition.

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

Subclause 57(7)

ITA
138(11)

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

February 22, 1994. As a consequence, subsection 138(11) is also repealed.

Subclauses 57(8) and (9)

ITA
138(11.3)

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

- property that was acquired for use in an insurance business in Canada begins to be used for another purpose, or vice versa; or

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

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

Subsection 138(11.3) is also amended to make its application subject to new subsection 138(11.31), which provides that subsection 138(11.3) does not apply to certain changes in use occurring in taxation years that begin after October 1994.

Subclause 57(10)

ITA
138(11.31)

New subsection 138(11.31) provides that subsection 138(11.3) does not apply to a change in use of property of an insurer where new subsection 142.5(2) (mark-to-market requirement) deems the property to have been disposed of at the end of the taxation year ending immediately before the change in use. The purpose of subsection 138(11.31) is to prevent two deemed dispositions of the same property from occurring, one immediately after the other. Subsection 138(11.31) applies to changes in use occurring in taxation years that begin after October 1994.

Subclause 57(11)

ITA
138(11.4)

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

Subclause 57(12)

ITA
138(11.41)

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

Subclauses 57(13) and (14)

ITA
138(11.5)

Subsection 138(11.5) contains rules which enable a non-resident insurer to transfer, on a rollover basis, an insurance business carried on in Canada to a qualified related corporation. These rules also apply, by virtue of subsection 138(11.94), to the transfer by a resident insurer of a Canadian insurance business to a subsidiary wholly-owned corporation. Paragraphs 138(11.5)(e) and (k) are amended, and new paragraphs 138(11.5)(k.1) and (k.2) are added, as described below.

ITA
138(11.5)(e)

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

Paragraph 138(11.5)(e) is amended to make it subject to new paragraph 138(11.5)(k.1), which contains continuity rules for specified debt obligations. This amendment is applicable to transfers of insurance businesses occurring after February 22, 1994.

ITA
138(11.5)(k)

Paragraph 138(11.5)(k) contains a continuity rule that provides that the transferee of the insurance business is considered, for the purposes of a number of provisions in the Act, to be the same person as, and a continuation of, the transferor in respect of the business, the transferred property and the transferred obligations.
Paragraph 138(11.5)(k) is amended to add new paragraphs 142.4(4)(c) and (d) and new subsections 142.5(5) and (7) as provisions for which the paragraph applies. Paragraphs 142.4(4)(c) and (d) provide for the spreading of all or part of gains and losses on the disposition of certain debt obligations. Subsections 142.5(5) and (7) contain transition rules that apply with respect to the commencement of the mark-to-market requirement for financial institutions.

Paragraph 138(11.5)(k) is also amended to delete the reference to section 33 of the former Income Tax Act. That section was repealed as part of the 1987 tax reform.

The amendments to paragraph 138(11.5)(k) apply with respect to transfers of insurance businesses after October 1994.

ITA
138(11.5)(k.1)

New paragraph 138(11.5)(k.1) applies where paragraph 138(11.5)(e) does not require subsection 85(1) to be applied in respect of the transfer of the insurance business. It deems the transferor not to have disposed of transferred property that is a specified debt obligation (other than a mark-to-market property), and it deems the transferee to be a continuation of the transferor in respect of such property. ("Mark-to-market property" and "specified debt obligation" are defined in new subsection 142.2(1).) This continuity is required so that the tax treatment of specified debt obligations under new sections 142.3 and 142.4 is not affected by the transfer. For further information, see the commentary on new subsection 142.6(5), which contains a similar continuity rule.

New paragraph 138(11.5)(k.1) applies with respect to transfers of insurance businesses after February 22, 1994.

ITA
138(11.5)(k.2)

New paragraph 138(11.5)(k.2) deems the transferee to be a continuation of the transferor for the purpose of new subsections 112(5) to (5.2) and (5.4) and the definition of "mark-to-market property" in new subsection 142.2(1).
Paragraph 138(11.5)(k.2) applies with respect to transfers of insurance businesses occurring at any time, including transfers that have occurred in the past.

Subsections 112(5) to (5.2) and (5.4) contain a stop-loss rule applicable where a financial institution has losses from the disposition of shares on which dividends have been received.
Paragraph 138(11.5)(k.2) ensures that the stop-loss rule applies in the same way to the transferee as it would have applied to the transferor had the business not been transferred. In particular, the transferee is considered to have acquired shares when they were acquired by the transferor, and the transferor is not considered to have disposed of the shares that have become property of the transferee. For example, dividends received by the transferor are taken into account in applying the rule to the transferee. Another example is that in

determining whether the transferee has held a share for 365 days, the period during which the share was held by the transferor is included.

The definition of "mark-to-market property" includes certain debt obligations that have always been accounted for on a mark-to-market basis for financial statement purposes. As a result of the continuity rule in paragraph 138(11.5)(k.2), the transferor's accounting for transferred debt obligations must be considered in determining whether the obligations are mark-to-market property of the transferee. (Because of the way that insurers account for debt obligations, it is expected that few, if any, of their obligations will be mark-to-market property.)

Subclauses 57(15) to (19)

ITA
138(12)

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

"Canada security"

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

"cost"

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

"gross investment revenue"

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

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

- Quantity E in the formula, which is currently defined to equal the total of the amounts included in income by subsections 12(3) and 20(14) (accrued interest on debt obligations), is amended so that it also includes the total of the amounts required by new paragraph 142.3(1)(a) to be included in computing income. Paragraph 142.3(1)(a) applies to specified debt obligations (as defined in new subsection 142.2(1)) held by financial institutions. Regulations made for the purpose of that paragraph will require a taxpayer's return from a specified debt obligation to be recognized on an accrual basis, taking into account the total economic return to the taxpayer. This change applies to taxation years that end after February 22, 1994.

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

Subclause 57(20)

ITA
138(13)

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

Clause 58

Financial institutions

ITA
142.2 to 142.6

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

- Section 142.2 defines several terms that are used in these sections (and in other provisions of the Act).

- Section 142.3 provides that the income from specified debt obligations is to be determined in accordance with rules set out in the Regulations.

- Section 142.4 sets out the rules for the measurement and timing of recognition of gains and losses from the disposition of specified debt obligations.

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

- Section 142.6 contains a number of additional rules that apply in various situations.

Interpretation

ITA
142.2

New section 142.2 of the Act contains interpretation provisions. Subsection 142.2(1) defines several terms for the purposes of sections 142.2 to 142.6. The definitions are also referenced in other provisions of the Act. Subsections 142.2(2) to (5) contain rules relating to the definition of "mark-to-market property" in subsection 142.2(1). Section 142.2 applies to taxation years that end after February 22, 1994.

Definitions

ITA
142.2(1)

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

"financial institution"

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

- a corporation referred to in any of paragraphs (a) to (e) of the definition of "restricted financial institution" in subsection 248(1) of the Act – a bank, a trust company, a credit union, an insurance corporation or a corporation whose principal business is any combination of the lending of money to, and the purchasing of debt obligations issued by, arm's length persons;

- an investment dealer;

- a corporation controlled by one or more financial institutions, unless the control was acquired because of the default of a debtor and control is being retained in order to minimize losses – for example, because there is no ready market for the shares;

- a trust or partnership if financial institutions hold interests totalling more than 50% of the fair market value of all interests.

It should be noted that where one trust (Trust A) is a beneficiary of another trust (Trust B), it is the status of Trust A, and not of its trustee, that determines whether the interest in Trust B is held by a financial institution.

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

- investment corporations, mortgage investment corporations and mutual fund corporations;

- deposit insurance corporations (as defined in subsection 137.1(5) of the Act);

- mutual fund trusts; and

- prescribed persons and partnerships.

"investment dealer"

An "investment dealer" is a corporation that is a registered securities dealer, as defined in subsection 248(1) of the Act. Under that new definition, a "registered securities dealer" is a person who is registered or licensed in a province to trade in securities without any restriction on the types or kinds of securities in which the person may trade.

"mark-to-market property"

A "mark-to-market property" for a taxation year of a taxpayer other than an investment dealer is a property that is a share or, depending on how it has been accounted for in the taxpayer's financial statements, a specified debt obligation. A specified debt obligation is a mark-to-market property for a particular taxation year if:

- it has been carried at fair market value in the taxpayer's financial statements for each taxation year ending after the obligation was acquired (including the particular year, if it is held at the end of the year), or

- the taxpayer acquired and sold the obligation in the particular year, and it is reasonable to expect that the obligation would have been carried at fair market value if it had been held at the end of the year.

However, there are two exceptions to this. A specified debt obligation is not a mark-to-market property if the only reason it is carried at fair market value is that its fair market value is less than its cost (i.e. it is being carried at the lower of cost or market value), or if it is carried at fair market value because the debtor is in default.

In the case of an investment dealer, a mark-to-market property is a property that is a share or a specified debt obligation.

Certain properties are excluded from being mark-to-market properties for a year. One exclusion is for shares of a corporation in which the taxpayer has a significant interest at any time in the year. New subsections 142.2(2) to (5) provide rules for determining when a significant interest exists.

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

- A qualified small business share. A share of a corporation will be a qualified small business share if, at the time the share is acquired,

  - the corporation is a Canadian-controlled private corporation, and an eligible corporation (as defined in subsection 5100(1) of the Regulations for the purposes of the deferred income plan rules);

  - the total assets of the corporation and all related corporations do not exceed $50 million; and

  - the corporation and all related corporations have no more than 500 employees.

- A preferred share held by a bank and reported as a substitute for a loan.

- A debt obligation held by a bank where the obligation is a debt of a country that has been designated by the Office of the Superintendent of Financial Institutions or is a United Mexican

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

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

"specified debt obligation"

A "specified debt obligation" of a taxpayer is the taxpayer's interest in a loan, bond, debenture, mortgage, note, agreement of sale or any other similar indebtedness, or in any debt obligation purchased by the taxpayer. However, it does not include an interest in an income bond, an income debenture, a small business development bond, a small business bond or a prescribed property. This definition would not include a taxpayer's interest in various derivative instruments such as interest rate and cross-currency swaps.

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

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

Significant interest in corporation

ITA
142.2(2) to (5)

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

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

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

- Paragraph 142.2(3)(a) provides that shares held by a person or partnership related to the taxpayer are to be considered to be held by the taxpayer.

- Under paragraph 142.2(3)(b), shares held by the taxpayer are to be disregarded if they were acquired because of the default of a debtor and are being retained in order to minimize losses. Consequently, such shares are not to be taken into account in determining whether the taxpayer is related to the corporation or holds more than 10% of the votes and value of the corporation.

- Paragraph 142.2(3)(c) provides that shares that are prescribed in respect of the taxpayer are to be disregarded. It is intended that certain preferred shares issued by a corporation in financial difficulty be prescribed. This will ensure, in particular, that a taxpayer does not cease to have a significant interest in a corporation because the corporation has, as a consequence of financial difficulty, issued preferred shares to its debtors.

Subsection 142.2(4) extends the concept of relatedness (as defined in section 251 of the Act) to partnerships and trusts for the purpose of determining whether a taxpayer has a significant interest in a corporation. It provides that the rules in section 251 are to be used to determine whether a person or partnership is related to any other person or partnership. For this purpose, all trusts and partnerships are considered to be corporations. Also, a trust is considered to be controlled by majority vote of its beneficiaries, with each beneficiary having a proportionate number of 100 votes based on the ratio of the fair market value of the beneficiary's interest to the total fair market value of all interests. (No one is considered to control a discretionary trust if the fair market value of all beneficial interests is nil.) For partnerships, control is to be determined based on all the facts.

Subsection 142.2(5) contains a transition rule that treats a significant interest as if it had been acquired sooner than it was actually acquired. The subsection applies where a taxpayer whose 1994 taxation year ends after October 30, 1994 held a share in a corporation on October 31, 1994 but did not have a significant interest in the corporations in the year. If the taxpayer acquires a significant interest in the corporation (as determined under subsection 142.2(2)) before May 1995, the taxpayer is considered to have had a significant interest in its 1994 taxation year.

Income from specified debt obligations

ITA
142.3

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

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

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

The regulations will provide for foreign currency denominated obligations to be translated to their Canadian dollar equivalent each year. Any foreign exchange gain or loss will be included in the amount prescribed for the purposes of paragraph 142.3(1)(a) or (b). Most financial institutions currently follow this mark-to-market approach for recognizing foreign exchange gains and losses in preparing their financial statements.

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

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

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

Disposition of specified debt obligations

ITA
142.4

New section 142.4 of the Act, which applies to financial institutions other than investment dealers, contains rules for the measurement and timing of recognition of gains and losses from the disposition of specified debt obligations (other than mark-to-market properties). The section applies to debt obligations disposed of after February 22, 1994.

Definitions

ITA
142.4(1)

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

"tax basis"

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

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

(a) the cost of the obligation to the taxpayer – this includes amounts advanced under a loan;

(b) amounts included under subsection 12(3) (accrual of interest), subsection 16(2) or (3) (discount bonds issued by governments and other tax exempts), or new paragraph 142.3(1)(a) (accrual rules for financial institutions) in computing the taxpayer's income for taxation years beginning before that time;

(c) if the taxpayer acquired the obligation at a discount in a taxation year ending before February 23, 1994, the amount of the discount that has been included in computing the taxpayer's income for taxation years ending before that date;

(d) if the taxpayer is a life insurer, amounts that were deemed by paragraph 142(3)(a) to be gains for taxation years ending before 1978;

(e) if the obligation is an indexed debt obligation, amounts determined under subparagraph 16(6)(a)(i) (inflation adjustments) that have been included in computing the taxpayer's income for taxation years beginning before that time;

(f) if the obligation is denominated in a foreign currency, amounts included in computing the taxpayer's income for taxation years ending at or before that time in respect of changes in the value of the obligation attributable to fluctuations in the value of the foreign currency (other than amounts that are taken into account in the tax basis because they are included under new paragraph 142.3(1)(a) in computing income);

(g) amounts included under paragraph 12(1)(i) (recovery of bad debts) in computing the taxpayer's income for taxation years beginning before that time; and

(h) if the obligation was a capital property of the taxpayer on February 22, 1994, amounts added under paragraphs 53(1)(f) and (f.1) (denied capital losses) in computing the taxpayer's adjusted cost base on that day;

minus the following amounts:

(i) amounts deducted under new paragraph 142.3(1)(b) in computing the taxpayer's income for taxation years beginning before that time;

(j) payments (other than proceeds of disposition) received by the taxpayer at or before that time in respect of amounts added to the tax basis of the obligation as described in (a) to (f);

(k) if the taxpayer acquired the obligation at a premium in a taxation year ending before February 23, 1994, the amount of the premium that has been deducted in computing the taxpayer's income for taxation years ending before that date;

(l) if the taxpayer is a life insurer, amounts that were deemed by paragraph 142(3)(b) to be losses for taxation years ending before 1978;

(m) amounts deducted under subsection 20(14) (interest accrued before acquisition) in computing the taxpayer's income for taxation years beginning before that time;

(n) if the obligation is an indexed debt obligation, amounts determined under subparagraph 16(6)(a)(ii) (adjustments for deflation) that have been deducted in computing the taxpayer's income for taxation years beginning before that time;

(o) if the obligation is denominated in a foreign currency, amounts deducted in computing the taxpayer's income for taxation years ending at or before that time in respect of changes in the value of the obligation attributable to fluctuations in the value of the foreign currency (other than amounts that are taken into account in the tax basis because they are deducted under new paragraph 142.3(1)(b) in computing income);

(p) amounts deducted under paragraph 20(1)(p) (bad debt deduction) in computing the taxpayer's income for taxation years beginning before that time; and

(q) if the obligation was a capital property of the taxpayer on February 22, 1994, amounts deducted under paragraphs 53(2)(b.2) and (g) (reduction of ACB on change of control and on debt forgiveness) in computing the taxpayer's adjusted cost base on that day.

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

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

"transition amount"

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

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

Scope of section

ITA
142.4(2)

Subsection 142.4(2) provides that section 142.4 applies to the disposition of a specified debt obligation by a financial institution, other than the disposition of a mark-to-market property. Because of the exclusion for mark-to-market property, section 142.4 has no application to investment dealers.

Rules applicable to disposition

ITA
142.4(3)

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

Inclusions and deductions re disposition

ITA
142.4(4)

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

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

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

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

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

Gain or loss not amortized

ITA
142.4(5)

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

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

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

- a disposition before 1995;

- a disposition after 1994 in connection with the transfer of all or part of a business; and

- a deemed disposition under paragraph 142.6(1)(c), which provides that a taxpayer that ceases to be a financial institution at any time is deemed to dispose of its specified debt obligations immediately before that time.

Gain or loss from disposition of obligation

ITA
142.4(6)

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

- the taxpayer's proceeds of disposition

minus

- the tax basis of the obligation to the taxpayer, and

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

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

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

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

Current amount

ITA
142.4(7)

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

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

- the taxpayer's transition amount in respect of the obligation – the transition amount is defined in subsection 142.4(1);

- if the taxpayer has a gain from the disposition, the part of the gain reasonably attributable to a material increase in the probability that the debtor will make all payments under the obligation; and

- if the taxpayer has a loss from the disposition, the negative amount claimed by the taxpayer not exceeding the part of the loss reasonably attributable to a default by the debtor or to a material decrease in the probability that the debtor will make all payments under the obligation.

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

Subsection 142.4(7) does not require a financial institution to treat credit-related losses as current amounts. For administrative ease, a financial institution may choose, for example, not to identify the credit-related component on dispositions of certain categories of debt obligations.

Residual portion of gain or loss

ITA
142.4(8)

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

Disposition of part of obligation

ITA
142.4(9)

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

Mark-to-market properties

ITA
142.5

New section 142.5 of the Act requires shares and certain debt obligations to be marked to market each year, and puts the profit or loss on income account. It also contains transition rules for the introduction of the mark-to-market requirement. Section 142.5 applies to taxation years that end after October 30, 1994, except for the requirement to treat profits and losses on income account, which applies to dispositions in taxation years beginning after October 1994.

Income treatment for profits and losses

ITA
142.5(1)

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

Subsection 142.5(1) applies to dispositions in taxation years beginning after October 1994.

Mark-to-market requirement

ITA
142.5(2)

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

Subsection 142.5(2) initially applies at the end of a financial institution's first taxation year ending after October 30, 1994. Since subsection 142.5(1) does not commence to apply until the following taxation year, the treatment of profits and losses from the initial deemed disposition will be determined under the existing rules. Transition measures in subsections 142.5(4) to (7) apply to those profits and losses.

Mark-to-market debt obligation

ITA
142.5(3)

Subsection 142.5(3) contains rules that apply, in taxation years beginning after October 1994, to specified debt obligations that are mark-to-market property. These rules ensure that the treatment of interest on such obligations is consistent with the mark-to-market approach for recognizing changes in value.

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

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

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

EXAMPLE

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

Results:

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

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

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

Transition - deduction re non-capital amounts

ITA
142.5(4)

Subsection 142.5(4) is a transition rule for non-capital property that is deemed to be disposed of on the initial application of the mark-to-market requirement. This subsection allows a financial institution to deduct an amount not exceeding a prescribed amount in its taxation year that includes October 31, 1994. Subsection 142.5(5), in conjunction with the regulations under that provision, includes the deducted amount in income over a 5-year period starting in the taxation year that includes October 31, 1994.

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

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

minus

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

- the financial institution's net losses (i.e., losses minus profits) from actual dispositions in the year of non-capital mark-to-market properties (other than properties described below).

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

Transition - inclusion re non-capital amounts

ITA
142.5(5)

Subsection 142.5(5) applies to a financial institution that has claimed a transition deduction under subsection 142.5(4). It requires a prescribed portion of the deducted amount to be included in income in each taxation year starting with the year that includes October 31, 1994. Regulations for the purpose of subsection 142.5(5) will prorate the deducted amount over a 5-year period starting at the beginning of the taxation year that includes October 31, 1994. The amount allocated to the days in a particular taxation year will be the prescribed portion for that year.

Transition - deduction re net capital gains

ITA
142.5(6)

Subsection 142.5(6) is a transition rule for capital property that is deemed to be disposed of on the initial application of the mark-to-market requirement. This subsection permits a financial institution to claim, for its taxation year that includes October 31, 1994, an allowable capital loss not exceeding a prescribed amount. Subsection 142.5(7), in conjunction with the regulations under that provision, require an equivalent amount of taxable capital gains to be recognized over a 5-year period starting in the taxation year that includes October 31, 1994.

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

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

minus

- the financial institution's total allowable capital losses from the disposition of mark-to-market properties that subsection 142.5(2) deems the taxpayer to dispose of in the year, and

- the financial institution's net allowable capital losses (i.e., allowable capital losses minus taxable capital gains) from actual dispositions in the year of mark-to-market properties.

Subsection 142.5(6) allows a financial institution to elect the amount of allowable capital loss that it is claiming under that subsection. An election should be made by including a letter with the financial institution's tax return for its taxation year that includes October 31, 1994 stating the amount of allowable capital loss elected under the subsection.

Transition - inclusion re net capital gains

ITA
142.5(7)

Subsection 142.5(7) applies to a financial institution that has elected to claim an allowable capital loss under subsection 142.5(6) for its taxation year that includes October 31, 1994. Subsection 142.5(7) deems the financial institution to have a taxable capital gain for that year and for subsequent years equal to the portion of the elected amount prescribed for the year. Regulations for the purpose of subsection 142.5(7) will prorate the elected amount over a 5-year period starting at the beginning of the taxation year that includes October 31, 1994. The amount allocated to the days in a particular taxation year will be the prescribed portion for that year.

First deemed disposition of debt obligation

ITA
142.5(8)

Subsection 142.5(8) contains rules that apply on the initial deemed disposition under subsection 142.5(2) of a mark-to-market property that is a specified debt obligation, where the disposition occurs in the financial institution's taxation year that includes October 31, 1994. The rules in subsection 142.5(8) also apply on a disposition of such property where the disposition is deemed to occur by paragraph 142.6(1)(b) (deemed disposition when a taxpayer becomes a financial institution).

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

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

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

Transition - property acquired on rollover

ITA
142.5(9)

Subsection 142.5(9) provides grandfathering treatment with respect to the accrued gains on certain mark-to-market property that a financial institution has acquired on a rollover basis. More specifically, the subsection applies with respect to a property that a taxpayer is deemed by subsection 142.5(2) to dispose of in its taxation year that includes October 31, 1994 where the following conditions are satisfied:

- the taxpayer acquired the property before October 31, 1994 at a cost less than its fair market value at the time of acquisition;

- the property was acquired, directly or indirectly, from a person that was never a financial institution (assuming that the definition of financial institution in subsection 142.2(1) had always been applicable); and

- the reason for the difference between the cost and the fair market value when the property was acquired by the taxpayer is that subsection 85(1) applied in respect of the transfer of the property by that other person.

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

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

Additional rules

ITA
142.6

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

- Subsection 142.6(1) provides for the deemed disposition of property and for a deemed taxation year end when a taxpayer becomes or ceases to be a financial institution.

- Subsection 142.6(2) provides that deemed dispositions of shares are to be disregarded for certain purposes.

- Subsection 142.6(3) excludes specified debt obligations and mark-to-market property from the tax rules for inventory.

- Subsection 142.6(4) contains rules that apply with respect to specified debt obligations (other than mark-to-market property) that were inventory in a financial institution's most recent taxation year ending before February 23, 1994.

- Subsections 142.6(5) and (6) provide a continuity rule for specified debt obligations (other than mark-to-market property) that have been acquired in various rollover transactions occurring before February 23, 1994.

- Subsection 142.6(7) excludes certain property from the superficial loss rule in subsection 18(13).

Becoming or ceasing to be a financial institution

ITA
142.6(1)

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

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

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

However, if the change of status occurs before October 31, 1994, the deemed disposition does not apply to mark-to-market properties.

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

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

Deemed disposition not applicable

ITA
142.6(2)

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

Property not inventory

ITA
142.6(3)

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

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

Property that ceases to be inventory

ITA
142.6(4)

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

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

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

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

Debt obligations acquired in rollover transactions

ITA
142.6(5) and (6)

Under the new rules for specified debt obligations held by financial institutions, amounts to be included or deducted in respect of an obligation in computing income may depend on factors such as when the obligation was acquired, its cost to the financial institution and whether the financial institution was amortizing premiums and discounts before the introduction of the new rules. For example, the accrual rules that will be prescribed under subsection 142.3(1) will require an acquisition discount or premium to be amortized from the date of acquisition, and the transition amount that is determined by regulation for the purpose of the disposition rules in section 142.4 will depend on how the taxpayer treated premiums and discounts before the new rules applied.

It is intended that certain rollover transactions not affect the amounts to be included or deducted in respect of specified debt obligations in computing income. To achieve this result, it is necessary to have continuity rules that treat the taxpayer who acquires an obligation as the same person as the previous holder.

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

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

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

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

Superficial loss rule not applicable

ITA
142.6(7)

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

Subsection 142.6(7) applies to dispositions of property after October 30, 1994. However, it does not apply to the disposition of a specified debt obligation before July 1995 where the following conditions are satisfied:

- the disposition is part of a series of transactions or events that began before October 31, 1994,

- as part of that series, the taxpayer who acquired the obligation disposed of property before October 31, 1994, and

- the taxpayer's purpose in acquiring the obligation was to obtain a deduction because of income it has from the disposition of the property or because of a reduction in a balance of undeducted expenditures (such as its resource expenditure pools) resulting from the disposition.

Clause 59

Definitions

ITA
248(1)

Subclauses 59(1) and (2)

"amortized cost"

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

Subclauses 59(3), (4) and (5)

"cost amount"

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

New paragraph (c.1) provides that where a taxpayer is a financial institution, the cost amount at any time of a mark-to-market property is the cost of the property to the taxpayer. This paragraph applies to taxation years that begin after October 1994.

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

New paragraph (d.2) provides that where a taxpayer is a financial institution, the cost amount at any time of a specified debt obligation (other than a mark-to-market property) is the tax basis of the property to the taxpayer at that time. "Tax basis" is defined in new subsection 142.4(1).

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

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

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

Clause 60

Year-end on change of control

ITA
249(4)(c)

Where control of a corporation is acquired at any time, subsection 249(4) treats the corporation as having a taxation year-end immediately before that time. Where the corporation's preceding taxation year ended within 7 days of that time, paragraph 249(4)(c) allows the corporation to elect to extend that year so that it ends immediately before the acquisition of control. This election is not available in certain circumstances. The amendment to paragraph 249(4)(c) provides that a corporation may not elect to extend a taxation year that has ended because of new paragraph 142.6(1)(a). That paragraph deems a taxation year to end immediately before the time at which a taxpayer becomes, or ceases to be, a financial institution (as defined in new subsection 142.2(1)), where this change of status occurs after February 22, 1994.

PART IV

Eligible Funeral Arrangements

Part IV of this bill, which is composed of clauses 61 to 65, contains amendments to the *Income Tax Act* relating to the measures on eligible funeral arrangements, which were announced by the Minister of Finance on October 21, 1994.

Reference may also be made to clause 76 of Part IX of the bill and the related explanatory note, as this clause also contains an amendment pertaining to this measure.

Clause 61

Trusts - definitions

ITA
108(1)

"trust"

A "trust" is defined in subsection 108(1) of the Act, for the purposes of the 21-year deemed disposition rule and other specified measures, to exclude certain listed tax-exempt trusts and certain other trusts.

Paragraph (e.1) of the definition is introduced to add to that list a trust governed by an "eligible funeral arrangement", as defined in new subsection 148.1(1).

This amendment applies to the 1993 and subsequent taxation years.

Clause 62

Eligible funeral arrangements

ITA
148.1

New section 148.1 of the Act is introduced, in conjunction with new paragraph 149(1)(s.1), to allow for a tax-free build-up of income earned on contributions made under "eligible funeral arrangements". Such arrangements provide for the pre-funding of expenses with respect to funeral, burial, cremation or cemetery arrangements. It is intended that any amount paid under such arrangements for the provision of such services is recognized only in computing the income of the funeral director or other person providing such services.

Subsection 148.1(1) of the Act defines a number of expressions used in section 148.1.

The key definition is "eligible funeral arrangement". It is defined as an arrangement established for the purpose of funding "funeral services" for one or more individuals by a "qualifying person" and of which there is a "custodian", provided that

- each custodian was resident in Canada at the time the arrangement was established,

- each contribution under the arrangement was made for the purpose of funding funeral services to be provided by a qualifying person with respect to an individual, and

- the total "relevant contributions" to which have never exceeded $15,000 per individual.

A "custodian" of an arrangement is the trustee of any trust governed by the arrangement or, if a trust is not involved, a qualifying person who receives a deposit under the arrangement for the provision of the funeral services.

"Funeral services" means any property or services that relate directly to funeral, burial, cremation or cemetery arrangements in Canada in consequence of the death of an individual.

A "qualifying person" is any person licensed or authorized under the laws of a province to provide funeral services for individuals.

A "relevant contribution" to a particular arrangement is the amount of any contribution that is not made by way of a transfer from another eligible funeral arrangement or the amount of any other contribution made directly to another eligible funeral arrangement that can reasonably be considered to have been transferred into the particular arrangement.

Subsection 148.1(2) provides for the tax-free build-up of amounts (typically interest) accruing, added or credited in connection with an eligible funeral arrangement. The measure applies notwithstanding any other provisions in the Act.

Subsection 148.1(2) also provides that no amount is to be included in computing a person's income from property by reason of the provision by another person of funeral services pursuant to an eligible funeral arrangement. (The provider of such service would include amounts received under the arrangement in computing business income.) In addition, the disposition of an interest in an eligible funeral arrangement or a trust governed by such an arrangement is considered not to give rise to income for tax purposes. However, this latter provision does not affect the income tax consequences resulting from the dispositions of rights to payment under eligible funeral arrangements for the provision of funeral services.

Subsection 148.1(3) provides for an income inclusion in the event that there is a return of funds from an eligible funeral arrangement. The income inclusion does not apply, as more fully explained below, to the extent that the return of funds is a return of contributions.

More specifically, subsection 148.1(3) applies if

- an amount is distributed (otherwise than as payment for the provision of funeral services with respect to an individual) to a taxpayer from an eligible funeral arrangement, and

- the distributed amount is paid from the balance in respect of the individual.

Where this is the case, the lesser of the distributed amount and a second amount is added in computing the recipient's income. The second amount in respect of an eligible arrangement is determined as follows:

- ADD the balance, immediately before the amount was distributed, under the arrangement in respect of the individual from whose account the particular amount was distributed;

- ADD the total of all previous payments made from the particular arrangement for the provision of funeral services with respect to that individual; and

- SUBTRACT the total "relevant contributions" in respect of the individual, as described in the commentary above.

These amendments apply to the 1993 and subsequent taxation years.

The following examples illustrate the operation of subsection 148.1(3).

Example 1

A pre-paid funeral arrangement was made for Mr. A. Mr. A contributed $8,000 under the arrangement. The fund grew to $10,000 before Mr. A's death, but payments for funeral expenses from the arrangement amounted only to $9,400. There is a refund of $600 to Mr. A's estate.

Result:

Under subsection 148.1(3), the amount included in the income of Mr. A's estate is $600, which is the lesser of:

- *$600 (the amount of the refund), and*

- *$2,000 ($600 balance immediately before refund plus $9,400 payments for funeral expenses minus $8,000 contributions).*

Example 2

A pre-paid funeral arrangement was made for Ms. B. Ms. B made contributions of $4,000 which grew to $4,500. The arrangement was cancelled. Ms. B received back $4,400, as a $100 cancellation fee was charged.

Result:

Under subsection 148.1(3), the amount included in Ms. B's income is $400, which is the lesser of:

- *$4,400 (the amount of the refund), and*
- *$400 (the balance before the refund of $4,400 minus contributions of $4,000).*

Clause 63

Exemption from tax

ITA
149(1)(s.1)

New paragraph 149(1)(s.1) of the Act provides an exemption for a trust from income tax while the trust is an "eligible funeral arrangement". This expression is newly defined in subsection 148.1(1), as described in the commentary above.

This amendment applies to the 1993 and subsequent taxation years.

Clause 64

Non-resident withholding tax

ITA
212(1)(v) and (13)(e)

New paragraph 212(1)(v) of the Act provides for Part XIII non-resident withholding tax on payments from the custodian of an "eligible funeral arrangement", to the extent that those payments would have been included in the recipient's income under Part I of the Act if the recipient had been resident in Canada. Reference may be made to the commentary on new subsection 148.1(3) and the new definitions of "custodian" and "eligible funeral arrangement" in subsection 148.1(1).

Paragraph 212(13)(e) is amended to ensure that there is an obligation to withhold Part XIII tax in the case where a custodian of an eligible funeral arrangement has become non-resident after the arrangement was established.

These amendments apply to payments made after October 21, 1994.

Clause 65

Definitions

ITA
248(1)

"eligible funeral arrangement"

Subsection 248(1) of the Act is amended to introduce the definition "eligible funeral arrangement". For further information, see the commentary on the definition in new subsection 148.1(1).

This amendment applies after 1992.

PART V

Part V of this bill, which is composed of clauses 66 to 68, contains amendments to the *Income Tax Act* relating to the measures on real estate investment trusts, which were announced by the Minister of Finance on May 27, 1994.

Clause 66

Definition of unit trust

ITA
108(2)

Subsection 108(2) of the *Income Tax Act* defines the expression "unit trust". Under paragraph 108(2)(b), a trust qualifies as a unit trust if at least 80% of its property consists of specified property (not including real property) and other conditions are satisfied. One of these conditions is that the sole undertaking of the trust is the investing of its funds.

A trust must qualify as a "unit trust" in order to meet the conditions for qualifying as a "mutual fund trust" under subsection 132(6). Status as a unit trust or a mutual fund trust is relevant for a number of purposes, including paragraph 4900(1)(d) of the Income Tax Regulations under which mutual fund trust units are qualified investments for RRSPs, registered retirement income funds and deferred profit sharing plans. In addition, mutual fund trusts are exempted from Part XII.2 of Act in connection with distributions to non-resident and tax-exempt beneficiaries.

Paragraph 108(2)(b) is amended to allow the specified property for a unit trust to include real property situated in Canada.

Paragraph 108(2)(b) is also amended to provide that units of a trust to which the above amendment is applicable must be listed on a prescribed stock exchange in Canada in order for the trust to qualify as a unit trust. (Stock exchanges listed in section 3200 of the *Income Tax Regulations* will be prescribed for this purpose.)

Paragraph 108(2)(b) is also amended to ensure that the acquiring, holding, maintaining, improving, leasing or managing of real property will not disqualify the trust as a unit trust, where that property is capital property of the trust.

These amendments apply to the 1994 and subsequent taxation years.

Clause 67

Definition of mutual fund corporation

ITA
131(8)(b)

Subsection 131(8) of the Act sets out the definition of a "mutual fund corporation".

The definition is amended to ensure that the acquiring, holding, maintaining, improving, leasing or managing of real property will not disqualify the corporation as a mutual fund corporation, where that property is capital property of the corporation. This amendment is consistent with similar amendments to paragraphs 108(2)(b) and 132(6)(b).

This amendment applies to the 1994 and subsequent taxation years.

Clause 68

Definition of mutual fund trust

ITA
132(6)(b)

Subsection 132(6) of the Act sets out the definition of a "mutual fund trust".

The definition is amended to ensure that the acquiring, holding, maintaining, improving, leasing or managing of real property will not disqualify a trust as a mutual fund trust, where that property is capital property of the trust. This amendment is consistent with similar amendments to paragraphs 108(2)(b) and 131(8)(b).

This amendment applies to the 1994 and subsequent taxation years.

PART VI

Mutual Fund Reorganizations

Part VI of this bill, which is composed of clause 69, contains amendments to the *Income Tax Act* relating to the measures on mutual fund reorganizations, which were announced by the Minister of Finance on July 21, 1994.

Reference may also be made to clause 77 of Part IX of the bill and the related explanatory note, as this clause also contains an amendment pertaining to this measure.

Clause 69

Mutual funds – qualifying exchange

ITA
132.2

New section 132.2 of the Act provides a means, referred to as a "qualifying exchange", for one mutual fund to transfer its property to another on a tax-deferred or "rollover" basis, while its unitholders (or shareholders) in turn roll their units or shares over for units of the transferee fund. A qualifying exchange may thus facilitate the integration of two existing mutual funds. New section 132.2 applies after June 1994.

Tax effects of qualifying exchange

ITA
132.2(1)

New subsection 132.2(1) of the Act details the tax effects of a qualifying exchange. Those effects relate chiefly to the property transferred on the exchange – both the mutual fund property itself and the shares and units of the investors in the transferor fund. Subsection 132.2(1) also provides for a deemed year end, ensures the carryover of certain of the transferor fund's tax attributes, and restricts the use that may be made of realized and accrued losses following a qualifying exchange.

Timing and year-ends

A qualifying exchange is a series of transactions that begins with the disposition by a mutual fund corporation or a mutual fund trust (the transferor) to a mutual fund trust (the transferee) of all or substantially all of the transferor's property. Immediately after the "transfer time" at which that disposition takes place, other fund properties are deemed to have been disposed of and reacquired, and certain other adjustments are made, as outlined below in the description of paragraphs 132.2(1)(f) and (g). Immediately after that – and thus two moments after the transfer time – is the "acquisition time". The property disposed of by the transferor to the transferee is deemed, under paragraph 132.2(1)(a), not to have been acquired by the transferee until the acquisition time.

Paragraph 132.2(1)(b) provides that the taxation years of both the transferor and the transferee fund are treated as having ended at the acquisition time, with the funds' next years beginning immediately thereafter. Paragraph 132.2(1)(o) provides an exception to this rule: where the transferor is a corporation, the transferor's year is deemed for the purposes of Part I.3 of the Act to have ended immediately before the transfer time.

Disposition of transferor's property to transferee

In a property-by-property election similar to the one provided under section 85 of the Act for rollovers to taxable Canadian corporations, paragraph 132.2(1)(c) establishes both the transferor's proceeds of disposition of each of the properties it has disposed of to the transferee, and the transferee's cost of each property. The general result of the provision is to allow the transferor to avoid the realization of any accrued gain on the property, while requiring it to realize any loss. This is accomplished, as in section 85, by allowing the funds to elect the transferor's proceeds of disposition and the transferee's cost of each transferred property, subject to certain limits. The elected proceeds and cost in respect of any property must be no greater than the property's fair market value, but no less than the greater of, first, the fair market value of any "boot", or consideration other than units of the transferee, taken back by the transferor and, second, the property's cost amount (or, in the case of a depreciable property, the lesser of its capital cost and its cost amount) to the transferor.

Paragraph 132.2(1)(d) applies where the capital cost to the transferor of a depreciable property transferred on a qualifying exchange exceeds the transferor's proceeds of disposition of the property. To ensure that the transferee, on its eventual disposition of the property, is subject to the recapture of any excess capital cost allowance claimed by the transferor, paragraph 132.2(1)(d) deems the property's capital cost to the transferee to be the same as its capital cost to the transferor, and treats the excess as having been allowed to the transferee as capital cost allowance. This provision may be compared to subsection 85(5) of the Act.

Where two or more depreciable properties of the same class are disposed of, paragraph 132.2(1)(e) provides that paragraph 132.2(1)(c) will apply to the properties in the order designated by the transferor in the funds' election to carry out a qualifying exchange. If the transferor does not designate an order, paragraph 132.2(1)(c) will apply in the order designated by the Minister of National Revenue. This rule, which is similar to the rule in paragraph 85(1)(e.1) of the Act, may prevent inappropriate results in the measurement of depreciable properties' cost amounts.

Deemed dispositions of other property

In addition to the actual disposition that forms the basis of a qualifying exchange, subsection 132.2(1) includes a deemed disposition intended to realize any latent losses on the funds' other property. Specifically, paragraph 132.2(1)(f) treats the funds as having disposed of immediately before the acquisition time, and reacquired at that same time, all of their property, with two exceptions. The first exception is depreciable property of a prescribed class to which paragraph 132.2(1)(g) would apply – that is, a class carrying a latent terminal loss. The second exception is property actually disposed of by the transferor to the transferee. Since a qualifying exchange requires the transferor to have disposed of all or substantially all of its property, the deemed disposition in paragraph 132.2(1)(f) will usually be more significant for the transferee fund than for the transferor.

In respect of each property to which they apply, the paragraph 132.2(1)(f) deemed disposition and reacquisition take place at a value equal to the lesser of (1) the property's fair market value at the transfer time, and (2) the greater of its cost amount (or, if depreciable property, the lesser of its capital cost and its cost amount) at that time and a designated amount. The effect of this valuation is that any accrued losses (other than terminal losses) are realized, while accrued gains may or may not be realized as well, as the fund chooses.

Realization of terminal losses

Paragraph 132.2(1)(g) effectively requires that any latent terminal loss be realized as well. The provision applies where the transferee (or the transferor, after its disposition to the transferee) has depreciable property of a prescribed class with an undepreciated capital cost (UCC) that exceeds the total of its fair market value and the capital cost allowance or terminal loss otherwise deductible in respect of that class for the taxation year that includes the transfer time. The excess UCC in such a case is deducted in computing the fund's income for that year, as deemed capital cost allowance. Since paragraph 132.2(1)(g) measures UCC immediately before the acquisition time, property disposed of by the transferor to the transferee in the qualifying exchange will not figure in that measurement in respect of either fund.

Transferor's cost of property taken back

Paragraph 132.2(1)(h) fixes the transferor fund's cost of property received from the transferee fund as consideration on a qualified exchange. It is expected that in most instances the only property taken back will be units of the transferee, which are deemed by subparagraph 132.2(1)(h)(i) to have a cost of nil. Where any other property ("boot") is taken in consideration, that property's cost to the transferor is deemed to be its fair market value at the transfer time.

Exchange of investors' shares or units

Under the definition of "qualifying exchange" in subsection 132.2(2), all or substantially all of the outstanding shares or units issued by the transferor must be disposed of to the transfer or within the 60 days after the transfer time, and every person so disposing of shares or units of the transferor must receive only units of the transferee as consideration. The second leg of a qualifying exchange is thus a set of transactions in which the transferor's investors replace their shares or units of the transferor with units of the transferee. The tax effects of those transactions are governed by paragraphs 132.2(1)(i) and (j). For clarity, these notes reflect the legislation by referring to investments in the transferor – whether a corporation or a trust – as shares, reserving the term "units" to refer to the units of the transferee mutual fund trust.

If, within 60 days after the transfer time, the transferor fund disposes of units of the transferee in exchange for shares of itself, paragraph 132.2(1)(i) deems its proceeds of disposition to be nil. Since the units acquired by the transferor in return for its property are deemed under paragraph (h) also to have had a cost of nil, this provision allows the transferor to roll those units out to its investors with no tax consequence to it. Nor will the transferor's investors realize any gain or loss on their exchange of their shares for units of the transferee. Subparagraph 132.2(1)(j)(i) provides that where a taxpayer disposes of shares of the transferor in exchange for units of the transferee within that same 60 - day period, both the taxpayer's proceeds of disposition of the shares and the taxpayer's cost of the units is deemed to be equal to the cost amount of the shares immediately before the transfer time.

Under section 39.1 of the Act, an individual investor in a mutual fund may have an "exempt capital gains balance" in respect of the fund. This balance represents a capital gain recognized on a deemed disposition under subsection 110.6(19) of the Act, and may be used to shelter later gains. Subparagraph 132.2(1)(j)(ii) provides that on a qualifying exchange, an investor's exempt capital gains balance in respect of the transferor mutual fund is carried over to the investor's interest in the transferee fund. Provided the investor uses the qualifying exchange to dispose of all of the investor's shares in the transferor, subparagraph 132.2(1)(j)(ii) deems the transferee fund to be the same entity as the transferor for the purposes of section 39.1.

Qualified investments

Paragraph 132.2(1)(k) ensures that a qualifying exchange will not cause shares of the transferor fund to cease to be qualified investments for trusts governed by registered retirement savings plans, registered retirement income funds and deferred profit sharing plans. Under paragraph 132.2(1)(k), a share of the transferor that would but for the qualifying exchange be a qualified investment will be deemed to be a qualified investment until either it is disposed of to the transferee in accordance with paragraph 132.2(1)(j), or 60 days have passed since the transfer time.

Carryover of RCGTOH

Under subsections 131(2) and 132(1) of the Act, the tax paid by a mutual fund on its taxable capital gains may be refunded to the fund as its investors redeem their shares or units or, in the case of a mutual fund corporation, as it distributes the gains to its shareholders in the form of capital gains dividends. Until it is refunded, this tax is accumulated in a notional account known as the mutual fund's "refundable capital gains tax on hand" (RCGTOH). After a qualifying exchange, the transferor fund's remaining RCGTOH is added to the RCGTOH of the transferee, where it will be available for refund on the redemption of units of the transferee. More specifically, paragraph 132.2(1)(l) provides an addition to the transferee's RCGTOH, for its taxation years beginning after the transfer time, equal to any amount by which the transferor's RCGTOH at the end of its taxation year that includes the transfer time exceeds its capital gains refund for that year.

Loss restriction

Paragraph 132.2(1)(m) provides that where a fund takes part in a qualifying exchange, its losses for taxation years that began before the transfer time may not be deducted in computing its taxable income for any taxation year beginning after the transfer time.

Status of funds after qualifying exchange

Section 132.1 of the Act provides a mechanism by which a mutual fund trust may ensure an appropriate matching of unitholders' benefits from the fund – including distributions and, before 1988, capital cost allowance – and tax liabilities. In broad terms, this mechanism consists of a designation by the trust of an amount as income for a unitholder and a deduction for the trust. A section 132.1 designation by the fund may also increase the unitholder's adjusted cost base (ACB) of the unit, under subsection 132.1(2). New paragraph 132.2(1)(n) provides that for the purposes of section 132.1, the transferee mutual fund in a qualifying exchange is to be treated as the same trust as, and a continuation of, the transferor. The one exception to this treatment is with respect to the subsection 132.1(2) ACB increase, which will operate appropriately in any event.

Where the transferor fund in a qualifying exchange is a corporation, it may be liable to the Large Corporations Tax (LCT) imposed under Part I.3 of the Act. Under Part I.3, a corporation's taxable capital for a taxation year is generally based on its capital at the end of the year. In order to measure the capital of the transferor fund appropriately, paragraph 132.2(1)(o) treats the taxation year that ends at the acquisition time as having ended immediately before the transfer time. It should be noted that this deemed year end applies only for purposes of Part I.3, and does not affect the determination of, for example, the transferor's Canadian surtax payable for the year.

Once a qualifying exchange is accomplished, the transferor will no longer be treated as either a mutual fund corporation or a mutual fund trust. This change in the transferor's status, which is provided under paragraph 132.2(1)(p), applies as of the start of its first taxation year beginning after the transfer time.

Definitions

ITA
132.2(2)

New subsection 132.2(2) of the Act defines certain terms for the purposes of new section 132.2.

"qualifying exchange"

Four criteria must be satisfied for a qualifying exchange to take place. First, the transferor mutual fund (which may be a mutual fund corporation or a mutual fund trust) must transfer all or substantially all of its property to a mutual fund trust at a particular time (the "transfer time). Second, all or substantially all of the shares of the transferor that were outstanding immediately before the transfer time must be disposed of to the transfer or within the 60-day period following the transfer time. Third, the only consideration provided for those shares must be units of the transferee. Finally, the transferor and the transferee must jointly elect to have section 132.2 apply to the transfer. The funds' election, which must be made in a prescribed form filed with the Minister of National Revenue, will include a listing of the amounts elected as the transferor's proceeds of disposition and the transferee's cost of each transferred property, under paragraph 132.2(1)(c). The election may also include a designation by the transferor of the order in which depreciable properties of a given class are to be considered to have been disposed of, under paragraph 132.2(1)(e). In the normal course, a qualifying exchange election must be made within 6 months after the transfer time. An election will, however, be treated as having been made in a timely manner if it is made before the end of the sixth month ending after the month in which legislation enacting new section 132.2 receives Royal Assent.

"share"

For greater clarity, new section 132.2 uses the term "share" to refer to units or shares of the transferor mutual fund on a qualifying exchange, and the term "unit" to refer to units of the transferee fund. The word "share" is therefore defined in subsection 132.2(2) to mean both a share of the capital stock of a mutual fund corporation and a unit of a mutual fund trust.

PART VII

Objections and Appeals

Part VII of this bill, which is composed of clauses 70 and 71, contains amendments to the *Income Tax Act* relating to the measures on income tax objections and appeals, which were announced by the Minister of Finance on September 26, 1994 and December 8, 1994.

Clause 70

Objections to assessments and determinations

ITA
165

Section 165 of the Act provides rules governing a taxpayer's right to object to an assessment or determination by the Minister of National Revenue of tax, interest, penalties and certain other amounts under the Act.

New subsection 165(1.11) requires large corporations to reasonably describe the issues under dispute, to specify the amount of relief sought in respect of each issue, and to provide facts and reasons in support of the objection. In addition, under new subsections 165(1.13) and (1.14) only those issues and related relief set out in a valid notice of objection may be the subject of a further objection or an appeal taken before the courts. New issues raised by Revenue Canada on a subsequent reassessment may be the subject of a separate objection, which will itself be required to satisfy the new requirements in section 165 of the Act.

These new provisions generally apply after September 26, 1994 to notices of objection filed at any time, except that these new provisions will not apply to any assessment or reassessment where an appeal to a court has been instituted on or before the day these new provisions receive Royal Assent.

ITA
165(1.11)

New subsection 165(1.11) provides a number of requirements for notices of objection served by large corporations. A corporation's notice of objection must comply with the requirements if the objection is from an assessment of a taxation year in which the corporation is a large corporation within the meaning of subsection 225.1(8) of the Act. Under that provision, a corporation is a large corporation in a particular taxation year if tax under Part I.3 is payable by it for the particular year or if, at the end of the year, it is related to a corporation that is itself a large corporation.

Paragraph 165(1.11)(a) states that a corporation must reasonably describe each issue which is to be decided.

Paragraph 165(1.11)(b) requires a notice of objection to specify the relief sought by the taxpayer in respect of each issue in the notice. The relief sought may be expressed as a change in a "balance" of the taxpayer as defined in subsection 152(4.4), which includes references to a taxpayer's income, taxable income, taxable income earned in Canada, loss for the year, or the tax or any amount payable by the taxpayer for the year. The relief sought may also be expressed as a change in a balance of undeducted outlays, expenses or other amounts of the taxpayer. This provision is not intended to require a taxpayer to calculate all of the potential effects that interdependent or related issues may have on each other, but only that the relief sought in respect of a particular issue be quantified in isolation of any other issues raised in a notice of objection.

Paragraph 165(1.11)(c) requires a notice of objection to include a statement of facts and reasons in support of each issue. While a notice should set out the basis for a taxpayer's objection, it is not intended that notices contain all the possible facts or reasons which could be relied upon by a taxpayer. Additional facts or reasons may be raised by a taxpayer subsequent to the filing of a notice of objection.

Any notice of objection served before 1995 may be revised to meet the new requirements if the taxpayer submits the required information to a Chief of Appeals in a district office or taxation centre of the Department of National Revenue before March 1995.

ITA
165(1.12)

New subsection 165(1.12) allows the Minister of National Revenue to request the taxpayer to specify the required information with respect to an issue where it was not specified in the notice of objection. If the taxpayer specifies the information in writing within 60 days of the request, it will be treated as having been specified in the notice of objection.

ITA
165(1.13)

New subsection 165(1.13) precludes large corporations from raising new issues or revising the relief sought with respect to an issue in an objection to an assessment made under subsection 165(3) of the Act except where that assessment was made pursuant to a notice of objection to another assessment made under any of the provisions or circumstances referred to in paragraph 165(1.1)(a).
Subsection 165(1.1) already restricts objections to assessments made under any of the provisions or circumstances referred to in paragraph 165(1.1)(a).

ITA
165(1.14)

New subsection 165(1.14) provides that the limitation in subsection 165(1.13) does not apply to limit a taxpayer's right to object to a new issue raised for the first time by Revenue Canada in an assessment made under subsection 165(3).

ITA
165(1.2)

Subsection 165(1.2) precludes any taxpayer from filing a notice of objection with respect to an assessment made under certain provisions of the Act. This subsection is amended to preclude also the filing of a notice of objection to an issue in respect of which the taxpayer has waived, in writing, the right to object, applicable after September 26, 1994 for waivers signed at any time.

Clause 71

Appeals to Tax Court of Canada

ITA
169

Section 169 of the Act provides a taxpayer's right to appeal an income tax assessment to the Tax Court of Canada.

ITA
169(2.1)

New subsection 169(2.1) precludes large corporations from appealing an assessment to the Tax Court of Canada if the issue to be decided was not specified in the notice of objection to the assessment in the manner required by new subsection 165(1.11) of the Act. They are also precluded from revising the relief sought with respect to an issue. These restrictions do not apply if the issue was a new issue raised for the first time by Revenue Canada in an assessment made under subsection 165(3) pursuant to an objection made by the corporation to an earlier assessment and the corporation has exercised its right under subsection 165(7) to appeal to the Tax Court of Canada in lieu of filing another notice of objection.

This rule applies to appeals instituted after the day this provision receives Royal Assent.

ITA
169(2.2)

New subsection 169(2.2) clarifies that a taxpayer may not appeal an issue to the Tax Court of Canada in respect of which the taxpayer has waived in writing the right to object or appeal. This rule applies after the day this provision receives Royal Assent to waivers signed at any time.

PART VIII

Securities Lending

Part VIII of this bill, which is composed of clauses 72 to 75, contains amendments to the *Income Tax Act* relating to the measures on securities lending, which were announced by the Minister of Finance on June 23, 1994.

Reference may also be made to clauses 80, 81 and 82 of the bill and the related explanatory notes, as those clauses also contain amendments pertaining to this measure.

Clause 72

Definition of "financial institution"

ITA
181(1)(e)

Subsection 181(1) of the Act defines a number of terms for the purposes of the Part I.3 tax on large corporations. The amendment to paragraph (e) of the definition of "financial institution" in subsection 181(1) adopts the term "registered securities dealer". This expression is newly defined in subsection 248(1) of the Act to mean a person registered or licensed under the provincial law to trade in securities, as agent or principal, without restriction in terms of the types or kinds of securities in which they may trade. This amendment applies to taxation years ending after June 1989.

Clause 73

Non-resident withholding tax

ITA
212

Paragraph 212(1)(b) of the Act imposes the non-resident withholding tax of 25% tax (reduced in most tax treaties with other countries) on certain categories of interest paid or credited to non-residents.

Subparagraph 212(1)(b)(xii) provides an exemption for interest payable under certain securities lending arrangements by registered or licensed securities traders resident in Canada. Subsection 212(18) of the Act requires an annual information return to be filed by such traders that pay interest which is exempt from withholding tax because of subparagraph 212(1)(b)(xii). In addition, subsection 212(19) of the Act imposes a special tax to the extent that the amount of money provided to a securities lender, on which the interest is exempt by virtue of subparagraph 212(1)(b)(xii), exceeds certain limits.

The amendments to subparagraph 212(1)(b)(xii) and subsections 212(18) and (19) confirm that their application is limited to those dealers registered or licensed under provincial law to trade in securities, as agent or principal, without restriction in terms of the types or kinds of securities in which they may trade. Such traders are referred to as "registered securities dealers" as defined in section 248 of the Act. Amended subparagraph 212(1)(b)(xii) and subsection 212(19) of the Act apply to securities lending arrangements entered into after May 28, 1993, while amended subsection 212(18) applies to taxation years ending after May 28, 1993. These are the dates on which those provisions originally became effective.

Clause 74

Definitions

ITA
248(1)

Subclause 74(1)

"dividend rental arrangement"

A "dividend rental arrangement" is, in general terms, an arrangement under which one person receives a dividend on a share that has been borrowed from another person who retains the risk of loss or opportunity for gain from fluctuations in the share value. As currently enacted, this definition applies to cases in which a person has borrowed a share under a securities lending arrangement and has either retained the share or disposed of it and acquired an identical or similar share. The terms of such a securities loan typically require that the borrower compensate the lender of the share for any dividends received on the share during the term of the arrangement. However, while the dividend is required to be included in the borrower's taxable income, under the special rules in section 260 such compensation payments are either non-deductible or deductible only in part for income tax purposes. The result is that the borrower may have taxable income under an arrangement that, in economic terms, has generated no profit or loss. The amendments to this definition, in conjunction with new subsection 260(6.1) of the Act, provide relief in these circumstances.

Under subsection 112(2.3) of the Act, dividends received on a share as part of a dividend rental arrangement remain non-deductible by the recipient corporation. However, the compensation payment related to such dividends are deductible under new rules provided in subsection 260(6.1).

These amendments to the definition "dividend rental arrangement" ensure that it includes an arrangement where a corporation receives a taxable dividend on a share and is required to make a corresponding compensation payment that is deemed under the securities lending arrangement rules in section 260 of the Act to be received by another person as a taxable dividend. Under the amended definition of "dividend rental arrangement" the compensation payment may be for a dividend on the loaned share, a share that is identical to the loaned share, or a share providing the same or substantially the same risk of loss or opportunity for gain as the loaned share.

The amended definition of "dividend rental arrangement" applies to dividends received by a corporation on shares acquired after June 1994, subject to an election to have the amended definition apply to shares acquired after April 1989 - the date on which the rules relating to dividend rental arrangements became effective.

Subclause 74(2)

"registered securities dealer"

The definition of "registered securities dealer" is added to subsection 248(1), applicable after April 26, 1989. This term is used in the definition of financial institution in Part I.3 of the Act relating to the special tax on large corporations, in section 212 of the Act in regard to the application of withholding tax in certain securities lending arrangements, and in section 260 of the Act with respect to the tax treatment of securities lending arrangements. A registered securities dealer is defined as a person registered or licensed under the laws of a province to trade in securities, in the capacity of an agent or principal, without restriction in the securities in which that person may trade.

Clause 75

Securities lending arrangements

ITA
260

Section 260 of the Act sets out rules relating to the tax treatment of securities lending arrangements. Paragraph 260(5)(b) of the Act treats an amount received from a securities dealer, as compensation for a dividend under a securities lending arrangement, as having been received as a taxable dividend on the share loaned under the arrangement. The amendment to this paragraph is consequential to the new definition of "registered securities dealer" in subsection 248(1) of the Act. It confirms that the application of paragraph 260(5)(b) is limited to those securities dealers who are registered or licensed under provincial law to trade in securities, as agent or principal, without restriction in terms of the types or kinds of securities in which they may trade. Amended paragraph 260(5)(b) applies to transfers, loans and payments made after April 26, 1989.

Subsections 260(6) and (7) of the Act set out certain rules relating to the tax treatment of persons making payments, under securities lending arrangements, as compensation for taxable dividends payable on the borrowed securities. As currently enacted, subsection 260(6) denies any deduction in respect of such payments and subsection 260(7) treats such payments by corporations as taxable dividends for the purposes of determining their entitlement to a dividend refund under section 129 of the Act. A special transitional rule applies to allow securities dealers to deduct 2/3 of their dividend compensation payments made before July 1994 where the payments are deemed under subsection 260(5) of the Act to be received as taxable dividends.

Subsection 260(6) is amended to provide a permanent 2/3 deduction for dividend compensation payments made by registered securities dealers. Payments made by taxpayers who are not securities dealers continue to be non-deductible. These limitations on deductibility will not apply where the rules in subsection 260(6.1) apply (see discussion below).

ITA 260(6.1)

Under the existing law, the definition of "dividend rental arrangement" can apply where a person has borrowed a share under a securities lending agreement and has either retained the share or disposed of it and acquired an identical or similar share. Under the terms of the agreement the borrower must compensate the lender of the share for any dividends paid on the share during the term of the agreement. Under subsection 260(6) such compensation payments are either non-deductible or only partially deductible for income tax purposes. Pursuant to subsection 112(2.3) of the Act, the dividends received by the borrower under the arrangement are not deductible. Thus, the borrower will have income for tax purposes although, economically, there may be no gain or loss on the transaction. Subsection 260(6.1), in conjunction with the dividend rental arrangement rules, is intended to remedy this result.

New subsection 260(6.1) provides a deduction for dividend compensation payments made in the types of arrangements outlined above. The amount deductible is the lesser of the amount the corporation is obligated to pay as compensation under the arrangement and the amount of the dividends received by the corporation under the arrangement which were identified in its return of income as amounts which are not deductible because of subsection 112(2.3). This identification requirement ensures that the deduction for dividend compensation payments is matched with dividends included in income. Payments made by registered securities dealers which do not meet the conditions under subsection 260(6.1), may still be partially deductible under amended subsection 260(6).

Subsection 260(6.1) applies to payments made after June 1994 unless a corporation elects to have the amended definition of "dividend rental arrangement" in subsection 248(1) of the Act apply. Where a corporation has so elected, subsection 260(6.1) will apply to payments made after April 1989. For the purposes of the identification requirement in subsection 260(6.1), dividends received after 1989 and before 1994 can be identified in the corporation's return of income for its first taxation year ending after the amendments to section 260 receive Royal Assent. The dividends so identified will be deemed to have been identified in the corporation's return of income for the taxation year in which the dividends were received.

Where a corporation does not elect, the limitations on deductibility in amended subsection 260(6) will apply to any payments made before July 1994 although the arrangement may still constitute a "dividend rental arrangement" under subsection 248(1). In such a case, the dividends received by a corporation under the arrangement will not be deductible by virtue of subsection 112(2.3) and the deductibility of any compensation payments will be restricted by amended subsection 260(6) without reference to subsection 260(6.1).

ITA 260(7)

The amendment to subsection 260(7) of the Act is consequential to the addition of subsection 260(6.1) and applies to payments which are deemed by subsection 260(5) to be a taxable dividend. The amendment provides that to the extent such payments are not deductible by the corporation under amended subsection 260(6) or new subsection 260(6.1), they will be treated as dividend payments for the purposes of section 129 of the Act. This enables a private corporation to obtain a refund of its refundable dividend tax on hand on making such non-deductible payments. The application date for amended subsection 260(7) is the same as that for the amendment to subsection 260(6).

Part IX

General

Part IX of this bill, which is composed of clauses 76 to 79, contains those amendments to the *Income Tax Act* that each relate to more than one of the measures found in the bill, and that therefore could not appropriately be included in any one preceding part of the bill.

Clause 76

Business and property income

ITA
12(1)(z.3) and (z.4)

Subsection 12(1) of the Act sets out various amounts included in computing a taxpayer's income from a business or property.

ITA
12(1)(z.3)

The addition of new paragraph 12(1)(z.3) to the Act is consequential on the amendments to section 80 relating to forgiveness of debt contained in Part I of this bill. New paragraph 12(1)(z.3) provides that income of a taxpayer arising from the application of new subsection 80(13) or (17) to the taxpayer is included in computing the taxpayer's income from a business or property.

This amendment applies to taxation years ending after February 21, 1994.

ITA
12(1)(z.4)

The addition of new paragraph 12(1)(z.4) to the Act is consequential on the amendments relating to eligible funeral arrangements contained in Part IV of this bill. New paragraph 12(1)(z.4) provides that income of a taxpayer arising from the application of new subsection 148.1(3) is included in computing the taxpayer's income from property. This will cover any income earned under an eligible funeral arrangement that is distributed if the arrangement is cancelled. For further detail, see the commentary on section 148.1.

This amendment applies to the 1993 and subsequent taxation years.

Clause 77

Superficial loss

ITA
54

Section 54 of the Act defines various terms for the purposes of the rules relating to taxable capital gains and allowable capital losses. Among these terms is "superficial loss". These amendments to the definition "superficial loss" relate to both the amendments on securities held by financial institutions (in Part III of this bill) and the amendments on mutual fund reorganizations (in Part VI).

Under paragraph 40(2)(g) of the Act, a taxpayer's loss from the disposition of a property is nil, if the loss is a superficial loss. For this purpose, the definition "superficial loss" in section 54 excludes losses on dispositions listed in paragraphs (c) to (e) from being superficial losses. The loss denied to the transferor may be added in computing the adjusted cost base of the property to the transferee, to the extent provided under paragraph 53(1)(f).

Paragraph (c) of the definition "superficial loss" is amended so that it also excludes losses on deemed dispositions under the following:

- new subsection 142.5(2) (mark-to-market requirement);
- new paragraph 142.6(1)(b) (deemed disposition when a taxpayer becomes a financial institution); and
- new paragraph 132.2(1)(f) (deemed disposition by a mutual fund trust upon a reorganization).

This amendment applies to dispositions under new subsection 142.5(2) and new paragraph 142.6(1)(b) after

February 22, 1994, and to dispositions under new paragraph 132.2(1)(f) after June 1994.

Clause 78

Foreign accrual property income

ITA
95(1)

"foreign accrual property income"

The foreign accrual property income (FAPI) of a controlled foreign affiliate of a taxpayer resident in Canada is taken into account under section 91 of the Act in computing the taxpayer's income for the year in which it is earned by the affiliate, rather than the year in which it is distributed. Under subsection 95(1), one of the components of FAPI is certain income from property and business, other than active business. However, certain losses and loss carryforwards of the affiliate reduce the affiliate's FAPI.

These amendments to the definition "foreign accrual property income" are consequential on both the amendments relating to forgiveness of debt in Part I of this bill, and the amendments relating to foreign affiliates in Part II.

Subclause 78(1)

The description of A in the FAPI definition is amended so that the application of section 80 is ignored for the purposes of the FAPI definition, except to the extent described below. In this connection, also see the commentary on new paragraph 95(2)(g.1).

This amendment applies to taxation years ending after February 21, 1994.

Subclause 78(2)

The description of the letter A and the formula in that definition includes in FAPI the affiliate's income for the year from property and businesses other than active businesses with some exceptions. The amendment to the description of A provides that such income is to be determined without reference to those expenses of the foreign affiliate that are referred to in new clause 95(2)(a)(ii)(D) of the Act where an amount in respect of the income derived from those amounts of expense payments was included in computing the income from an active business of another foreign affiliate of the taxpayer or a foreign affiliate of a person with which the taxpayer does not deal at arm's length. Under proposed new subsection 5907(2.8) of the *Income Tax Regulations* (released by the Minister of Finance on January 23, 1995), such expenses of the affiliate are to be deducted in computing the income or loss of the affiliate from an active business carried on or deemed to have been carried on by it in the country in which it is resident and subject to income taxation. This amendment ensures that the payment of an expense by one affiliate that is included in the active business income of another affiliate cannot be used to reduce the FAPI of the paying affiliate.

This amendment applies to taxation years of a foreign affiliate of a taxpayer that begin after 1994 except that, where there has been a change to the taxation year of a foreign affiliate of a taxpayer in 1994 and after February 22, 1994, the amendments will apply to taxation years of such foreign affiliate of the taxpayer that end after 1994. However, where a written request to change the taxation year had been made before February 22, 1994 to the income taxation authority of the country in which the affiliate was resident and subject to income taxation, or where the change in taxation year causes the first taxation year commencing after 1994 to commence earlier than if there had been no change in the affiliate's taxation year, the amendment will remain applicable to taxation years that begin after 1994.

Amendments to the *Income Tax Application Rules* and Other Acts

Clause 79

Capital gains

ITAR
26(3) and (5)

These amendments to the *Income Tax Application Rules* are related to the amendments to the *Income Tax Act* on debt forgiveness in Part I of this bill.

Subsections 26(3) and (5) of the *Income Tax Application Rules* are relevant for the purposes of computing the adjusted cost base of certain capital property held by a taxpayer (or a person not dealing at arm's length with the taxpayer) on December 31, 1971. These rules have the effect of ignoring any increases in the adjusted cost base of such property arising because of the operation of the stop-loss rules in paragraph 40(2)(e) and subsection 85(4) of the Act.

Subsections 26(3) and (5) of the Rules are amended so that the new stop-loss rules under paragraphs 40(2)(e.1) and (e.2) of the Act, which correspond to the adjusted cost base increase provided under new paragraphs 53(1)(f.11) and (f.12) of the Act, are treated in the same way.

These amendments apply to taxation years ending after February 21, 1994.

Clause 80

Securities lending

S.C. 1990
c.39

Subsection 55(3) of S.C. 1990, c. 39 (Bill C-28) provided a special transitional rule for subsection 260(6) of the *Income Tax Act* to allow securities dealers to deduct 2/3 of their dividend compensation payments made after June 1989 but before April 1990. The provision also provided a transitional rule for subsection 260(7) of the Act to allow 1/3 of dividend compensation payments to be treated as taxable dividends paid by corporations for the purposes of section 129 of the Act.

As a consequence of the amendments to subsections 260(6) and (7) dealing with securities lending, contained in Part VIII of this bill, this provision is repealed.

Clause 81

Securities lending

S.C. 1991
c.49

Subsection 258 of S.C. 1991, c. 49 (Bill C-18) extended the transitional rules relating to securities dealers (discussed in the preceding note to clause 80 of this bill) to dividend compensation payments made before 1993.

As a consequence of the amendments to subsections 260(6) and (7) of the *Income Tax Act* dealing with securities lending, contained in Part VIII of this bill, this provision is repealed.

Clause 82

Securities lending

S.C. 1994
c.21

Subsection 133 of S.C. 1994, c. 21 (Bill C-27) extended the transitional rules relating to securities dealers (discussed in the preceding note to clause 80 of this bill) to dividend compensation payments made before July 1994.

As a consequence of the amendments to subsections 260(6) and (7) of the *Income Tax Act* dealing with securities lending, contained in Part VIII of this bill, this provision is repealed.