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# Draft Amendments to the Income Tax Act and Explanatory Notes

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Relating to Securities Held  
by Financial Institutions

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

June 1995

Canada

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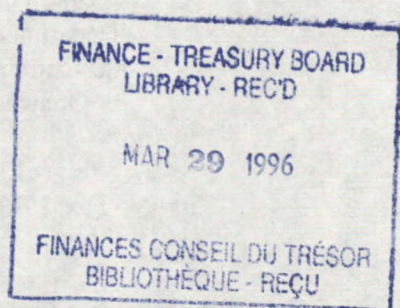
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Department of Finance  
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# Draft Amendments to the Income Tax Act

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# SECURITIES HELD BY FINANCIAL INSTITUTIONS

## DRAFT AMENDMENTS TO THE INCOME TAX ACT

**1. (1) The portion of subsection 18(9.1) of the *Income Tax Act* before paragraph (a) is replaced by the following:**

Penalties, bonuses and rate-reduction payments

(9.1) Subject to subsection 142.4(10), where at any time a payment, other than a payment that

5

**(2) Subsection (1) applies to taxation years that end after February 22, 1994.**

**2. (1) Sub-subclause 20(1)(l)(ii)(B)(II)2 of the Act is replaced by the following:**

2. the total of all amounts included under subsection 12(3) or paragraph 142.3(1)(a) in computing the taxpayer's income for the year or a preceding taxation year to the extent that those amounts reduced the part of the reserve referred to in sub-subclause 1

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**(2) Subsection (1) applies to taxation years that end after February 22, 1994.**

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**3. (1) Subsection 136(1) of the Act is replaced by the following:**

Cooperative not private corporation

136. (1) Notwithstanding any other provision of this Act, a cooperative corporation that would, but for this section, be a private corporation shall be deemed not to be a private corporation except for the purposes of sections 15.1, 125, 125.1, 127, 127.1, 152 and 157, the definition "mark-to-market property" in subsection 142.2(1) and the definition "small business corporation" in subsection 248(1) as it applies for the purpose of paragraph 39(1)(c).

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**(2) Subsection (1) applies to taxation years that end after February 22, 1994.**

**4. (1) The portion of subsection 142.3(1) of the Act before paragraph (a) is replaced by the following:**

## Amounts to be included and deducted

142.3 (1) Subject to subsection (3), where a taxpayer that is, in a taxation year, a financial institution holds a specified debt obligation at any time in the year,

**(2) Paragraph 142.3(1)(c) of the Act is replaced by the following:** 5

(c) except as provided by this section, paragraphs 12(1)(d) and (i) and 20(1)(l) and (p) and section 142.4, no amount shall be included or deducted in respect of payments under the obligation (other than fees and similar amounts) in computing the income of the taxpayer for the year. 10

**(3) Subsection 142.3(2) of the Act is replaced by the following:**

## Failure to report accrued amounts

(2) Subject to subsection (3), where

(a) a taxpayer holds a specified debt obligation at any time in a particular taxation year in which the taxpayer is a financial institution, and 15

(b) all or part of an amount required by paragraph (1)(a) or subsection 12(3) to be included in respect of the obligation in computing the taxpayer's income for a preceding taxation year was not so included, 20

that portion of the amount shall be included in computing the taxpayer's income for the particular year, to the extent that it was not included in computing the taxpayer's income for a preceding taxation year. 25

## Exception for certain obligations

(3) Subsections (1) and (2) do not apply for a taxation year in respect of a specified debt obligation of a taxpayer that is

(a) a mark-to-market property for the year; or 30

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

**(4) Subsections (1) to (3) apply to taxation years that end after February 22, 1994, except that the subsections do not apply to debt obligations disposed of before February 23, 1994.**

**5. (1) Paragraph (b) of the definition "tax basis" in subsection 142.4(1) of the Act is replaced by the following:**

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

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**(2) Paragraph (j) of the definition "tax basis" in subsection 142.4(1) of the Act is replaced by the following:**

(j) the amount of a payment received by the taxpayer under the obligation at or before that time, other than

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(i) a fee or similar payment, or

(ii) proceeds of disposition of the obligation,

**(3) Subsections 142.4(4) and (5) of the Act are replaced by the following:**

**Inclusions and deductions re disposition**

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(4) Subject to subsection (5), where after 1994 a taxpayer disposes of a specified debt obligation in a taxation year, the following rules apply:

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

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

(c) where the taxpayer has a gain from the disposition of the obligation,

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(i) the current amount of the gain shall be included in computing the income of the taxpayer for the year, and

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

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(d) where the taxpayer has a loss from the disposition of the obligation,

(i) the current amount of the loss shall be deducted in computing the taxpayer's income for the year, and

(ii) there shall be deducted in computing the taxpayer's income for taxation years that end on or after the day of disposition the amount allocated, in accordance with prescribed rules, to the year in respect of the residual portion of the loss. 5

#### Gain or loss not amortized

(5) Where, after February 22, 1994, a taxpayer disposes of a specified debt obligation in a taxation year, and 10

(a) the obligation is

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

(ii) a debt obligation prescribed in respect of the taxpayer, 15

(b) the disposition occurred

(i) before 1995,

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

(iii) because of paragraph 142.6(1)(c), or 20

(c) in the case of a taxpayer other than a life insurance corporation,

(i) the disposition occurred before 1996, and

(ii) the taxpayer elects in writing, filed with the Minister within 6 months after the end of the taxpayer's 1995 taxation year, to have this paragraph apply, 25

the following rules apply:

(d) subsection (4) does not apply to the disposition,

(e) there shall be included in computing the taxpayer's income for the year the amount, if any, by which the taxpayer's proceeds of disposition exceed the tax basis of the obligation to the taxpayer immediately before the disposition, and

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(f) there shall be deducted in computing the taxpayer's income for the year the amount, if any, by which the tax basis of the obligation to the taxpayer immediately before the disposition exceeds the taxpayer's proceeds of disposition.

**(4) Paragraph 142.4(6)(b) of the Act is replaced by the following:**

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

**(5) The description of C in subsection 142.4(6) of the Act is replaced by the following:**

15

C is the taxpayer's transition amount in respect of the disposition.

**(6) Subsections 142.4(7) to (9) of the Act are replaced by the following:**

Current amount

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(7) For the purposes of subsections (4) and (8), the current amount of a taxpayer's gain or loss from the disposition of a specified debt obligation is

(a) where the taxpayer has a gain from the disposition of the obligation, the part, if any, of the gain that is reasonably attributable to a material increase in the probability, or perceived probability, that the debtor will make all payments as required by the obligation; and

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(b) where the taxpayer has a loss from the disposition of the obligation, the amount that the taxpayer claims not exceeding the part, if any, of the loss that is reasonably attributable to a default by the debtor or a material decrease in the probability, or perceived probability, that the debtor will make all payments as required by the obligation.

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Residual portion of gain or loss

(8) For the purpose of subsection (4), the residual portion of a taxpayer's gain or loss from the disposition of a specified debt

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obligation is the amount, if any, by which the gain or loss exceeds the current amount of the gain or loss.

#### Disposition of part of obligation

(9) Where a taxpayer disposed of part of a specified debt obligation, section 142.3 and this section apply as if the part disposed of and the part retained were separate specified debt obligations. 5

#### Penalties and bonuses

(10) Notwithstanding subsection 18(9.1), where a taxpayer that holds a specified debt obligation receives a penalty or bonus because of the repayment before maturity of all or part of the principal amount of the debt obligation, the payment shall be deemed to be received by the taxpayer as proceeds of disposition of the specified debt obligation. 10

#### Payments received on or after disposition

(11) For the purposes of this section, where a taxpayer receives a payment (other than proceeds of disposition) under a specified debt obligation on or after the disposition of the obligation, the payment shall be deemed to have been received by the taxpayer immediately before the disposition. 15

(7) Subsections (1) to (6) apply to taxation years that end after February 22, 1994, and the election referred to in paragraph 142.4(5)(c) of the Act, as enacted by subsection (3), shall be deemed to have been filed on a timely basis if it is filed with the Minister of National Revenue before the end of the sixth month after the month in which this Act is assented to. 20

6. (1) Subsections 142.5(5) to (7) of the Act are replaced by the following: 25

#### Transition — inclusion re non-capital amounts

(5) Where an amount is deducted under subsection (4) in computing a taxpayer's income, there shall be included, in computing the taxpayer's income for each taxation year that begins before 1999 and ends after October 30, 1994, the total of all amounts prescribed for the year. 30

#### Transition — deduction re net capital gains

(6) Such amount as a taxpayer elects, not exceeding a prescribed amount in respect of capital properties disposed of by the taxpayer because of subsection (2), shall be deemed to be an allowable capital 35

loss of the taxpayer for its taxation year that includes October 31, 1994 from the disposition of property (or, where the taxpayer is non-resident throughout the year, from the disposition of taxable Canadian property).

Transition — inclusion re net capital gains

(7) A taxpayer that elects an amount under subsection (6) shall be deemed, for each taxation year that begins before 1999 and ends after October 30, 1994, to have a taxable capital gain for the year from the disposition of property (or, where the taxpayer is non-resident throughout the year, from the disposition of taxable Canadian property) equal to the total of all amounts prescribed for the year. 5 10

(2) Subsection (1) applies to taxation years that end after October 30, 1994.

7. (1) Paragraph 186.1(b) of the Act is replaced by the following:

(b) that was, throughout the year,

(i) a bank, 15

(ii) a corporation licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as trustee,

(iii) an insurance corporation,

(iv) a prescribed labour-sponsored venture capital corporation, 20

(v) a prescribed investment contract corporation, or

(vi) a non-resident-owned investment corporation.

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

8. (1) Paragraph (d.1) of the definition "term preferred share" in subsection 248(1) of the Act is replaced by the following: 25

(d.1) that is listed on a prescribed stock exchange in Canada and was issued before April 22, 1980 by

(i) a corporation referred to in any of paragraphs (a) to (d) of the definition "specified financial institution" in this subsection,

(ii) a corporation whose principal business is the lending of money or the purchasing of debt obligations or a combination thereof, or

(iii) an issuing corporation associated with a corporation described in subparagraph (i) or (ii),

**(2) Subsection (1) applies after February 22, 1994.**

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Explanatory Notes  
to Draft Amendments  
to the Income Tax Act

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

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**SECURITIES HELD BY FINANCIAL INSTITUTIONS**  
**EXPLANATORY NOTES TO**  
**DRAFT AMENDMENTS TO THE INCOME TAX ACT**

**Clause 1**

**Penalties, bonuses and rate-reduction payments**

**ITA**

**18(9.1)**

Subsection 18(9.1) of the *Income Tax Act* applies where a penalty or bonus is paid in respect of the repayment of all or part of a debt obligation before its maturity. The subsection provides, in certain circumstances, that the penalty or bonus is deemed to have been paid and received as interest, to the extent that it does not exceed the future interest that would, but for the repayment, have been payable on the obligation. Subsection 18(9.1) also applies with respect to certain interest rate reduction payments.

Subsection 18(9.1) is amended to provide that it is subject to new subsection 142.4(10). That subsection provides that a penalty or bonus received by a financial institution in respect of the early repayment of all or part of the principal amount of a specified debt obligation is considered to be received by the institution as proceeds of disposition.

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

**Clause 2**

**Reserve for doubtful debts**

**ITA**

**20(1)(l)(ii)(B)(II)2**

Subparagraph 20(1)(l)(ii) of the Act permits a taxpayer that is an insurer or whose ordinary business includes the lending of money to claim a reserve in respect of doubtful loans or lending assets. The maximum reserve is equal to the sum of a prescribed reserve amount

under clause 20(1)(l)(ii)(A) in respect of certain loans and lending assets and an amount determined under clause 20(1)(l)(ii)(B) in respect of other doubtful loans and lending assets. The amount under clause 20(1)(l)(ii)(B) is based on the lesser of two amounts, one of which is the reserve reported in the taxpayer's financial statements. For this purpose, the financial statement reserve is increased by the amount of interest included by subsection 12(3) of the Act in the taxpayer's income, to the extent that the interest has reduced the reserve. This addition to the reserve recognizes that some taxpayers such as banks are required to apply interest payments received on a doubtful loan or lending asset towards reducing the reserve taken in respect of that loan or lending asset.

Sub-subclause 20(1)(l)(ii)(B)(II)2, which specifies the amount to be added to the financial statement reserve, is amended so that it also applies with respect to interest included in a taxpayer's income by paragraph 142.3(1)(a). This amendment is consequential on the introduction of the new rules for debt obligations held by financial institutions.

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

### **Clause 3**

#### **Cooperative not private corporation**

##### **ITA**

##### **136(1)**

Subsection 136(1) of the Act provides that cooperative corporations that would otherwise be private corporations are considered not to be private corporations, except for the purposes of certain provisions of the Act listed in that subsection. Subsection 136(1) is amended to add to the list the definition of "mark-to-market property" in subsection 142.2(1) of the Act. Thus, a cooperative that is a private corporation retains its status for the purpose of that definition and any regulations made under the definition. At present, whether a cooperative is a private corporation is relevant only for proposed subsection 9001(1) of the *Income Tax Regulations*, which prescribes certain small business corporation shares for the purpose of paragraph (e) of the definition of mark-to-market property.

The amendment to subsection 136(1) applies to taxation years that end after February 22, 1994.

#### **Clause 4**

#### **Income from specified debt obligations**

##### **ITA**

##### **142.3(1)**

Subsection 142.3(1) of the Act provides that the amounts included or deducted in respect of a specified debt obligation (as defined in subsection 142.2(1) of the Act) in computing the income of a financial institution are to be determined in accordance with rules set out in the Regulations. Two consequential amendments are made to subsection 142.3(1): (i) the reference to subsection 142.3(2) is changed to subsection 142.3(3) as a consequence of the renumbering of that provision; and (ii) paragraph 142.3(1)(c) is amended so that it allows new subsection 142.3(2) to apply with respect to the determination of amounts to be included or deducted in respect of specified debt obligations.

##### **ITA**

##### **142.3(2) and (3)**

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). This subsection is renumbered as subsection 142.3(3) and is amended so that it also applies for the purpose of new subsection 142.3(2). The latter amendment is made because of the reference in new subsection 142.3(2) to amounts required by subsection 12(3) to be included in a taxpayer's income in respect of specified debt obligations.

New subsection 142.3(2) applies where a financial institution has failed to include an amount in income in respect of a specified debt obligation, as required by paragraph 142.3(1)(a). Subsection 142.3(2) provides that the amount is to be included in computing the financial institution's income for a subsequent taxation year in which it still holds the obligation, except to the extent that the amount has been included in computing income for a preceding taxation year. This

rule is similar to the requirement in subsection 12(3) of the Act that all interest that has accrued to a taxpayer or was received by the taxpayer to the end of a taxation year be included in computing the taxpayer's income for the year, to the extent that it was not included in computing the taxpayer's income for a preceding taxation year.

Subsection 142.3(2) also applies if a financial institution has not included an amount in income as required by subsection 12(3). This is relevant for specified debt obligations that were acquired before subsection 142.3(1) began to apply to the taxpayer. If a taxpayer failed to report an amount as required by subsection 12(3), that subsection will not apply to later years when the tax treatment of the obligation is governed by subsection 142.3(1).

These amendments apply to taxation years ending after February 22, 1994, except that they do not apply to a debt obligation disposed of before February 23, 1994.

## **Clause 5**

### **Disposition of specified debt obligations**

#### **ITA 142.4**

Section 142.4 of the Act contains rules for the measurement and treatment of the gain or loss realized by a financial institution on the disposition of a specified debt obligation (other than a mark-to-market property). The amendments to this section apply to taxation years ending after February 22, 1994.

#### **Definition of "tax basis"**

#### **ITA 142.4(1)**

Subsection 142.4(1) defines the tax basis of a specified debt obligation. The tax basis, which is analogous to the adjusted cost base of a capital property, is used to measure the gain or loss from a disposition of the obligation. Paragraphs (b) and (j) of the definition are amended.

Paragraph (b) of the definition adds to the tax basis of a specified debt obligation amounts included by several provisions in respect of the obligation in computing the income of the taxpayer. This paragraph is amended to add a reference to new subsection 142.3(2).

Paragraph (j) of the definition reduces the tax basis of a specified debt obligation to a taxpayer by the amount of a payment received by the taxpayer under the obligation where the payment is in respect of an amount included in the tax basis by any of paragraphs (a) to (f) of the definition and is not proceeds of disposition. Paragraph (j) is amended to provide that the tax basis of a specified debt obligation is reduced by all payments received by the taxpayer under the obligation, other than a payment that is proceeds of disposition or a fee or similar amount.

### **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.

The amendments to subsection 142.4(4) are consequential on the amendment of the definition of "current amount" in subsection 142.4(7). They do not change the net amount required by subsection 142.4(4) to be included or deducted in respect of a disposition in computing income. The definition of "current amount" is amended so that it does not include the transition amount in respect of the disposition. Thus, it is just the credit-related component of a gain or loss.

As amended, paragraph 142.4(4)(a) applies where the transition amount in respect of the disposition of a specified debt obligation is positive. It requires the transition amount to be included in computing the taxpayer's income for the taxation year in which the disposition occurs. Paragraph 142.4(4)(b) provides for an amount equal to the absolute value of the transition amount to be deducted if the transition amount is negative.

Paragraph 142.4(4)(c), which applies where a taxpayer has a gain from the disposition of a specified debt obligation, requires the current amount of the gain to be included in income in the year of disposition, and requires a prescribed part of the residual portion of the gain (as defined in subsection 142.4(8)) to be included in income each year, starting in the year of disposition. Proposed Part XCII of the Regulations contains the rules for amortizing the residual portion of a gain.

Paragraph 142.4(4)(d), which is similar to paragraph 142.4(4)(c), provides for deductions where a taxpayer has a loss from the disposition of a specified debt obligation.

### **Gain or loss not amortized**

#### **ITA**

#### **142.4(5)**

Subsection 142.4(5) provides that the full gain or loss from the disposition after February 22, 1994 of certain specified debt obligations is to be included or deducted in computing income for the taxation year in which the disposition occurs. This subsection is replaced by a new subsection 142.4(5) that differs from the existing subsection in the following respects:

- a new paragraph 142.4(5)(c) is added;
- existing paragraph 142.4(5)(c) is relabelled as paragraph (d); and
- existing paragraphs 142.4(5)(d) and (e) are replaced by new paragraphs 142.4(5)(e) and (f).

New paragraph 142.4(5)(c) permits a taxpayer (other than a life insurance corporation) to elect to postpone the commencement of the amortization requirement for gains and losses. If the election is made, subsection 142.4(5) applies to all dispositions of specified debt obligations before 1996. The election must be in writing and filed with the Minister of National Revenue within 6 months after the end of the taxpayer's 1995 taxation year. (An election that is filed within 6 months after Royal Assent to the bill that contains the amendments

to subsection 142.4(5) will be considered to have been filed on a timely basis.)

New paragraph 142.4(5)(e) provides that the amount to be included in a taxpayer's income in respect of the disposition of a specified debt obligation is the amount, if any, by which the taxpayer's proceeds of disposition exceed the tax basis of the obligation.

Paragraph 142.4(5)(f) contains a similar rule for the measurement and deduction of a loss. Currently, the corresponding provisions in paragraphs 142.4(5)(d) and (e) refer to the gain or loss determined under subsection 142.4(6). This amendment to subsection 142.4(5) does not affect the amount of the gains and losses to be recognized, but is made so that subsection 142.4(6) can be simplified.

### **Gain or loss from disposition of obligation**

#### **ITA**

#### **142.4(6)**

Subsection 142.4(6) provides for the determination of a taxpayer's gain or loss from the disposition of a specified debt obligation. The gain or loss 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 (as defined in subsection 142.4(1) of the Act) in respect of the obligation. (If the transition amount is negative, the absolute value of that amount is added.)

Two amendments are made to subsection 142.4(6).

Paragraph 142.4(6)(b) is amended so that a loss from a disposition is expressed as a positive amount rather than a negative amount. The second amendment, which is made to the description of C in the formula in the subsection, provides for the transition amount to always be taken into account in determining the gain or loss. A related amendment is made to subsection 142.4(5) so that that subsection does not use the gain or loss as determined under

subsection 142.4(6), but instead provides a separate determination of the gain or loss for the purpose of that subsection.

### **Current amount**

#### **ITA**

##### **142.4(7)**

Subsection 142.4(7) defines the current amount in respect of the disposition of a specified debt obligation by a taxpayer. It is the positive or negative amount equal to the sum of the transition amount in respect of the obligation and the credit-related portion of the gain or loss from the disposition (with the credit-related portion of a loss treated as a negative amount).

Subsection 142.4(7) is amended to define the current amount to be the credit-related portion of the gain or loss from the disposition of a specified debt obligation. The transition amount is not included as part of the current amount. Also, the current amount is a positive amount whether there was a gain or a loss. A related amendment to subsection 142.4(4) provides for the separate inclusion or deduction of the transition amount in computing income. These amendments do not make any substantive changes to the current rules.

### **Residual portion of gain or loss**

#### **ITA**

##### **142.4(8)**

Subsection 142.4(8) defines the residual portion of a taxpayer's gain or loss from the disposition of a specified debt obligation. The amendment to subsection 142.4(8) is consequential on the amendment to subsection 142.4(7), and does not change the determination of the residual portion.

### **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. This subsection is amended so that it also applies for the purposes of section 142.3. In addition, the reference to regulations is deleted, since subsection 142.4(9) applies to the regulations without explicitly referring to them.

## **Penalties and bonuses**

### **ITA**

#### **142.4(10)**

New subsection 142.4(10) provides that a penalty or bonus received by a taxpayer in respect of the early repayment of a specified debt obligation is to be treated as part of the proceeds of disposition of the obligation. Subsection 142.4(10) applies instead of subsection 18(9.1), where that latter subsection would otherwise apply to deem the amount to be received as interest.

## **Payments received on or after disposition**

### **ITA**

#### **142.4(11)**

New subsection 142.4(11) provides that a payment (other than proceeds of disposition) received by a taxpayer under a specified debt obligation on or after the disposition of the obligation shall be considered to have been received immediately before the disposition. Consequently, the payment will be taken into account in determining the tax basis of the obligation to the taxpayer immediately before the disposition, and hence in determining the taxpayer's gain or loss from the disposition.

**Clause 6****Mark-to-market properties****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) in respect of the introduction of the mark-to-market requirement. 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. Subsection 142.5(5) is amended to modify the way in which it confers regulation-making authority. This amendment applies to taxation years that end after October 30, 1994.

**Transition - deduction re net capital gains****ITA****142.5(6)**

Subsection 142.5(6) is a transition rule that applies with respect to capital property that is deemed to be disposed of on the initial application of the mark-to-market requirement. It permits a financial institution to claim an allowable capital loss not exceeding a prescribed amount. The amendment to subsection 142.5(6) provides that, in the case of a taxpayer not resident in Canada, the allowable capital loss is considered to be from the disposition of taxable Canadian property. This amendment applies to taxation years that end after October 30, 1994.

**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. Subsection 142.5(7) is amended to modify the way in which it confers regulation-making authority. It is also amended to provide that, in the case of a taxpayer not resident in Canada, the taxable capital gain is considered to be from the disposition of taxable Canadian property. These amendments apply to taxation years that end after October 30, 1994.

## **Clause 7**

### **Part IV tax - exempt corporations**

#### **ITA**

##### **186.1(b)**

Section 186.1 of the Act exempts certain corporations from the requirement to pay the special refundable Part IV tax on dividend income. Paragraph 186.1(b) lists a number of types of corporations to which the exemption applies, including corporations described in paragraphs 39(5)(b) and (c) (banks and trust companies).

Section 186.1 is amended, as a consequence of amendments to subsection 39(5), to replace the reference to paragraphs 39(5)(b) and (c) by the descriptions that were contained in those paragraphs. This amendment applies after February 22, 1994.

## **Clause 8**

### **Definition of "term preferred share"**

#### **ITA**

##### **248(1)**

Subsection 248(1) of the Act contains a definition of "term preferred share". These are shares the dividends on which are denied the intercorporate dividend deduction if received by a specified financial institution in certain circumstances. The definition contains a number of exclusions, including that in paragraph (d.1) for shares issued before April 22, 1980 by a corporation described in any of paragraphs 39(5)(b) to (f) (or an associated corporation) if the shares are listed on a Canadian stock exchange.

Paragraph (d.1) of the definition is amended so that instead of referring to a corporation described in any of paragraphs 39(5)(b) to (f), it refers to a corporation referred to in any of paragraphs (a) to (d) of the definition of "specified financial institution" in subsection 248(1) or a corporation whose principal business is money lending or purchasing debt obligations. This amendment is made as a consequence of amendments to subsection 39(5), and does not change the substance of the exclusion. This amendment applies after February 22, 1994.

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# Draft Amendments to the Income Tax Regulations

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# SECURITIES HELD BY FINANCIAL INSTITUTIONS

## DRAFT AMENDMENTS TO THE INCOME TAX REGULATIONS

**1. Subparagraph 304(1)(c)(ii) of the *Income Tax Regulations* is replaced by the following:**

(ii) issued by a life insurance corporation, a registered charity, a corporation referred to in any of paragraphs (a) to (c) of the definition "specified financial institution" in subsection 248(1) of the Act or subparagraph (b)(ii) of the definition "retirement savings plan" in subsection 146(1) of the Act or a corporation (other than a mutual fund corporation or a mortgage investment corporation) the principal business of which is the making of loans (which corporation or charity is referred to in this section as the "issuer"),

**2. (1) Section 2402 of the Regulations is amended by adding the following after paragraph (a):**

(a.1) there shall be included the amount determined by the formula

$$(A + B) \times \frac{C}{D}$$

where

A is the amount required by subsection 142.5(5) of the Act to be included in computing the insurer's income for the year,

B is the amount deemed by subsection 142.5(7) of the Act to be a taxable capital gain of the insurer for the year from the disposition of property,

C is the amount determined under subparagraph (a)(i) for the taxation year of the insurer that includes October 31, 1994, and

D is the amount determined under subparagraph (a)(ii) for the taxation year of the insurer that includes October 31, 1994;

**(2) Paragraph 2402(b) of the Regulations is amended by adding the word "and" at the end of subparagraph (ii), by striking out the word "and" at the end of subparagraph (iii) and by repealing subparagraph (iv).**

**(3) Paragraph 2402(e) of the Regulations is replaced by the following:**

(e) except as provided in paragraph (a), there shall not be included any amount that was included in determining the insurer's gross Canadian life investment income for the year;

**(4) Section 2402 of the Regulations is amended by adding the following after paragraph (e):**

5

(e.1) except as provided in paragraph (a.1), there shall not be included the amounts referred to in the descriptions of A and B in that paragraph;

(e.2) where the year includes October 31, 1994, there shall be deducted the amount determined by the formula

10

$$(A + B) \times \frac{C}{D}$$

where

A is the amount deducted under subsection 142.5(4) of the Act in computing the insurer's income for the year,

15

B is the amount deemed by subsection 142.5(6) of the Act to be an allowable capital loss of the insurer for the year from the disposition of property,

C is the amount determined under subparagraph (a)(i) for the year, and

20

D is the amount determined under subparagraph (a)(ii) for the year;

**(5) Paragraph 2402(f) of the Regulations is amended by adding the word "and" at the end of subparagraph (i), by striking out the word "and" at the end of subparagraph (ii) and by repealing subparagraph (iii).**

25

**(6) Paragraph 2402(h) of the Regulations is replaced by the following:**

(h) except as provided in paragraph (a), no deduction shall be made in respect of

(i) any amount taken into account in determining the insurer's gross Canadian life investment income for the year, or

30

(ii) any amount deductible under paragraph 20(1)(l) of the Act in computing the insurer's income for the year;

**(7) Section 2402 of the Regulations is amended by adding the following after paragraph (h):**

(h.1) except as provided in paragraph (e.2), no deduction shall be made in respect of the amounts referred to in the descriptions of A and B in paragraph (e.2); 5

**3. (1) Paragraph (a) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:** 10

(a) the insurer's gross investment revenue for the year, to the extent that the revenue is from Canadian business property of the insurer for the year in respect of the insurer's life insurance business,

**(2) Paragraphs (c) and (d) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations are replaced by the following:** 15

(d) the portion of the amount deducted under paragraph 20(1)(l) of the Act in computing the insurer's income for the preceding taxation year that was in respect of Canadian business property of the insurer for that year in respect of the insurer's life insurance business, 20

**(3) Paragraph (e) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:**

(d.1) the total of all amounts each of which is an amount included under section 142.4 of the Act in the insurer's income for the year in respect of a property disposed of by the insurer that was, in the taxation year of disposition, a Canadian business property of the insurer for that year in respect of the insurer's life insurance business, 25

(e) the total of all amounts each of which is the insurer's gain for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business, other than a capital property or a property in respect of which section 142.4 of the Act applies, and 30

**(4) Paragraph (f) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:** 35

(f) the total of all amounts each of which is the insurer's taxable capital gain for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business,

**(5) Paragraph (g) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is repealed.** 5

**(6) Paragraph (h) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is repealed.** 10

**(7) Paragraph (i) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:**

(i) the portion of the amount deducted under paragraph 20(1)(l) of the Act in computing the insurer's income for the year that is in respect of debt obligations that are Canadian business property of the insurer for the year in respect of the insurer's life insurance business, 15

**(8) Paragraph (j) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:** 20

(i.1) the total of all amounts each of which is an amount deductible under section 142.4 of the Act in computing the insurer's income for the year in respect of a property disposed of by the insurer that was, in the taxation year of disposition, a Canadian business property of the insurer for that year in respect of the insurer's life insurance business, 25

(j) the total of all amounts each of which is the insurer's loss for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business, other than a capital property or a property in respect of which section 142.4 of the Act applies, and 30

**(9) Paragraph (k) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations is replaced by the following:**

(k) the total of all amounts each of which is the insurer's allowable capital loss for the year from the disposition of a Canadian business property of the insurer for the year in respect of the insurer's life insurance business; 35

**(10) Subsection 2405(3) of the Regulations is amended by adding the following in alphabetical order:**

"Canadian business property" of an insurer for a taxation year in respect of an insurance business means

(a) where the insurer was resident in Canada throughout the year and either did not carry on a life insurance business in the year or did not carry on an insurance business outside Canada in the year, the property used by it in the year in, or held by it in the year in the course of, carrying on the business in Canada, and 5

(b) in any other case, the property designated under subsection 2400(1) for the year by the insurer in respect of the business; 10

**(11) Section 2405 of the Regulations is amended by adding the following after subsection (4):**

(5) For the purposes of subsection (3), the cost of a property shall be determined without regard to subsection 142.5(2) of the Act. 15

**4. (1) The formula in subsection 2411(1) of the Regulations is replaced by the following:**

$$A - (B + B.1 + C)$$

**(2) Subsection 2411(1) of the Regulations is amended by striking out the word "and" at the end of the description of B and by adding the following after the description of B:** 20

B.1 is the positive or negative amount, as the case may be, determined in respect of the insurer for the year under subsection (4.1) in respect of property disposed of by the insurer that was, in the taxation year of disposition, investment property designated by the insurer under subsection 2400(1) as property used by it in the year in, or held by it in the year in the course of, carrying on an insurance business in Canada; 25

**(3) The first formula in subsection 2411(3) of the Regulations is replaced by the following:** 30

$$\left[ \frac{(A + A.1)}{B} \times C \right] + \frac{(D \times F)}{E} + \left[ \frac{(G + G.1)}{H} \times J \right]$$

**(4) The second formula in subsection 2411(3) of the Regulations is replaced by the following:**

$$\frac{[(A + A.1) \times (C + J)]}{B} + \frac{(D \times F)}{E}$$

**(5) Subsection 2411(3) of the Regulations is amended by adding the following after the description of A:**

- A.1 is the positive or negative amount, as the case may be, determined in respect of the insurer for the year under subsection (4.1) in respect of Canadian investment property (other than Canadian equity property) disposed of by the insurer in the year or a preceding taxation year; 5

**(6) Subsection 2411(3) of the Regulations is amended by adding the following after the description of G:** 10

- G.1 is the positive or negative amount, as the case may be, determined in respect of the insurer for the year under subsection (4.1) in respect of foreign investment property disposed of by the insurer in the year or a preceding taxation year; 15

**(7) The portion of the description of A in subsection 2411(4) of the Regulations before paragraph (a) is replaced by the following:**

- A is the total of the following amounts determined in respect of the property for the year, or that would be determined in respect of the property for the year if it were insurance property of the insurer for the year in respect of an insurance business in Canada and if it had been insurance property of the insurer in respect of an insurance business in Canada for each preceding taxation year in which it was held by the insurer: 20

**(8) Paragraph (b) of the description of A in subsection 2411(4) of the Regulations is repealed.** 25

**(9) Paragraph (d) of the description of A in subsection 2411(4) of the Regulations is replaced by the following:**

- (c.1) all amounts that were or would be included under paragraph 142.4(5)(e) of the Act in respect of the property in computing the insurer's income for the year, 30
- (d) all amounts that were or would be included in computing the insurer's income for the year as gains from the disposition of such of the property as is not capital property or a specified debt obligation (as defined in subsection 142.2(1) of the Act), 35

**(10) Paragraph (i) of the description of A in subsection 2411(4) of the Regulations is replaced by the following:**

(i) all other amounts that were or would be included in computing the insurer's income for the year in respect of the property otherwise than because of subsection 142.4(4) of the Act; and

5

**(11) The part of the description of B in subsection 2411(4) of the Regulations before paragraph (a) is replaced by the following:**

B is the total of the following amounts determined in respect of the property for the year, or that would be determined in respect of the property for the year if it were insurance property of the insurer for the year in respect of an insurance business in Canada and if it had been insurance property of the insurer in respect of an insurance business in Canada for each preceding taxation year in which it was held by the insurer:

10

**(12) Paragraph (b) of the description of B in subsection 2411(4) of the Regulations is replaced by the following:**

15

(a.1) all amounts that were or would be deductible under paragraph 142.4(5)(f) of the Act in respect of the property in computing the insurer's income for the year,

(b) all amounts that were or would be deductible in computing the insurer's income for the year as losses from the disposition of such of the property as is not capital property or a specified debt obligation (as defined in subsection 142.2(1) of the Act),

20

**(13) Paragraph (c) of the description of B in subsection 2411(4) of the Regulations is repealed.**

25

**(14) Section 2411 of the Regulations is amended by adding the following after subsection (4):**

(4.1) The positive or negative amount, as the case may be, determined under this subsection in respect of an insurer for a taxation year in respect of property disposed of by the insurer in the year or a preceding taxation year is the amount determined by the formula

30

$$A - B$$

where



A is the total of the amounts included under paragraphs 142.4(4)(a) and (c) of the Act in the insurer's income for the year in respect of the property, or that would be so included if the property had been insurance property of the insurer in respect of an insurance business in Canada for each taxation year in which it was held by the insurer; and 5

B is the total of the amounts deductible under paragraphs 142.4(4)(b) and (d) of the Act in respect of the property in computing the insurer's income for the year, or that would be so deductible if the property had been insurance property of the insurer in respect of an insurance business in Canada for each taxation year in which it was held by the insurer. 10

**(15) Subsection 2411(5) of the Regulations is repealed.**

**5. Paragraph (c) of the definition "eligible corporation" in subsection 5100(1) of the Regulations is replaced by the following:** 15

(c) a corporation that is

(i) a trader or dealer in securities,

(ii) a bank,

(iii) a corporation licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as trustee, 20

(iv) a credit union,

(v) an insurance corporation, or

(vi) a corporation the principal business of which is the lending of money or the purchasing of debt obligations or a combination thereof, 25

**6. (1) The portion of subsection 6201(5) of the Regulations before paragraph (a) is replaced by the following:**

(5) For the purpose of paragraph (f) of the definition "term preferred share" in subsection 248(1) of the Act, a share of a class of the capital stock of a corporation that is listed on a stock exchange referred to in section 3200 is a prescribed share at any particular time with respect to another corporation that is registered or licensed under the laws of a province to trade in securities and that holds the share for the purpose of sale in the course of the business ordinarily carried on by it unless 30 35

**(2) The portion of subsection 6201(5.1) of the Regulations before paragraph (a) is replaced by the following:**

(5.1) For the purpose of the definition "taxable RFI share" in subsection 248(1) of the Act, a share of a class of the capital stock of a corporation that is listed on a stock exchange referred to in section 3200 is a prescribed share at any particular time with respect to another corporation that is registered or licensed under the laws of a province to trade in securities and that holds the share for the purpose of sale in the course of the business ordinarily carried on by it unless

**7. Subparagraphs 6209(b)(i) and (ii) are replaced by the following:**

(i) the security is a mark-to-market property (as defined in subsection 142.2(1) of the Act) for the year of a financial institution (as defined in that subsection), or

(ii) the security is at any time in the year a property described in an inventory of a taxpayer.

**8. (1) Part LXXXI of the Regulations is amended by adding the following after section 8101:**

*Mark-to-Market — Transition Deduction*

8102. (1) In this section,

"excluded property" of a taxpayer means a mark-to-market property used in a business of the taxpayer in its taxation year that includes October 31, 1994 where it is reasonable to expect that the property would have been valued at its fair market value for the purpose of computing the taxpayer's income from the business for the year if

(a) the Act were read without reference to subsection 142.5(2), and

(b) the property were held at the end of the year;

"mark-to-market property" has the meaning assigned by subsection 142.2(1) of the Act.

(2) For the purpose of subsection 142.5(4) of the Act, the prescribed amount for a taxpayer's taxation year that includes October 31, 1994 is the amount, if any, by which

(a) the total of all amounts each of which is the taxpayer's profit from the disposition in the year, because of subsection 142.5(2) of the

Act, of a property other than a capital property or an excluded property

exceeds the total of

(b) the total of all amounts each of which is the taxpayer's loss from the disposition in the year, because of subsection 142.5(2) of the Act, of a property other than a capital property or an excluded property, and 5

(c) the amount, if any, by which

(i) the total of all amounts each of which is the taxpayer's loss from the disposition in the year of a mark-to-market property (other than a capital property, an excluded property or a property disposed of because of subsection 142.5(2) of the Act) 10

exceeds

(ii) the total of all amounts each of which is the taxpayer's profit from the disposition in the year of a mark-to-market property (other than a capital property, an excluded property or a property disposed of because of subsection 142.5(2) of the Act). 15

#### *Mark-to-Market — Transition Inclusion*

8103. (1) In this section, "transition deduction" of a taxpayer means the amount deducted under subsection 142.5(4) of the Act in computing the taxpayer's income for its taxation year that includes October 31, 1994. 20

(2) Subject to subsections (3), (5) and (7), there is prescribed for the purpose of subsection 142.5(5) of the Act in respect of a taxpayer for a taxation year that ends after October 30, 1994 the amount determined by the formula 25

$$\frac{A}{1825} \times B$$

where

A is the number of days (other than February 29) in the year that are before the day that is 5 years after the first day of the taxation year of the taxpayer that includes October 31, 1994, and 30

B is the taxpayer's transition deduction minus the amount, if any, required by subsection (4) or paragraph (6)(b) to be subtracted.

(3) Where subsection 88(1) of the Act has applied to the winding-up of a taxpayer (in this subsection referred to as the "subsidiary"),

(a) the value of A in subsection (2) shall be determined in respect of the subsidiary without including any days that are after the day on which the subsidiary's assets were distributed to its parent on the winding-up; and 5

(b) there is prescribed for the purpose of subsection 142.5(5) of the Act in respect of the parent for its taxation year that includes the day referred to in paragraph (a) the total of 10

(i) the amount that would be determined under subsection (2) in respect of the parent for the year if the parent's transition deduction did not include the subsidiary's transition deduction, and

(ii) the amount that would be determined under subsection (2) in respect of the parent for the year if 15

(A) the value of A in that subsection were determined without including the day referred to in paragraph (a) and any days before that day, and

(B) the value of B in that subsection were equal to the subsidiary's transition deduction. 20

(4) Where subsection 138(11.5) or (11.94) of the Act has applied to the transfer of an insurance business by an insurer, there shall be subtracted, in determining the value of B in subsection (2) in respect of the insurer for a taxation year that ends after the insurer ceased to carry on all or substantially all of the business, the part of the insurer's transition deduction that is included, because of paragraph 138(11.5)(k) of the Act, in the transition deduction of the person to whom the business was transferred. 25

(5) Where subsection 98(6) of the Act deems a partnership (in this subsection referred to as the "new partnership") to be a continuation of another partnership (in this subsection referred to as the "predecessor partnership"), 30

(a) the value of A in subsection (2) shall be determined in respect of the predecessor partnership without including any days that are after the day on which the predecessor partnership's property was transferred to the new partnership; and 35

(b) there is prescribed for the purpose of subsection 142.5(5) of the Act in respect of the new partnership for its taxation year that includes the day referred to in paragraph (a) the total of

(i) the amount that would be determined under subsection (2) in respect of the new partnership for the year if its transition deduction did not include the predecessor partnership's transition deduction, and

5

(ii) the amount that would be determined under subsection (2) in respect of the new partnership for the year if

(A) the value of A in that subsection were determined without including the day referred to in paragraph (a) and any days before that day, and

10

(B) the value of B in that subsection were equal to the predecessor partnership's transition deduction.

(6) Where a taxpayer ceases to carry on all or substantially all of a business, otherwise than as a result of a merger to which subsection 87(2) of the Act applies, a winding-up to which subsection 88(1) of the Act applies or a transfer of the business to which subsection 98(6) or 138(11.5) or (11.94) of the Act applies,

15

(a) there is prescribed for the purpose of subsection 142.5(5) of the Act in respect of the taxpayer for its taxation year in which the cessation of business occurs, in addition to the amount prescribed by subsection (2), the amount, if any, by which

20

(i) the part of the taxpayer's transition deduction that can reasonably be attributed to the business

25

exceeds

(ii) that part of the total of the amounts included under subsection 142.5(5) of the Act in computing the income of the taxpayer for preceding taxation years that can reasonably be considered to be in respect of the amount determined under subparagraph (i); and

30

(b) there shall be subtracted, in determining the value of B in subsection (2) in respect of the taxpayer for the year or a subsequent taxation year, the amount determined under subparagraph (a)(i).

(7) Where a taxpayer ceases at any time to be a financial institution otherwise than because it ceases to carry on a business,

35

(a) there is prescribed for the purpose of subsection 142.5(5) of the Act in respect of the taxpayer for its taxation year that ended immediately before that time, the amount, if any, by which

(i) the taxpayer's transition deduction

exceeds

5

(ii) the total of the amounts included under subsection 142.5(5) of the Act in computing the taxpayer's income for preceding taxation years; and

(b) the amount prescribed for the purpose of subsection 142.5(5) of the Act in respect of the taxpayer for taxation years after the taxation year referred to in paragraph (a) is nil. 10

*Mark-to-Market — Transition Capital Loss*

8104. (1) In this section,

"excluded property" of a taxpayer means a mark-to-market property of the taxpayer for its taxation year that includes October 31, 1994 where 15

(a) the taxpayer had a taxable capital gain or an allowable capital loss for the year from the disposition of the property to which section 142 of the Act applied, or

(b) in the case of a taxpayer that was non-resident in the year, the property was a capital property other than a taxable Canadian property; 20

"mark-to-market property" has the meaning assigned by subsection 142.2(1) of the Act.

(2) For the purpose of subsection 142.5(6) of the Act, the prescribed amount for a taxpayer's taxation year that includes October 31, 1994 is the amount, if any, by which 25

(a) the total of all amounts each of which is the taxable capital gain of the taxpayer for the year from the disposition, because of subsection 142.5(2) of the Act, of a property other than an excluded property 30

exceeds the total of

(b) the total of all amounts each of which is the allowable capital loss of the taxpayer for the year from the disposition, because of

subsection 142.5(2) of the Act, of a property other than an excluded property, and

(c) the amount, if any, by which

(i) the total of all amounts each of which is the allowable capital loss of the taxpayer for the year from the disposition of a mark-to-market property (other than an excluded property or a property disposed of because of subsection 142.5(2) of the Act)

5

exceeds

(ii) the total of all amounts each of which is the taxable capital gain of the taxpayer for the year from the disposition of a mark-to-market property (other than an excluded property or a property disposed of because of subsection 142.5(2) of the Act).

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### *Mark-to-Market — Transition Capital Gains*

8105. (1) In this section, "transition loss" of a taxpayer means the amount elected by the taxpayer under subsection 142.5(6) of the Act to be an allowable capital loss of the taxpayer for its taxation year that includes October 31, 1994.

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(2) There is prescribed for the purpose of subsection 142.5(7) of the Act in respect of a taxpayer for a taxation year that ends after October 30, 1994 the amounts that would be prescribed in respect of the taxpayer for the year by section 8103 if the references in subsections 8103(2) to (7) to

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(a) "subsection 142.5(5)" were read as "subsection 142.5(7)", and

(b) "transition deduction" were read as "transition loss (as defined in subsection 8105(1))".

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**9. (1) The Regulations are amended by adding the following after Part LXXXIX:**

### PART XC FINANCIAL INSTITUTIONS - PRESCRIBED ENTITIES AND SECURITIES

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9000. For the purpose of paragraph (e) of the definition "financial institution" in subsection 142.2(1) of the Act, a trust that is deemed to exist by paragraph 138.1(1)(a) of the Act is prescribed at a particular time where

(a) the trust was created not more than two years before that time; and

(b) the cost at that time of the trustee's interest in the trust does not exceed \$5,000,000.

9001. (1) In this section, "qualified small business corporation", at any time, means a corporation that, at that time, is 5

(a) a Canadian-controlled private corporation, and

(b) an eligible corporation (as defined in subsection 5100(1)) or a corporation that would be an eligible corporation if the definition "eligible corporation" in subsection 5100(1) were read without reference to paragraph (e), 10

where, at that time,

(c) the carrying value of the total assets of the corporation and all corporations related to it (determined in accordance with generally accepted accounting principles on a consolidated or combined basis, where applicable) does not exceed \$50,000,000, and 15

(d) the number of employees of the corporation and all corporations related to it does not exceed 500.

(2) For the purpose of paragraph (e) of the definition "mark-to-market property" in subsection 142.2(1) of the Act, a share of the capital stock of a corporation is a prescribed property in respect of a taxpayer where 20

(a) immediately after the time at which the taxpayer acquired the share, the corporation was a qualified small business corporation, and

(i) the corporation continued to be a qualified small business corporation for one year after that time, or 25

(ii) the taxpayer could not reasonably expect at that time that the corporation would cease to be a qualified small business corporation within one year after that time; or

(b) the share was issued to the taxpayer in exchange for one or more shares of the capital stock of the corporation that were prescribed by this subsection in respect of the taxpayer. 30



9002. (1) For the purposes of

(a) paragraph (e) of the definition "mark-to-market property" in subsection 142.2(1) of the Act, and

(b) subparagraph 142.6(4)(a)(ii) of the Act,

a debt obligation held by a bank is a prescribed property of the bank where the obligation is 5

(c) an exposure to a designated country (as defined in section 8006), or

(d) a United Mexican States Collateralized Par or Discount Bond Due 2019. 10

(2) For the purpose of paragraph (e) of the definition "mark-to-market property" in subsection 142.2(1) of the Act, a share is a prescribed property of a taxpayer for a taxation year where

(a) the share is a lending asset of the taxpayer in the year; or

(b) immediately after its issuance, the share was a share described in paragraph (e) of the definition "term preferred share" in subsection 248(1) of the Act and, at any time in the year, the share would be a term preferred share if 15

(i) that definition were read without reference to the portion following paragraph (b), and 20

(ii) where the share was issued or acquired on or before June 28, 1982, it were issued or acquired after that day.

(3) For the purpose of paragraph (e) of the definition "mark-to-market property" in subsection 142.2(1) of the Act, a share of the capital stock of a corporation held by a credit union is a prescribed property of the credit union for a taxation year where, throughout the year, 25

(a) the corporation is a credit union; or

(b) credit unions hold

(i) shares of the corporation that give the credit unions more than 50% of the votes that could be cast under all circumstances at an annual meeting of shareholders of the corporation, and 30

(ii) shares of the corporation having a fair market value of more than 50% of the fair market value of all the issued shares of the corporation.

9003. For the purpose of paragraph 142.2(3)(c) of the Act, a share described in paragraph 9002(2)(b) is prescribed in respect of all taxpayers. 5

## PART XCI FINANCIAL INSTITUTIONS - INCOME FROM SPECIFIED DEBT OBLIGATIONS

### *Interpretation* 10

9100. In this Part,

"fixed payment obligation" of a taxpayer means a specified debt obligation under which

(a) the amount and timing of each payment (other than a fee or similar payment or an amount payable because of a default by the debtor) to be made by the debtor were fixed when the taxpayer acquired the obligation and have not been changed, and 15

(b) all payments are to be made in the same currency;

"primary currency" of a specified debt obligation means

(a) the currency with which the obligation is primarily connected, and 20

(b) where there is no such currency, Canadian currency;

"specified debt obligation" of a taxpayer has the meaning assigned by subsection 142.2(1) of the Act;

"tax basis" of a specified debt obligation at any time to a taxpayer has the meaning assigned by subsection 142.4(1) of the Act; 25

"total return" of a taxpayer from a fixed payment obligation means the amount (measured in the primary currency of the obligation) by which

(a) the total of all amounts each of which is the amount of a payment (other than a fee or similar payment) required to be made by the debtor under the obligation after its acquisition by the taxpayer 30

exceeds

(b) the cost to the taxpayer of the obligation.

### *Prescribed Inclusions and Deductions*

9101. (1) For the purpose of paragraph 142.3(1)(a) of the Act, where a taxpayer holds a specified debt obligation at any time in a taxation year, the amount prescribed in respect of the obligation for the year is the total of 5

(a) the taxpayer's accrued return from the obligation for the year;

(b) where the taxpayer's accrual adjustment determined under section 9102 in respect of the obligation for the year is greater than nil, the amount of the adjustment; and 10

(c) where a foreign exchange adjustment is determined under section 9104 in respect of the obligation for the year and is greater than nil, the amount of the adjustment.

(2) For the purpose of paragraph 142.3(1)(b) of the Act, where a taxpayer holds a specified debt obligation at any time in a taxation year, the amount prescribed in respect of the obligation is the total of 15

(a) where the taxpayer's accrual adjustment determined under section 9102 in respect of the obligation for the year is less than nil, the absolute value of the amount of the adjustment; and 20

(b) where a foreign exchange adjustment is determined under section 9104 in respect of the obligation for the year and is less than nil, the absolute value of the amount of the adjustment.

### *General Accrual Rules*

Fixed Payment Obligations not in Default 25

9102. (1) For the purpose of paragraph 9101(1)(a), a taxpayer's accrued return for a taxation year from a fixed payment obligation, under which each payment required to be made before the end of the year was made by the debtor when it was required to be made, shall be determined in accordance with the following rules: 30

(a) determine, in the primary currency of the obligation, the portion of the taxpayer's total return from the obligation that is allocated to each day in the year using

(i) the level-yield method described in subsection (2), or

(ii) any other reasonable method that is substantially similar to the level-yield method;

(b) where the primary currency of the obligation is not Canadian currency, translate to Canadian currency the amount allocated to each day in the year, using a reasonable method of translation; and 5

(c) determine the total of all amounts each of which is the Canadian currency amount allocated to a day, in the year, at the beginning of which the taxpayer holds the obligation.

#### Level-Yield Method 10

(2) For the purpose of subsection (1), the level-yield method for allocating a taxpayer's total return from a fixed payment obligation is the method that allocates, to each particular day in the period that begins on the day following the day on which the taxpayer acquired the obligation and that ends on the day on which the obligation matures, the amount determined by the formula 15

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

where

A is the cost of the obligation to the taxpayer (measured in the primary currency of the obligation), 20

B is the total of all amounts each of which is the portion of the taxpayer's total return from the obligation that is allocated to a day before the particular day,

C is the total of all payments required to be made under the obligation after it was acquired by the taxpayer and before the particular day, and 25

D is the rate of interest per day that, if used in computing the present value (as of the end of the day on which the taxpayer acquired the obligation and based on daily compounding) of all payments to be made under the obligation after it was acquired by the taxpayer, produces a present value equal to the cost to the taxpayer of the obligation (measured in the primary currency of the obligation). 30

### Other Obligations

(3) For the purpose of paragraph 9101(1)(a), a taxpayer's accrued return for a taxation year from a specified debt obligation, other than an obligation to which subsection (1) applies, shall be determined

(a) using a reasonable method that,

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(i) taking into account the extent to which the obligation differs from fixed payment obligations, is consistent with the principles implicit in the methods that can be used under subsection (1) for fixed payment obligations, and

(ii) is in accordance with generally accepted accounting practice for the measurement of profit from debt obligations; and

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(b) on the basis of reasonable assumptions with respect to the timing and amount of any payments to be made by the debtor under the obligation that are not fixed in their timing or amount (measured in the primary currency of the obligation).

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### Accrual Adjustment

(4) For the purposes of paragraphs 9101(1)(b) and (2)(a), where a taxation year of a taxpayer is the first taxation year for which subsection 142.3(1) of the Act applies to the taxpayer in respect of a specified debt obligation, the taxpayer's accrual adjustment in respect of the obligation for the year is nil.

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(5) For the purposes of paragraphs 9101(1)(b) and (2)(a), where subsection (4) does not apply to determine a taxpayer's accrual adjustment in respect of a specified debt obligation for a particular taxation year, the taxpayer's accrual adjustment is the positive or negative amount determined by the formula

25

$$A - B$$

where

A is the total of all amounts each of which is the amount that would be the taxpayer's accrued return from the obligation for a taxation year, before the particular year, for which subsection 142.3(1) of the Act applied to the taxpayer in respect of the obligation if the accrued return were redetermined on the basis of

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(a) the information available at the end of the particular year, and

(b) the assumptions, if any, with respect to the timing and amount of payments to be made under the obligation after the particular year that were used for the purpose of determining the taxpayer's accrued return from the obligation for the particular year; and

5

B is the total of

(a) the amount included under paragraph 9101(1)(a) as the taxpayer's accrued return from the obligation for the taxation year immediately preceding the particular year, and

(b) where the taxpayer's accrual adjustment in respect of the obligation for that immediately preceding taxation year was determined under this subsection, the value of A for the purpose of determining that accrual adjustment.

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### Special Cases and Transition

(6) The rules in this section for determining accrued returns and accrual adjustments are subject to section 9103.

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### *Accrual Rules — Special Cases and Transition*

#### Convertible Obligation

9103. (1) For the purposes of section 9102, where the terms of a specified debt obligation of a taxpayer give the taxpayer the right to exchange the obligation for shares of the debtor or of a corporation related to the debtor,

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(a) subject to paragraph (b), the right shall be disregarded (whether or not it has been exercised); and

(b) unless less than 5% of the cost of the obligation to the taxpayer is attributable to the right, the cost shall be deemed to equal the amount by which the cost exceeds the portion of the cost attributable to the right.

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#### Default by Debtor

(2) For the purposes of section 9102, in determining amounts in respect of a specified debt obligation, no reduction shall be made on account of the possible or actual failure of the debtor to make any payments under the obligation.

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## Amendment of Obligation

(3) For the purposes of determining accrued returns and accrual adjustments under section 9102, where the terms of a specified debt obligation of a taxpayer have been amended to change the timing or amount of any payment to be made under the obligation, the amendment shall be taken into account as if the obligation had been acquired at the time the amendment was made. 5

### Obligations Acquired Before Financial Institution Rules Apply

(4) Where a taxpayer held a specified debt obligation at the beginning of the taxpayer's first taxation year (in this subsection referred to as the "initial year") for which subsection 142.3(1) of the Act applied to the taxpayer in respect of the obligation, the following rules apply: 10

(a) the taxpayer's accrued return from the obligation for the initial year or a subsequent taxation year shall not include an amount to the extent that the amount was included in computing the taxpayer's income for a taxation year preceding the initial year; and 15

(b) where

(i) interest on the obligation in respect of a period before the initial year becomes receivable or is received by the taxpayer in a particular taxation year that is the initial year or a subsequent taxation year, and 20

(ii) all or part of the interest would not, but for this paragraph, be included in computing the taxpayer's income for any taxation year, 25

there shall be included in determining the taxpayer's accrued return from the obligation for the particular year the amount, if any, by which

(iii) the portion of the interest that would not otherwise be included in computing the taxpayer's income for any taxation year 30

exceeds

(iv) the portion of the cost of the obligation to the taxpayer that is reasonably attributable to that portion of the interest.

### Prepaid Interest -- Transition Rule

(5) Where, before November 1994 and in a taxation year that ended after February 22, 1994, a taxpayer received an amount under a specified debt obligation in satisfaction, in whole or in part, of the debtor's obligation to pay interest in respect of a period after the year, 5

(a) the amount may, at the election of the taxpayer, be included in determining the taxpayer's accrued return for the year from the obligation; and

(b) where the amount is so included, the taxpayer's accrued returns for subsequent taxation years from the obligation shall not include any amount in respect of interest that, because of the payment of the amount, the debtor is no longer required to pay. 10

### *Foreign Exchange Adjustment*

9104. (1) For the purposes of paragraphs 9101(1)(c) and (2)(b), where, at the end of a taxation year, a taxpayer holds a specified debt obligation the primary currency of which is not Canadian currency, the taxpayer's foreign exchange adjustment in respect of the obligation for the year is the positive or negative amount determined by the formula 15

$$(A \times B) - C$$

where 20

A is the amount that would be the tax basis of the obligation to the taxpayer at the end of the year if

(a) the tax basis were determined using the primary currency of the obligation as the currency in which all amounts are expressed,

(b) the definition "tax basis" in subsection 142.4(1) of the Act were read without reference to paragraphs (f), (h), (o) and (q), and 25

(c) the taxpayer's foreign exchange adjustment in respect of the obligation for each year were nil,

B is the rate of exchange at the end of the year of the primary currency of the obligation into Canadian currency, and 30

C is the amount that would be the tax basis of the obligation to the taxpayer at the end of the year if

(a) the definition "tax basis" were read without reference to paragraphs (h) and (q), and



(b) the taxpayer's foreign exchange adjustment in respect of the obligation for the year were nil.

(2) Where a taxpayer disposes of a specified debt obligation the primary currency of which is not Canadian currency, the taxpayer's foreign exchange adjustment in respect of the obligation for the taxation year in which the disposition occurs is the amount that would be the foreign exchange adjustment if the year had ended immediately before the disposition.

(3) At the election of a taxpayer, subsection (2) does not apply to specified debt obligations disposed of by the taxpayer before 1996.

## PART XCII FINANCIAL INSTITUTIONS - DISPOSITION OF SPECIFIED DEBT OBLIGATIONS

### *Interpretation*

#### Definitions

9200. (1) In this Part,

"financial institution" has the meaning assigned by subsection 142.2(1) of the Act;

"gain" of a taxpayer from the disposition of a specified debt obligation means the gain from the disposition determined under paragraph 142.4(6)(a) of the Act;

"loss" of a taxpayer from the disposition of a specified debt obligation means the loss from the disposition determined under paragraph 142.4(6)(b) of the Act;

"residual portion" of a taxpayer's gain or loss from the disposition of a specified debt obligation means the amount determined under subsection 142.4(8) of the Act in respect of the disposition;

"specified debt obligation" of a taxpayer has the meaning assigned by subsection 142.2(1) of the Act;

"tax basis" of a specified debt obligation to a taxpayer has the meaning assigned by subsection 142.4(1) of the Act.

### Amortization Date

(2) For the purposes of this Part, the amortization date for a specified debt obligation disposed of by a taxpayer is the day determined as follows:

(a) subject to paragraphs (b) to (d), the amortization date is the later of the day of disposition and the day on which the debtor is required to make the final payment under the obligation, determined without regard to any option respecting the timing of payments under the obligation (other than an option that was exercised before the disposition); 5 10

(b) subject to paragraphs (c) and (d), where the day on which the debtor is required to make the final payment under the obligation is not determinable for the purpose of paragraph (a), the amortization date is the day of disposition;

(c) subject to paragraph (d), where 15

(i) the obligation provides for stipulated interest payments,

(ii) the rate of interest for one or more periods after the issuance of the obligation was not fixed on the day of issue, and

(iii) when the obligation was issued, it was reasonable to expect that the interest rate for each period would equal or approximate a reasonable market rate of interest for that period, 20

the amortization date is the first day, if any, after the disposition on which the interest rate could change; and

(d) where, for purposes of its financial statements, the taxpayer had a gain or loss from the disposition that is being amortized to profit, the amortization date is the last day of the amortization period. 25

### Transition Amount

9201. For the purpose of subsection 142.4(1) of the Act, "transition amount" of a taxpayer in respect of the disposition of a specified debt obligation means, 30

(a) where neither paragraph (b) nor (c) applies, nil;

(b) where

(i) the taxpayer acquired the obligation before its taxation year that includes February 23, 1994,

(ii) neither paragraph 7000(2)(a) nor (b) has applied to the obligation, and

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(iii) the principal amount of the obligation exceeds the cost of the obligation to the taxpayer (which excess is referred to in this paragraph as the "discount"),

the amount determined by the formula

$$A - B$$

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where

A is the total of all amounts each of which is the amount included in respect of the discount in computing the taxpayer's profit for a taxation year that ended before February 23, 1994, and

B is the total of all amounts each of which is the amount included in respect of the discount in computing the taxpayer's income for a taxation year that ended before February 23, 1994; and

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(c) where

(i) the conditions in subparagraphs (b)(i) and (ii) are satisfied, and

(ii) the cost of the obligation to the taxpayer exceeds the principal amount of the obligation (which excess is referred to in this paragraph as the "premium"),

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the negative of the amount determined by the formula

$$A - B$$

where

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A is the total of all amounts each of which is the amount deducted in respect of the premium in computing the taxpayer's profit for a taxation year that ended before February 23, 1994, and

- B** is the total of all amounts each of which is the amount deducted in respect of the premium in computing the taxpayer's income for a taxation year that ended before February 23, 1994.

*Prescribed Debt Obligations*

9202. (1) The following rules apply with respect to an election made under subsection (3) or (4) by a taxpayer: 5

(a) the election applies only if

(i) it is in writing,

(ii) it specifies the first taxation year (in this subsection referred to as the "initial year") of the taxpayer to which it is to apply, and 10

(iii) either it is received by the Minister within 6 months after the end of the initial year, or the Minister has expressly accepted the later filing of the election;

(b) subject to paragraph (c), the election applies to dispositions of specified debt obligations in the initial year and subsequent taxation years; and 15

(c) where the Minister has approved, on written application by the taxpayer, the revocation of the election, the election does not apply to dispositions of specified debt obligations in the taxation year specified in the application and in subsequent taxation years. 20

(2) Subject to subsection (3), for the purpose of subparagraph 142.4(5)(a)(ii) of the Act, a specified debt obligation disposed of by a taxpayer in a taxation year is prescribed in respect of the taxpayer where the amortization date for the obligation is not more than two years after the end of the year. 25

(3) Subsection (2) does not apply in respect of a taxpayer for a taxation year where

(a) generally accepted accounting principles require that the taxpayer's gains and losses arising on the disposition of a class of debt obligations be amortized to profit for the purpose of the taxpayer's financial statements; 30

(b) the taxpayer has elected not to have subsection (2) apply; and

(c) the election applies to dispositions in the year.

(4) For the purpose of subparagraph 142.4(5)(a)(ii) of the Act, a specified debt obligation disposed of by a taxpayer in a taxation year is prescribed in respect of the taxpayer where

(a) the taxpayer has elected to have this subsection apply; 5

(b) the election applies to dispositions in the year; and

(c) the absolute value of the positive or negative amount determined by the formula

$$A - B$$

does not exceed the lesser of \$5,000 and the amount, if any, specified in the election, where 10

A is the total of all amounts each of which is the residual portion of the taxpayer's gain from the disposition of the obligation or any other specified debt obligation disposed of in the same transaction, and 15

B is the total of all amounts each of which is the residual portion of the taxpayer's loss from the disposition of the obligation or any other specified debt obligation disposed of in the same transaction.

(5) For the purpose of subparagraph 142.4(5)(a)(ii) of the Act, a specified debt obligation disposed of by a taxpayer in a taxation year is prescribed in respect of the taxpayer where 20

(a) the disposition resulted in an extinguishment of the obligation, other than an extinguishment that occurred because of a purchase of the obligation by the debtor in the open market;

(b) the taxpayer had the right to require the obligation to be settled at any time; or 25

(c) the debtor had the right to settle the obligation at any time.

### *Residual Portion of Gain or Loss*

#### *Allocation of Residual Portion*

9203. (1) Subject to section 9204, where subsection 142.4(4) of the Act applies to the disposition of a specified debt obligation by a taxpayer, the amount allocated to each taxation year in respect of the 30

residual portion of the gain or loss from the disposition shall be determined, for the purpose of that subsection,

(a) by a method that complies with, or is substantially similar to a method that complies with, subsection (2); or

(b) where gains and losses from the disposition of debt obligations are amortized to profit for the purpose of the taxpayer's financial statements, by the method used for the purpose of the taxpayer's financial statements. 5

#### Proration Method

(2) For the purpose of subsection (1), a method for allocating to taxation years the residual portion of a taxpayer's gain or loss from the disposition of a specified debt obligation complies with this subsection where the amount allocated to each taxation year is determined by the formula 10

$$A \times \frac{B}{C} \quad 15$$

where

A is the residual portion of the taxpayer's gain or loss;

B is the number of days in the year that are in the period referred to in the description of C; and 20

C is the number of days in the period that,

(a) where subsection (3) applies in respect of the obligation, is determined under that subsection, and

(b) in any other case,

(i) begins on the day on which the taxpayer disposed of the obligation, and 25

(ii) ends on the earlier of

(A) the amortization date for the obligation, and

(B) the day that is 20 years after the day on which the taxpayer disposed of the obligation. 30

### Single Proration Period

#### (3) Where

(a) a taxpayer has elected in its return of income for a taxation year to have this subsection apply in respect of the specified debt obligations disposed of in a transaction in the year, 5

(b) all the obligations were disposed of at the same time, and

(c) the number of the obligations to which subsection 142.4(4) of the Act applies is at least 50,

the period determined under this subsection in respect of the obligations is the period that begins on the day of disposition of the obligations and ends on the weighted average amortization date for those obligations to which subsection 142.4(4) applies. 10

#### Weighted Average Amortization Date

(4) For the purpose of subsection (3), the weighted average amortization date for a group of specified debt obligations disposed of on the same day by a taxpayer is, 15

(a) where paragraph (b) does not apply, the day that is the number of days after the day of disposition equal to the total of the number of days determined in respect of each obligation by the formula

$$A \times \frac{B}{C} \quad 20$$

where

A is the number of days from the day of disposition to the amortization date for the obligation,

B is the residual portion of the gain or loss from the disposition of the obligation, and 25

C is the total of all amounts each of which is the residual portion of the gain or loss from the disposition of an obligation in the group; and

(b) the day that the taxpayer determines using a reasonable method for estimating the day determined under paragraph (a). 30

*Special Rules for Residual Portion of Gain or Loss*

Application of Section

9204. (1) This section applies for the purposes of subparagraphs 142.4(4)(c)(ii) and (d)(ii) of the Act.

Winding-Up

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(2) Where subsection 88(1) of the Act has applied to the winding-up of a taxpayer (in this subsection referred to as the "subsidiary"), the following rules apply in respect of the residual portion of a gain or loss of the subsidiary from the disposition of a specified debt obligation to which subsection 142.4(4) of the Act applies:

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(a) the amount of that residual portion allocated to the taxation year of the subsidiary in which its assets were distributed to its parent on the winding-up shall be determined on the assumption that the taxation year ended when the assets were distributed to its parent;

(b) no amount shall be allocated in respect of that residual portion to any taxation year of the subsidiary after its taxation year in which its assets were distributed to its parent; and

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(c) the amount of that residual portion allocated to the taxation year of the parent in which the subsidiary's assets were distributed to it shall be determined on the assumption that the taxation year began when the assets were distributed to it.

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Transfer of Insurance Business

(3) Where

(a) subsection 138(11.5) or (11.94) of the Act has applied to the transfer of an insurance business by an insurer, and

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(b) the person to whom the business was transferred is considered, because of paragraph 138(11.5)(k) of the Act, to be the same person as the insurer in respect of the residual portion of a gain or loss of the insurer from the disposition of a specified debt obligation to which subsection 142.4(4) of the Act applies,

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no amount in respect of that residual portion shall be allocated to any taxation year of the insurer that ends after the insurer ceased to carry on all or substantially all of the business.



### Transfer to New Partnership

(4) Where subsection 98(6) of the Act deems a partnership (in this subsection referred to as the "new partnership") to be a continuation of another partnership (in this subsection referred to as the "predecessor partnership"), the following rules apply in respect of the residual portion of a gain or loss of the predecessor partnership from the disposition of a specified debt obligation to which subsection 142.4(4) of the Act applies: 5

(a) the amount of that residual portion allocated to the taxation year of the predecessor partnership in which its property was transferred to the new partnership shall be determined on the assumption that the taxation year ended when the property was transferred; 10

(b) no amount shall be allocated in respect of that residual portion to any taxation year of the predecessor partnership after its taxation year in which its property was transferred to the new partnership; and 15

(c) the amount of that residual portion allocated to the taxation year of the new partnership in which the predecessor partnership's property was transferred to it shall be determined on the assumption that the taxation year began when the property was transferred to it.

### Ceasing to Carry on Business 20

(5) Where

(a) at any time a taxpayer ceases to carry on all or substantially all of a business, otherwise than as a result of a merger to which subsection 87(2) of the Act applies, a winding-up to which subsection 88(1) of the Act applies or a transfer of the business to which subsection 98(6) or 138(11.5) or (11.94) of the Act applies, 25

(b) before that time, the taxpayer disposed of a specified debt obligation that was property used in the business, and

(c) subsection 142.4(4) of the Act applies to the disposition of the obligation, 30

there shall be allocated to the taxpayer's taxation year that includes that time the part, if any, of the residual portion of the taxpayer's gain or loss from the disposition that was not allocated to a preceding taxation year.

## Ceasing to be a Financial Institution

### (6) Where

(a) at any time a taxpayer ceases to be a financial institution otherwise than because it has ceased to carry on a business,

(b) before that time, the taxpayer disposed of a specified debt obligation, and 5

(c) subsection 142.4(4) of the Act applies to the disposition of the obligation,

there shall be allocated to the taxpayer's taxation year that ends immediately before that time the part, if any, of the residual portion of the taxpayer's gain or loss from the disposition that was not allocated to a preceding taxation year. 10

### 10.(1) Sections 1 and 5 apply after February 22, 1994.

(2) Subsections 2(1), (4) and (7) and 3(4), (9) and (11) and section 8 apply to taxation years that end after October 30, 1994 except that 15

(a) in its application to property disposed of in a taxation year that ends on or before ANNOUNCEMENT DATE, paragraph (f) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations, as enacted by subsection 3(4), shall be read as follows: 20

(f) the amount included in computing the insurer's taxable capital gains for the year from the disposition of property (other than an amount included because of subsection 142.5(7)) of the Act,

(b) in its application to property disposed of in a taxation year that ends on or before ANNOUNCEMENT DATE, paragraph (k) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations, as enacted by subsection 3(9), shall be read as follows: 25

(k) the amount included in computing the insurer's allowable capital losses for the year from the disposition of property (other than an amount included because of subsection 142.5(6)) of the Act); 30

**(3) Subsections 2(2) and (5) apply to taxation years that begin after 1992.**

**(4) Subsections 2(3) and (6), 3(7) and (10) and 4(10) and sections 7 and 9 apply to taxation years that end after February 22, 1994.**

5

**(5) Subsections 3(1) and 4(7) and (11) apply to taxation years that end after ANNOUNCEMENT DATE.**

**(6) Subsections 3(2), (5) and (6) and 4(8), (13) and (15) apply to taxation years that begin after February 22, 1994.**

**(7) Subsections 3(3) and (8) and 4(9) and (12) apply to dispositions of property that occur after February 22, 1994 except that,**

10

**(a) in its application to property disposed of in a taxation year that ends on or before ANNOUNCEMENT DATE, paragraph (e) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations, as enacted by subsection 3(3), shall be read as follows:**

15

**(e) the amount included in computing the insurer's gains for the year from the disposition of property (other than capital property or property in respect of which section 142.4 of the Act applies),**

20

**(b) in its application to property disposed of in a taxation year that ends on or before ANNOUNCEMENT DATE, paragraph (j) of the definition "gross Canadian life investment income" in subsection 2405(3) of the Regulations, as enacted by subsection 3(8), shall be read as follows:**

25

**(j) the amount included in computing the insurer's losses for the year from the disposition of property (other than capital property or property in respect of which section 142.4 of the Act applies),**

**(8) Subsections 4(1) to (6) and (14) apply to the 1995 and subsequent taxation years.**

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**(9) Section 6 applies to dividends received in taxation years that begin after October 1994.**

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# Explanatory Notes to the Income Tax Regulations

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

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## **Section 1**

### **Prescribed Annuity Contracts**

#### **ITR**

#### **304(1)(c)(ii)**

Section 304 of the *Income Tax Regulations* prescribes certain annuity contracts for exclusion from the rules in the *Income Tax Act* that require income from insurance policies to be reported on an accrual basis. Paragraph 304(1)(c) provides an exclusion for an annuity under which payments have commenced if a number of other conditions are also satisfied. Subparagraph 304(1)(c)(ii) requires that the annuity have been issued by a person specified in that provision. Acceptable issuers include corporations described in any of paragraphs 39(5)(b) to (d) of the Act — banks, trust companies and credit unions.

Subsection 39(5) of the Act is being amended to replace several of its paragraphs by a reference to "financial institutions" (as defined in subsection 142.2(1) of the Act). Consequently, subparagraph 304(1)(c)(ii) is amended to refer to corporations referred to in any of paragraphs (a) to (c) of the definition of "specified financial institution" in subsection 248(1) of the Act, which are the same corporations as were referred to in paragraphs 39(5)(b) to (d).

## **Section 2**

### **Income from Participating Life Insurance Businesses**

#### **ITR**

#### **2402**

Section 2402 of the Regulations contains rules for determining a life insurer's income for a year from carrying on its participating life insurance business in Canada. This income is relevant for subparagraph 138(3)(a)(iii) of the Act, which permits an insurer to deduct policy dividends to the extent that the total amount of dividends paid after its 1968 taxation year does not exceed the total amount of its participating business income after that year. Section 2402 is amended to reflect the new rules in the Act for the tax treatment of securities held by financial institutions, and to delete provisions which are no longer applicable.

**ITR****2402(a.1)**

New paragraph 2402(a.1) includes in an insurer's income from its participating business for a taxation year an amount in respect of the transition adjustments for the mark-to-market requirement for shares. The amount included is equal to a proportion of the transition amount for non-capital gains included in the insurer's income for the year by subsection 142.5(5) of the Act, plus the same proportion of the insurer's deemed taxable capital gain for the year under subsection 142.5(7). The ratio used for this purpose is equal to the ratio used under paragraph 2402(a) in determining the proportion of the insurer's gross Canadian life investment income for its taxation year that includes October 31, 1994 that is included in its income from its participating business. Paragraph 2402(a.1) applies to taxation years ending after October 30, 1994.

**ITR****2402(b)(iv)**

Subparagraph 2402(b)(iv) relates to a transitional provision introduced in conjunction with the 1987 tax reform measures. The transitional provision, and subparagraph 2402(b)(iv), last applied to taxation years that began in 1992. The subparagraph is repealed since it is no longer applicable.

**ITR****2402(e)**

Paragraph 2402(e) provides that certain amounts are not included in computing an insurer's income from its participating life insurance business, except as provided by paragraph 2402(a).

Paragraph 2402(e) is amended so that it applies with respect to all amounts included in determining an insurer's gross Canadian life investment income. This amendment is made for purposes of clarification, and because of the introduction of the new rules for the taxation of securities held by financial institutions. In this latter regard, subparagraph 2402(e)(i) refers to paragraphs 138(4)(b) and (c) of the Act, which are being repealed.

The amendment to paragraph 2402(e) applies to taxation years that end after February 22, 1994.

**ITR**  
**2402(e.1)**

New paragraph 2402(e.1) provides that the transition amounts associated with the introduction of the mark-to-market requirement for shares are not to be included in an insurer's income from its participating life insurance business, except as provided by new paragraph 2402(a.1).

**ITR**  
**2402(e.2)**

New paragraph 2402(e.2) provides for a deduction in computing an insurer's income from its participating business in respect of the transition deductions associated with the introduction of the mark-to-market requirement for shares. This deduction applies for the insurer's taxation year that includes October 31, 1994. The deducted amount is equal to a proportion of the transition deduction for non-capital gains claimed by the insurer under subsection 142.5(4) of the Act, plus the same proportion of the allowable capital loss claimed by the insurer under subsection 142.5(6). The ratio used for this purpose is equal to the ratio used under paragraph 2402(a) in determining the proportion of the insurer's gross Canadian life investment income for its taxation year that includes October 31, 1994 that is included in its income from its participating business.

**ITR**  
**2402(f)(iii)**

Subparagraph 2402(f)(iii) relates to a transitional deduction provided in conjunction with the 1987 tax reform measures. The transitional deduction, and subparagraph 2402(f)(iii), applied to an insurer's first taxation year that began after June 17, 1987 and ended after 1987. The subparagraph is repealed since it is no longer applicable.

**ITR**  
**2402(h)**

Paragraph 2402(h) provides that certain amounts are not deducted in computing an insurer's income from its participating life insurance business, except as provided by paragraph 2402(a). Paragraph 2402(h) is amended so that it applies with respect to all

amounts that are included in determining an insurer's gross Canadian life investment income. This amendment is made for purposes of clarification and because of the introduction of the new rules for the taxation of securities held by financial institutions. In this latter regard, subparagraph 2402(h)(i) refers to paragraphs 138(3)(b) and (d) of the Act, which are being repealed.

The amendment to paragraph 2402(h) applies to taxation years that end after February 22, 1994.

## **ITR**

### **2402(h.1)**

New paragraph 2402(h.1) provides that the transition amounts deducted by an insurer in connection with the introduction of the mark-to-market requirement for shares are not to be deducted in computing the insurer's income from its participating life insurance business, except as provided by new paragraph 2402(e.2).

## **Section 3**

### **Interpretation**

## **ITR**

### **2405(3)**

Subsection 2405(3) of the Regulations defines a number of expressions used in Part XXIV of the Regulations.

### **"gross Canadian life investment income"**

The expression "gross Canadian life investment income" is defined for the purpose of section 2402 of the Regulations, which contains rules for determining an insurer's income for a year from carrying on its participating life insurance business in Canada. Several amendments are made to this definition:

- Paragraph (a) is amended to use the newly-defined term "Canadian business property", which is defined in subsection 2405(3). Gross investment revenue from such property held in respect of an insurer's life insurance business is

included by paragraph (a) in determining the insurer's gross Canadian life investment income. This amendment applies to taxation years that end after ANNOUNCEMENT DATE.

- Paragraph (c) is repealed. This paragraph includes, in determining an insurer's gross Canadian life investment income, the amounts included in the insurer's income by paragraphs 138(4)(b) and (c) of the Act (profit on disposition of a Canada security, and amortization of discount on such a security). This amendment is consequential on the repeal of paragraphs 138(4)(b) and (c).
- Paragraphs (d) and (i), which deal with doubtful debt reserves, are amended as a consequence of the repeal of the definition of "Canada security" in subsection 138(12) of the Act. The amended paragraphs refer to debt obligations that are "Canadian business property" of the insurer in respect of the insurer's life insurance business.
- New paragraph (d.1) includes in an insurer's gross Canadian life investment income the amounts that are included in the insurer's income by section 142.4 of the Act in respect of property disposed of by the insurer that was "Canadian business property" of the insurer in respect of its life insurance business. New paragraph (i.1) is a corresponding rule for deductions. New section 142.4 of the Act contains rules for the measurement and the timing of recognition of gains and losses from the disposition of specified debt obligations.
- Paragraph (e), which includes certain non-capital gains in an insurer's gross Canadian life investment income, is amended to exclude from its scope property in respect of which section 142.4 of the Act applies. Gains from the disposition of this property are taken into account by new paragraph (d.1). Paragraph (e) is also amended, for dispositions of property in taxation years ending after ANNOUNCEMENT DATE, to clarify that it applies only to the property of an insurer's Canadian life insurance business. Similar changes are made to the rule in paragraph (j) for certain non-capital losses.
- Paragraph (f), which includes an insurer's taxable capital gains in its gross Canadian life investment income, is amended so that

it does not include amounts deemed by subsection 142.5(7) of the Act to be taxable capital gains of the insurer. That subsection contains a transition rule relating to the introduction of the mark-to-market requirement. Paragraph (f) is also amended, for dispositions of property in taxation years ending after ANNOUNCEMENT DATE, to clarify that it applies only to the property of an insurer's Canadian life insurance business. Similar changes are made to the rule in paragraph (k) for allowable capital losses.

- Paragraph (g) is repealed since the provision to which it refers — paragraph 138(3)(c) of the Act (investment reserve) — was repealed in the tax reform of 1987.
- Paragraph (h) is repealed. This paragraph deducts in determining an insurer's gross Canadian life investment income the amounts deducted under paragraphs 138(3)(b) and (d) of the Act (loss on disposition of a Canada security, and amortization of premium on such a security) in computing an insurer's income. This amendment is consequential on the repeal of paragraphs 138(3)(b) and (d).

### **"Canadian business property"**

A definition of "Canadian business property" is added to subsection 2405(3). This expression is used in the definition of "gross Canadian life investment income", which is also in subsection 2405(3).

In the case of an insurer that is required to designate property under subsection 2400(1) of the Regulations, the "Canadian business property" of the insurer for a taxation year in respect of an insurance business is the property designated for the year in respect of the business. (The designation rules apply to non-resident insurers, and to multinational resident life insurers.)

The "Canadian business property" of any other insurer for a taxation year in respect of an insurance business is the property that is factually determined to have been used by the insurer in the year in, or held by it in the year in the course of, carrying on the business in Canada.

**ITR  
2405(5)**

New subsection 2405(5) of the Regulations contains a rule for the purposes of the definitions in subsection 2405(3). It provides that the cost of property is to be determined without regard to the mark-to-market requirement in subsection 142.5(2) of the Act. Thus, the cost of mark-to-market property will not change each year for the purpose of the definitions in subsection 2405(3). This rule is relevant for determining the "valuation" of shares, and hence the "value for the year" of shares. As a consequence of this rule, the original cost of shares to an insurer will generally be used in measuring the Canadian investment fund, designating property, and determining any additional investment revenue prescribed by section 2411.

Subsection 2405(5) applies to taxation years ending after October 30, 1994.

**Section 4****Minimum Net Investment Revenue****ITR  
2411**

Subsection 138(9) of the Act requires a resident multinational life insurer or a non-resident insurer to include the following amounts in income: (i) its gross investment revenue from property designated as property used or held by it in carrying on its insurance businesses in Canada; and (ii) any additional amount that is prescribed.

Section 2411 of the Regulations prescribes an amount for this purpose that ensures that the insurer's net investment revenue from its designated property is not less than the net investment revenue that would be determined if the average rate of return on its designated assets of each class were equal to the average rate of return on all its investment property of that class. This prevents an insurer from understating its Canadian business income by designating assets with lower investment returns.



**Prescribed amount****ITR****2411(1)**

Subsection 2411(1) prescribes the additional amount, if any, that an insurer is required by paragraph 138(9)(b) of the Act to include in computing its income for a taxation year. This amount is equal to the difference between the insurer's minimum amount of net investment revenue for the year determined under subsection 2411(3) and the insurer's actual net investment revenue for the year from its designated property determined under subsection 2411(4). If, in preceding taxation years, the insurer's actual revenue has exceeded the required minimum, the insurer may have a carryforward amount that can be used to reduce the prescribed amount.

Subsection 2411(1) is amended as a consequence of the introduction of rules in subsection 142.4(4) of the Act that apply to the disposition of certain specified debt obligations (as defined in subsection 142.2(1) of the Act). The amendment includes in the determination of the insurer's actual net investment revenue for a particular taxation year the amount determined under new subsection 2411(4.1) in respect of specified debt obligations disposed of by the insurer at any time that were designated as property of an insurance business carried on by the insurer in Canada. The amount determined under subsection 2411(4.1) for a taxation year is equal to the net amount required by subsection 142.4(4) of the Act to be included in respect of the obligations in computing the income of the insurer for the year (or the net amount that is deductible in respect of the obligations, expressed as a negative amount).

The amendments to subsection 2411(1) apply to 1995 and subsequent taxation years.

**Determination of minimum net investment revenue****ITR****2411(3)**

Subsection 2411(3) provides for the computation of the minimum amount of net investment revenue that must be reported by an insurer for a taxation year. This revenue is calculated by determining

average yield rates for either two or three classes of assets, and applying each rate to the amount of assets of the class that have been designated for the year as property of an insurance business carried on by the insurer in Canada. The amounts that are taken into account in determining average yield rates are specified by subsection 2411(4), and include gains and losses from the disposition of property. In the case of property that has not been designated as property of an insurance business carried on by the insurer in Canada, the amounts are determined as if the property had been so designated.

Subsection 2411(3) is amended as a consequence of the introduction of rules in subsection 142.4(4) of the Act that apply to the disposition of certain specified debt obligations. The amendment includes, in determining the average yield rate for a class of assets, the amount determined under new subsection 2411(4.1) in respect of those assets. The amount determined under subsection 2411(4.1) for a taxation year is equal to the net amount required by subsection 142.4(4) of the Act to be included in respect of the assets in computing the income of the insurer for the year (or the net amount that is deductible in respect of the assets, expressed as a negative amount).

The amendments to subsection 2411(3) apply to 1995 and subsequent taxation years.

### **Investment revenue from class of property**

#### **ITR**

#### **2411(4)**

Subsection 2411(4) provides that an insurer's net investment revenue from property of a particular class is determined by the formula "A - B", where A is the total of the gross investment revenue from the property, gains from the disposition of the property and other income inclusions in respect of the property, and B is losses from the property and other deductions in respect of the property. The amounts included in A and B in respect of property that has not been designated as property of an insurance business carried on by the insurer in Canada are determined as if the property had been so designated. Several changes are made to the determination of amounts A and B.

The descriptions of both A and B are amended to clarify that, in determining the amounts to be taken into account in respect of property that has not been designated, the property is to be treated as if it had been designated for each year from the time it was acquired.

The other changes to A are as follows:

- Paragraph (b) is repealed. This paragraph includes in A the amounts included in the insurer's income under paragraphs 138(4)(b) and (c) of the Act (profit on disposition of a Canada security, and amortization of discount on such a security). This amendment is consequential on the repeal of paragraphs 138(4)(b) and (c).
- New paragraph (c.1) includes in A the amounts that are included in the insurer's income by subsection 142.4(5) of the Act. That subsection includes in income the gain from the disposition of specified debt obligations after February 22, 1994 where the gain is not required to be amortized.
- Paragraph (d), which includes certain non-capital gains in A, is amended to replace the exclusion for gains from Canada securities by an exclusion for gains from specified debt obligations. Those gains are dealt with, in some cases, by new paragraph (c.1) and in other cases by new subsection 2411(4.1).
- Paragraph (i), which includes in A all amounts that are included in the insurer's income in respect of the property, but that are not specifically referred to in the preceding paragraphs, is amended so that it does not apply to amounts that are included in income by subsection 142.4(4) of the Act. New subsection 2411(4.1), in conjunction with amendments to subsections 2411(1) and (3), provides for subsection 142.4(4) amounts to be taken into account.

The changes to B, in addition to the change described above, are as follows:

- New paragraph (a.1) includes in B the amounts that are deductible under subsection 142.4(5) of the Act in computing the insurer's income. That subsection provides a deduction for

the loss from the disposition of specified debt obligations after February 22, 1994 where the loss is not required to be amortized.

- Paragraph (b), which includes certain non-capital losses in B, is amended to replace the exclusion for losses from Canada securities by an exclusion for losses from specified debt obligations. Those losses are dealt with, in some cases, by new paragraph (a.1) and in other cases by new subsection 2411(4.1).
- Paragraph (c) is repealed. This paragraph includes in B the amounts that are deductible under paragraphs 138(3)(b) and (d) of the Act (loss on disposition of a Canada security, and amortization of premium on such a security). This amendment is consequential on the repeal of paragraphs 138(3)(b) and (d).

### **Net inclusion or deduction re specified debt obligations**

#### **ITR**

#### **2411(4.1)**

New subsection 142.4(4) of the Act contains rules that apply with respect to the disposition of certain specified debt obligations. (The term "specified debt obligation" is defined in subsection 142.2(1) of the Act.) In particular, subsection 142.4(4) provides in general for the amortization of all or part of a gain or loss. New subsection 2411(4.1) of the Regulations, in conjunction with amendments to subsections 2411(1) and (3), provides for the subsection 142.4(4) amounts to be taken into account in determining the amount, if any, prescribed by subsection 2411(1). A related amendment to subsection 2411(4) ensures that subsection 142.4(4) amounts are not taken into account twice.

New subsection 2411(4.1) determines an amount with respect to a group of specified debt obligations disposed of by an insurer before the end of a taxation year. (This includes obligations disposed of in preceding taxation years.) The amount for a year (which may be positive or negative) is equal to:

- the total of all amounts included by subsection 142.4(4) in the insurer's income for the year in respect of the obligations (or that would be so included if the property had been property of a Canadian insurance business)

minus

- the total of all amounts deductible under subsection 142.4(4) in respect of the obligations in computing the insurer's income for the year (or that would be so deductible if the property had been property of a Canadian insurance business).

Subsection 2411(4.1) is invoked by subsections 2411(1) and (3). For the purpose of subsection 2411(1), the subsection 2411(4.1) amount is determined in respect of specified debt obligations that were designated as property of an insurance business carried on by the insurer in Canada. Subsection 2411(3) provides for the subsection 2411(4.1) amount to be determined in respect of all specified debt obligations that are Canadian investment property, whether or not they have been designated by the insurer. It also provides for a similar determination in respect of specified debt obligations that are foreign investment property.

### **Non-designated property**

#### **ITR**

#### **2411(5)**

Where property has not been designated as property used or held in a Canadian insurance business, subsection 2411(4) applies on the assumption that the property had been so designated. Subsection 2411(5) contains an additional rule for this purpose. It provides that the property is to be considered property of the business in respect of which it is reported in the insurer's annual report. This rule was required because of the special rules for the tax treatment of debt obligations (referred to as Canada securities) that are property of a life insurance business. Subsection 2411(5) is repealed, for taxation years beginning after February 22, 1994, as a consequence of the repeal of the special rules for Canada securities.

## **Section 5**

### **Deferred Income Plans -- Investments in Small Business**

**ITR**

**5100(1)**

#### **"eligible corporation"**

Subsection 5100(1) of the Regulations defines the expression "eligible corporation". This expression is relevant for various rules relating to investments made by registered retirement savings plans and other deferred income plans. Paragraph (c) of the definition provides that the expression does not include a corporation described in subsection 39(5) of the Act. These are financial institutions — banks, trust companies, credit unions, insurance corporations and money-lenders — and also traders or dealers in securities.

Subparagraph 39(5) of the Act is being amended to replace several of its paragraphs by a reference to "financial institutions" (as defined in subsection 142.2(1) of the Act). Consequently, paragraph (c) of the definition of "eligible corporation" is amended to specifically list the types of corporations that are excluded. This amendment applies after February 22, 1994.

## **Section 6**

### **Term Preferred Shares -- Prescribed Shares**

**ITR**

**6201(5) and (5.1)**

Subsections 6201(5) and (5.1) of the Regulations prescribe certain shares held by securities dealers as shares that are excluded from being "term preferred shares" and "taxable RFI shares". One of the requirements for the exclusion to apply to a share is that it be held as inventory of the business ordinarily carried on by the securities dealer. This requirement is replaced by a requirement that the share be held for the purpose of sale in the course of the business ordinarily carried on by the securities dealer. This amendment is made as a consequence of the introduction of subsection 142.6(3) of

the Act, which provides that certain property held by a financial institution is considered not to be inventory. The new requirement is intended to be the same, in substance, as the former requirement.

The amendments to subsections 6201(5) and (5.1) apply to dividends received in taxation years that begin after October 1994.

## **Section 7**

### **Lending Assets -- Prescribed Securities**

#### **ITR**

#### **6209(b)**

Section 6209 of the Regulations prescribes certain shares and other securities for the purpose of the definition of "lending asset" in subsection 248(1) of the Act. Securities prescribed by paragraph 6209(b) are excluded from being lending assets. Paragraph 6209(b) prescribes a security if it is included in the trading account of a bank or in the inventory of a taxpayer other than a bank.

Paragraph 6209(b) is amended to provide that a security is prescribed if it is a mark-to-market property or is included in a taxpayer's inventory. "Mark-to-market property", which is defined in new subsection 142.2(1) of the Act, includes most shares and some debt obligations.

As a consequence of this amendment, a specified debt obligation (as defined in subsection 142.2(1) of the Act) held by a bank in its trading account will be treated as a lending asset if it is not a mark-to-market property. This observation applies, in particular, to the debt obligations of a country that has been designated by the Office of the Superintendent of Financial Institutions and to the United Mexican States Collateralized Par or Discount Bonds Due 2019.

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

## **Section 8**

### **Mark-to-Market Requirement -- Transition Rules**

#### **ITR**

##### **Part LXXXI**

Part LXXXI of the Regulations contains transition rules for the 1987 tax reform changes to the reserves available to financial institutions. On December 8, 1994, draft amendments were announced that would repeal these rules and introduce (in sections 8100 and 8101) new transition rules relating to unpaid claims reserves for non-life insurance policies.

New transition rules are added in sections 8102 to 8105 in connection with the introduction of the mark-to-market requirement for shares and certain debt obligations held by financial institutions. These new rules apply to taxation years ending after October 30, 1994.

### **Mark-to-market -- transition deduction**

#### **ITR**

##### **8102**

Section 8102 of the Regulations prescribes the maximum transition deduction that may be claimed under subsection 142.5(4) of the Act in respect of non-capital properties.

### **Definitions**

#### **ITR**

##### **8102(1)**

Subsection 8102(1) defines terms that are used in section 8102.

"Excluded property" of a taxpayer is property that it is reasonable to consider would have been marked to market for tax purposes in the taxpayer's taxation year that includes October 31, 1994, even if a requirement to do so had not been introduced. The determination of whether property that has been sold during the year is excluded property is to be made assuming that the taxpayer continued to hold the property throughout the year.



"Mark-to-market property" of a taxpayer has the meaning given by subsection 142.2(1) of the Act. In general terms, it comprises most shares held by the taxpayer and debt obligations that are marked to market for financial statement purposes.

### **Prescribed amount**

#### **ITR**

#### **8102(2)**

Subsection 142.5(4) of the Act contains a transition deduction in respect of the introduction of the requirement that certain property be marked to market for tax purposes. It permits a taxpayer to deduct an amount not exceeding a prescribed amount in its taxation year that includes October 31, 1994. Subsection 8102(2) of the Regulations prescribes the following maximum amount for this purpose:

- the taxpayer's total profits from the disposition of non-capital mark-to-market properties (other than excluded properties, as defined in subsection 8102(1)) that the mark-to-market rules deem the taxpayer to have disposed of in the year

#### **minus**

- the taxpayer's total losses from the disposition of non-capital mark-to-market properties (other than excluded properties) that the mark-to-market rules deem the taxpayer to have disposed of in the year, and
- the taxpayer's net losses (i.e., losses minus profits) from actual dispositions in the year of non-capital mark-to-market properties (other than excluded properties) and from deemed dispositions of such properties otherwise than because of the mark-to-market rules.

### **Mark-to-market -- transition inclusion**

#### **ITR**

#### **8103**

Section 8103 of the Regulations applies where a taxpayer has claimed a deduction under subsection 142.5(4) of the Act in respect of the

introduction of the mark-to-market requirement. It prescribes the amount to be included in income each year under subsection 142.5(5) of the Act in respect of the deducted amount. Generally, the deducted amount is required to be included in income over a 5-year period. Section 8103 also contains rules for the income inclusion after certain corporate reorganizations have occurred or where a taxpayer ceases to carry on a business or to be a financial institution.

### **"Transition deduction" defined**

#### **ITR**

#### **8103(1)**

Subsection 8103(1) defines the "transition deduction" of a taxpayer to be the amount deducted under subsection 142.5(4) of the Act in computing the taxpayer's income for its taxation year that includes October 31, 1994.

Where a taxpayer has been formed by amalgamation, the continuity rule in paragraph 87(2)(g.2) of the Act ensures that any amount deducted by a predecessor corporation under subsection 142.5(4) of the Act is considered to have been deducted by the taxpayer. Therefore, the taxpayer's transition deduction is the sum of the transition deductions of its predecessors.

Similarly, the transition deduction of a taxpayer to which a business has been transferred in a transaction to which subsection 88(1) (winding-up), 138(11.5) (transfer of insurance business by a non-resident insurer) or 138(11.94) (transfer of insurance business by a resident insurer) of the Act applies will include the amount deducted by the transferor under subsection 142.5(4) in respect of the business. The relevant continuity rules are in paragraph 87(2)(g.2) (which applies to a winding-up by reason of paragraph 88(1)(e.2)) and paragraph 138(11.5)(k).

### **Prescribed amount**

#### **ITR**

#### **8103(2)**

Subsection 8103(2) prescribes the amount to be included in income each year under subsection 142.5(5) of the Act by a taxpayer that has

claimed a transition deduction under subsection 142.5(4). The first taxation year for which an amount is prescribed is the taxation year that includes October 31, 1994. The prescribed amount for a taxation year is given by the formula:

$$\frac{A}{1825} \times B$$

where

A = the number of days in the year that are not more than 5 years after the start of the taxpayer's taxation year that includes October 31, 1994 -- February 29th is disregarded for this purpose, and

B = the taxpayer's transition deduction minus the amounts specified by subsection 8103(4) and paragraph 8103(6)(b).

Subsections 8103(3), (5) and (7) contain rules that override the determination of the prescribed amount under subsection 8103(2) when a taxpayer undergoes a reorganization, ceases to be a financial institution or ceases to carry on a business.

## **Winding-up**

### **ITR 8103(3)**

As noted in the commentary on subsection 8103(1), where a subsidiary is wound up into its parent corporation and subsection 88(1) of the Act applies to the winding-up, the parent will be considered to have deducted the amount deducted by the subsidiary under subsection 142.5(4) of the Act. Thus, this amount will be taken into account in determining the amounts prescribed by subsection 8103(2) in respect of the parent.

Subsection 8103(3) contains additional rules relating to the winding-up of a subsidiary. These rules ensure that no part of the subsidiary's transition deduction is required to be included in both the parent's and the subsidiary's income.

Paragraph 8103(3)(a) provides that the amounts prescribed by subsection 8103(1) for the subsidiary are to be determined ignoring any days after the day on which the subsidiary's assets are distributed to its parent. This rule is relevant only if the subsidiary has a taxation year that ends after the day on which the distribution occurs.

Paragraph 8103(3)(b) prescribes the amount to be included in the parent's income under subsection 142.5(5) of the Act for the taxation year in which it receives the subsidiary's assets. The prescribed amount is equal to the sum of

- the amount that would otherwise be prescribed by subsection 8103(2) if the parent's transition deduction did not include any amount in respect of the subsidiary's transition deduction, and
- the part of the subsidiary's transition deduction that must be recognized in respect of the days in the taxation year after the parent receives the subsidiary's assets.

### **Transfer of insurance business**

#### **ITR**

#### **8103(4)**

Subsection 8103(4) applies where an insurer has transferred an insurance business to another corporation on a rollover basis pursuant to subsection 138(11.5) or (11.94) of the Act. It provides that after the transfer of the business, the portion of the transferor's transition deduction that is considered a transition deduction of the transferee because of paragraph 138(11.5)(k) of the Act is to be disregarded in determining the amount prescribed by subsection 8103(2) in respect of the transferor. Paragraph 138(11.5)(k) contains a continuity rule for the portion of the transition amount that is reasonably attributable to the transferred business. Since paragraph 138(11.5)(h) of the Act deems the transferor and transferee to have taxation year ends immediately before the business is transferred, special rules are not required for the taxation year of transfer.

**Transfer to new partnership****ITR****8103(5)**

Subsection 8103(5) contains rules that apply where a partnership ceases to exist and another partnership replaces it, in circumstances such that the continuity rule in subsection 98(6) of the Act applies. The rules are similar to those in subsection 8103(3) for the winding-up of a taxpayer into its parent corporation.

**Ceasing to carry on business****ITR****8103(6)**

Subsection 8103(6) applies where a taxpayer ceases to carry on all or substantially all of a business otherwise than because of a merger, winding-up or transfer of the business to which the rollover rules in subsection 87(2), 88(1), 98(6) or 138(11.5) or (11.94) of the Act apply. In general terms, it accelerates the inclusion in income of the portion of the taxpayer's transition deduction that relates to the business.

Subsection 8103(6) prescribes an amount for inclusion, under subsection 142.5(5) of the Act, in the taxpayer's income for its taxation year in which it ceases to carry on the business. The prescribed amount, which is in addition to the amount prescribed for the year by subsection 8103(2), is equal to the portion of the taxpayer's transition deduction that is attributable to the business minus the amount of that portion that has already been included in the taxpayer's income. Subsection 8103(6) also provides that the portion of the taxpayer's transition deduction that is attributable to the business is to be disregarded in determining the amount prescribed by subsection 8103(2) in respect of the taxpayer for the taxation year in which it ceases to carry on the business and for subsequent taxation years.

## **Ceasing to be a financial institution**

### **ITR 8103(7)**

Subsection 8103(7) applies where a taxpayer ceases to be a financial institution (as defined in subsection 142.2(1) of the Act) otherwise than because it has ceased to carry on a business. This subsection would apply, for example, where a taxpayer ceases to be a financial institution because of a change in control.

Subsection 8103(7) requires the taxpayer to include the remaining amount of its transition deduction in income in the taxation year that ends immediately before it ceases to be a financial institution. (There will always be such a taxation year because of paragraph 142.6(1)(a) of the Act.)

## **Mark-to-market -- transition capital loss**

### **ITR 8104**

Section 8104 of the Regulations prescribes the maximum amount that a taxpayer may claim under subsection 142.5(6) of the Act as an allowable capital loss in respect of the introduction of the mark-to-market requirement.

## **Definitions**

### **ITR 8104(1)**

Subsection 8104(1) defines terms that are used in section 8104.

"Excluded property" of a taxpayer is certain mark-to-market property held by the taxpayer in its taxation year that includes October 31, 1994. This definition is relevant for a taxpayer that is a resident multinational life insurer or a non-resident insurer. In the case of a resident multinational life insurer, excluded property is capital property disposed of by the insurer in the year that was used by the insurer in a foreign insurance business. Excluded property of a non-resident insurer is capital property that is not taxable Canadian property (as defined in subsection 115(1) of the Act). Taxable capital

gains and allowable capital losses from excluded property are disregarded in determining the insurer's income.

"Mark-to-market property" of a taxpayer has the meaning given by subsection 142.2(1) of the Act. In general terms, it comprises most shares held by the taxpayer and debt obligations that are marked to market for financial statement purposes.

### **Prescribed amount**

#### **ITR**

#### **8104(2)**

Subsection 142.5(6) of the Act contains a transition rule in respect of the introduction of the requirement that certain property be marked to market for tax purposes. It permits a taxpayer to claim, for its taxation year that includes October 31, 1994, an allowable capital loss not exceeding a prescribed amount. Subsection 8104(2) of the Regulations prescribes the following maximum amount for this purpose:

- the taxpayer's total taxable capital gains from the disposition of mark-to-market properties (other than excluded properties, as defined in subsection 8101(1)) that the mark-to-market rules deem the taxpayer to have disposed of in the year

#### **minus**

- the taxpayer's total allowable capital losses from the disposition of mark-to-market properties (other than excluded properties) that the mark-to-market rules deem the taxpayer to have disposed of in the year, and
- the taxpayer'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 (other than excluded properties) and from deemed dispositions of such properties otherwise than because of the mark-to-market rules.

## **Mark-to-market -- transition capital gains**

### **ITR**

#### **8105**

Section 8105 of the Regulations applies where a taxpayer has elected to claim an allowable capital loss under subsection 142.5(6) of the Act in respect of the introduction of the mark-to-market requirement. It prescribes the amount that is deemed by subsection 142.5(7) of the Act to be a taxable capital gain for each year. Generally, the prescribed amount for a year is a proportionate amount of the allowable capital loss that was claimed, based on a 5-year transition period.

Subsection 8105(1) defines the "transition loss" of a taxpayer to be the amount claimed by the taxpayer under subsection 142.5(6) of the Act as an allowable capital loss for the taxation year that includes October 31, 1994. The commentary on subsection 8103(1) regarding the effect of various restructurings on the "transition deduction" also applies to the transition loss.

Subsection 8105(2) provides that prescribed amounts are determined using the rules in section 8103. For this purpose, the references in that section to "transition deduction" are replaced by "transition loss" and to "142.5(5)" are replaced by "142.5(7)". For information on section 8103, see the commentary on that provision.

## **Section 9**

### **Financial Institutions**

New Parts XC to XCII of the Regulations contain provisions relating to the tax treatment of securities held by financial institutions. The purpose of each Part is as follows:

- Part XC prescribes various entities and properties for the purposes of the definitions in subsection 142.2(1) of the Act. It also prescribes properties for certain other rules.
- Part XCI contains the rules for determining income from specified debt obligations.



- Part XCII sets out rules relating to the disposition of specified debt obligations. These include rules for amortizing gains and losses from the disposition of such obligations.

These new Parts apply to taxation years that end after February 22, 1994.

## **Part XC**

### **Prescribed Entities and Property**

#### **Segregated fund trust**

##### **ITR**

##### **9000**

The definition of "financial institution" in subsection 142.2(1) of the Act excludes a prescribed person or partnership. Section 9000 prescribes for this purpose certain segregated funds maintained by life insurers. A segregated fund is prescribed at a particular time if it was created not more than two years before that time and the insurer's interest in the fund does not exceed \$5 million. This exclusion enables an insurer to hold more than 50% of a segregated fund during its start-up phase without having the rules for securities held by financial institutions apply to the fund.

#### **Shares of qualified small business corporations**

##### **ITR**

##### **9001**

The definition of "mark-to-market property" in subsection 142.2(1) of the Act excludes a prescribed property. Section 9001 prescribes certain shares of qualified small business corporations for this purpose.

Subsection 9001(1) provides that a corporation is a "qualified small business corporation" at any time at which:

- the corporation is a Canadian-controlled private corporation;

- the corporation is an eligible corporation (as defined in subsection 5100(1) of the Regulations for the purposes of the deferred income plan rules) or would be an eligible corporation if the exclusion for certain venture capital corporations were disregarded;
- the carrying value of the total assets of the corporation and all related corporations does not exceed \$50 million; and
- the corporation and all related corporations have no more than 500 employees.

Subsection 9001(2) prescribes a share of a corporation where, immediately after the taxpayer acquired the share, the corporation was a qualified small business corporation. However, a share is not prescribed if the corporation ceases to be a qualified small business corporation within a year, unless the change of status was not reasonably foreseeable.

Subsection 9001(2) also prescribes a share if it was issued to a taxpayer in exchange for one or more shares that were prescribed in respect of the taxpayer. Since the definition of "share" in subsection 248(1) of the Act includes a fraction of a share, subsection 9001(2) applies even if a taxpayer receives less than one share for each share exchanged.

## **Other prescribed property**

### **ITR**

#### **9002**

Section 9002 prescribes various properties for exclusion from the definition of "mark-to-market property" in subsection 142.2(1) of the Act.

### **ITR**

#### **9002(1)**

Subsection 9002(1) prescribes as property excluded from the definition of "mark-to-market property" in subsection 142.2(1) of the Act certain debt obligations held by a bank. A debt obligation is prescribed if it is an exposure to 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").

Subsection 9002(1) also prescribes such debt obligations for the purpose of subparagraph 142.6(4)(a)(ii) of the Act. This provision contains a rule relating to prescribed debt obligations held by a bank on February 23, 1994 that were inventory of the bank in its last taxation year ending before February 23, 1994. For further information, see the commentary on subsection 142.6(4) of the Act.

## **ITR**

### **9002(2)**

Subsection 9002(2) prescribes certain preferred shares for exclusion from the definition of "mark-to-market property" in subsection 142.2(1) of the Act.

Paragraph 9002(2)(a) provides for a share to be prescribed if it is a lending asset. By virtue of the definition of a lending asset in subsection 248(1) of the Act and paragraph 6209(a) of the Regulations, a share is a lending asset if it is a preferred share held by a bank that is reported as a loan substitute.

Paragraph 9002(2)(b) provides for a share to be prescribed if it meets two tests. The first is that, immediately after it was issued, it was a share described in paragraph (e) of the definition of "term preferred share" in subsection 248(1) of the Act, i.e., a financial difficulty share. In this regard, it should be noted that the 5- or 10-year period referred to in paragraph (e) is not part of the description of the share. The second test is that the share would be a term preferred share if the portion of the definition of "term preferred share" following paragraph (b) were disregarded and, where the share was issued or acquired on or before June 28, 1982, it had been issued or acquired after that date.

## **ITR**

### **9002(3)**

Subsection 9002(3) prescribes certain shares held by credit unions for exclusion from the definition of "mark-to-market property" in subsection 142.2(1) of the Act. A share is prescribed if it is

- a share of a credit union, or
- a share of a corporation in which credit unions hold shares carrying more than 50% of the votes and shares representing more than 50% of the fair market value of all issued shares.

### **Significant interest -- prescribed property**

#### **ITR 9003**

Paragraph 142.2(3)(c) of the Act provides that shares that are prescribed are to be ignored in determining whether a taxpayer has a significant interest in a corporation pursuant to subsection 142.2(2). Section 9003 prescribes for this purpose shares that are described in paragraph 9002(2)(b). These are certain preferred shares issued by a corporation in financial difficulty. More specifically, a share is prescribed if it is a share described in paragraph (e) of the definition of "term preferred share" in subsection 248(1) of the Act and it would be a term preferred share if the portion of the definition following paragraph (b) were disregarded (and, in the case of a share that was issued or acquired on or before June 28, 1982, it had been issued or acquired after that date).

### **Financial Institutions -- Income from Specified Debt Obligations**

#### **Part XCI**

Part XCI of the Regulations contains rules for determining the amounts that a financial institution is required to include and deduct each year in respect of a specified debt obligation in computing its income. These rules apply for the purpose of subsection 142.3(1) of the Act.

#### **Interpretation**

#### **ITR 9100**

Section 9100 defines certain terms that are used in Part XCI.

**"fixed payment obligation"**

A "fixed payment obligation" of a taxpayer is a specified debt obligation held by the taxpayer under which the payments to be made by the debtor are all fixed in timing and amount, and are all denominated in the same currency. Fees and similar payments are to be disregarded for the purpose of this definition, as are any additional payments that the debtor will be required to make if the debtor fails to make a payment as required under the obligation.

**"primary currency"**

The "primary currency" of a specified debt obligation is the currency with which the obligation is primarily connected. Where there is no such currency, the primary currency is the Canadian dollar.

**"specified debt obligation"**

"Specified debt obligation" has the meaning given to that term by subsection 142.2(1) of the Act. It should be noted that this term is defined from the perspective of the holder. For example, where a taxpayer holds a coupon that has been stripped from a debt obligation and holds no other interest in the obligation, the specified debt obligation of the taxpayer is just the coupon. It should also be noted that, if a taxpayer disposes of part of a specified debt obligation, subsection 142.4(9) of the Act applies to deem the part disposed of and the retained part to be separate specified debt obligations.

**"tax basis"**

The "tax basis" of a specified debt obligation to a taxpayer is the amount defined by subsection 142.4(1) of the Act. The tax basis is analogous to the adjusted cost base of capital property.

**"total return"**

A taxpayer's "total return" from a fixed payment obligation is equal to (i) the total amount of payments required to be made under the obligation by the debtor after the acquisition of the obligation by the taxpayer minus (ii) the cost of the obligation to the taxpayer. Fees and similar payments (such as insurance premiums) are excluded in determining the total return. The total return is to be measured in the

primary currency of the obligation. Where the taxpayer's cost was determined in another currency, it should be translated to the primary currency using the spot rate of exchange at the time of acquisition.

### **Prescribed inclusions and deductions**

#### **ITR 9101**

Paragraph 142.3(1)(a) of the Act requires a financial institution that holds a specified debt obligation in a taxation year to include a prescribed amount in income in respect of the obligation.

Subsection 9101(1) of the Regulations prescribes an amount for this purpose equal to the sum of:

- the accrued return from the obligation for the year;
- the accrual adjustment in respect of the obligation for the year (if this amount is positive); and
- in the case of a foreign-currency obligation, the foreign exchange adjustment in respect of the obligation for the year (if this amount is positive).

Paragraph 142.3(1)(b) of the Act provides that a financial institution that holds a specified debt obligation in a taxation year must deduct a prescribed amount in respect of the obligation. Subsection 9101(2) of the Regulations prescribes an amount for this purpose equal to the absolute value of the sum of:

- the accrual adjustment in respect of the obligation for the year (if this amount is negative); and
- in the case of a foreign-currency obligation, the foreign exchange adjustment in respect of the obligation for the year (if this amount is negative).

In general terms, the accrued return for a year is the total expected economic return to the taxpayer (assuming the taxpayer holds the obligation to maturity) that is allocated to the year under accrual principles of income recognition. Sections 9102 and 9103 contain rules relating to the determination of accrued returns.

The accrual adjustment is the amount by which prior years' accrued returns have to be adjusted to reflect subsequent events. For example, the accrued return for a year may have been based on an estimate of the amount of a future payment under the obligation. When the actual amount becomes known, or the estimate needs to be revised, an adjustment would be determined. Subsections 9102(4) and (5) contain rules relating to the determination of accrual adjustments.

The foreign exchange adjustment in respect of a foreign-currency obligation is the amount determined under section 9104. In general terms, this is the amount by which the tax value of the obligation has changed because of a change in the value of the foreign currency relative to the Canadian dollar.

### **General accrual rules**

#### **ITR**

#### **9102**

Section 9102 contains the general rules for determining a financial institution's accrued returns and accrual adjustments in respect of a specified debt obligation. These amounts are included in the amounts prescribed by section 9101. Transition rules and rules for special situations are contained in section 9103. Examples are provided at the end of the commentary on this section.

Section 9102 is organized as follows:

- Subsection 9102(1) provides for the determination of accrued returns from specified debt obligations under which all payments are fixed in timing and amount. Subsection 9102(2) describes the level-yield method that is referred to in subsection 9102(1).
- Subsection 9102(3) provides for the determination of accrued returns from obligations other than those to which subsection 9102(1) applies.
- Subsections 9102(4) and (5) provide for the determination of accrual adjustments.

- Subsection 9102(6) provides that the rules in section 9102 are subject to the rules in section 9103.

### **Fixed payment obligations not in default**

#### **ITR**

#### **9102(1) and (2)**

Subsection 9102(1) sets out, for the purpose of paragraph 9101(1)(a), the method for determining a taxpayer's accrued return for each taxation year from a specified debt obligation that is a fixed payment obligation under which the debtor has made all required payments. A "fixed payment obligation" is defined in section 9100 as a specified debt obligation under which the payments to be made by the debtor are all fixed in timing and amount, and are all denominated in the same currency.

In the case of a Canadian-dollar obligation that a taxpayer holds throughout a taxation year, the accrued return for the year is the total of the amounts allocated to each day in the year in respect of the taxpayer's total return from the obligation. Where the taxpayer does not hold the obligation throughout the year, the accrued return is the total of the amounts allocated to the days in the year at the beginning of which the taxpayer holds the obligation. The amount allocated to each day is to be determined using the level-yield method described in subsection 9102(2), or any other reasonable method that is substantially similar. Generally, a method would be considered reasonable only if it is in accordance with generally accepted accounting practice.

Under the level-yield method described in subsection 9102(2), the internal rate of return of an obligation is used to determine the amount of the taxpayer's total return from the obligation that is allocated to each day. The internal rate of return is the interest rate that produces a present value of payments under the obligation equal to the cost of the obligation to the taxpayer. For this purpose, compounding is on a daily basis. The amount of the total return allocated to a particular day is determined by the formula:

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

where



- A = the cost of the obligation to the taxpayer;
- B = the portion of the total return allocated to preceding days;
- C = the total payments required to be made under the obligation to the taxpayer before the particular day; and
- D = the internal rate of return of the obligation, expressed as a daily rate of interest.

It is recognized that few, if any, taxpayers use precisely this method for financial statement purposes. As noted above, subsection 9102(1) allows the use of any other reasonable method that is substantially similar. For example, a taxpayer could use a method based on semi-annual compounding, in which case a suitable approach to proration between compounding dates would be necessary (where the taxation year end falls between compounding dates).

It is intended that straight-line proration be an acceptable method where it can be used for financial statement purposes and the obligation provides for a level rate of interest. Under this method, any premium or discount on the acquisition of an obligation is recognized on a uniform basis from the acquisition date to the maturity date of the obligation. Similarly, each interest payment is spread over the period to which it relates. An amount paid in respect of accrued interest on the acquisition of the obligation would normally be taken into account by offsetting it against the interest, and then spreading the remainder of the interest over the period from acquisition to the interest payment date.

In the case of a foreign-currency obligation, the first step is to determine, in the currency of the obligation, the total return and the amount of that return allocated to each day. For this purpose, the level-yield method (or any similar method that is permissible) is applied using the foreign currency as the currency in which all computations are done. Next, the amounts allocated to each day in a taxation year are translated to Canadian dollars using a reasonable method of translation. Finally, the Canadian dollar amounts for the days at the beginning of which the taxpayer holds the obligation are totalled. One translation method that would generally be acceptable is to use the average exchange rate for the year. Where this approach is used, it will make no difference whether the amount allocated to

each day is totalled before or after being translated to Canadian dollars. Thus, the accrued return for the year could be determined in the foreign currency, and then translated to Canadian dollars.

Subsection 9102(1) is restricted to specified debt obligations under which the debtor has made all required payments. If a debtor is in default, subsection 9102(3) will apply. In general, under subsection 9102(3) the accrued return for a taxation year will equal the amount that would be determined under subsection 9102(1) plus any additional interest that accrues in the year because of the default.

### **Other obligations**

#### **ITR 9102(3)**

Subsection 9102(3) contains rules regarding the determination of accrued returns from specified debt obligations for the purpose of paragraph 9101(1)(a). It applies to obligations other than those to which subsection 9102(1) applies. Generally, subsection 9102(3) should allow a taxpayer to recognize income from an obligation using the same method for tax purposes as it uses for financial statement purposes.

Subsection 9102(3) requires that a taxpayer's accrued return from an obligation for each taxation year be determined using a reasonable method that is consistent with the principles implicit in the methods that subsection 9102(1) allows to be used for fixed payment obligations. The degree of consistency that is required depends on the extent to which the obligation is similar to fixed payment obligations. Subsection 9102(3) also requires that the method for determining the accrued return be in accordance with generally accepted accounting practice. Finally, it provides that reasonable assumptions are to be made with respect to the amount and timing of payments that are not fixed. Each of these requirements is discussed below.

#### *Consistency with methods for fixed payment obligations*

The following paragraphs describe the main consequences of the requirement that an accrual method used for a particular specified

debt obligation be consistent with the principles that are implicit in the methods that can be used for fixed payment obligations.

The first consequence is that the accrued return for each year must be based on the total return that the taxpayer would realize if the obligation were held to maturity. Whether or not particular payments under the obligation are characterized as interest is irrelevant in determining the total return, and thus the amount to be accrued each year. Also, each year's return must include an amount in respect of any discount on the acquisition of the obligation. Conversely, an acquisition premium is to be applied to reduce the amount that would otherwise accrue each year.

Second, to the extent that the total return derives from fixed payments, it must generally accrue at a uniform (or approximately uniform) rate. For example, if the rate of interest for each period is the sum of a fixed rate and a variable rate, and the fixed rate is not the same for all periods, there would have to be a "levelling" of the fixed rates. This requirement to "level the interest rate" is not new. A similar requirement is contained in the accrual rules under subsection 7000(2) of the Regulations.

It is not intended that interest be levelled where this would be inappropriate, such as where additional interest is payable because of the default of the debtor. For example, assume that a debt obligation that was acquired at its face amount provides for interest at the rate of 8%, and also provides that where the debtor fails to make a payment as required, interest on the overdue payment accrues at the rate of 11%. In this case, the accrued return for a year would equal the sum of the regular interest that accrues at the rate of 8% and any interest that accrues at 11% on overdue payments.

As indicated above, the consistency requirement is to be applied taking into account the extent to which an obligation differs from fixed payment obligations. This is relevant, in particular, for the levelling principle. For many variable rate debt obligations, it is appropriate to accrue the variable rate interest on the basis of the actual rates for each year. This would apply for example, if a debt obligation provides for interest that is set annually at a rate equal to the 1-year London Interbank Offered Rate (LIBOR) plus 1/2%. Another example is a debt obligation that provides for interest at a bank's prime rate plus 1%. Of course, any acquisition premium or

discount would have to be taken into account in determining the accrued return for each year.

The third consequence of the consistency requirement is that payments of interest in a year are not directly included in the accrued return for the year. In other words, the accrued return is determined on the basis of accrual principles only. (In some circumstances, interest payments may be included in accrual adjustments determined under subsection 9102(5).) However, interest payments, like other payments, would be subtracted from the base on which the return is considered to accrue. Thus, if a debtor prepays interest, the payment has the same tax consequences as a payment of principal (assuming the payment of principal does not constitute a partial disposition of the obligation). In particular, accrued returns continue to be determined throughout the period for which the interest was prepaid.

Fourth, interest that has accrued before a taxpayer acquires an obligation is included in determining the taxpayer's accrued returns only to the extent that the accrued interest exceeds the portion of the cost of the obligation to the taxpayer that is attributable to the interest. This follows from the fact that the amount included in respect of the interest in the taxpayer's total projected return from the obligation is equal to the difference between the amount of the interest and the amount the taxpayer has paid for it.

Finally, in the case of a foreign-currency obligation, the amount that accrues each day is to be determined in the primary currency of the obligation and then translated to Canadian dollars. However, where amounts are translated using the average exchange rate for each year, the same result is obtained by totalling the daily accruals to give the accrued return for the year (measured in the primary currency) before translating to Canadian dollars.

### *Generally accepted accounting practice*

One of the requirements imposed by subsection 9102(3) is that a method for determining accrued returns be in accordance with generally accepted accounting practice. The term "practice" is used rather than "principles" to indicate that the Handbook of The Canadian Institute of Chartered Accountants would not be the only source of information for determining what is acceptable.

### *Assumptions*

The requirement that assumptions be made with respect to the timing and amount of payments that are not fixed is intended to ensure that a taxpayer reports reasonable accrued returns from an obligation that provides for contingent payments. For example, assume that a taxpayer holds an obligation that provides for interest payments at the rate of 3% per year, and an amount payable at maturity equal to \$1,000 adjusted by the change in a stock index from the date of issue to the maturity date. In determining its accrued returns, the taxpayer would have to make a reasonable assumption about the amount that will be paid at maturity. This assumption may change from year to year, depending on the performance of the stock index. (The performance of the stock index may also give rise to accrual adjustments under subsection 9102(5).)

Whether it is actually necessary to make assumptions with respect to contingent payments depends on the method used to determine accrued returns. For example, assume that a 5-year obligation provides for interest that, at issue date and at each anniversary of that date, is set equal to the 1-year LIBOR rate plus 1%. A taxpayer that acquires the obligation at a discount may choose to accrue the discount on a straight-line basis over a reasonable period, and in addition to recognize the actual amount of interest that accrues each year. In this case, there would be no need to make any assumptions about future interest payments.

### **Accrual adjustment**

#### **ITR**

#### **9102(4) and (5)**

Subsections 9102(4) and (5) provide for the determination of accrual adjustments in respect of specified debt obligations. Where an accrual adjustment for a taxation year is positive, it is included in the amount prescribed by subsection 9101(1) in respect of the obligation for the year. A negative accrual adjustment is included in determining the amount prescribed by subsection 9101(2).

In general terms, an accrual adjustment in respect of an obligation for a taxation year is the amount by which prior years' accrued returns have to be adjusted to recognize payments under the obligation in the

year that differ from those assumed for the purpose of determining the accrued returns. The adjustment also takes into account changes in assumptions regarding anticipated future payments under the obligation, to the extent that the changed assumptions will not be fully reflected in the determination of accrued returns for the current and future taxation years.

Subsection 9102(4) provides that a taxpayer's accrual adjustment in respect of a specified debt obligation is nil where the adjustment is being determined for the first taxation year for which subsection 142.3(1) of the Act applies with respect to the obligation. In this case, there are no accrued returns to be adjusted.

Subsection 9102(5), which applies where subsection 9102(4) is not applicable, provides that a taxpayer's accrual adjustment in respect of a specified debt obligation for a particular taxation year is equal to

- the total of the taxpayer's accrued returns from the obligation for previous taxation years, redetermined to take into account all information available at the end of the particular year and to use the same assumptions regarding the timing and amount of payments as are used for the purpose of determining the accrued return for the particular year

minus

- the taxpayer's accrued return for the taxation year preceding the particular year, and
- if subsection 9102(5) applied to that preceding year, the redetermined amounts of the accrued returns that were used in determining the accrual adjustment for that year.

## **Special cases and transition**

### **ITR 9102(6)**

Subsection 9102(6) provides that the rules in section 9102 for determining accrued returns and accrual adjustments are subject to

section 9103. Section 9103 contains rules for convertible obligations, impaired obligations and amended obligations, and also transition rules.

## Examples

The following examples illustrate acceptable methods for determining accrued returns under subsection 9102(3), and show the calculation of accrual adjustments under subsection 9102(5). It should be noted that other methods may also be acceptable. It has been assumed that all methods are in accordance with generally acceptable accounting practice.

### EXAMPLE 1

*A debt obligation is issued on January 1, 1996 and matures on January 1, 2001. The obligation has a face amount of \$1,000 and provides for an interest payment each January 1st based on the value of 1-year LIBOR on the preceding January 1st minus 2%. The taxpayer acquires the obligation when it is issued, at a cost of \$877. The taxpayer's taxation year is the calendar year.*

*The value of 1-year LIBOR on January 1, 1996 is 6% and on January 1, 1997 is 8%.*

*The taxpayer has chosen to recognize the discount using a level-yield approach.*

*Accrued returns and accrual adjustments:*

*1. Using the value of 1-year LIBOR on January 1, 1996 to project the future values produces interest payments of \$40 each January 1st. On this basis, the internal rate of return for the obligation is 7%.*

*2. The taxpayer's accrued return for 1996 is equal to \$61.39 (=  $\$877 \times .07$ ).*

*3. The taxpayer's accrued return for 1997 consists of two components. The first is the amount that would be the accrued return if the value of 1-year LIBOR had remained at 6%. This amount is equal to \$62.89 (=  $(\$877 + \$61.39 - \$40) \times .07$ ). The*

*second component is equal to the additional interest because of the difference between the assumed and the actual value of LIBOR. This additional interest is \$20. Thus, the accrued return for 1997 is \$82.89.*

*4. Accrued returns for 1998 to 2000 would be determined in a similar manner.*

*5. There are no accrual adjustments.*

## **EXAMPLE 2**

*The facts are the same as in example 1, except that the taxpayer has chosen to accrue the discount using a straight-line approach.*

*Accrued returns and accrual adjustments:*

*1. The amount of the discount to be accrued each year is \$24.60 (=  $(\$1,000 - \$877) / 5$ ).*

*2. The taxpayer's accrued return for 1996 is equal to \$64.60 (=  $\$40 + \$24.60$ ).*

*3. The taxpayer's accrued return for 1997 is equal to \$84.60 (=  $\$60 + \$24.60$ ).*

*4. Accrued returns for 1998 to 2000 would be determined in a similar manner.*

*5. There are no accrual adjustments.*

## **EXAMPLE 3**

*A debt obligation is issued on January 1, 1996 and matures on January 1, 1999. The obligation has a face amount of \$1,000 and provides for quarterly interest payments. The interest payment for a quarter is based on a 90-day commercial paper rate at the beginning of the quarter, increased or decreased by a specified amount. For the first 4 interest payments, an amount of 1% is subtracted from the commercial paper rate (expressed on an*



annualized basis). For the next 4 payments, there is an increase of 1%. For the last 4 payments, the commercial paper rate is increased by 3%. The taxpayer acquires the obligation when it is issued, at a cost of \$1,000. The taxpayer's taxation year is the calendar year.

The rates for 90-day commercial paper (on an annualized basis) are 6% throughout 1996, 5% throughout 1997 and 7% throughout 1998.

*Accrued returns and accrual adjustments:*

1. The adjustments to the commercial paper rate must be levelled. The average adjustment is an increase of 1% per year ( $= (-1\% + 1\% + 3\%) / 3$ ).

2. The accrued return for 1996 is \$70 ( $= \$1,000 \times (.06 + .01)$ ). The accrued returns for 1997 and 1998 are \$60 and \$80 respectively.

3. There are no accrual adjustments.

#### **EXAMPLE 4**

A debt obligation is issued on January 1, 1996 and matures on January 1, 2001. The obligation has a face amount of \$1,000 and provides for annual interest payments equal to 5% of the face amount. In addition, a bonus is payable on maturity, based on the debtor's cumulative profits over the 5 years. The taxpayer acquires the obligation when it is issued, at a cost of \$1,000. The taxpayer's taxation year is the calendar year.

*If the debtor had issued a fixed interest rate obligation for the same price, the interest rate would have been 9%.*

The amount of the bonus payment is \$151.32, and this amount is known before the end of 2000.

*Accrued returns and accrual adjustments:*

1. *The taxpayer's accrued return for 1996 is equal to \$90 ( $= \$1,000 \times .09$ ).*
2. *For 1997, the amount to which the 9% rate of return is applied is equal to the face amount plus the difference between the accrued return for 1996 and the amount of interest that was paid, i.e. compounding applies to the unpaid portion of the accrued return. Thus, the taxpayer's accrued return for 1997 is equal to \$93.60 ( $= (\$1,000 + \$90 - \$50) \times .09$ ).*
3. *The taxpayer's accrued returns for 1998 and 1999 are \$97.52 and \$101.80 respectively.*
4. *Based on the actual bonus payment, the internal rate of return of the obligation to the taxpayer is 7.6%. Computing the taxpayer's accrued return for 2000 on the basis that all accrued returns were determined using this rate gives an accrued return for 2000 equal to \$84.85.*
5. *Redetermining the taxpayer's accrued returns for 1996 to 1999 on the basis of the rate of return of 7.6% gives total accrued returns for those years equal to \$316.47. Since the accrued returns that were reported by the taxpayer totalled \$382.92, the taxpayer has an accrual adjustment for 2000 equal to -\$66.45. Thus, in computing its income for the year 2000, the taxpayer can claim a deduction of \$66.45 under paragraph 142.3(1)(b) of the Act.*
6. *The net amount included in the taxpayer's income for the year 2000 in respect of the obligation is \$18.40 ( $= \$84.85 - \$66.45$ ). This is equal to the total return of \$401.32 minus \$382.92 which was included in computing income for previous years.*

**EXAMPLE 5**

*A debt obligation is issued on January 1, 1996 and matures on January 1, 2001. The amount payable at maturity is equal to \$1,000 multiplied by the ratio of the value of a stock index on*

*December 31, 2000 to the value of the index on December 31, 1995. In addition, the obligation provides for interest payments each January 1st equal to \$30 multiplied by the ratio of the value of the stock index on the preceding December 31st to the value of the index on December 31, 1995. The taxpayer acquires the obligation when it is issued, at a cost of \$1,050. The taxpayer's taxation year is the calendar year.*

*Accrued returns and accrual adjustments:*

*1. The taxpayer's accrued return from the obligation for each year is equal to*

- the increase, if any, in the adjusted face amount from the end of the preceding year to the end of the current year -- the adjusted face amount at any time is equal to \$1,000 multiplied by the ratio of the value of the stock index at that time to the value of the stock index on December 31, 1995*

*plus*

- the actual interest for the year*

*minus*

- \$10 in respect of the \$50 premium over the initial face amount.*

*2. There would be an accrual adjustment for any year in which the stock index declines. The adjustment would be a negative amount equal to the decrease in the adjusted face amount of the obligation.*

## **Accrual rules - special cases and transition**

### **ITR**

### **9103**

Section 9103 contains rules that apply with respect to the determination of accrued returns and accrual adjustments under section 9102. There are rules for convertible obligations, impaired obligations and amended obligations, and also transition rules.

## **Convertible obligation**

### **ITR**

#### **9103(1)**

Subsection 9103(1) contains two rules that apply with respect to a specified debt obligation that is convertible into shares of the debtor or of a corporation related to the debtor. Paragraph 9103(1)(a) provides that the conversion right is to be disregarded in determining accrued returns and accrual adjustments. Thus, the possibility that the obligation will be settled by way of shares does not enter into the determination of these amounts. In addition, the actual exercise of the conversion right is ignored for the purpose of determining the accrued return and accrual adjustment for the year of exercise. However, any gain from converting to shares is recognized under the rules in section 142.4 of the Act for the disposition of obligations.

Paragraph 9103(1)(b) provides that if 5% or more of the cost of a convertible obligation is attributable to the conversion right, the taxpayer's cost is to be considered to be the actual cost minus the amount that is attributable to the conversion right. This rule has the effect of preventing a taxpayer from deducting the cost of a conversion right, where this cost is a significant amount. The cost attributable to a conversion right can be determined as the difference between the actual cost of the obligation and the estimated fair market value of the obligation without the conversion right.

It should be noted that subsection 9103(1) does not apply where a debt obligation is convertible into shares of a corporation not related to the debtor. In this case, the possibility of conversion must be taken into account in determining accrued returns. Where the value of the conversion right is material, a method for determining accrued returns will generally not be considered reasonable unless it is based on an assumption that the right will be exercised and a reasonable value is assumed for the shares.

**Default by debtor****ITR****9103(2)**

Subsection 9103(2) provides that accrued returns and accrual adjustments are to be determined in respect of a specified debt obligation without any reduction for the possible or actual failure of the debtor to make any payments under the obligation. Deductions in respect of impaired debts can be claimed under paragraphs 20(1)(l) (doubtful debt reserve) and 20(1)(p) (bad debt deduction) of the Act.

**Amendment of obligation****ITR****9103(3)**

Subsection 9103(3) applies where a specified debt obligation has been amended to change the timing or amount of a payment to be made under the obligation. It provides that the amendment is to be taken into account as if the obligation had been acquired when the amendment was made. This means that the amendment affects future accrued returns only. For example, if accrued returns are being determined for a debt obligation using the level-yield method, the rate of return would be redetermined for the period after the amendment, and there would be no accrual adjustment in respect of the amendment.

It should be noted that subsection 9103(3) applies with respect to payments that are not required to be made until after the amendment. If overdue payments are forgiven, a bad debt deduction would generally be available under paragraph 20(1)(p) of the Act.

**Obligations acquired before financial institution rules apply****ITR****9103(4)**

Subsection 9103(4) applies with respect to a specified debt obligation held by a taxpayer at the beginning of its first taxation year to which subsection 142.3(1) of the Act applies. Subsection 9103(4) ensures a proper transition from subsection 12(3) of the Act to

subsection 142.3(1). It is expected that there will be few obligations for which subsection 9103(4) is relevant.

Paragraph 9103(4)(a) provides that a taxpayer's accrued return for a taxation year does not include an amount to the extent that the amount was included in computing the taxpayer's income for a taxation year before subsection 142.3(1) commenced to apply. This rule would apply, for example, where prepaid interest has been included in income under subsection 12(3). A reasonable adjustment would be made to the accrued returns that are otherwise determined to allow for the return that has already been recognized.

Paragraph 9103(4)(a) would also apply where subsection 16(3) of the Act has required a discount on the issue of a debt obligation to be included in the taxpayer's income.

Paragraph 9103(4)(b) applies with respect to interest that is received or becomes receivable in a taxation year in which subsection 142.3(1) of the Act is applicable, where the interest is in respect of a period before that subsection applied. Paragraph 9103(4)(b) provides that the taxpayer's accrued return for the year from the obligation includes the amount by which (i) the portion of the interest that would not otherwise be taken into account in computing the taxpayer's income for any taxation year exceeds (ii) the portion of the taxpayer's cost of the obligation that is reasonably attributable to that portion of the interest. This paragraph might apply, for example, where a taxpayer receives a contingent interest payment in the first year in which subsection 142.3(1) applies, and part or all of the payment is in respect of a previous taxation year. If the portion of the interest payment that is in respect of the previous year has not been included in computing the taxpayer's income for that year, and would not otherwise be included in the taxpayer's accrued return for the current year, paragraph 9103(4)(b) will include it in the accrued return.

### **Prepaid interest - transition rule**

#### **ITR 9103(5)**

Subsection 9103(5) applies where a taxpayer received a prepayment of interest on a debt obligation before November 1994 and in a taxation year that ended after February 22, 1994. Subsection 9103(5) allows the taxpayer to include the full amount of the prepaid interest

in its accrued return for the year in which it received the prepayment, in which case the taxpayer's accrued returns for subsequent years are to be determined without including any amount in respect of the prepaid interest.

### **Foreign exchange adjustment**

#### **ITR 9104**

Section 9104 provides for the determination of foreign exchange adjustments in respect of specified debt obligations. Foreign exchange adjustments are determined if the primary currency of an obligation is not the Canadian dollar. As defined in section 9100, the primary currency of an obligation is the currency with which the obligation is primarily connected. Where a foreign exchange adjustment for a taxation year is positive, it is included in the amount prescribed by subsection 9101(1) in respect of the obligation for the year. A negative adjustment is included in determining the amount prescribed by subsection 9101(2).

#### **ITR 9104(1)**

Subsection 9104(1) applies where a taxpayer holds a foreign currency obligation at the end of a taxation year. It provides that the foreign exchange adjustment in respect of the obligation for the year is to be computed as follows:

1. Determine the tax basis of the obligation to the taxpayer at the end of the year, using the primary currency of the obligation as the currency in which all amounts are expressed. For this purpose, the definition of "tax basis" in subsection 142.4(1) of the Act is modified so that it does not include (i) any amounts in respect of the change in value of a foreign currency relative to the Canadian dollar, and (ii) the amounts referred to in paragraphs (f) and (q) of the definition (adjustments in determining the adjusted cost base on February 22, 1994 of an obligation that was a capital property).
2. Translate the tax basis to Canadian dollars using the spot rate of exchange at the end of the year.

3. Subtract the Canadian dollar tax basis at the end of the year, determined on the assumption that the foreign exchange adjustment in respect of the obligation for the year is nil, and without taking into account the amounts referred to in paragraphs (f) and (q) of the definition of "tax basis".

The following example illustrates the operation of subsection 9104(1):

*Example*

*A U.S. dollar debt obligation is issued on December 31, 1995 and matures on December 31, 2000. The obligation has a face amount of US\$1,000 and provides for interest at the rate of 6%, payable annually. The taxpayer acquires the obligation when it is issued, at a cost of US\$900. The taxpayer's taxation year is the calendar year.*

*The exchange rates (C\$/US\$) to the end of 1998 are:*

	<u>Year-end</u>	<u>Average</u>
1995	\$1.36	-
1996	1.30	\$1.34
1997	1.35	1.32
1998	1.32	1.34

*Results for first 3 years:*

	<u>1996</u>	<u>1997</u>	<u>1998</u>
<u>US Dollar Tax Basis</u>	(US\$)	(US\$)	(US\$)
<i>Tax basis (beginning of year)</i>	900.00	916.86	935.17
<i>Add: accrued return</i>	76.86	78.30	79.87
<i>Deduct: interest received</i>	60.00	60.00	60.00
<i>Tax basis (end of year)</i>	916.86	935.17	955.03



<u>Foreign Exchange Adjustment</u>	(C\$)	(C\$)	(C\$)
<i>Tax basis (beginning of year)</i>	1224.00	1191.92	1262.48
<i>Add: accrued return<sup>1</sup></i>	103.00	103.36	107.02
<i>Deduct: interest received</i>	78.00	81.00	79.20
<i>Tax basis (before current year foreign exchange adjustment)</i>	1249.00	1214.28	1290.30
<i>US\$ tax basis - translated</i>	1191.92	1262.48	1260.65
<i>Foreign exchange adjustment</i>	(57.07)	48.19	(29.65)

1. *Translated using the average exchange rate for the year.*

## **ITR**

### **9104(2) and (3)**

Subsection 9104(2) provides for the determination of a foreign exchange adjustment for the taxation year in which a taxpayer disposes of a foreign currency debt obligation. The foreign exchange adjustment is the amount that would be determined under subsection 9104(1) if the taxation year had ended immediately before the disposition.

Subsection 9104(3) provides that, at the election of a taxpayer, subsection 9104(2) does not apply to dispositions of debt obligations before 1996. Where a taxpayer makes this election, any foreign-exchange-related change in value of an obligation that arises in the year of disposition will be an element in the determination of the total gain or loss from the disposition of the obligation.

## **Financial Institutions -- Disposition of Specified Debt Obligations**

### **Part XCII**

Part XCII of the Regulations contains provisions relating to the disposition of specified debt obligations by financial institutions. These include:

- a definition of "transition amount";

- provisions that prescribe certain specified debt obligations for exclusion from the amortization requirement; and
- rules for amortizing gains and losses from the disposition of specified debt obligations.

## **Interpretation**

### **ITR 9200**

## **Definitions**

### **ITR 9200(1)**

Subsection 9200(1) defines certain terms that are used in Part XCII.

#### **"financial institution"**

"Financial institution" has the meaning given to that term by subsection 142.2(1) of the Act.

#### **"gain"**

A taxpayer's "gain" from the disposition of a specified debt obligation is the gain determined under paragraph 142.4(6)(a) of the Act.

#### **"loss"**

A taxpayer's "loss" from the disposition of a specified debt obligation is the loss determined under paragraph 142.4(6)(b) of the Act.

#### **"residual portion"**

The "residual portion" of a taxpayer's gain or loss from the disposition of a specified debt obligation is the amount determined under subsection 142.4(8) of the Act in respect of the disposition. The residual portion is the amount of the gain or loss that is required to be amortized (if the amortization requirement applies to the obligation).

**"specified debt obligation"**

"Specified debt obligation" has the meaning given to that term by subsection 142.2(1) of the Act. It should be noted that this term is defined from the perspective of the holder. For example, where a taxpayer holds a coupon that has been stripped from a debt obligation and holds no other interest in the obligation, the specified debt obligation of the taxpayer is just the coupon. It should also be noted that, if a taxpayer disposes of part of a specified debt obligation, subsection 142.4(9) applies to deem the part disposed of and the retained part to be separate specified debt obligations.

**"tax basis"**

The "tax basis" of a specified debt obligation to a taxpayer is the amount defined by subsection 142.4(1) of the Act. The tax basis is analogous to the adjusted cost base of capital property.

**Amortization date****ITR****9200(2)**

Subsection 9200(2) contains rules for determining the amortization date for a specified debt obligation disposed of by a taxpayer. This date is used in subsections 9203(2) and (4) to determine the end of the amortization period for an obligation or group of obligations. It is also used in subsection 9202(2) for determining whether an obligation is excluded from the amortization requirement.

Paragraph 9200(2)(a) provides that the amortization date is the day on which the debtor is required to make the final payment under the specified debt obligation or, if later, the day of disposition. The day of disposition would be later where, for example, the debtor has failed to repay borrowed money on the maturity date of the obligation. In determining when the final payment is required to be made, an option to redeem or retract an obligation, or to extend its maturity date, is to be disregarded unless it has been exercised. Paragraph 9200(2)(a) applies only if none of paragraphs 9200(2)(b) to (d) applies.

It should be noted that a specified debt obligation is a taxpayer's interest in a debt obligation issued by the debtor. The amortization date is determined with respect to the taxpayer's interest. Where, for example, the taxpayer holds a coupon stripped from a debt obligation, the amortization date is the payment date for the coupon.

Paragraph 9200(2)(b) applies where the date for the last payment is not determinable, and so paragraph 9200(2)(a) cannot be applied. This would be the case, for example, where the maturity date is based on a contingency. Paragraph 9200(2)(b) provides that, subject to paragraphs 9200(2)(c) and (d), the amortization date is the day of disposition.

Paragraph 9200(2)(c) applies if the obligation is a variable interest rate debt obligation and, at the time the obligation was issued, the interest rate for each period was expected to equal or approximate a reasonable market rate. In this case, the amortization date is the day before the next interest reset date. Paragraph 9200(2)(c) does not apply if there are no interest reset dates after the disposition, or if paragraph 9200(2)(d) is applicable. An example of a debt obligation to which paragraph 9200(2)(c) would apply is an obligation with a 10-year term that provides for the interest rate to be reset every two years to LIBOR plus 1%.

Paragraph 9200(2)(d) applies where, for the purposes of its financial statements, the taxpayer has a gain or loss from the disposition that is being amortized. In this case, the amortization date is the last day of the financial statement amortization period.

## **Transition amount**

### **ITR**

#### **9201**

Subsection 142.4(1) of the Act provides that the transition amount of a taxpayer in respect of the disposition of a specified debt obligation is the amount defined by regulation. This amount is relevant if subsection 142.4(4) of the Act applies in respect of the disposition. The transition amount is required to be recognized in the year of disposition.

Section 9201 defines "transition amount" for the purpose of subsection 142.4(1). In general terms, the transition amount is the amount of any premium or discount that has been recognized for financial statement purposes, but not for tax purposes, to the beginning of the taxation year that includes February 23, 1994.

Paragraphs 9201(b) and (c) provide for the determination of the transition amount in respect of the disposition of a specified debt obligation by a taxpayer where the following conditions are satisfied:

- the taxpayer acquired the obligation before its taxation year that includes February 23, 1994,
- the accrual rules in paragraphs 7000(2)(a) and (b) of the Regulations have not applied to the obligation, and
- the principal amount of the obligation differs from its cost to the taxpayer, i.e. the obligation was purchased at a discount or premium.

Paragraph 9201(b), which applies in the case of a discount, provides that the transition amount is equal to the amount of the discount that has been included in determining the taxpayer's financial statement profit for taxation years ending before February 23, 1994 minus the amount of the discount included in determining its income for those years for tax purposes. Thus, the transition amount will be nil if, for tax purposes, the taxpayer has been following its financial statement reporting.

Paragraph 9201(c) contains a similar rule for premiums, except that the transition amount will be negative if it is not nil.

Paragraph 9201(a) provides that if neither of paragraphs 9201(b) and (c) applies, the transition amount is nil.

## **Prescribed debt obligations**

### **ITR**

#### **9202**

Subsection 142.4(5) of the Act provides that the full gain or loss from the disposition of certain specified debt obligations is required to be taken into account in the taxation year of disposition. In other words, the amortization rules do not apply to these gains and losses. Obligations to which this subsection applies include obligations prescribed under subparagraph 142.4(5)(a)(ii). Section 9202 prescribes certain debt obligations for this purpose.

## **Elections**

### **ITR**

#### **9202(1)**

Subsections 9202(3) and (4) provide for elections to be made by a taxpayer. An election is made under subsection 9202(3) if a taxpayer does not want subsection 9202(2) to apply. An election is made under subsection 9202(4) if a taxpayer wants that subsection to apply. Subsection 9202(1) sets out the rules that apply with respect to these elections.

An election must (i) be in writing, (ii) specify the first taxation year to which it applies, and (iii) be received by the Minister of National Revenue within 6 months after the end of that first year (unless the Minister accepts a later filing). An election continues to apply until the taxpayer revokes it. A revocation requires the Minister's approval, and written application must be made for that approval.

## **Amortization period less than two years**

### **ITR**

#### **9202(2)**

Subsection 9202(2) prescribes certain specified debt obligations for the purpose of subparagraph 142.4(5)(a)(ii) of the Act. Prescribed obligations are excluded from the amortization rules for gains and losses. An obligation is prescribed by subsection 9202(2) if its amortization date (as determined under subsection 9200(2)) is within

two years of the end of the taxation year in which the taxpayer disposed of the obligation. However, subsection 9202(2) does not apply to a taxpayer if the conditions in subsection 9202(3) are satisfied.

## **Exclusion**

### **ITR**

#### **9202(3)**

Subsection 9202(3) provides that subsection 9202(2) does not apply to a taxpayer if (i) the taxpayer is required by generally accepted accounting principles (GAAP) to amortize gains and losses from a class of debt obligations, and (ii) the taxpayer has elected not to have subsection 9202(2) apply. This exclusion enables a taxpayer that is required to amortize some or all of its gains and losses for financial statement purposes to choose to also amortize them for tax purposes even if the amortization period is short. It should be noted that the exclusion applies to all obligations, not just those for which GAAP requires amortization. See subsection 9202(1) for rules regarding elections under subsection 9202(3).

## **Small net gain or loss**

### **ITR**

#### **9202(4)**

Subsection 9202(4) prescribes certain specified debt obligations for the purpose of subparagraph 142.4(5)(a)(ii) of the Act. Prescribed obligations are excluded from the amortization rules that apply to gains and losses. Subsection 9202(4) is an elective provision -- see subsection 9202(1) for rules relating to elections.

Where subsection 9202(4) applies, a specified debt obligation is prescribed if the taxpayer's net gain or loss from the disposition of the obligation and from other obligations disposed of in the same transaction does not exceed \$5,000. A taxpayer may elect to have a lower threshold for this purpose. Such an election might be made where, for example, the taxpayer is required to amortize gains and losses for financial statement purposes, but does not amortize if the gain or loss is less than \$1,000.

## **Obligations that are extinguished and demand obligations**

### **ITR**

#### **9202(5)**

Subsection 9202(5) prescribes certain specified debt obligations for the purpose of subparagraph 142.4(5)(a)(ii) of the Act. Prescribed obligations are excluded from the amortization rules for gains and losses. A specified debt obligation is prescribed by subsection 9202(5) if the disposition of the obligation results in its extinguishment. An obligation would be prescribed, for example, where the disposition occurs because the debtor settles it, whether at the scheduled maturity date or as a result of the exercise of an option to redeem or retract before that date. As another example, a specified debt obligation would be prescribed where the holder exercises an option to convert it into shares. As an exception, an obligation is not prescribed where the extinguishment occurs because of an open market purchase of the obligation by the debtor.

Subsection 9202(5) also prescribes a specified debt obligation if the obligation is an obligation that was payable on demand or that could be redeemed at any time by the debtor.

## **Residual portion of gain or loss**

### **ITR**

#### **9203**

Section 9203 contains rules for determining the amount of the residual portion of a gain or loss from the disposition of a specified debt obligation that must be recognized each year under subparagraph 142.4(4)(c)(ii) or (d)(ii) of the Act. These rules are subject to section 9204, which applies after certain reorganizations and other events.



## **Allocation of residual portion**

### **ITR**

#### **9203(1)**

Subsection 9203(1) specifies the methods that are permitted for amortizing the residual portion of a gain or loss from the disposition of a specified debt obligation. Any method may be used if it complies with subsection 9203(2), or is substantially similar to a method that so complies. Subsection 9203(2) provides for the amount allocated to each year to be determined on a straight-line proration basis. It is intended that the reference to substantially similar methods generally include the method that provides for the amount allocated to each year to equal to the difference between (i) the amount that would have accrued in the year in respect of the obligation if the taxpayer had retained it, and (ii) the amount that would have accrued in the year in respect of the obligation if the taxpayer had reacquired the obligation immediately after disposing of it.

Where a taxpayer amortizes gains and losses for the purpose of its financial statements, the taxpayer is permitted to use the same method of amortization for tax purposes. This rule allows the financial statement method to be used for all obligations, including obligations that are not subject to amortization for financial statement purposes.

### **Proration method**

### **ITR**

#### **9203(2)**

Subsection 9203(2) sets out, for the purpose of subsection 9203(1), a method for amortizing the residual portion of the gain or loss from the disposition of a specified debt obligation. The method involves prorating the residual portion on a straight-line basis over the amortization period. More specifically, the amount allocated to a particular taxation year is equal to the residual portion of the gain or loss times the proportion of days in the amortization period that are in the year. Generally, the amortization period for an obligation is the period that begins on the day of disposition of the obligation and ends on the earlier of the amortization date determined under subsection 9200(2) and the day that is 20 years after the day of

disposition. However, where subsection 9203(3) applies, the amortization period is determined pursuant to that subsection and subsection 9203(4).

### **Single proration period**

#### **ITR 9203(3)**

Under the amortization method set out in subsection 9203(2), the residual portion of the gain or loss from the disposition of a specified debt obligation is spread on a straight-line basis over the amortization period for the obligation. Subsection 9203(3) allows a taxpayer to use the same amortization period for a group of specified debt obligations that were disposed of at the same time in the same transaction, if there are at least 50 obligations to which subsection 142.4(4) of the Act applies. This enables the net residual gain or loss to be spread as if it were from the disposition of a single obligation.

Where subsection 9203(3) applies, the amortization period starts on the day of disposition of the obligations, and ends on the weighted average amortization date determined under subsection 9203(4) for those obligations to which subsection 142.4(4) applies. In this regard, obligations that are prescribed by section 9202 (obligations excluded from amortization requirement) are not taken into account in determining the weighted average amortization date. In particular, obligations that are prescribed because their amortization dates are not more than two years after the end of the year of disposition are disregarded.

Subsection 9203(3) applies on an elective basis. An election must be made in the tax return for the year in which the obligations were disposed of. No special form is required for the election -- it could be made, for example, by including a page with the return that identifies the transaction to which the election applies.

## **Weighted average amortization date**

### **ITR**

#### **9203(4)**

Subsection 9203(3) allows a taxpayer to use a single amortization period for a group of specified debt obligations. The period ends on the weighted average amortization date for the obligations.

Subsection 9203(4) specifies how the weighted average amortization date is to be determined for this purpose. A taxpayer is given a choice between using a precisely determined date and a reasonable estimate of that date.

Under paragraph 9203(4)(a), the weighted average amortization date for a group of obligations disposed of on the same day is obtained as follows:

1. For each obligation, determine the number of days from the day of disposition to the amortization date for the obligation -- the amortization date is determined under subsection 9200(2).
2. Multiply the number of days by the ratio of the residual portion of the gain or loss from the disposition of the obligation to the total of the residual portions for all the obligations.
3. Compute the total of the amounts determined under step 2 for all the obligations.
4. Determine the day that follows the day of disposition by that total amount.

Paragraph 9203(4)(b) allows a taxpayer to determine the weighted average amortization date for a group of obligations using a reasonable method for estimating the exact date determined under paragraph 9203(4)(a). An example of an approach that would generally be reasonable is to select a random sample of the debt obligations and determine the exact date for that sample.

## **Special rules for residual portion of gain or loss**

### **ITR**

#### **9204**

Section 9204 contains rules relating to the amortization of the residual portion of the gain or loss from the disposition of a specified debt obligation. These rules, which modify the normal rules in section 9203, apply where

- a subsidiary corporation has been wound up into its parent corporation on a rollover basis pursuant to subsection 88(1) of the Act;
- an insurer has transferred an insurance business on a rollover basis pursuant to subsection 138(11.5) or (11.94) of the Act;
- a new partnership is a continuation of another partnership pursuant to subsection 98(6) of the Act;
- a taxpayer ceases to carry on a business; or
- a taxpayer ceases to be a financial institution.

### **Application of section**

### **ITR**

#### **9204(1)**

Subsection 9204(1) provides that section 9204 applies for the purpose of subparagraphs 142.4(4)(c)(ii) and (d)(ii) of the Act.

Subparagraph 142.4(4)(c)(ii) requires the residual portion of the gain from the disposition of a specified debt obligation to be amortized in accordance with prescribed rules. Subparagraph 142.4(4)(d)(ii) contains a similar requirement with respect to the residual portion of a loss.

## **Winding-up**

### **ITR**

#### **9204(2)**

Where a subsidiary is wound up into its parent corporation and subsection 88(1) of the Act applies to the winding-up, the parent is considered to be a continuation of the subsidiary for the purpose of paragraphs 142.4(4)(c) and (d) of the Act. The relevant continuity provision is paragraph 87(2)(g.2) of the Act, which applies to a winding-up by reason of paragraph 88(1)(e.2). Consequently, amounts may be allocated to the parent in respect of the residual portion of the subsidiary's gains and losses from the disposition of specified debt obligations.

Subsection 9204(2) contains the following rules that ensure that no part of the residual portion of a gain or loss is taken into account in determining the income of both a parent and a subsidiary:

- The amount of the residual portion of a gain or loss allocated to the taxation year of the subsidiary in which its assets were distributed to its parent is to be determined on the assumption that the taxation year ended when the assets were distributed.
- No amount is to be allocated to any subsequent taxation year of the subsidiary.
- The amount of the residual portion of a gain or loss allocated to the taxation year of the parent in which it received the subsidiary's assets is to be determined on the assumption that the taxation year began when the assets were received.

## **Transfer of insurance business**

### **ITR**

#### **9204(3)**

Where an insurer has transferred an insurance business to another corporation on a rollover basis pursuant to subsection 138(11.5) or (11.94) of the Act, paragraph 138(11.5)(k) provides that, for the purpose of paragraphs 142.4(4)(c) and (d) of the Act, the transferee is considered to be a continuation of the transferor in respect of the

transferred business. Consequently, amounts may be allocated to the transferee in respect of the residual portion of the transferor's gains and losses from the disposition of specified debt obligations in the course of the business. Subsection 9204(3) provides that, after the transfer of the business, amounts that are allocated to the transferee are not also to be allocated to the transferor. Since paragraph 138(11.5)(h) of the Act deems the transferor and transferee to have taxation year ends immediately before the business is transferred, special rules are not required for the taxation year of transfer.

### **Transfer to new partnership**

#### **ITR**

#### **9204(4)**

Subsection 9204(4) contains rules that apply where a partnership has ceased to exist and another partnership has replaced it, in circumstances such that the continuity rule in subsection 98(6) of the Act applies. The rules are similar to those in subsection 9204(2) for the winding-up of a taxpayer into its parent corporation.

### **Ceasing to carry on business**

#### **ITR**

#### **9204(5)**

Subsection 9204(5) applies where a taxpayer ceases to carry on all or substantially all of a business otherwise than because of a merger, winding-up or transfer of the business to which the rollover rules in subsection 87(2), 88(1), 98(6) or 138(11.5) or (11.94) of the Act apply. It requires the residual portion of the gain or loss from each specified debt obligation disposed of in the course of the business to be recognized in the taxation year in which the cessation occurs, except to the extent that the residual portion has been recognized in a previous year.

**Ceasing to be a financial institution****ITR****9204(6)**

Subsection 9204(6) applies where a taxpayer ceases to be a financial institution, as defined in subsection 142.2(1) of the Act, otherwise than because it has ceased to carry on a business. This subsection would apply, for example, where a taxpayer ceases to be a financial institution because of a change in control.

Subsection 9204(6) requires the residual portion of the gain or loss from each specified debt obligation that the taxpayer disposed of before it ceased to be a financial institution to be recognized in the taxation year ending immediately before it ceased to be a financial institution, except to the extent that the residual portion has been recognized in a previous year.

