Amendments to the Income Tax Act

Explanatory Notes

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

December 1995

Canada

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PREFACE

The legislation to which these explanatory notes relate contains amendments to the *Income Tax Act* and related statutes. These amendments are designed to implement a number of the income tax measures put forth in the budget of February 27, 1995. Draft amendments to the *Income Tax Regulations*, with corresponding explanatory notes, are also included.

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

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These explanatory notes are provided to assist in understanding amendments to the *Income Tax Act* and various other Acts. 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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Clause 2

Income or Loss from a Source

ITA
4(4)

Subsection 4(4) of the Act provides that, unless a contrary intention is evident, no provision in Part I of the Act is to be interpreted to require an amount to be included or deducted more than once in computing a taxpayer's income.

This provision is repealed effective for taxation years that end after July 19, 1995 and is replaced by new subsection 248(28) of the Act.

Clause 3

Proprietors

ITA
11(1)

Subsection 11(1) of the Act provides that, where an individual is a proprietor of a business, the individual's income from the business for a taxation year is the individual's income from the business for the fiscal periods of the business that end in the year.

Subsection 11(1) is amended consequential on the introduction of new sections 34.1 and 34.2 of the Act which provide for the inclusion and deduction of certain amounts in computing a taxpayer's income from a business for a taxation year rather than a fiscal period.

This amendment applies to 1995 and subsequent taxation years.

Clause 4

Income from Business or Property

ITA
12(1)(*x*)(vi)

Paragraph 12(1)(*x*) of the Act provides that certain inducements, reimbursements, contributions, allowances and assistance received by a taxpayer in the course of earning income from a business or property will be included in income to the extent that they have not otherwise reduced the cost of a property or the amount of an outlay or expense.

Subparagraph 12(1)(*x*)(vi) is amended for taxation years that begin after 1995 to include references to new subsections 127(11.5) and (11.6) of the Act. These subsections relate to the determination of qualified expenditures for investment tax credit purposes.

Clause 5

Income from Business or Property - Prohibited Deductions

ITA
18

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

Subclause 5(1)

ITA
18(9)

Subsection 18(9) of the Act prohibits the deduction of certain prepaid expenses before the taxation year to which the expenses relate.

Paragraph 18(9)(*d*) is amended to provide an exception to the prohibition of the deduction of prepaid expenses in paragraph 18(9)(*a*). Any payment for scientific research and

experimental development (SR&ED) (commonly known as a "third party payment") referred to in subparagraph 37(1)(*a*)(ii) or (iii) of the Act is excluded from the application of the prepaid expense rule where

1) the payer and the payee are dealing with each other at arm's length at the time of the payment; and

2) the payment cannot also be characterized as an expenditure described in subparagraph 37(1)(*a*)(i) (i.e., for SR&ED done for or on behalf of the taxpayer).

The amendment to paragraph 18(9)(*d*) applies to payments made after 1995.

New paragraph 18(9)(*e*) clarifies that, for the purposes of section 37 and the definition of "qualified expenditure" in subsection 127(9) of the Act, an expenditure that is not deductible in a taxation year because of the application of paragraph 18(9)(*a*), is to be treated as not being made or incurred in the year but rather made or incurred in the later year to which the expenditure can reasonably be considered to relate. Where an expenditure is not deductible in a taxation year under subsection 37(1), that expenditure will also not be a qualified expenditure for investment tax credit purposes for that taxation year.

Paragraph 18(9)(*e*) applies to expenditures made or incurred at any time.

Subclause 5(2)

ITA
18(12)(*b*)

Subsection 18(12) of the Act restricts the deduction of expenses incurred by an individual in respect of a home office. No amount may be deducted in respect of a "work space" in a self-contained domestic establishment in which the individual resides unless certain conditions are met. The work place must be either the principal place of business of the individual or be used by the individual exclusively for the purpose of earning income from the business and for meeting clients, customers, or patients on a regular and continuous basis.

Where these conditions are met, a deduction in respect of a home office may be claimed; however, paragraph 18(12)(*b*) limits such a deduction to the individual's income from the business for the year. This paragraph is amended to provide that the individual's income from the business is to be computed without reference to inclusions and deductions under new section 34.1 of the Act and the new reserve deductions and inclusions for December 31, 1995 income under new section 34.2 of the Act. This new reserve is consequential on changes to the definition of "fiscal period" in new section 249.1 of the Act (formerly in subsection 248(1) of the Act). This amendment applies to 1995 and subsequent taxation years.

Clause 6

Judges

ITA
24.1

Section 24.1 of the Act permits a taxpayer appointed as a judge in a taxation year to elect to defer a portion of income from his or her professional practice for a fiscal period commencing before, and ending in, the year to the next year. Section 24.1 is repealed in respect of appointments made after 1995 consequential on changes to the definition of "fiscal period" in new section 249.1 of the Act (formerly in subsection 248(1) of the Act).

Clause 7

Fiscal Period

ITA
25

Section 25 of the Act provides that, where an individual who is a resident of Canada disposes of a business carried on as a sole proprietorship, the individual may elect to extend the fiscal year-end of the business to the date on which it would have ended if the business had not been disposed of. Section 25 is repealed in respect of fiscal periods that begin after 1995 consequential on the changes to

the definition of "fiscal period" in new section 249.1 of the Act (formerly in subsection 248(1) of the Act). Under that new definition a fiscal period of a business of an individual cannot end after the end of the calendar year in which the fiscal period commenced. Accordingly, the application of section 25 and the definition of "fiscal period" in paragraph 249.1(1)(*b*) of the Act to a fiscal period that begins in 1995 will result in that fiscal period ending in 1995.

Clause 8

Additional Business Income

ITA
34.1

New section 34.1 of the Act provides the rules for computing the "additional business income" of individuals who carry on an unincorporated business for which an election to have an off-calendar fiscal period is filed under new subsection 249.1(4) of the Act (i.e., the "alternative fiscal-period method"). The alternative fiscal-period method is available, on a business-by-business basis, to individuals and partnerships all the members of which are individuals. However, partnerships that are members of other partnerships cannot utilize the alternative method, nor can partnerships which have another partnership as a member.

Because of the application of new section 34.1, many affected individuals may have more than 12 months of income from an unincorporated business in 1995. In such cases, and subject to certain restrictions, eligible individuals may claim a 10-year reserve in respect of their additional business income for the 1995 taxation year. The commentary below, in conjunction with the commentary on the 10-year transitional rules in new section 34.2 of the Act, describe the manner in which those rules may apply to an individual's additional business income for the 1995 taxation year.

The detailed rules found in new section 34.1 are discussed below.

Additional business income

ITA
34.1(1)

New subsection 34.1(1) of the Act provides the formula for computing an individual's "additional business income" in respect of a business carried on by the individual in a taxation year in which the "alternative fiscal-period method" applies to the business (for further details on the alternative fiscal-period method, see the commentary on new subsections 249.1(4), (5) and (6) of the Act).

New subsection 34.1(1) applies where

- an individual (other than a testamentary trust) carries on a business in a taxation year (including an individual who has a residual interest in a partnership to which subsections 96(1.1) and (1.6) of the Act apply),

- a fiscal period of the business begins in the year and ends after the end of the year, and

- the individual has elected under new subsection 249.1(4) of the Act to have an off-calendar fiscal period for the business and the election has not been revoked.

The amount of additional business income to be included in an individual's income for a taxation year under new subsection 34.1(1) is determined by the formula (A - B) x C/D. (Note: negative amounts determined by an algebraic formula are deemed to be nil because of section 257 of the Act.)

The description of A is the total of the individual's income from the business for the fiscal periods of the business that end in a taxation year in which new subsection 34.1(1) applies. (Note: new subsections 34.1(4) and (7) of the Act sets out the manner for computing such income for the purpose of determining the "December 31, 1995 income" of an individual which may be recognized over a 10-year transitional period.)

The description of B reduces, for the purpose of computing "additional business income", an individual's income from a business for a fiscal period of the business ending in a taxation year by the amount of such income that is in respect of the disposition of eligible capital property where the individual deducted a capital gains exemption in the taxation year (see subparagraph 14(1)(*a*)(v) and section 110.6 of the Act). (Note: new subsections 34.1(4) and (7) require that "deducted" be read as "deductible" for the purpose of determining the "December 31, 1995 income" of an individual in respect of a business to which those subsections apply).

The description of C is the number of days on which the individual carries on the business that are both in the taxation year and the fiscal period of the business that straddles the end of the year.

The description of D is the number of days on which an individual carries on the business that are in fiscal periods of the business that end in the taxation year.

EXAMPLE:

Assume that:

Mark is issued a partnership interest on January 11, 1996. Mark remains a partner throughout the fiscal period of the business that begins on February 1, 1996 and ends on January 31, 1997.

Mark's share of income from the partnership is $5,000 for the fiscal period that ends on January 31, 1996. There is no eligible capital property income arising in respect of the business.

Mark deducts $100 of automobile expenses incurred between January 11 and 31, 1996 from his share of partnership income.

Mark's "additional business income" in 1996 under new subsection 34.1(1) is:

$78,167 *[(A-B) x C/D)]*

where

A = ***$4,900*** *($5,000 - $100).*

Note: A partner's income from a business for a fiscal period is net of any amounts deducted by the partner on a fiscal period basis from his or her share of partnership income for the fiscal period.

B = Nil.

C = 335 days (i.e., 366 days -31 days in January).

D = 21 days (i.e., the 21 days in the partnership's fiscal period ending on January 31, 1996 on which Mark carried on the business).

New subsection (1) does not, however, apply in computing an individual's income for a taxation year from a business if the individual dies or otherwise ceases to carry on the business in the year or becomes a bankrupt in the calendar year in which the taxation year ends (discussed below in commentary on new subsection 34.1(8) of the Act).

New subsection 34.1(1) applies after 1994.

Additional income election

ITA
34.1(2)

New subsection 34.1(2) of the Act permits certain individuals to designate an amount to be included in their income from a business for a taxation year. New subsection 34.1(2) applies to individuals (other than testamentary trusts) who begin to carry on a business in a taxation year no earlier than the beginning of the first fiscal period of the business that begins in the taxation year and ends in the next year (in this commentary referred to as the "straddle fiscal period"), and the individual has elected to use the alternative fiscal-period method under new subsection 249.1(4) in respect of the business and the election has not been revoked.

In such cases, an individual may include in income for the taxation year from the business an amount not exceeding the amount determined by the formula (A - B) x C/D.

The description of A is the individual's income from the business for the straddle fiscal period. (Note: new subsections 34.1(5) and (6) of the Act require that such income be computed in a certain manner for the purpose of determining the "December 31, 1995 income" of an individual in respect of a business to which those provisions apply.)

The description of B reduces, for the purpose of computing "additional business income", an individual's income from a business for a fiscal period of the business ending in a taxation year by the amount of such income that is in respect of the disposition of eligible capital property where the individual deducted a capital gains deduction in the taxation year (see subparagraph 14(1)(*a*)(v) and section 110.6 of the Act). (Note: new subsections 34.1(5) and (6) require that "deducted" be read as "deductible" for the purpose of determining the "December 31, 1995 income" of an individual in respect of a business to which those subsections apply.)

The description of C is the number of days on which the individual carries on the business that are both in the taxation year and in the straddle fiscal period.

The description of D is the number of days on which the individual carries on the business that are in the straddle fiscal period.

EXAMPLE:

Assume the facts are the same as those stated above in the example accompanying the commentary to new subsection 34.1(1) of the Act, except that:

Mark became a member of the partnership on July 1, 1996 rather than January 11, 1996 (thus, there is no "additional business income" under new subsection 34.1(1) because the value for A would be nil).

Mark's income is $69,000 for the fiscal period of the partnership that ends on January 31, 1997 (Mark's share of partnership income is $70,000 and he deducts $1,000 of automobile expenses for the period July 1, 1996 to January 31, 1997). There is no eligible capital property income arising in respect of the business.

Mark has $10,000 of carrying charges in respect of his partnership interest that are claimed on a taxation year basis.

Mark may designate as "additional business income" for 1996 under new subsection 34.1(2) an amount not exceeding:

$59,051 *[(A - B) x C/D]*

where

A = ***$69,000*** *($70,000 - $1,000).*

B = *Nil.*

C = ***184*** *days (i.e., the number of days on which Mark carries on the business in the 1996 taxation year -- July 1 to December 31, 1996).*

D = ***215*** *days (i.e., the number of days in the partnership's straddle fiscal period during which Mark carried on the business -- July 1, 1996 to January 31, 1997).*

New subsection (2) does not, however, apply in computing an individual's income for a taxation year from a business if the individual dies or otherwise ceases to carry on the business in the year or becomes a bankrupt in the calendar year in which the taxation year ends (see new subsection 34.1(8) of the Act).

New subsection 34.1(2) applies after 1994.

Deduction

ITA
34.1(3)

New subsection 34.1(3) of the Act provides that, in computing an individual's income for a taxation year from a business, the individual shall deduct any additional business income included in computing income for the preceding taxation year under new subsection 34.1(1) or (2).

New subsection 34.1(3) applies after 1994.

Deemed December 31, 1995 income

ITA
34.1(4)

New subsection 34.1(4) of the Act provides a rule that applies to certain individuals who include additional business income in their income for the 1995 taxation year under new subsection 34.1(1). Subject to certain restrictions, such income is deemed to be the "December 31, 1995 income" of the individual in respect of the business for the purpose of the 10-year transitional reserve in new section 34.2. The commentary below, in conjunction with the commentary to new subsection 34.1(7) and new section 34.2 of the Act, describe the manner in which the 10-year reserve rules may apply to an individual's additional business income for the 1995 taxation year.

Subsection 34.1(4) applies on a business-by-business basis to individuals who

- at the end of 1994, carried on a particular business that did not have a fiscal period end at that time, and

- have "additional business income" for the 1995 taxation year under new subsection 34.1(1) from the particular business or from another business that is included in the particular business because of the extended meaning of "business" in new subsection 34.2(3) of the Act.

If applicable, the "December 31, 1995 income" of an individual in respect of a business is deemed to be, for the purpose of the 10-year reserve rule in new subsection 34.2(4), the amount that would have been determined under new subsection 34.1(1) if descriptions A and B in that subsection were read with two changes. First, the description of A is to be read as if the individual's income from the business for the fiscal periods ending in 1995 were determined using the special rules in new subsection 34.2(2) (e.g., by maximizing any claims for reserves and capital cost allowance). Second, subparagraph (ii) of the description of B is to be read as if "deducted" were "deductible" (i.e., as if the maximum available capital gains exemption were claimed under section 110.6 for the 1996 taxation year).

EXAMPLE:

Assume that:

Debbie has been a member of a partnership since February 1, 1994 and the partnership's fiscal period ends on January 31 of each year.

While Debbie's share of partnership income for the fiscal period ending on January 31, 1995 is $68,000, it would have been $60,000 if the assumptions in new subsection 34.2(2) were applied. Debbie deducted partner level expenses of $2,000 for the fiscal period February 1, 1994 to January 31, 1995 (which was the maximum amount deductible). There is no income arising from the disposition of eligible capital property.

Debbie has $10,000 of carrying charges in respect of her partnership interest that were claimed on a taxation year basis.

Debbie's "additional business income" in respect of the business in 1995 is $60,395 under new subsection 34.1(1) (i.e., $66,000 x 334/365).

Debbie's "December 31, 1995 income" is, subject to new subsection 34.1(7), deemed to be:

*$53,074** [(A - B) x C/D]*

where

A = $58,000 ($60,000 - $2,000).

B = Nil.

C = 334 days (i.e., the number of days Debbie carries on the business that are both in the 1995 taxation year and in the straddle fiscal period that ends in 1996-- February 1 to December 31, 1995).

D = 365 days (i.e., the number of days in the fiscal periods that end in 1995 and during which Debbie carries on the business -- February 1, 1994 to January 31, 1995).

*** While Debbie's additional business income for 1995 is $60,395 under new subsection 34.1(1), her deemed "December 31, 1995 income" in respect of the business is, subject to new subsection 34.1(7), $53,074 for the purpose of claiming the 10-year transitional reserve under new subsection 34.2(4).*

For the 1996 and subsequent taxation years, an individual's "December 31, 1995 income" in respect of a business may be revised under new subsection 34.1(7) for the purposes of applying the 10-year reserve rule in those years (see the commentary on new subsection 34.1(7) of the Act which includes a detailed example).

New subsection 34.1(4) applies after 1994.

Deemed December 31, 1995 income

ITA
34.1(5)

New subsection 34.1(5) of the Act provides a rule that deems the designated income from a 1995 start-up business under new subsection 34.1(2) to be the "December 31, 1995 income" of the individual's start-up business. New subsection 34.1(5) applies to an individual if

- the individual carried on at the end of 1994 a business that did not have a fiscal period end at that time,

- the individual started up another business in the 1995 taxation year that is considered to be the same business as was carried on at the end of 1994 because of the extended meaning of "business" in new subsection 34.2(3) of the Act, and

- an amount is included under new subsection 34.1(2) in computing the individual's income for the 1995 taxation year from the start-up business (discussed above in commentary on that subsection).

If new subsection 34.1(5) applies, the "December 31, 1995 income" of an individual in respect of a business is deemed to be, for the purpose of the 10-year reserve rule in new subsection 34.2(4), the amount that would have been determined under subsection 34.1(2) if descriptions A and B in that subsection were read with two changes.

First, the description of A is to be read as if the individual's income from the business for the straddle fiscal period of the business ending in 1996 were determined using the rules in new subsection 34.2(2) (e.g., by maximizing deductible reserves and capital cost allowance). Second, subparagraph (ii) of the description of B is to be read as if "deducted" were "deductible" (i.e., as if the maximum available capital gains exemption were claimed under section 110.6 for the 1996 taxation year).

EXAMPLE:

Assume that:

Martine is a member of Partnership A at the end of 1994 and the fiscal period of the business does not end at that time.

Martine ceases to be a member of Partnership A on February 1, 1995 (new section 34.1 does not apply to Martine with respect to that business because of new subsection 34.1(8)). Martine becomes a member of Partnership B on February 1, 1995.

The fiscal period of Partnership B begins on February 1 and ends on the following January 31.

The business carried on by Martine as a member of Partnership B is a business to which the extended meaning of "business" in new subsection 34.2(3) applies.

While Martine's share of income from the Partnership B is $60,000 for the fiscal period that ends on January 31, 1996, it would have been $56,000 if the assumptions in new subsection 34.2(2) were applied. Martine deducts $1,000 of partner expenses incurred between February 1, 1995 and January 31, 1996 -- the maximum amount deductible. There is no income arising from the disposition of eligible capital property.

Martine designated $52,000 as "additional business income" in 1995 in respect of the business of Partnership B under new subsection 34.1(2) -- the maximum that Martine could have designated in 1995 under new subsection 34.1(2) was ***$53,989*** *($59,000 x 334/365).*

Martine's "December 31, 1995 income" in respect of the business of Partnership B for the purpose of claiming the 10-year transitional reserve under new subsection 34.2(4) is:

*$50,328** [(A-B) x C/D)]*

where

A = $55,000 ($56,000 - $1,000).

B = Nil.

C = 334 days (Feb. 1, 1995 to December 31, 1995).

D = 365 days (Feb. 1, 1995 to January 31, 1996).

*** While Martine has $52,000 of additional business income in 1995 under new subsection 34.2(2), her deemed "December 31, 1995 income" in respect of the business is $50,328 for the purpose of claiming the 10-year transitional reserve under new subsection 34.2(4).*

New subsection 34.1(5) applies after 1994.

Deemed December 31, 1995 income

ITA
34.1(6)

New subsection 34.1(6) applies to an individual where

- at the end of 1995 the individual carries on a business as a member of a partnership no fiscal period of which ended at the end of 1994,
- the business was carried on by a professional corporation as a member of the partnership at the end of 1994,
- the professional corporation transferred its interest in the partnership to the individual before the end of 1995,

- the individual is a practising member of the professional body under the authority of which the professional corporation practised the profession,

- the individual was a specified shareholder of the professional corporation immediately before the time of transfer,

- the professional corporation does not have a share of the income or loss of the partnership for the first fiscal period of the partnership that ends after the end of 1995, and

- an amount is included under subsection 34.1(2) in computing the individual's income for the 1995 taxation year in respect of the business (discussed above in the commentary on new subsection 34.1(2)).

If applicable, the December 31, 1995 income of an individual in respect of the business is deemed to be the amount that would have been determined under subsection 34.1(2) if descriptions A and B in that subsection were read with two changes. First, the description of A is to be read as if the individual's income from the business for the straddle fiscal period of the business ending in 1996 were determined using the rules in new subsection 34.2(2) (e.g., by maximizing deductible reserves and capital cost allowance). Second, subparagraph (ii) of the description of B is to be read as if "deducted" were "deductible" (i.e., as if the maximum available capital gains exemption were claimed under section 110.6 for the 1996 taxation year).

New subsection 34.1(6) applies after 1994.

Maximum December 31, 1995 income

ITA
34.1(7)

New subsection 34.1(7) of the Act places an upper limit on the deemed "December 31, 1995 income" that an individual may have in respect of a business for the purpose of applying the 10-year reserve rule in new section 34.2. New subsection 34.1(7) applies to an individual where

- an amount of "additional business income" is included in computing the individual's income from a business for the 1995 taxation year under new subsection 34.1(1), and

- the individual has "December 31, 1995 income" in respect of the business under new subsection 34.1(4) for the purpose of the 10-year reserve rule in new section 34.2.

If applicable, an individual's "December 31, 1995 income" in respect of a business under new subsection 34.1(4) is reduced, for the purpose of applying the 10-year reserve rule in the 1996 and subsequent taxation years, by the amount that would have been determined under new subsection 34.1(4) if the descriptions A, B and D in the formula in that subsection were read with the following changes.

First, the description of A in new subsection 34.1(4) is to be read as if the individual's income from the business for the straddle period (i.e., the first fiscal period of the business ending in 1996) were determined using the rules in new subsection 34.2(2) (e.g., by maximizing deductible reserves and capital cost allowance).

Second, subparagraph (ii) of the description of B is to be read as if "deducted" were "deductible" (i.e., as if the maximum available capital gains exemption were claimed under section 110.6 for the 1996 taxation year).

Third, the description of D is to be read as the number of days on which the individual carries on the business that are in the straddle period.

EXAMPLE:

Assume that:

Susan has $78,000 of additional business income in respect of Business A for her 1995 taxation year under subsection 34.1(1).

Susan's "December 31, 1995 income" in respect of Business A is deemed to be $75,000 under new subsection 34.1(4) (see the commentary to that subsection for a detailed example).

Susan claimed a reserve for the 1995 taxation year in respect of her December 31, 1995 income in respect of Business A equal to $71,250 under new subsection 34.2(4) (i.e., $75,000 x 95%).

While Susan's income for the fiscal period of Business A that ends on January 31, 1996 is $70,000, that income would have been $60,000 if it were computed by applying the assumptions listed in new subsection 34.2(2) of the Act. There is no income arising from the disposition of eligible capital property.

Susan carries on Business A throughout the 1996 taxation year and new subsection 34.1(1) applies to her income from that business in 1996.

Application of new subsections 34.1(1), (3), (4) and (7) and new subsections 34.2(4) and (5) to Susan in her 1996 taxation year:

Computation of Susan's business income for 1996:

1. *Income from business for the 1996 taxation year (before applying 10-year reserve rule).*

$70,000	*Fiscal period of the business that ends in 1996.*
$64,247	*Ss. 34.1(1) -- 335/365 x $70,000.*
($78,000)	*Ss. 34.1(3) deduction of prior year inclusion.*
$56,247	*Income before applying 10-year reserve rules.*

2. *Income from business for 1996 after applying 10-year reserve rule.*

$56,247	*See above calculation.*
$71,250	*Ss. 34.2(5) inclusion of prior year reserve (in 1995: **$75,000 x 95%**).*
($46,688)	*Ss. 34.2(4) reserve for 1996 (**$60,000 x 334/365 x 85%**).*
$80,829	*Susan's income from the business for her 1996 taxation year.*

The commentary to new subsection 34.2(4) includes a more detailed example of the application of the 10-year reserve rule to an individual's "December 31, 1995 income" in respect of a business.

New subsection 34.1(7) applies after 1994.

No additional income inclusion

ITA
34.1(8)

New subsection 34.1(8) of the Act provides that new subsections 34.1(1) and (2) do not apply in computing an individual's income for a taxation year from a business if

- the individual dies or otherwise ceases to carry on the business in the year; or
- the individual becomes a bankrupt in the calendar year in which the taxation year ends.

Reserve for December 31, 1995 Income

ITA
34.2

New section 34.2 of the Act sets out a 10-year reserve rule consequential on changes to the definition of "fiscal period" in new section 249.1 of the Act (formerly in subsection 248(1) of the Act). Under that new definition the fiscal periods of businesses carried on by individuals, or by professional corporations that are members of a partnership, must end on December 31 unless, in the case of a business carried on by an individual, an election is filed with the Minister of National Revenue under new subsection 249.1(4) to have the "alternative fiscal-period method" apply to the business (in which case, the individual may have "additional business income" under new section 34.1). Because most affected taxpayers would otherwise be required to report more than 12 months of business income in computing income for the 1995 taxation year, new section 34.2 provides a 10-year transitional reserve rule. However, the income eligible for transitional relief is restricted in certain circumstances.

Definitions

ITA
34.2(1)

New subsection 34.2(1) of the Act defines "December 31, 1995 income", "qualifying fiscal period" and "specified percentage" for the purposes of the 10-year transitional reserve for December 31, 1995 income in new section 34.2.

"December 31, 1995 income"

The definition "December 31, 1995 income" in respect of a business carried on by a taxpayer means the amount determined by the formula (A-B-C+D) x E. (Note: negative amounts determined by an algebraic formula are deemed to be nil because of section 257 of the Act.) The definition "December 31, 1995 income" is to be applied on a business-by-business basis and is to be computed with reference to the assumptions listed in new subsection 34.2(2) (e.g., by maximizing reserve and capital cost allowance claims).

The description of A is the total of the taxpayer's income from the business for a qualifying fiscal period (after deducting, in the case of a partner, partner level expenses claimed on a fiscal period basis).

The description of B is the total of the taxpayer's losses from the business for a qualifying fiscal period (after deducting, in the case of a partner, partner level expenses claimed on a fiscal period basis).

The description of C reduces, for the purposes of computing "December 31, 1995 income", the amount included in the taxpayer's income for qualifying fiscal periods of the business because of a disposition of eligible capital property where the taxpayer may claim a capital gains exemption under section 110.6 of the Act by reason of subparagraph 14(1)(*a*)(v) in the taxation year in which the qualifying fiscal periods end.

The description of D is

- where the taxpayer is a professional corporation, the salary or wages payable to a specified shareholder of the corporation who is a practising member of the profession practised by the

corporation (and which are deductible in computing the value of A or B above), and

- in any other case, nil.

The value of E is 1 unless the taxpayer carrying on the business is a professional corporation, a taxation year of which ended at the end of 1995 because of paragraph 249.1(1)(*b*), in which case the taxpayer is required to multiply the amount otherwise determined by the fraction

$$\frac{F - G}{F}$$

where

- F is the sum of all of the days in all of the qualifying fiscal periods of the business, and

- G is the number of days in the taxation year ending at the end of 1995.

This proration factor for professional corporations recognizes that, under the definition "qualifying fiscal period", a corporation may, depending on the circumstances, have more than one qualifying fiscal period in respect of the business.

"qualifying fiscal period"

The definition "qualifying fiscal period" is relevant for determining the "December 31, 1995 income" in respect of a business carried on by a taxpayer.

Paragraph (*a*) of the definition provides that a particular fiscal period of a business of a taxpayer is a qualifying fiscal period if

1. the taxpayer carried on the business at the end of 1994,

2. a fiscal period of the business did not end at the end of 1994,

3. the particular fiscal period begins after the beginning of the taxpayer's taxation year that includes the end of 1995, and

4. the particular fiscal period ends at the end of 1995 because of the new definition of "fiscal period" in new paragraph 249.1(1)(*b*) of the Act..

The first condition ensures that taxpayers have a qualifying fiscal period only if they carry on the business for at least 12 months as of December 31, 1995.

The third condition is of particular relevance to corporations and testamentary trusts that have taxation years which do not coincide with the calendar year and that are members of a partnership that is required to have a fiscal period that coincides with the calendar year. In this case, a fiscal period of the partnership ending at the end of 1995 is not a qualifying fiscal period of such a taxpayer unless the period began after the beginning of the taxpayer's taxation year that includes the end of 1995.

Where certain conditions are met, paragraph (*b*) of the definition of "qualifying fiscal period" applies to other fiscal periods of businesses that end at the end of 1995 because of the definition of "fiscal period" in new paragraph 249.1(1)(*b*). The conditions are that:

- the taxpayer is an individual who carries on the business as a member of a partnership at the end of 1995,

- the individual acquired the individual's interest in the partnership in 1995 from a professional corporation,

- the professional corporation carried on the business at the end of 1994 as a member of the partnership and does not have a share of the income or loss of the partnership for the first fiscal period of the partnership that ends in 1995,

- the individual is a practising member of the professional body under the authority of which the professional corporation practised the profession, and

- the individual was a specified shareholder of the professional corporation immediately before acquiring the interest.

Where certain conditions are met, paragraph (*c*) of the definition treats as a qualifying fiscal period any fiscal period of a business that

ends in the taxation year of a professional corporation that ends at the end of 1995 because of the new definition of "fiscal period" in new paragraph 249.1(1)(*b*). In particular, at the end of 1994, the business must be carried on by the corporation as a member of a partnership, or by an individual

- who transferred an interest in the partnership to the corporation before the end of 1995,
- who is a practising member of the professional body under the authority of which the corporation practises the profession,
- who was a specified shareholder of the corporation immediately after the transfer, and
- who does not have a share of the income or loss of the partnership for the first fiscal period of the partnership that ends in 1995.

In such circumstances, each fiscal period of the partnership that ends in the professional corporation's shortened taxation year ending at the end of 1995 is considered to be a qualifying fiscal period for the purposes of new section 34.2 (New paragraph 249.1(1)(*b*) requires professional corporations that are members of a partnership to have fiscal periods that coincide with the calendar year.)

EXAMPLE:

Janet, Professional Corporation A and Non-Professional Corporation B have been carrying on business together as the only partners of Partnership C since it was formed on September 1, 1993. Before 1995, the fiscal period of Partnership C was September 1 to August 31 under the former definition of "fiscal period" in subsection 248(1) of the Act.

Until 1995, the taxation year of each corporate partner was:

Professional Corporation A:	*August 28 to August 27.*
Non-Professional Corporation B:	*October 1 to September 30.*

The fiscal period of Partnership C that would otherwise end in 1996 will end on December 31, 1995 because of the application of new paragraph 249.1(1)(b) of the Act. The fiscal period and

taxation year of Professional Corporation A must change to the calendar year because of new paragraph 249.1(1)(b).

Application of the Definition of "Qualifying Fiscal Period":

(A) ***Janet:***

Janet carries on a business that has a fiscal period within the meaning of paragraph (a) of the definition of "qualifying fiscal period" because:

1. *She carried on the business at the end of 1994 and no fiscal period of that business ended at that time.*

2. *The fiscal period begins after the beginning of Janet's taxation year that includes the end of 1995 (i.e., Janet's 1995 taxation year which is calendar year 1995).*

3. *The fiscal period ends at the end of 1995 because of the application of new paragraph 249.1(1)(b).*

Therefore, Janet's "qualifying fiscal period" in respect of the partnership is the period September 1, 1995 to December 31, 1995.

(B) ***Professional Corporation A:***

Professional Corporation A carries on a business that has two fiscal periods within the meaning of paragraph (c) of the definition of "qualifying fiscal period" because:

1. *It has a taxation year that ends at the end of 1995 because of the application of new paragraph 249.1(1)(b) (in addition to its taxation year that ends on August 27, 1995).*

2. *At the end of 1994 the business was carried on by the corporation as a member of the partnership.*

3. *Two fiscal periods of the business end in the corporation's 1995 taxation year that includes the end of 1995.*

Therefore, Professional Corporation A's two "qualifying fiscal periods" in respect of the partnership are the period September 1, 1994 to August 31, 1995 and the period September 1, 1995 to December 31, 1995. (Note: see the description of E in the definition "December 31, 1995 income" for the formula that prorates the income of a professional corporation for qualifying fiscal periods.)

(C) ***Non-Professional Corporation B:***

Non-Professional Corporation B does not carry on a business that has a fiscal period within the meaning of the definition of "qualifying fiscal period" because the fiscal period of the business that ends at the end of 1995 because of the application of new paragraph 249.1(1)(b) begins before the beginning of the corporation's taxation year that includes the end of 1995 (i.e., the fiscal period begins on September 1, 1995 which is before the corporation's taxation year of October 1, 1995 to September 30, 1996).

For descriptions of the definition of "professional corporation" in subsection 248(1) and new section 249.1, see the commentary accompanying those provisions.

"specified percentage"

The definition "specified percentage" of a taxpayer in a particular taxation year is a percentage that declines from 95% to 15% in increments of 10% per year. The definition of "specified percentage" is relevant in computing a taxpayer's maximum reserve for December 31, 1995 income in respect of a business under new paragraph 34.2(4)(*a*) of the Act. Whether 1995 or 1996 is the first taxation year in which the definition "specified percentage" applies to a taxpayer depends upon whether the taxpayer's 1995 or 1996 taxation year is the first year in which the taxpayer is required to include in income, income from a qualifying fiscal period (see commentary above).

EXAMPLE:

In the example included in the commentary on the definition "qualifying fiscal period", Janet's specified percentage for her 1995 taxation year is "95%".

Assume that Non-Professional Corporation B has:

- *a taxation year that begins on August 1, rather than October 1 (i.e., the fiscal period September 1, 1995 to December 31, 1995 is a "qualifying fiscal period" in respect of the business it carries on through Partnership C).*

In such circumstances, "95%" would be Non-Professional Corporation B's specified percentage for its taxation year that ended on July 31, 1996 (i.e., the first taxation year in which a qualifying fiscal period ends).

This amendment applies after 1994.

Computation of December 31, 1995 Income

ITA
34.2(2)

New subsection 34.2(2) of the Act applies for the purpose of the definition of "December 31, 1995 income" in new subsection 34.2(1). For that purpose, the income or loss of a business of a taxpayer for a qualifying fiscal period is to be computed as if

- the Act were read without reference to the optional inventory adjustment under paragraph 28(1)(*b*),

- the taxpayer made the work-in-progress election referred to in paragraph 34(*a*) of the Act in respect of the business,

- the maximum amount deductible in respect of any reserve, allowance or other amount were deducted. For example, such amounts would include (but are not limited to) amounts deductible as reserves for doubtful accounts or unrendered services under paragraphs 20(1)(*l*) and (*m*) of the Act, or capital cost allowance or

cumulative eligible capital amounts under paragraphs 20(1)(*a*) and (*b*) of the Act, and

- the taxpayer had not received any taxable dividends.

This amendment applies after 1994.

Business defined

ITA
34.2(3)

New subsection 34.2(3) of the Act provides that a particular business of a taxpayer includes another business substituted therefor by the taxpayer (and that other business includes the particular business). This rule is relevant for the purposes of

- obtaining (and maintaining) a 10-year transitional reserve in respect of the "December 31, 1995 income" of a business, and

- determining whether an individual's "additional business income" in 1995 from a business is the "December 31, 1995 income" of a business under new subsection 34.1(4) or (5).

Subsection 34.2(3) applies for these purposes where

- all or substantially all of the gross revenue of the particular business is derived from the sale, leasing, renting or development of properties or the rendering of services, and

- all or substantially all of the gross revenue of the other business is derived from the sale, leasing, rental or development of similar properties or the rendering of similar services.

If applicable, a taxpayer may continue to be eligible to claim a reserve in respect of December 31, 1995 income under new subsection 34.2(4) notwithstanding that the taxpayer has ceased to carry on the particular business from which the taxpayer derived such income. Similarly, a taxpayer that begins a business in 1995 that was substituted for a business carried on at the end of 1994 may have "December 31, 1995 income" in respect of the new business.

This amendment applies after 1994.

Reserve

ITA
34.2(4)

New subsection 34.2(4) of the Act is the key provision of section 34.2. It establishes the amount that a taxpayer may deduct as a reserve in respect of December 31, 1995 income of a business of the taxpayer. The maximum reserve that a taxpayer may claim, on a business-by-business basis, is the least of the following three amounts:

1. the "specified percentage" (as defined by subsection 34.2(1)) for the year of the taxpayer's "December 31, 1995 income" (as defined by new subsection 34.2(1)) in respect of the business,

   (Generally, this calculation spreads the income inclusion over a 10-year transitional period -- with 5% being included in the first year, 10% in each of the next eight years and 15% in the last year.)

2. for each taxation year ending after the first taxation year in which a taxpayer claims a reserve under new subsection 34.2(4), the amount included in the taxpayer's income for the year under new subsection 34.2(5) (i.e., the taxpayer's reserve for the immediately preceding taxation year), and

3. the taxpayer's income for the particular year (from all sources) computed before any amount is deducted as a reserve under new subsection 34.2(4) in respect of the business or under paragraph 60(*w*), sections 61.2 to 61.4, or subsection 80(17) of the Act.

   (Generally, new paragraph 34.2(4)(*c*) ensures that a reserve claim does not create or increase a non-capital loss.)

EXAMPLE

Sharon carries on two businesses; one business is carried on as a member of a partnership and the other as a sole proprietor. Sharon has a qualifying fiscal period that ends on December 31, 1995 in respect of each business.

Sharon's income from the first fiscal period of the partnership ending in 1995 is $120,000 and from its qualifying fiscal period, $100,000. That amount ($100,000) is also "December 31, 1995 income" as that term is defined in new subsection 34.2(1). In addition, Sharon has $10,000 of deductions claimed at the partner level on a fiscal period basis in respect of the qualifying fiscal period of the business.

Sharon's income from the proprietorship is $12,000 for the first fiscal period ending in 1995 and $10,000 in respect of the qualifying fiscal period.

Sharon also has a deductible loss of $140,000 arising in her 1995 taxation year which is unrelated to the above-mentioned businesses.

Therefore, Sharon's income for her 1995 taxation year, before deducting any amount under new subsection 34.2(4), is as follows:

$120,000	*Partnership (fiscal period 1)*
$ 90,000	*Partnership (fiscal period 2 minus partner level deductions)*
$ 12,000	*Proprietorship (fiscal period 1)*
$ 10,000	*Proprietorship (fiscal period 2)*
($140,000)	*Loss*
$ 92,000	

Calculation of reserve for December 31, 1995 income:

(a) Partnership

$ 85,500

which is the least of:

34.2(4)(a) $85,500 ($90,000 x 95%),
34.2(4)(b) previous reserve included in income (not applicable in first taxation year), and
34.2(4)(c) $85,500 ($92,000 - $6,500 income for the year before deduction of a reserve for the partnership business).

(b) Proprietorship

$6,500

which is the least of:

34.2(4)(a) $9,500 (95% x $10,000),
34.2(4)(b) not applicable in first taxation year, and
34.2(4)(c) $6,500 (income for the year net of reserves in respect of other businesses under section 34.2 -- $92,000 - $85,500).

Note: Paragraph 34.2(4)(c) is to be computed with reference to any reserve claimed under this subsection in respect of another business.

The commentary on new subsection 34.2(1) describes the definitions of "December 31, 1995 income", "qualifying fiscal period", and "specified percentage". For commentary on the extended meaning of "business" and circumstances in which a taxpayer may not claim a reserve under this subsection, see the commentary on new subsections 34.2(3) and (6), respectively. For special rules that apply for the purpose of computing a taxpayer's "December 31, 1995 income" in respect of a business, see the commentary on new subsection 34.2(2) of the Act.

This amendment applies after 1994.

Reserve Included in Income

ITA
34.2(5)

New subsection 34.2(5) of the Act provides that a taxpayer's income for a taxation year includes the amount of any reserve deducted by the taxpayer under new subsection 34.2(4) for the preceding taxation year.

This amendment applies after 1994.

No Reserve

ITA
34.2(6)

New subsection 34.2(6) of the Act describes the circumstances (including death and bankruptcy) in which a taxpayer may not claim a reserve in respect of December 31, 1995 income for a business. Generally, individuals who cease to carry on the business in a taxation year may claim a reserve at the end of that taxation year but not in the following year. A corporation is eligible to claim a reserve only if it carried on the business at the end of the year and the beginning of the following year.

This amendment applies after 1994.

Anti-avoidance rule

ITA
34.2(7)

New subsection 34.2(7) of the Act provides that a business is not considered to be carried on principally by a person (and the person is not considered to be a member of a partnership) if it is reasonable to conclude that one of the main reasons the person carries on the business or is a member of the partnership is to avoid the application of the "reserve denial" rules in new subparagraphs 34.2(6)(*b*)(i) and (*c*)(i) of the Act.

This amendment applies after 1994.

Clause 9

Scientific Research and Experimental Development

ITA
37

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

Subclause 9(1)

ITA
37(1)

Under subsection 37(1), certain expenditures incurred by a taxpayer for SR&ED carried on in Canada are accumulated in a SR&ED pool. The balance of the pool at the end of a taxation year may either be deducted in that year or carried forward to be deducted in a subsequent taxation year.

This subsection currently requires that such an expenditure be reported in a prescribed form by the taxpayer by a certain date for it to be deductible. For taxation years that begin after 1995, the reporting requirement is removed from this subsection. A new reporting requirement is set out in new subsection 37(11).

Subclause 9(2)

ITA
37(1)(*a*)(i.1)

Currently, clause 37(1)(*a*)(ii)(D) of the Act applies to third party payments made to a corporation resident in Canada to be used for SR&ED. That clause is repealed for payments made after 1995. New paragraph 37(1)(*a*)(i.1) will apply to such payments made after 1995.

Because of subsection 18(9) of the Act, a taxpayer making a third party payment to a corporation resident in Canada for SR&ED after 1995 is permitted to deduct the payment under subsection 37(1) only

once the SR&ED is performed. Reference may be made to the commentary on the amendments to that subsection for further details.

Subclauses 9(3) to (5)

ITA
37(1)(*a*)(ii)

Consequential on the introduction of new subparagraph 37(1)(*a*)(i.1) which is applicable to certain third party payments to corporations resident in Canada, clause 37(1)(*a*)(ii)(D) of the Act is repealed.

This amendment is effective for payments made after 1995.

Subclause 9(6)

ITA
37(1)(*a*)(iii)

Subparagraph 37(1)(*a*)(iii) of the Act is amended to delete the superfluous word "and" at the end of that paragraph effective upon Royal Assent.

Subclause 9(7)

ITA
37(1)(*d*) and (*e*)

Paragraph 37(1)(*d*) of the Act reduces a taxpayer's SR&ED pool by the amount of any government assistance or non-government assistance in respect of an expenditure described in paragraph 37(1)(*a*) or (*b*) which assistance the taxpayer has received, is entitled to receive, or can reasonably be expected to receive by the time the return of income for a year must be filed.

Paragraph 37(1)(*d*) is amended, applicable to taxation years that begin after 1995, to change the time referred to in the provision to the filing-due date for a taxation year. The new definition of "filing-due date" found in subsection 248(1) generally means the day on or before which a taxpayer is required to file an income tax return for the year.

Paragraph 37(1)(*e*) of the Act provides for the reduction of a taxpayer's SR&ED pool for a taxation year where the taxpayer has claimed investment tax credits (ITCs) in earlier years in respect of prescribed proxy amounts and qualified expenditures attributable to expenditures of a current nature.

This paragraph is amended to ensure that the SR&ED pool is similarly reduced by ITCs claimed in earlier years in respect of amounts transferred to the taxpayer's SR&ED qualified expenditure pool as defined in subsection 127(9) at the end of a preceding year because of paragraph 127(13)(*e*).

These amendments apply to taxation years that begin after 1995.

Subclause 9(8)

ITA
37(7)

Consequential on the introduction of the definition of "scientific research and experimental development" in subsection 248(1) of the Act, the definition of "scientific research and experimental development" in subsection 37(7) of the Act is repealed. This amendment generally applies to work performed after February 27, 1995. However, the definition in subsection 37(7) continues to apply, for the purposes of paragraphs 149(1)(j) and (8)(*d*), to work performed pursuant to an agreement in writing entered into before February 28, 1995.

Subclause 9(9)

ITA
37(10)

Subsection 37(10) of the Act requires a taxpayer making an election under clause 37(8)(*a*)(ii)(B) for a taxation year to file the election with the taxpayer's tax return for the year.

This subsection is amended to require that such an election for a taxation year be filed by a taxpayer on the day on which the taxpayer first files a prescribed form (referred to in subsection 37(11))

reporting the taxpayer's SR&ED expenditures incurred in the year. This amendment applies to taxation years that begin after 1995.

Subclause 9(10)

ITA
37(11) to (13)

Reporting requirement

ITA
37(11)

Subsection 37(11) of the existing Act deals with the reclassification of SR&ED expenditures. As a result of renumbering, that provision is now found in new subsection 37(12).

New subsection 37(11) requires a taxpayer to report in a prescribed form the taxpayer's SR&ED expenditures incurred in a taxation year on or before a reporting deadline. This reporting requirement was formerly found in subsection 37(1).

If an expenditure is not reported by the reporting deadline, the taxpayer will be precluded from deducting the expenditure under subsection 37(1). As well, the taxpayer will not be allowed to claim any ITC with respect to the expenditure.

The new provision differs from the former reporting requirement in subsection 37(1) in two main respects. First, any expense that would otherwise be incurred, but for the application of subsection 78(4) of the Act, in respect of unpaid wages, salaries, or other remuneration in a taxation year that begins after 1995, must be identified by a taxpayer for that year even though the expense is not deductible for that year. Where the reporting requirement is satisfied, such an expense would then be deductible for the taxation year in which the expense is actually paid. Where an expense would, but for subsection 78(4), be incurred by a taxpayer in a taxation year that begins before 1996, the taxpayer is required to report that expense only for the year in which it is paid, as under the current practice.

The second difference is the reporting deadline. Currently, the prescribed form must be filed by the taxpayer's tax return due date

for the taxation year following the year in which the SR&ED was incurred. The new deadline is 12 months after the taxpayer's filing-due date for the taxation year in which the expenditures would be incurred if the Act were read without reference to subsection 78(4).

Reclassification of expenses

ITA
37(12)

New subsection 37(12) of the Act replaces subsection 37(11) of the existing Act which relates to the reclassification of expenses by Revenue Canada.

The new provision provides that where a SR&ED expenditure is reclassified in the course of an audit initiated by Revenue Canada, a taxpayer is not required to file the prescribed form referred to in new subsection 37(11) for that expenditure. In those circumstances, a taxpayer will not be prohibited from treating the expenditure as an SR&ED expenditure for the purpose of subsection 37(1) solely because the taxpayer has not filed the prescribed form in respect of the expenditure. Revenue Canada will not, however, reclassify an expenditure as a result of a taxpayer requested adjustment.

Work considered SR&ED

ITA
37(13)

New subsection 37(13) of the Act deems certain work that would not otherwise be considered to be SR&ED to be SR&ED for the purposes of sections 37, 127 and 127.1 of the Act.

Currently, work that is described in paragraph 2900(1)(*d*) of the *Income Tax Regulations* (linked work) would not be considered SR&ED to a taxpayer unless that work is commensurate with the needs and directly in support of work described in paragraph 2900(1)(*a*), (*b*) or (*c*) of the Regulations and that is carried out directly by, or on behalf of, the same taxpayer.

Where a taxpayer (payer) contracts out only linked work to another taxpayer (performer), the payer would currently be eligible to claim SR&ED tax incentives in respect of the amount of the contract. However, the performer would not be eligible for SR&ED tax incentives on expenditures incurred in respect of the linked work.

The 1995 federal budget announced that, in situations where a payer contracts out its SR&ED to a non-arm's length performer, the qualified expenditures on which ITCs are earned will be restricted to the allowable SR&ED expenditures incurred by the performer. In addition, the payer's expenditure in respect of the contract amount will not be a qualified expenditure for ITC purposes. In the case of linked work, the performer would, but for this subsection, have no SR&ED expenditures since the work would not be SR&ED to the performer. As a result, no expenditures incurred either by the payer or the performer would be qualified expenditures for ITC purposes.

New subsection 37(13) addresses this concern by treating the expenditures incurred by a performer in respect of certain work contracted to the performer to be SR&ED to the performer where

1. the work is performed by the performer for a non-arm's length person or partnership (payer), and

2. the work would be SR&ED described in paragraph 2900(1)(*d*) of the *Income Tax Regulations* if it were performed by the payer.

These amendments apply to taxation years that begin after 1995.

Clause 10

Election Concerning Principal Residence

ITA
45(3)

When an individual acquires residential real estate for use in a business or for rental purposes and at a later time occupies the property as a principal residence, paragraph 45(1)(*a*) of the Act treats

the individual as having disposed of the property at its fair market value at that time. This deemed disposition on change of use may result in recognition of a capital gain. Subsection 45(3) of the Act allows the individual to elect to defer the recognition of the capital gain until an actual disposition of the real estate.

Subsection 45(3) of the Act is amended consequential on the extension of the "filing-due date" of a taxpayer's return of income to June 15 (under amended subsection 150(1) of the Act and the definition of "filing-due date" in subsection 248(1) of the Act).

This amendment applies to 1995 and subsequent taxation years.

Clause 11

Gain When Small Business Becomes Public

ITA
48.1(2)

Section 48.1 of the Act ensures that the owners of qualified small business corporation shares do not lose their entitlement to the special $500,000 capital gains deduction in respect of gains accrued but not realized on their shares prior to the corporation becoming a public corporation.

Subsection 48.1(2), which provides the day by which an election made under subsection (1) must be filed, is amended consequential on the extension of the "filing-due date" of a taxpayer's return of income to June 15 (under amended subsection 150(1) of the Act and the definition of "filing-due date" in subsection 248(1) of the Act).

This amendment applies to 1995 and subsequent taxation years.

Clause 12

Adjustments to Cost Base

ITA
53(2)(*c*)(i.4)

Subsection 53(2) of the Act provides for reductions in computing the adjusted cost base of a taxpayer's property.

Paragraph 53(2)(*c*) provides for certain amounts that must be deducted in computing the adjusted cost base to a taxpayer of a passive partnership interest (i.e., of a limited partner or specified member of a partnership). New subparagraph 53(2)(*c*)(i.4) reduces the cost base of a taxpayer's passive partnership interest to the extent that the taxpayer claimed a reserve in respect of the interest in computing the taxpayer's income (i.e., in respect of the taxpayer's "December 31, 1995 income" in respect of the business carried on as a member of a partnership).

The reduction to the adjusted cost base of a taxpayer's interest in a partnership under this subparagraph occurs at a particular time and in respect of a particular amount of the taxpayer's entitlement to the 10-year reserve (e.g., each yearly reserve claim does not form a cumulative total). Also, an adjusted cost base reduction does not occur in two circumstances. First, there is to be no reduction in the adjusted cost base of a taxpayer's passive partnership interest at the time that is immediately before the disposition of the interest if the taxpayer cannot deduct a reserve under new subsection 34.2(4) in respect of the interest in the taxation year that follows the taxation year in which the taxpayer disposes of the interest. Second, no reduction applies to amounts deductible in respect of the "December 31, 1995 income" by a partner in respect of a business under new section 34.1 since amounts included in income under new section 34.1 are not added to the adjusted cost base of the partner's partnership interest (i.e., a partner's section 34.1 amounts arise in a taxation year of the partner rather than in respect of a fiscal period of the partnership).

This amendment applies after 1994.

Clause 13

Transfer of Retiring Allowances

ITA
60(*j*.1)

Paragraph 60(*j*.1) of the Act provides an individual with a deduction for the portion of a retiring allowance received by the individual that is contributed to a registered pension plan or registered retirement savings plan. The deduction is limited, in general terms, to $2,000 for each year in which the individual was employed by the employer who paid the retiring allowance (or who contributed to the retirement compensation arrangement under which the retiring allowance was paid) or by a person related to the employer, plus $1,500 for each such year of employment before 1989 in respect of which no employer contributions to a pension plan or deferred profit sharing plan vested in the individual.

Paragraph 60(*j*.1) is amended so that the limit on the amount that can be deducted is determined without taking into account years of employment after 1995. This amendment applies to 1996 and subsequent taxation years.

Clause 14

Special Rules for Spousal Trusts

ITA
70(7)(*a*)

Subsection 70(7) of the Act provides rules under which certain "tainted" spousal trusts may be considered qualifying spousal trusts for the purposes of the rollover of capital property under subsection 70(6). These rules apply where a spousal trust is not a qualifying spousal trust because of the payment of, or provision for payment of, certain testamentary debts. Essentially, these rules provide a mechanism by which such testamentary debts may be applied against certain property of the trust so listed by the legal representatives of the deceased taxpayer whose will created the trust. In these circumstances, paragraph 70(7)(*a*) provides that the terminal

return of the deceased taxpayer whose will created the trust may be filed up to 18 months after the date of death.

Paragraph 70(7)(*a*) is amended consequential on changes to paragraph 150(1)(*d*) of the Act.

This amendment applies after 1994.

Clause 15

Amalgamations

ITA
87

Subsection 87(2) of the Act applies where two or more taxable Canadian corporations amalgamate to form a new corporation.

Subclause 15(1)

ITA
87(2)(*j*)

Paragraph 87(2)(*j*) of the Act provides that, for the purpose of certain special reserves, the new corporation on an amalgamation is considered to be the same corporation as, and a continuation of, the predecessor corporation.

Paragraph 87(2)(*j*) is amended to add a reference to the 10-year transitional reserve available for "December 31, 1995 income" in new section 34.2 of the Act.

This amendment applies to amalgamations that occur and windings up that begin after 1994.

Subclause 15(2)

ITA
87(2)(*j*.94)

New paragraph 87(2)(*j*.94) of the Act treats a corporation formed on an amalgamation as a continuation of each predecessor corporation for the purposes of the Canadian film or video production tax credit in new section 125.4 of the Act. This amendment applies to amalgamations that occur and windings-up that begin after 1994.

Subclause 15(3)

ITA
87(2)(*aa*)

Paragraph 87(2)(*aa*) of the Act provides that in most cases any refundable dividend tax on hand (RDTOH) of the predecessor corporations is added to the new corporation's RDTOH. This rule is amended to reflect changes to the way in which a corporation's RDTOH is computed under subsection 129(3) of the Act. Amended paragraph 87(2)(*aa*) provides that where the new corporation was a private corporation immediately after the amalgamation, its RDTOH for its first taxation year will include the RDTOH of all predecessor corporations for their last taxation years, less any dividend refunds the predecessors received for those years. This transfer of RDTOH will take place only in respect of a predecessor that was a private corporation at the end of its last taxation year. As well, the transfer will not take place if subsection 129(1.2) of the Act would have deemed a dividend paid by the predecessor before the amalgamation not to be a taxable dividend for the purposes of subsection 129(1) of the Act.

This amendment applies to amalgamations that occur after June 1995. Since, as a result of an accompanying amendment to paragraph 88(1)(*e*.2) of the Act, paragraph 87(2)(*aa*) also applies mutatis mutandis for the purpose of subsection 88(1) of the Act, this amendment also applies to windings-up that begin after June 1995.

Clause 16

Windings-up of Subsidiaries - RDTOH

ITA
88(1)(*e*.2) and (*e*.5)

Subsection 88(1) of the Act sets out detailed rules relating to the winding-up of a subsidiary into a parent corporation that owns at least 90% of each class of shares of the subsidiary.
Paragraph 88(1)(*e*.2) provides that a number of the rules that apply to amalgamations under subsection 87(2) of the Act also apply to windings-up under subsection 88(1). As a consequence of changes to the computation of a corporation's refundable dividend tax on hand (RDTOH) under subsection 129(3) of the Act, this amendment adds paragraph 87(2)(*aa*) to the list of those rules. A parent corporation that is a private corporation immediately after its subsidiary is wound up will therefore include the subsidiary's RDTOH, less any dividend refund, in its own RDTOH for its first taxation year ending after the winding-up. This transfer of RDTOH will take place only in respect of a subsidiary that was a private corporation at the end of its last taxation year. As well, the transfer will not take place if subsection 129(1.2) of the Act would have deemed a dividend paid by the subsidiary before the winding-up not to be a taxable dividend for the purposes of subsection 129(1) of the Act.

Existing paragraph 88(1)(*e*.5) performs essentially the same function as amended paragraph 88(1)(*e*.2), and is therefore repealed.

These amendments apply to windings-up that begin after June 1995.

Clause 17

Partnerships and Their Members

ITA
96

Section 96 provides general rules for determining the income or loss of a partnership and its members.

Subclause 17(1)

ITA
96(1)(*d*)

Under subsection 96(1) of the Act, the income earned and losses incurred by a partnership are generally calculated at the partnership level for each fiscal period of the partnership and allocated to partners in accordance with their respective interests. Paragraph 96(1)(*d*) is amended so that

- the amount of additional business income included in computing a partner's income for a taxation year (and deducted in the following year) under new section 34.1 is not to be calculated at the partnership level since those adjustments to income are to be made by individuals who are members of the partnership, and

- no reserve for December 31, 1995 income is permitted under new subsection 34.2(4) at the partnership level since that reserve is to be claimed only by individuals or corporations that are members of the partnership.

This amendment applies after 1994.

Subclause 17(2)

ITA
96(1.1)

Subsection 96(1.1) of the Act sets out certain rules that apply for the purposes of subsection 96(1) and sections 101 and 103 of the Act where a taxpayer ceases to be a member of a partnership and the partnership's members enter into an agreement to allocate a share of its income or loss to the taxpayer or to the taxpayer's spouse or estate. For this rule to apply, the partnership's principal activity is required to be the carrying on of a business in Canada. Where the rule applies, the taxpayer or the taxpayer's spouse, estate or heirs, as the case may be, is considered to be a member of the partnership and the share of the partnership's income or loss allocated to such a person is to be included in the person's income for the taxation year in which the partnership's fiscal period ends.

Subsection 96(1.1) is amended consequential on the addition of new sections 34.1 and 34.2 and new subsection 249.1(1) to the Act. Accordingly, a taxpayer that is considered to be a member of a partnership under subsection 96(1.1) may be eligible to claim a reserve under new section 34.2 for December 31, 1995 income in respect of a business carried on by members of the partnership.

This amendment applies after 1994.

Subclause17(3)

ITA
96(1.6)

Subsection 96(1.6) of the Act deems residual members of a partnership that carries on a business in Canada to be carrying on business in Canada for the purpose of subsection 2(3) of the Act.

Subsection 96(1.6) is amended so that residual partners are also considered to be carrying on business in Canada for the purposes of the additional business income and 10-year reserve rules in new sections 34.1 and 34.2 of the Act, respectively. This amendment does not, however, apply to persons to whom the anti-avoidance rule in new subsection 34.2(7) applies.

This amendment applies after 1994.

Subclause 17(4)

ITA
96(2.2)(*d*)

Subsection 96(2.2) of the Act defines the "at-risk amount" of a limited partner. Subparagraph 96(2.2)(*d*)(ii) exempts prescribed revenue guarantees in respect of prescribed film productions from the limited partnership at-risk rules. As a consequence of the introduction of the Canadian film or video production tax credit, the components of the existing film tax incentive are to be eliminated for films acquired after 1995 and films acquired in 1995 in respect of which the new tax credit is claimed. Accordingly, subparagraph 96(2.2)(*d*)(ii) is no longer required and is repealed. The

repeal of this provision applies to revenue guarantees granted after 1995.

Subclause 17(5)

ITA
96(3)

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

Subsection 96(3) is amended to treat an election filed by a member under new subsections 249.1(4) or (6) in the same way as other elections referred to in subsection 96(3). The commentary on new subsections 249.1(4) and (6) discuss the elections available to individuals who carry on a business and who elect to have an off-calendar fiscal period or to revoke such an election.

This amendment applies after 1994.

Clause 18

Trusts and Their Beneficiaries

Section 104 of the Act provides rules governing the tax treatment of trusts and their beneficiaries.

Subclause 18(1) and (2)

ITA
104(4)(*a*.1) and (*b*)

Subsections 104(4) to (5.2) of the Act set out what is generally referred to as the "21-year deemed disposition" rule for trusts. Under paragraph 104(4)(*a*.1), a deemed disposition for a trust that is a pre-1972 spousal trust on January 1, 1993 occurs on the later of the day on which the beneficiary spouse dies and January 1, 1993. The

expression "pre-1972 spousal trust" is defined in subsection 108(1). Paragraph 104(4)(*b*) causes a deemed disposition with respect to a pre-1972 spousal trust 21 years after any deemed disposition under paragraph 104(4)(*a*) or (*a*.1).

Paragraph 104(4)(*a*.1) is amended to provide that a pre-1972 testamentary spousal trust is not subject to a deemed disposition under that paragraph, unless the beneficiary spouse was alive on January 1, 1976. Amended paragraph 104(4)(*a*.1) also provides that a pre-1972 *inter vivos* spousal trust is not subject to deemed disposition under that paragraph unless the beneficiary spouse was alive on May 26, 1976. These amendments recognize that, in the event that a beneficiary spouse died after 1971 and before 1976 (or before May 26, 1976 in the case of an *inter vivos* trust), a pre-1972 spousal trust would have already been subject to a deemed disposition on the day the beneficiary spouse died because of the former wording of paragraph 104(4)(*a*). Paragraph 104(4)(*b*) is amended to clarify that, in these circumstances, such a trust is subject to a further deemed disposition on the day that is 21 years after the beneficiary spouse died.

These amendments apply to trust taxation years that end after February 11, 1991.

Subclause 18(3) and (4)

ITA
104(5.3)

Subsections 104(4), (5) and (5.2) of the Act set out what is generally referred to as the "21-year deemed realization" rule for trusts. These subsections generally treat trust assets as having been disposed of and reacquired by trusts at their fair market value every 21 years. Subsection 104(5.3) of the Act provides an exception to the 21-year deemed realization rule. This exception applies where a trust elects to have the rules in paragraphs 104(5.3)(*a*) to (*d*) of the Act apply. The election must be made in prescribed form and filed with Revenue Canada within 6 months after the end of the trust's taxation year which includes the day that, but for the election, would be its first deemed realization day (or its second realization day in the case of a post-1971 spousal trust to which the rules in paragraph 104(4)(*a*) apply). Where the trust so elects and, at the end of such day, any

individual is an exempt beneficiary under the trust, the deemed realization of a trust's property would generally be postponed to the first day of the first taxation year following the death of the last surviving "exempt beneficiary". In addition, because of existing paragraph 104(5.3)(*b*), rollovers from a trust under subsection 107(2) of the Act are available only to exempt beneficiaries during the period for which the 21-year deemed realization rule is postponed. An "exempt beneficiary" under a trust is defined in subsection 104(5.4) of the Act.

Subsection 104(5.3) is amended so that no election is available to postpone deemed disposition days that occur after 1998.

Paragraph 104(5.3)(*a*) is amended to modify the tax consequences for trusts which have elected under subsection 104(5.3) to postpone the 21-year deemed realization rule. Under amended paragraph 104(5.3)(*a*), a trust which has so elected will generally be subject to a deemed realization of its assets at fair market value on January 1, 1999 (or, if earlier, the first day of the first taxation year following the death of the last surviving exempt beneficiary).

Paragraph 104(5.3)(*b*.1) is introduced so that rollovers under subsection 107(2) to all beneficiaries under a trust are available after February 1995 where the prescribed form containing the election under subsection 104(5.3) was filed before March 1995. This measure, in conjunction with new subsection 104(5.31) of the Act, ensures that trusts are not penalized by having made an election under subsection 104(5.3).

These amendments apply after February 11, 1991.

Subclause 18(5)

ITA
104(5.31)

New subsection 104(5.31) of the Act allows a trust to apply before 1997 to the Minister of National Revenue to revoke an election that was filed under subsection 104(5.3) before July 1995. Where the Minister grants permission to revoke an election under subsection 104(5.3), paragraph 104(5.31)(*a*) provides that it is to be treated as if it were never made.

New paragraph 104(5.31)(*b*) provides that a trust is not liable to any penalty under the Act to the extent that the liability would otherwise have increased because of the revocation of the election under subsection 104(5.3).

New paragraph 104(5.31)(*c*) requires the Minister to assess each taxation year of any taxpayer to take into consideration the consequences of the revocation of an election under subsection 104(5.3), even if the normal reassessment period for that year has expired.

New subsection 104(5.31) applies after Royal Assent.

Subclause 18(6)

ITA
104(6)

Subsection 104(6) of the Act generally permits a trust to deduct any trust income payable in the year to a beneficiary under the trust. However, a post-1971 spousal trust described in paragraph 104(4)(*a*) is not allowed to deduct amounts payable in a taxation year to anyone except the beneficiary spouse, if the beneficiary spouse is alive throughout the year.

Subparagraph 104(6)(*b*)(iii) is introduced to provide that, where the beneficiary spouse under such a post-1971 spousal trust died on a day in the trust's taxation year, the trust is not allowed to deduct income for that year that is payable to a beneficiary (other than the deceased spouse) that relates to any disposition by the trust, before the end of that day, of capital property (other than excluded properties), land described in an inventory of the trust, Canadian resource property or foreign resource property. The purpose of this amendment is to ensure that the gains recognition for spousal trusts under subsections 104(4), (5) and (5.2) cannot be avoided by actual dispositions by the trust before the beneficiary spouse dies.

This amendment applies to trust taxation years that end after July 19, 1995.

Subclause 18(7)

ITA
104(12)

Subsection 104(12) of the Act allows a trust to deduct in computing its income amounts of such income allocated under subsection 104(14) to its preferred beneficiaries.

Subsection 104(12) is amended to ensure that the amount that may be deducted in computing the trust's income for a taxation year under this subsection does not exceed its accumulating income for the year. This amendment is consequential on amendments to subsections 104(14) and (15) of the Act which are described below.

This amendment applies to trust taxation years that begin after 1995.

Subclauses 18(8) and (9)

ITA
104(14) and (15)

Subsections 104(12), (14) and (15) of the Act provides that a trust and a preferred beneficiary under the trust may elect that an amount not exceeding the preferred beneficiary's share in the accumulating income of the trust be deducted in computing the trust's income and be included in computing the beneficiary's income.
Subsection 108(1) defines the expressions "preferred beneficiary" and "accumulating income". Under the existing definition, a "preferred beneficiary" under a trust is the trust settlor, the settlor's spouse or former spouse, as well as the settlor's children, grandchildren, great-grandchildren, and their respective spouses.

Existing subsection 104(15) sets out the rules governing the computation of a preferred beneficiary's share in accumulating income. Special rules are provided under existing paragraph 104(15)(*a*) for spousal trusts where the beneficiary spouse is still alive, in which case, the beneficiary spouse's share in accumulating income is equal to the full amount of the accumulating income, and the share of any other beneficiary is considered to be nil. Rules are also provided for non-discretionary and discretionary trusts under existing paragraphs 104(15)(*b*) and (*c*), as well as Part XXVIII

of the *Income Tax Regulations*. Where none of these rules apply, a preferred beneficiary's share in accumulating income is considered to be nil under paragraph 104(15)(*d*).

The definition of "preferred beneficiary" is amended to provide that a beneficiary under a trust no longer qualifies as a preferred beneficiary unless the beneficiary is entitled to a tax credit for mental or physical impairment under subsection 118.3(1) of the Act (or would be so entitled if there were no deductions claimed for an attendant or care in a nursing home in respect of the beneficiary).

Subsections 104(14) and (15) are amended so that a preferred beneficiary's share in the accumulating income of a trust is now referred to as the "allocable amount" for the preferred beneficiary, to take into account the possibility that there may be more than one preferred beneficiary under a trust, and that the total allocable amounts for those preferred beneficiaries will typically exceed the accumulating income of the trust. (However, because of amended subsection 104(12), there will be no advantage to a trust to make elections for a taxation year under subsection 104(14) in excess of the trust's accumulating income for the year.)

Subsection 104(15) has been amended to simplify the calculation of the allocable amount for a preferred beneficiary. Except where existing paragraph 104(15)(*a*), described above, applies, the allocable amount for a preferred beneficiary under a trust for a taxation year is

- the accumulating income of the trust for the year, provided the beneficiary has a right of any type to any portion of that income and such right is not entirely contingent on the death of another beneficiary who has a capital interest in the trust and who does not have an income interest in the trust, and

- in any other case, nil.

These amendments apply to trust taxation years that begin after 1995.

Subclause 18(10)

ITA
104(18)

Subsection 104(6) of the Act generally permits a trust to deduct any trust income payable in the year to a beneficiary under the trust. Subsection 104(18) of the Act provides that, where the only reason that the income of a trust is not payable to a beneficiary under the trust in the year is that the beneficiary was a minor, such amount will be considered to be payable to the beneficiary. The expression "minor" is not defined in the Act.

Subsection 104(18) is amended so that it applies to a trust for a taxation year only where the trust is resident in Canada throughout the year.

Subsection 104(18) is also amended to provide that trust income will be considered payable under the subsection to an individual in a taxation year only where

- the individual is less than 21 years of age at the end of the year;
- the individual's right to the income is vested by the end of the year;
- the individual's right to that income did not become vested because of the exercise or the non-exercise of a discretionary power; and
- the individual's right is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years).

Subsection 104(18) is also amended to clarify that it overrides subsection 104(24), under which trust income not paid out in a taxation year is generally considered not to be an amount payable to a beneficiary for the purposes of trust taxation rules.

These amendments apply to trust taxation years that begin after 1995.

Subclause 18(11)

ITA
104(23)(*a*)

Subsection 104(23) of the Act provides rules that apply to testamentary trusts. Paragraph 104(23)(*a*), which defines the taxation year of a testamentary trust, is amended consequential on the new definition of "fiscal period" in new section 249.1 of the Act (formerly in subsection 248(1) of the Act).

This amendment applies after 1994.

Clause 19

Trusts - Definitions

ITA
108

Section 108 of the Act sets out certain definitions and rules that apply for the purposes of the rules dealing with the taxation of trusts and their beneficiaries.

Subclause 19(1)

ITA
108(1)

"accumulating income"

Subsection 108(1) of the Act defines the expression "accumulating income", which is relevant for the purposes of determining amounts that can be allocated to preferred beneficiaries under the preferred beneficiary election in subsection 104(14). Subject to a number of adjustments, it is essentially the undistributed income of a trust for a taxation year.

The definition of "accumulating income" is amended to ensure that, if a trust fails to claim a deduction to the maximum extent possible under subsection 104(6), "accumulating income" is computed as if the

maximum claim had been made. (It may be advantageous for a trust not to claim the maximum deduction under subsection 104(6) in order to allow for a tax-free distribution to a beneficiary under subsection 104(13.1) or (13.2) of the Act.)

The definition is also amended to provide that, where a trust is a post-1971 spousal trust and the beneficiary spouse died on a day in a trust's taxation year, the trust's accumulating income for the year is computed as if any disposition by the trust before the end of that day of capital property, land described in an inventory of the trust, Canadian resource property or foreign resource property had not occurred. The purpose of this amendment is to ensure that the capital gains recognition for spousal trusts under subsections 104(4) to (5.1) cannot be avoided by actual dispositions by the trust before the beneficiary spouse dies.

These amendments apply to trust taxation years that end after July 19, 1995.

Subclause 19(2)

ITA
108(1)

"preferred beneficiary"

The amendment to this definition is discussed in the commentary on the amendments to subsections 104(14) and (15) of the Act.

This amendment applies to trust taxation years that begin after 1995.

Clause 20

Charitable Gifts Made by Corporations

ITA
110.1

Section 110.1 of the Act contains the provisions governing the tax treatment of gifts made by corporations to charities and certain other entities.

Subclause 20(1)

ITA
110.1(1)(*d*)

Subsection 110.1(1) of the Act provides a deduction in computing taxable income in respect of gifts made by corporations to registered charities and certain other entities. The deduction is generally limited to 20% of the corporation's net income in a year, except where the gift is made to the Crown or where it is a gift of cultural property. Donors may carry unused claims for charitable gifts forward for up to five years.

New paragraph 110.1(1)(*d*) provides an exemption from the annual 20% income limit for gifts of land provided that certain conditions are met. First, the gift must be of land (including a covenant, an easement or a servitude) that is certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is, in the opinion of that Minister, important to the preservation of Canada's environmental heritage. Second, the beneficiary of the gift must be a Canadian municipality or a registered charity the primary purpose of which is, in the opinion of the Minister of the Environment, the conservation and protection of Canada's environmental heritage. Finally, where the beneficiary is a registered charity, it must be approved by the Minister of the Environment in respect of the gift.

This amendment applies to gifts made after February 27, 1995.

Subclause 20(2)

ITA
110.1(3)(*a*)(i)

Subsection 110.1(3) of the Act provides that if a corporation donates capital property to a charity, it may elect a value between the adjusted cost base and the fair market value of the donated property to be treated both as the proceeds of disposition for purposes of calculating its capital gain and the amount of the gift for purposes of the deduction allowed for charitable donations under subsection 110.1(1).

This amendment, which is consequential on the addition of new paragraph 110.1(1)(*d*) to the Act, adds a reference in subparagraph 110.1(3)(*a*)(i) to that new paragraph. The amendment applies to gifts made after February 27, 1995.

Clause 21

Capital Gains Deduction

ITA
110.6(24)(*a*)(i)

Subparagraph 110.6(24)(*a*)(i) of the Act sets the time limit for filing a capital gains election in respect of an eligible capital property owned on February 22, 1994.

Subparagraph 110.6(24)(*a*)(i) is amended consequential on the amendment to paragraph 150(1)(*d*) of the Act which extends the filing due-date of individuals who carry on a business.

This amendment applies to 1995 and subsequent taxation years.

Clause 22

Indexation of Amounts

ITA
117.1

Section 117.1 of the Act provides for the indexing of amounts upon which various personal tax credits and the recovery of Old Age Security benefits in Part I.2 of the Act are calculated. The indexation is based on annual increases in the Consumer Price Index in excess of 3%.

The amendment to paragraph 117.1(1)(*b*), which applies to 1996 and subsequent taxation years, replaces the reference to subsection 180.2(1) of the Act with a reference to Part I.2 of the Act. The amendment is consequential on the amendments to Part I.2 which modify the provisions relating to the recovery of Old Age Security

benefits. It ensures that the threshold upon which the repayment is calculated will continue to be indexed.

Clause 23

Charitable Gifts Made by Individuals

ITA
118.1

Section 118.1 of the Act provides rules for determining the tax credit available to individuals in respect of gifts made to charities and certain other entities.

Subclauses 23(1) and (2)

ITA
118.1(1)

"total charitable gifts"
"total Crown gifts"

Subsection 118.1(1) provides definitions of various terms, including "total charitable gifts", and "total Crown gifts", for the purposes of the tax credit available to individuals who make such gifts.

These definitions are amended, in their application to gifts made after February 27, 1995, to add references to the new definition of "total ecological gifts", to ensure that an amount claimed in respect of an ecological gift cannot be claimed in respect of these other types of gifts.

Subclause 23(3)

ITA
118.1(1)

"total gifts"

The definition of "total gifts" in subsection 118.1(1) of the Act determines the amount upon which an individual's tax credit for gifts to various entities is based. The tax credit is generally based on 20% of the individual's income for a year, except where the gift is made to the Crown or where it is a gift of cultural property. Donors may carry unused claims for charitable gifts forward for up to five years.

New paragraph (*d*) is added to the definition of "total gifts", applicable to gifts made after February 27, 1995, to provide that an individual may claim a tax credit in relation to total ecological gifts that will not be subject to the annual 20% income limit. A definition of total ecological gifts has also been added to subsection 118.1(1).

Subclause 23(4)

ITA
118.1(1)

"total ecological gifts"

A new definition of "total ecological gifts" is added to the Act. It applies to gifts made after February 27, 1995.

In order to be considered an ecological gift, the gift must be of land (including a covenant, an easement or a servitude) that is certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is, in the opinion of that Minister, important to the preservation of Canada's environmental heritage. As well, the beneficiary of the gift must be a Canadian municipality or a registered charity the primary purpose of which is, in the opinion of the Minister of the Environment, the conservation and protection of Canada's environmental heritage. Finally, where the beneficiary is a registered charity, it must be approved by the Minister of the Environment in respect of the gift.

Subclause 23(5)

ITA
118.1(2)

Subsection 118.1(2) of the Act provides that a gift shall not be included in computing a tax credit under section 118.1 unless the gift is proven by filing a receipt containing prescribed information. This amendment to subsection 118.1(2), which applies to gifts made after February 27, 1995, adds a reference to total ecological gifts.

Subclause 23(6)

ITA
118.1(6)(*a*)

Subsection 118.1(6) of the Act provides that an individual who donates capital property to a charity may elect a value between the adjusted cost base and the fair market value of the donated property to be both its proceeds of disposition (for purposes of calculating any gain on the disposition) and the amount of the gift (for purposes of calculating the tax credit in respect of charitable donations under subsection 118.1(3) of the Act).

This amendment, which is consequential on the addition of the definition of "total ecological gifts" to subsection 118.1(1) of the Act, adds a reference in paragraph 118.1(6)(*a*) to that new definition. The amendment applies to gifts made after February 27, 1995.

Clause 24

Corporate Surtax

ITA
123.2

Section 123.2 of the Act imposes a 3% surtax on the tax payable under Part I of the Act by a corporation, other than a non-resident owned investment corporation. This amendment changes the rate of the surtax to 4% for taxation years that end after February 27, 1995.

For any taxation year that spans that date, the additional surtax is reduced in proportion to the number of days in the year that are before February 28, 1995.

The amendment also provides that the additional refundable tax imposed under new section 123.3 of the Act is excluded from the surtax base.

Clause 25

Refundable Tax on CCPC's Net Investment Income

ITA
123.3

New section 123.3 of the Act imposes an additional amount of tax under Part I of the Act on the investment income of a Canadian-controlled private corporation (CCPC). Under section 123.3, a corporation that is a CCPC throughout a taxation year adds to its tax otherwise payable under Part I for that year an amount equal to 6 2/3% of the lesser of two amounts. The first amount is the corporation's "aggregate investment income" for the year, as defined in amended subsection 129(4) of the Act. The second amount is the corporation's taxable income for the year less any amount in respect of which the corporation claimed the "small business deduction" under subsection 125(1) of the Act.

The additional tax imposed under section 123.3 is reflected in a CCPC's "refundable dividend tax on hand" under amended subsection 129(3) of the Act; accordingly, it is refundable to the corporation when it pays a taxable dividend.

New section 123.3 applies to taxation years that end after June 1995. Where any such year began before July 1995, the 6 2/3% rate is prorated according to the number of days in the year that are after June 1995.

Clause 26

Small Business Deduction

ITA
125

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

Subclause 26(1)

ITA
125(1)(*b*)

Subsection 125(1) of the Act calculates a corporation's small business deduction for a year as the least of three amounts. The second of these amounts, described in paragraph 125(1)(*b*), is the corporation's taxable income for the year, less any income that is sheltered from Canadian tax by a foreign tax credit (FTC) under section 126 of the Act, or that is tax-exempt. To determine the amount of income that has given rise to an FTC, subparagraphs 125(1)(*b*)(i) and (ii) multiply the amounts of any credits by the inverse of a notional tax rate.

New section 123.3 of the Act imposes an additional refundable tax on the investment income of Canadian-controlled private corporations (CCPCs). This additional tax is included in computing a corporation's non-business FTC. To preserve the effect of subparagraph 125(1)(*b*)(i) while avoiding a potential circularity among section 123.3, subsection 125(1) and section 126, this amendment provides that for the purposes of subparagraph 125(1)(*b*)(i), a corporation's non-business FTCs under subsection 126(1) are to be computed without reference to new section 123.3.

This amendment applies to taxation years that end after June 1995.

Subclause 26(2)

ITA
125(5.1)

Subsection 125(5.1) of the Act restricts larger corporations' access to the small business deduction through the gradual reduction of their annual business limit. This reduction phases out the small business deduction, on a straight-line basis, for corporations having taxable capital employed in Canada in excess of $10 million.

Although the effect of 125(5.1) is to phase out the small business deduction on the basis of a corporation's taxable capital employed in Canada, it uses a corporation's tax payable under Part I.3 of the Act (Tax on Large Corporations) in the computational formula to determine the applicable reduction in the corporation's business limit. The reduction is computed as the proportion of a corporation's business limit that the ratio of its Part I.3 tax liability in the preceding taxation year is to $10,000 (the tax payable under Part I.3, at the current rate of 0.2%, on taxable capital employed in Canada of $15 million).

An amendment to subsection 181.1(3) of the Act will increase the tax rate under Part I.3 from 0.2% to 0.225%. This amendment would, in the absence of any change to subsection 125(5.1), effectively accelerate the rate of the phase-out of the small business deduction. Subsection 125(5.1) is consequently amended by replacing the reference to $10,000 in the computational formula to $11,250 (the new tax payable under Part I.3 on taxable capital employed in Canada of $15 million). This ensures that a corporation's business limit does not change as a result of the rate increase under Part I.3.

A special transitional rule provides that the amendment to subsection 125(5.1) is to apply only where the corporation's preceding taxation year began after February 27, 1995. Where a particular corporation is associated with other corporations in a particular taxation year, the amendment will apply where the preceding taxation year of each associated corporation also began after February 27, 1995. Where the preceding taxation year of a particular corporation or associated corporation began before February 28, 1995, the particular corporation's tax payable under Part I.3, as determined for the purposes of subsection 125(5.1), is to

be computed without reference to the rate increase under amended subsection 181.1(1).

Subclause 26(3)

ITA
125(7)

"income ... from an active business"

Subsection 125(7) of the Act defines various terms for the purposes of the preferential small-business tax rate in section 125. The definition of "income of the corporation for the year from an active business" is amended to replace a reference to subsection 129(4.1) of the Act with a reference to subsection 129(4) of the Act. This amendment, which applies to taxation years that end after June 1995, is strictly a consequence of changes to section 129.

Subclause 26(4)

ITA
125(7)

"specified partnership income"

Subsection 125(7) of the Act provides definitions for the terms used in section 125 which relate to the small business deduction for Canadian-controlled private corporations (CCPCs). The "specified partnership income" of a corporation is defined in this provision and is used in determining the small business deduction of a CCPC that carries on business as a member of a partnership.

The definition of "specified partnership income" is amended to ensure that it includes an amount included in a corporation's income because of new subsection 34.2(5) of the Act. New subsection 34.2(5) includes in a taxpayer's income for a taxation year the amount of any reserve deducted under new subsection 34.2(4) for the preceding taxation year. Subsection 34.2(4) establishes a deductible reserve for a taxpayer's December 31, 1995 income of a business. Such a reserve for a preceding taxation year is, therefore, to be included in the description of G in the formula used to determine a corporation's specified partnership income for the next taxation year with any new

reserve for that following taxation year included in the description of H in that formula.

This amendment applies to 1995 and subsequent taxation years.

Clause 27

M & P Credit

ITA
125.1(1)(*b*)(iii)

Subsection 125.1(1) of the Act provides a deduction from a corporation's Part I tax otherwise payable (generally referred to as the "M & P credit") which is based on Canadian manufacturing and processing profits. If the corporation is a Canadian-controlled private corporation, it should not receive an M & P credit on income in respect of which it may receive a dividend refund under subsection 129(1) of the Act. This is effected by subparagraph 125.1(1)(*b*)(iii), which excludes from a corporation's income eligible for the M & P credit the amount determined under clause 129(3)(*a*)(i)(B) of the Act in respect of the corporation's Canadian investment income and foreign investment income for the year. To reflect the amendments made to subsection 129(3), subparagraph 125.1(1)(*b*)(iii) is amended by replacing the amount determined under clause 129(3)(*a*)(i)(B) with the amount of the corporation's "aggregate investment income". The aggregate investment income of a corporation is defined in amended subsection 129(4) of the Act and is discussed in the commentary on that provision.

The amendment to subparagraph 125.1(1)(*b*)(iii) applies to taxation years that end after June 1995.

Clause 28

Canadian Film or Video Production Tax Credit

ITA
125.4

New section 125.4 of the Act sets out the rules that apply for the purpose of computing the Canadian film or video production tax credit. Generally, this new tax credit is available at a rate of 25% of qualified labour expenditures incurred after 1994 by a qualified corporation for the production of a Canadian film or video production, except where the financing of the film is eligible for transitional relief from the termination of the capital cost allowance shelter mechanism. The application of these rules is described in detail in the commentary accompanying the following subsections.

Definitions

ITA
125.4(1)

New subsection 125.4(1) of the Act, which applies to 1995 and subsequent taxation years, provides definitions that apply for the purpose of new section 125.4.

"assistance"

The definition of "assistance" describes amounts that reduce the cost of a film or the amount of an otherwise eligible "labour expenditure" or "qualifying labour expenditure". Generally, all government assistance received in respect of an eligible production will reduce the related expenditure base for the Canadian film and video production tax credit in the same manner as is currently the case under the regular investment tax credit program. Also, new paragraph 125.4(2)(*c*) provides a special rule that applies to assistance in respect of the definition of "labour expenditure" which is discussed below.

"Canadian film or video production"

The definition of "Canadian film or video production" is to be set out in the *Income Tax Regulations*. As indicated in the February 1995 budget documents, the regulations are to be amended to provide new eligibility requirements for Canadian certified productions.

"Canadian film or video production certificate"

"Canadian film or video production certificate" is defined as a certificate issued in respect of a production by the Minister of Canadian Heritage:

- certifying that the production is a Canadian film or video production, and

- estimating amounts relevant for the purpose of determining the amount deemed under subsection 125.4(3) to have been paid in respect of the production. These estimates are subject to verification by the Minister of Canadian Heritage and Revenue Canada.

Under new subsection 125.4(3), a qualifying corporation which is producing a Canadian film or video production must file a Canadian film or video production certificate with its tax return for a taxation year in which it claims a Canadian film or video production tax credit in respect of the production. Reference should also be made to the commentary accompanying new subsection 125.4(6) which provides that a Canadian film or video production certificate in respect of a production may be revoked by the Minister of Canadian Heritage in certain circumstances.

"investor"

The definition of "investor" describes a person (other than a prescribed person) who is not actively engaged on a regular, continuous, and substantial basis in a Canadian film or video production business carried on through a permanent establishment (as defined by the *Income Tax Regulations*) in Canada. This definition is relevant for the purpose of new subsection 125.4(4) which ensures that no tax credit may be claimed in respect of expenditures related to a Canadian film or video production where an investor, or a

partnership in which an investor has an interest, may deduct an amount in respect of the production. Prescribed persons would generally include, for example, a broadcaster.

"labour expenditure"

The definition of "labour expenditure" describes the labour expenditures of a corporation that are referenced in the new definition of "qualified labour expenditure". In the case of a non-qualifying corporation, its labour expenditure is considered to be nil. In the case of a corporation that is a qualified corporation for a taxation year, the corporation's labour expenditure for the taxation year in respect of a Canadian film or video production is, subject to new subsection 125.4(2), the total of the three amounts described in paragraphs (*a*) to (*c*) of the definition of "labour expenditure" to the extent they are reasonable in the circumstances and are included in the cost or capital cost of the production.

New paragraph (*a*) of the definition of "labour expenditure" is the total salary or wages directly attributable to the production that are incurred by a corporation after 1994 in the taxation year, or the preceding year, of the corporation and, generally, paid by it in the year (or within 60 days after the end of the year) in respect of certain stages of the production. The eligible stages of production are the stages from the final script stage to the end of the post-production stage.

New paragraph (*b*) of the definition of "labour expenditure" is the non-salaried remuneration that is directly attributable to the production of the property. In order to constitute a labour expenditure for a taxation year, such remuneration paid in the year (or within 60 days after the end of the year) by a corporation, generally, must relate to services rendered after 1994 and in the taxation year, or the preceding year, to the corporation for the stages of production mentioned above (see the commentary above on paragraph (*a*)). Other prerequisites of the remuneration are set out in subparagraphs (*b*)(i) to (iv).

New paragraph (*c*) of the definition of "labour expenditure" provides a mechanism under which a wholly-owned corporation can obtain credit for a labour expenditure by reimbursing its parent for expenditures incurred by the parent in a particular year of the parent

in respect of the corporation's production if certain conditions are met. The expenditure reimbursed to the parent must be an expenditure that would have otherwise been an eligible labour expenditure of the corporation for the particular year if the expenditure were incurred by the corporation for the same purpose as it was by the parent and were paid at the same time and to the same person or partnership as it was by the parent.

"qualified corporation"

The definition of "qualified corporation" means a prescribed taxable Canadian corporation the activities of which, in the year, are primarily the carrying on through a permanent establishment (as defined by regulation) in Canada of a business that is a Canadian film or video production business. (The *Income Tax Regulations* will be amended to include the detailed conditions that a taxable Canadian corporation must meet in order to be considered a "qualified corporation".)

"qualified labour expenditure"

The definition of "qualified labour expenditure" is the portion of a qualified corporation's labour expenditures upon which it can claim a 25% investment tax credit for a Canadian film or video production. A qualified labour expenditure is defined as the lesser of two amounts.

Paragraph (*a*) of the definition of "qualified labour expenditure" describes the first of these two amounts and is, generally, the total of

(A) the corporation's "labour expenditure" in respect of the production for the taxation year,

(B) all repaid assistance, and

(C) the amount by which

- the corporation's "labour expenditure" and repaid assistance in respect of the production for a preceding year

exceeds

- the corporation's "qualified labour expenditure" in respect of the production for a preceding year before the end of which the principal photography of the film began

exceeds the total of

- the amount of assistance for the "labour expenditure" of the corporation for a preceding taxation year which has not reduced that labour expenditure (i.e., because new paragraph 125.4(2)(*c*) of the Act did not apply to the assistance in that preceding year), and

- any amount transferred to a subsidiary of the corporation that claims the amount as a "labour expenditure" in respect of the production (see paragraph (*c*) of the definition of "labour expenditure).

The effect of clauses (*a*)(i)(B) and (C) of the definition of "qualified labour expenditure" is to add back:

- "assistance" that is repaid in the year by a corporation, and

- a "labour expenditure" that was not a "qualified labour expenditure" in the corporation's preceding taxation year (e.g., due to the application of the 48% cap discussed below).

Subparagraphs (*a*)(ii) and (iii) of the definition ensure that certain types of assistance and reimbursements are not included in a corporation's "qualified labour expenditure".

As stated above, a "qualified labour expenditure" is the lesser of two amounts. The second amount is determined under the formula in paragraph (*b*) of the definition. The formula limits a corporation's Canadian film or video production tax credit to 48% of the cost of the production at the end of the year net of assistance. The description of B in the formula ensures that tax credits are claimed only once in respect of "qualifying labour expenditures". Given the 25% rate of the credit, a corporation's Canadian film or video production tax credit cannot exceed 12% of the cost of production net of assistance.

"salary or wages"

For the purposes of the Canadian film and video production tax credit, the definition of "salary or wages", which is generally defined in subsection 248(1) of the Act, does not include an amount described in section 7 of the Act (share option benefits) or any amount determined by reference to profits or revenues.

Reference may be made to the commentary on new subsection 125.4(3) of the Act for a detailed example which uses many of the above-described definitions for the purpose of computing a qualified corporation's Canadian film or video production tax credit.

Rules Governing Labour Expenditure

ITA
125.4(2)

New subsection 125.4(2) of the Act provides special rules that apply for the purpose of the definition of "labour expenditure" in subsection 125.4(1). Paragraph 125.4(2)(*a*) provides that remuneration does not include remuneration determined by reference to profits or revenues.

New paragraph 125.4(2)(*b*) provides that the services referred to in paragraph (*b*) of the definition of "labour expenditure", that relate to the post-production stage of the production, include only the services that are rendered at that stage of production by persons who perform particular specified duties.

New paragraph 125.4(2)(*c*) reduces the amount of the "labour expenditure" of a corporation for a taxation year in respect of a production by all assistance in respect of the expenditure that the corporation, or any other person or partnership, is entitled to receive or can reasonably be expected to receive (at the time of filing the corporation's tax return for the year).

This subsection applies to 1995 and subsequent taxation years.

Tax Credit

ITA
125.4(3)

New subsection 125.4(3) of the Act provides the Canadian film or video production tax credit. Where the conditions set out in the subsection are met, a qualifying corporation is considered to have paid an amount, on account of its tax payable under Part I of the Act for the year, equal to 25% of its qualified labour expenditure for the year. Thus, to the extent that the corporation has no tax otherwise payable, the credit is refundable.

EXAMPLE

Assume:

A qualified corporation is a private corporation that has a taxation year that coincides with the calendar year and it begins the principal photography of a Canadian film or video production in its 1995 taxation year.

The total cost of the production is $3,600,000 and the corporation can reasonably be expected to receive $600,000 in assistance in respect of the production. The corporation incurs in 1995, $2,000,000 of the total budgeted cost of $3,600,000. The remaining $1,600,000 is incurred in 1996. All of the amounts are directly attributable to the production and are paid for by the corporation within 60 days after the end of its applicable taxation year.

The corporation pays $1,000,000 in salary or wages in each of 1995 and 1996 in respect of the production and the production is completed before the end of 1996. The $1,000,000 of corporate salary or wages paid meets the definition of "labour expenditure" in subsection 125.4(1).

The assistance payable to the corporation is as follows: provincial assistance of $300,000 relating to labour expenditures and $300,000 in federal assistance to produce the film.

The Minister of Canadian Heritage issues a Canadian film or video production certificate in respect of the production and the corporation files all of the required information with its returns of income for the 1995 and 1996 taxation years.

Canadian Film or Video Production Tax Credit for the corporation's 1995 taxation year is $168,000, which is computed as follows:

25% x $672,000 (qualified labour expenditure)

where

"qualified labour expenditure" for the 1995 taxation year is:

the lesser of

(a) $700,000

which is the amount, if any, by which

- *$700,000 labour expenditure ($1m) for the year net of assistance ($.3m)*
  nil repayment of assistance
  nil capped labour expenditure
  $700,000

exceeds

- *the total of*

  Nil assistance for prior year - not previously netted
  Nil parent/sub reimbursement agreement
  Nil

*(b) **$672,000***

which is the amount, if, any by which

- *$ 672,000 (48% of film cost to the end of 1995 ($2m) net of assistance ($.6m))*

exceeds

Nil No prior "QLE"

Note: the capital cost of the film for capital cost allowance purposes at the end of the corporation's 1995 taxation year is:

$1,000,000	*labour expenditure*
$1,000,000	*other costs*
($300,000)	*assistance for labour*
($300,000)	*other assistance*
($168,000)	*1995 film credit*
$1,232,000	

Canadian Film or Video Production Tax Credit for the corporation's 1996 taxation year is $192,000, which is computed as follows:

25% x $768,000 (qualified labour expenditure)

where

"qualified labour expenditure" for the 1996 taxation year is:

the lesser of

(a) $1,028,000

- *which is the amount, if any, by which*

$1,000,000	*labour expenditure for the year*
nil	*repayment of assistance*
$ 28,000	*excess labour expenditure in 1995*
$1,028,000	

exceeds

Nil	*assistance for prior year - not previously netted*
Nil	*parent/sub reimbursement agreement*
Nil	

*(b) **$768,000***

- *which is the amount, if any, by which*

  $1,440,000 (48% of film cost to the end of 1996 ($3.6m) net of assistance ($.6m))

exceeds

$672,000 1995 qualifying labour expenditure

Note: the capital cost of the film for capital cost allowance purposes at the end of the corporation's 1996 taxation year is (assuming no capital cost allowance was claimed by the corporation for its 1995 taxation year):

$2,000,000	*labour expenditure*
$1,600,000	*other costs*
($300,000)	*assistance for labour*
($300,000)	*other assistance*
($168,000)	*1995 film credit*
($192,000)	*1996 film credit*
$2,640,000	

Accordingly, the total Canadian film or video production tax credit permitted in the above example is $360,000: $168,000 + $192,000 or 25% x (672,000 + $768,000).

This subsection applies to 1995 and subsequent taxation years.

Exception

ITA
125.4(4)

New subsection 125.4(4) of the Act provides that a Canadian film or video production tax credit is not available for a production if an investor may deduct an amount in respect of the production in computing its income for any taxation year. This subsection applies to 1995 and subsequent taxation years.

When assistance received

ITA
125.4(5)

New subsection 125.4(5) of the Act provides that the amount of tax that a corporation is considered to have paid under new subsection 125.4(3) for a taxation year is considered to be assistance received by the corporation from a government immediately before the end of the year (other than for the purpose of determining the production tax credit itself). As such, the cost base of a corporation's production is to be reduced for the purposes of claiming any capital cost allowance.

This subsection applies to 1995 and subsequent taxation years.

Revocation of a certificate

ITA
125.4(6)

New subsection 125.4(6) of the Act provides that a Canadian film or video production certificate in respect of a production may be revoked by the Minister of Canadian Heritage. A revocation of a certificate may occur if an incorrect statement or an omission was made in order to obtain the certificate or if the production is not a Canadian film or video production. A revoked certificate is considered never to have been issued, so a Canadian film or video production tax credit under new subsection 125.4(3) cannot be claimed in respect of the decertified production.

This amendment applies to 1995 and subsequent taxation years.

Clause 29

Foreign Tax Credit

ITA
126(7)

"tax for the year otherwise payable under this Part"

Section 126 of the Act allows a taxpayer to deduct foreign tax credits (FTCs) from tax otherwise payable under Part I of the Act. For the purpose of computing FTCs, subsection 126(7) of the Act includes three definitions of "tax for the year otherwise payable under this Part". The first definition is used in computing a taxpayer's FTCs in respect of foreign non-business income taxes under subsection 126(1), and in computing the special credit under subsection 126(3) for employees of international organizations. The second definition is used in determining the limit imposed in paragraph 126(2)(*c*) on a taxpayer's FTCs in respect of foreign business taxes, and in computing the subsection 126(2.2) credit for former Canadian residents who dispose of deemed taxable Canadian property. The third definition applies for purposes of the formula in subsection 126(2.1), which determines the limit imposed on business FTCs under paragraph 126(2)(*b*).

This amendment modifies the second and third definitions to exclude from "tax for the year otherwise payable" under Part I the additional refundable tax imposed by new section 123.3 on the investment income of Canadian-controlled private corporations. This amendment applies to taxation years that end after June 1995.

Clause 30

Investment Tax Credit

ITA
127

The 1995 federal budget announced a number of measures affecting the determination of SR&ED investment tax credits (ITCs). These measures relate to non-arm's length R&D contracts, goods and services provided by non-arm's length parties, and unpaid amounts.

Currently, if a taxpayer incurs an SR&ED expenditure that is deductible under subsection 37(1) of the Act, the expenditure is generally also a qualified expenditure of the taxpayer for ITC purposes. In addition, the qualified expenditures of the taxpayer will also include a fraction of the cost of a first term shared-used-equipment or second term shared-used-equipment and, where the taxpayer so elects, a prescribed proxy amount based generally on 65% of the wages and salaries incurred in respect of SR&ED by the taxpayer.

A qualified expenditure incurred by a taxpayer in a taxation year is reduced by any government assistance, non-government assistance and contract payments (as defined in subsection 127(9) of the Act) that the taxpayer has received, is entitled to receive or can reasonably be expected to receive, in respect of that expenditure at the time of filing of the taxpayer's tax return for the year.

A percentage (20% or 35%) of each "net" qualified expenditure is added to the taxpayer's ITC at the end of the year. In certain cases, ITCs earned in a taxation year, but not claimed in the year, may be eligible for a refund, either at a 40% rate or a 100% rate. The ITC earned in respect of qualified expenditures incurred in a taxation year may be used to offset tax payable in the year or be carried back up to three years or forward up to ten years to offset other years' taxes payable.

Under the revised SR&ED ITC system, and in situations where a taxpayer (payer) contracts out its SR&ED to a non-arm's length party (performer), the qualified expenditures on which ITCs are earned in respect of the non-arm's length R&D contract will be restricted to the

allowable SR&ED expenditures incurred by the performer. The payer's expenditures in respect of the contract amount will not be qualified expenditures for ITC purposes. The performer will instead be able to transfer its qualified expenditures incurred in a taxation year to the payer up to the portion of the contract amount that relates to that year.

New subsections 127(11.5) to (11.8) and (17) to (22) of the Act contain provisions which reduce the amount of qualified expenditures incurred by a taxpayer.

New subsection 127(11.5) is similar to various paragraphs currently found in subsection 127(11.1). However, the provisions to reduce qualified expenditures by government assistance, non-government assistance or contract payments found in current subsection (11.1) are replaced by new subsections 127(16) to (22).

New subsections 127(11.6) to (11.8) provide rules for the reduction of qualified expenditures where the expenditures relate to purchases of goods and services from a non-arm's length party.

New subsections 127(17) to (22) relate to the reduction of qualified expenditures by any government assistance, non-government assistance or contract payment that a taxpayer or a person or partnership not dealing at arm's length with the taxpayer has received, is entitled to receive, or can reasonably be expected to receive.

The list of expenditures that are excluded from being qualified expenditures is expanded to include expenditures relating to non-arm's length SR&ED contract amounts. Under a new exclusion added to the definition of "qualified expenditure", a taxpayer may not claim any ITC with respect to an expenditure paid or payable to a person or partnership that is not a taxable supplier as defined in subsection 127(9).

The requirement for reporting qualified expenditures is modified. An expense that is unpaid will be required to be reported in the year in which it is actually incurred. Otherwise, it will not be a qualified expenditure for the taxation year in which it is paid.

A new definition, "SR&ED qualified expenditure pool", is introduced in subsection 127(9). This definition and new subsections 127(13) to (17) implement the mechanism to transfer qualified expenditures between non-arm's length parties.

There are two provisions which deal with arrangements which attempt to circumvent the new rules above and are found in new subsections 127(24) and (25). However, it is intended that other schemes or arrangements that are designed to circumvent the new rules but are not specifically addressed by the SR&ED legislation, will be dealt with by the general anti-avoidance rule in section 245 of the Act.

New subsection 127(26) deals with unpaid amounts. An amount that is incurred in a taxation year, but unpaid on the 180th day after the end of the year, is deemed to be incurred at the time that the amount is paid for the purposes of the SR&ED ITCs.

Subclauses 30(1) and (2)

ITA
127(5)(*a*)

Subsection 127(5) of the Act provides for the deduction of ITCs from a taxpayer's Part I tax otherwise payable for a taxation year.

Subparagraph 127(5)(*a*)(i) is amended to ensure that the ITC in respect of an amount included in a taxpayer's SR&ED qualified expenditure pool at the end of a taxation year or a preceding taxation year (which includes qualified expenditures incurred by the taxpayer as well as amounts transferred to the taxpayer under new subsection 127(13)) is deductible in computing the taxpayer's tax payable.

Clause 127(5)(*a*)(ii)(A) is similarly amended to refer to the ITC in respect of a taxpayer's SR&ED qualified expenditure pool at the end of a subsequent taxation year rather than only the ITC in respect of qualified expenditures incurred by the taxpayer in the subsequent year.

These amendments apply to taxation years that begin after 1995.

Subclause 30(3)

ITA
127(7)

Subsection 127(7) of the Act permits a trust to allocate its ITC to its beneficiaries.

Subsection 127(7) is amended to add a reference to new paragraph (a.1) of the definition of "investment tax credit" in subsection 127(9).

This amendment applies to taxation years that begin after 1995.

Subclauses 30(4) and (5)

ITA
127(8)

Subsection 127(8) of the Act provides for the allocation of the ITC of a partnership to its partners.

Subparagraph 127(8)(*b*)(ii) specifies that, for the purpose of determining a partner's share of a partnership's ITC, paragraph (*e*.1) of the definition of "investment tax credit" is to be read without reference to certain words. This amendment removes the reference to the words "or that reduced" because they are not present in current paragraph (*e*.1) of that definition. This corrective amendment applies to taxation years that end after December 2, 1992 and begin before 1996.

For taxation years that begin after 1995, subsection 127(8) is amended in three respects. First, it specifies that a partnership can be neither a transferor nor a transferee of qualified expenditures for the purpose of subsection (13).

Second, a reference to new paragraph (*a*.1) of the definition of "investment tax credit" is added.

Third, since an ITC in respect of qualified expenditures cannot be allocated to a specified member of a partnership, this amendment ensures that no ITC for a repayment of government assistance,

non-government assistance or contract payments in respect of SR&ED expenditures for the purchase of a first term share-used-equipment or second term shared-use-equipment can be allocated to a specified member. In particular, in determining a specified member's share of the partnership's ITC, paragraph (*e*.1) of the definition of "investment tax credit" is to be read without reference to subparagraphs (ii) to (iv).

Subclause 30(6)

ITA
127(8.1)

Subsection 127(8.1) of the Act restricts the amount of ITC that may be allocated by a partnership to a limited partner.

Subsection 127(8.1) is amended to add a reference to new paragraph (*a*.1) of the definition of "investment tax credit" in subsection 127(9).

This amendment applies to taxation years that begin after 1995.

Subclause 30(7)

ITA
127(8.2)(*b*)(i)

For the purposes of the restriction in subsection 127(8.1), subsection 127(8.2) of the Act provides rules for determining a limited partner's expenditure base for a taxation year of the partnership (its fiscal period).

Subparagraph 127(8.2)(*b*)(i) is amended in two respects for taxation years that begin after 1995. First, the words "if paragraph (*a*) of that definition were read without reference to subparagraph (*a*)(iii) thereof" are deleted since subparagraph (*a*)(iii) of the definition of "investment tax credit" is repealed for taxation years that begin after 1995. Second, a reference to the new SR&ED qualified expenditure pool is added to ensure that qualified expenditures incurred by the partnership in a taxation year are taken into account in determining an expenditure base.

Subclause 30(8)

ITA
127(8.3)(*a*)

Subsection 127(8.3) of the Act provides rules for allocating to non-limited partners the ITCs that remain after the allocation to limited partners.

Paragraph 127(8.3)(*a*) is amended to include a reference to new paragraph (*a*.1) of the definition of "investment tax credit" in subsection 127(9).

Further, the words "if paragraph (*a*) of that definition were read without reference to subparagraph (*a*)(iii) thereof" are deleted from this paragraph since subparagraph (*a*)(iii) of the definition of "investment tax credit" is repealed for taxation years that begin after 1995.

This amendment applies to taxation years that begin after 1995.

Subclauses 30(9) to (18)

ITA
127(9)

Subsection 127(9) of the Act provides definitions for terms that are used in the provisions relating to the ITC.

"qualified expenditure"

The definition of "qualified expenditure" is amended for taxation years that begin after 1995. New subparagraph (*a*)(i) clarifies that only expenditures that are incurred directly for first term shared-used-equipment or second term shared-used-equipment would become qualified expenditures.

New paragraph (*e*) of the definition requires that a qualified expenditure be reported by a taxpayer in prescribed form. This new paragraph differs from the reporting requirement found in existing paragraph (*c*) in a number of respects. First, any expense, that would otherwise be incurred in respect of unpaid wages, salaries, and other

remuneration in a taxation year, must be identified in the year despite the expense being treated by subsection 78(4) of the Act as not having been incurred in the year. Similarly, any other unpaid amounts that would otherwise be considered to have been incurred in a taxation year but for new subsection 127(26) of the Act, must also be reported in that year. If such an amount is not so reported, it will not be a qualified expenditure for any taxation year.

The reporting deadline is also modified. Currently, a prescribed form identifying qualified expenditures must be filed by the day by which the taxpayer's tax return is required to be filed for the taxation year following the year in which the expenditures were incurred. The new deadline is 12 months after the taxpayer's filing-due date for the taxation year in which the qualified expenditures would be incurred if the Act were read without reference to subsections 78(4) and 127(26).

The three expenditures described in new paragraphs (*f*), (*g*) and (*h*) are excluded from being qualified expenditures.

Paragraph (*f*) applies to contract amounts in non-arm's length contracts. Where a taxpayer incurs an amount in respect of SR&ED that is performed at a time when the person or partnership to which the amount is paid or payable does not deal at arm's length with the taxpayer, that amount would not be a qualified expenditure incurred by the taxpayer. However, this paragraph does not apply to salaries and wages paid to non-arm's length employees.

EXAMPLE

A Canadian corporation, Parentco, contracts with its wholly-owned Canadian subsidiary, Subco, for SR&ED to be performed by the latter. $1000 is payable by Parentco under the contract. This SR&ED is subcontracted out by Subco to an arm's length party, Performerco, for $950. The work is completed in 1998 and all contract amounts are paid in full in 1998.

Since the work is performed at a time when Subco is not dealing at arm's length with Parentco, Parentco's $1000 expenditure is not a qualified expenditure.

Under the amended definition of "contract payment" in subsection 127(9), the $1000 would not be a contract payment paid or payable to Subco. As a result, Subco would have a qualified expenditure of $950 which it may elect to transfer back to Parentco using the transfer mechanism in subsection 127(13).

However, Performerco is required to reduce its qualified expenditures incurred in respect of the SR&ED by the contract payment of $950 from Subco.

New paragraph (*g*) applies to an expenditure paid or payable to a person or partnership that is not a taxable supplier in respect of the expenditure. "Taxable supplier" in respect of an amount is defined in subsection 127(9) to generally mean a resident of Canada, a Canadian partnership, or a person or partnership that pays or receives the amount in the course of carrying on a business through a permanent establishment in Canada.

This new paragraph prohibits a taxpayer from claiming any ITC with respect to an SR&ED expenditure described in paragraph 37(1)(*a*) of the Act that is paid or payable to or for the benefit of a person or partnership that is not a taxable supplier in respect of the expense. However, this paragraph does not apply to an expenditure on SR&ED directly undertaken by the taxpayer. This would include, for example, an expenditure for materials consumed in the prosecution of SR&ED undertaken directly by the taxpayer.

EXAMPLE

A Canadian corporation, Aco, contracts out its SR&ED to another Canadian corporation, Bco, with a contract amount of $1,000. Aco and Bco deal with each other at arm's length throughout the period in which the SR&ED is performed.

However, Bco does not actually perform the SR&ED. Instead it contracts out the SR&ED to a foreign company, Forco, for a contract price of $950. Forco in turn contracts it to a third Canadian company, Cco, with a contract amount of $900.

Since the SR&ED is not directly undertaken by Aco, $950 of the $1,000 would be considered to be paid or payable to or for the benefit of a corporation that is not a taxable supplier in respect of

the $950. Therefore, the $950 would not be a qualified expenditure because of paragraph (g) of the definition of "qualified expenditure".

However, Aco may still be able to claim $50 of qualified expenditure since the SR&ED is performed in Canada.

Bco, on the other hand, would not have any qualified expenditure for two reasons. First, the $950 paid or payable by Bco to Forco would also be subject to this paragraph. Second, there is a contract payment of $1000 paid or payable to Bco.

Subject to new subsection 127(25), Cco would not have to reduce its qualified expenditures incurred in respect of the SR&ED by the $900 contract amount.

New paragraph (*h*) reduces an amount that would otherwise be a qualified expenditure incurred by a taxpayer by any reduction required under any of new subsections 127(18) to (21). The provisions in those subsections require that qualified expenditures be reduced by any government assistance, non-government assistance and contract payment that the taxpayer or a person or partnership not dealing at arm's length with the taxpayer has received, is entitled to receive, or can reasonably be expected to receive. Reference may be made to the commentary on those subsections for further details.

These amendments apply to taxation years that begin after 1995.

"contract payment"

The definition of "contract payment" is amended for taxation years that begin after 1995. Generally, an amount received or receivable by a taxpayer is considered to be a contract payment if

1) the amount is received or receivable from a taxable supplier by the taxpayer;

2) the amount is for SR&ED;

3) the SR&ED is performed for or on behalf of a person or partnership entitled to deduct the amount because of subparagraph 37(1)(*a*)(i) or (i.1); and

4) the taxpayer and the person or partnership referred to in 3) are dealing at arm's length at the time when the SR&ED is performed.

The Act is amended to provide that, for a non-arm's length R&D contract, the payer does not have any qualified expenditure in respect of the contract amount for SR&ED. At the same time, the contract amount is not a contract payment to the payee. 4) above ensures the payee does not have a contract payment with respect to the portion of the contract amount that relates to the SR&ED performed while the payer and payee are not dealing at arm's length.

EXAMPLE

A corporation, Aco, contracts with another corporation, Bco, for SR&ED to be performed by Bco. The contract amount is $1,000. 40% of the work is done while the two parties are not dealing at arm's length.

Aco would have a qualified expenditure of only $600. In addition, a contract payment of $600 would be considered to be received or receivable by Bco.

This amendment applies to taxation years that begin after 1995.

"investment tax credit"

The definition of "investment tax credit" in subsection 127(9) of the Act is amended for taxation years that begin after 1995.

Paragraph (*a*) is simplified by removing the references to "approved project property", "qualified construction property equipment", "qualified small-business property", "qualified transportation equipment", and "qualified Canadian exploration expenditure" since they have no direct relevance for taxation years that begin after 1995. Further, subparagraph (*a*)(ii) is repealed consequential on the introduction of new paragraph (*a*.1).

New paragraph (*a*.1) adds 20% of a taxpayer's SR&ED qualified expenditure pool at the end of a taxation year to the taxpayer's ITC at the end of the year. This pool includes qualified expenditures incurred by a taxpayer in a taxation year, as well as amounts

transferred to the taxpayer for the year because of paragraph 127(13)(*a*). However, amounts transferred by the taxpayer for the year under subsection 127(13) reduce this pool.

Paragraph (*c*) is simplified by repealing subparagraph (*c*)(i) and the reference to "qualified Canadian exploration expenditure" in subparagraph (ii) as they are no longer relevant for taxation years that begin after 1995. In addition, a reference to new paragraph (*a*.1) is added to ensure that amounts determined in respect of that paragraph can be carried forward ten years or back three years.

Paragraph (*e*.1) is amended to ensure that a taxpayer's ITC for a taxation year is increased as a result of a repayment of government assistance, non-government assistance or a contract payment that reduced a qualified expenditure of the taxpayer that is not in respect of first term shared-use-equipment or second term shared-use-equipment under any of new subsections (18) to (20).

Paragraph (*e*.2) is amended to ensure that a taxpayer's ITC pool is increased as a result of a repayment of government assistance, non-government assistance or a contract payment that reduced a qualified expenditure of the taxpayer that is in respect of first term shared-use-equipment or second term shared-use-equipment under any of new subsections 127(18) to (20).

Paragraph (*f*) is simplified by repealing subparagraph (*f*)(i) because the subparagraph is not relevant for taxation years that begin after 1995. That paragraph is also amended to ensure that any ITC deducted under subsection 127(5) of the Act in respect of a taxpayer's SR&ED qualified expenditure pool reduces the taxpayer's ITC pool.

Paragraph (*g*) is amended to repeal subparagraph (*g*)(ii) which is no longer relevant for taxation years that begin after 1995. Further, subparagraph (*g*)(iii) is simplified to remove some obsolete words.

Paragraph (*h*) is amended to repeal subparagraph (*h*)(ii) which is no longer relevant for taxation years that begin after 1995. Further, subparagraph (*h*)(iii) is simplified to remove some obsolete words.

Last, the concluding words of the definition is amended to remove the references to "qualified Canadian exploration expenditure", "approved project property", and "qualified small-business property" since they have no direct relevance for taxation years that begin after 1995.

The amendments to the definition of "investment tax credit" applies to taxation years that begin after 1995.

"SR&ED qualified expenditure pool"

A new definition, "SR&ED qualified expenditure pool", is added to subsection 127(9) of the Act for taxation years that begin after 1995.

In general, the amount in this pool at the end of a taxation year is equal to all the qualified expenditures incurred by a taxpayer in the year, plus any amount transferred to the taxpayer under paragraph 127(13)(*d*) and less any amount transferred by the taxpayer to another person under 127(13)(*e*).

To be included in the SR&ED qualified expenditure pool of a taxpayer at the end of a taxation year, an amount transferred to the taxpayer for that year must be reported by the taxpayer in prescribed form by the day that is 12 months after the taxpayer's filing-due date for the year.

For a taxpayer that is not a party to any non-arm's length R&D contract, the amount in the pool is equal to the total qualified expenditures incurred by the taxpayer in a taxation year.

"taxable supplier"

A new definition, "taxable supplier", is added to subsection 127(9) of the Act for taxation years that begin after 1995. A taxable supplier in respect of an amount is a person resident in Canada, a Canadian partnership, or a non-resident person or partnership by which the amount was payable, or to or for the benefit of which the amount was receivable, in the course of carrying on a business through a permanent establishment in Canada.

other definitions

The definitions of "approved project property", "qualified Canadian exploration expenditure", "qualified construction equipment", "qualified small-business property" and "qualified transportation equipment" are repealed because they have no direct relevance for taxation years that begin after 1995.

Subclause 30(19)

ITA
127(10.1)

Subsection 127(10.1) of the Act, which provides an additional ITC for Canadian-controlled private corporations in certain circumstances, is amended for taxation years that begin after 1995.

As amended, the additional ITC for a taxation year is the amount that is 15% of the least of the following three amounts:

1. the amount that the corporation claims;

2. the corporation's SR&ED qualified expenditure pool at the end of the year; and

3. the expenditure limit for the corporation.

Subclause 30(20)

ITA
127(10.7)

Subsection 127(10.7) of the Act adds to the amount otherwise calculated under subsection 127(10.1) for a year where assistance in respect of an amount which would otherwise have qualified for the 35% investment tax credit is repaid. Subsection 127(10.7) is amended for taxation years that begin after 1995 to add a reference to amounts that reduced a prescribed proxy amount of the taxpayer and to add a reference to repayments of amounts to which new subsections 127(18) to (20) previously applied.

ITA
127(10.8)

Subsection 127(10.8) of the Act allows a taxpayer to regenerate entitlement to an investment tax credit where entitlement to assistance expires before being received by the taxpayer. Subsection 127(10.8) is amended for taxation years that begin after 1995 to add a reference to amounts that reduced a prescribed proxy amount of the taxpayer and to add a reference to amounts to which new subsections 127(18) to (20) previously applied.

Subclauses 30(21) and (22)

ITA
127(11.1)

Subsection 127(11.1) of the Act sets out rules for determining amounts to be included in the ITC calculation in subsection 127(9).

Paragraphs 127(11.1)(*c*), (*e*) and (*f*), which reduce the amount of qualified expenditures that are taken into account in the calculation of ITC, are repealed for taxation years that begin after 1995. These provisions are replaced by provisions found in new subsections 127(11.5) and (18) to (21).

Subclause 30(23)

ITA
127(11.2)

Subsection 127(11.2) of the Act provides that for the purposes of claiming an investment tax credit under subsection 127(5), or allocating a credit under subsection 127(7) or (8), property will not be considered to have been acquired, and expenditures will not be considered to have been made until the property is considered to have become "available for use". Subsection 127(11.2) is amended consequential on the introduction of new paragraph (*a*.1) of the definition "investment tax credit" in subsection 127(9). This amendment applies to taxation years that begin after 1995.

Subclause 30(24)

ITA
127(11.4)

For the purpose of the definition of "qualified expenditure" in subsection 127(9), subsection 127(11.4) of the Act provides that existing paragraph (*c*) (which requires an expenditure to be reported within a specified time) of that definition does not apply in respect of a cost or expense incurred by a taxpayer that is reclassified by the Minister of Revenue Canada in the course of an audit that is initiated by Revenue Canada.

With new paragraph (*e*) of the definition of "qualified expenditure" replacing paragraph (*c*) for taxation years that begin after 1995, this subsection is amended to refer to new paragraph (*e*).

This amendment applies to taxation years that begin after 1995.

ITA
127(11.5)

New subsection 127(11.5) applies to taxation years that begin after 1995. This subsection, which is similar to existing paragraphs 127(11.1)(*c*) and (*e*), reduces the amount of qualified expenditures incurred by a taxpayer in a taxation year.

For the purpose of the definition of "qualified expenditure" in subsection 127(9), the amount of an expenditure is generally determined without reference to subsections 13(7.1) and (7.4) of the Act.

However, where the expenditure is for first term shared-use-equipment or second term shared-use-equipment, only 1/4 of the capital cost of the equipment is taken into account. In addition, that capital cost is to be determined without reference to subsections 13(7.1) and (7.4) and without any amount (capitalized interest) being added to the capital cost under section 21 of the Act.

ITA
127(11.6)

For the purpose of subsection 127(11.5), subsection 127(11.6) of the Act provides rules for determining the expenditures in respect of purchases of goods and services from non-arm's length parties. This subsection applies to expenditures incurred in taxation years that begin after 1995.

This provision applies where a taxpayer incurs an expenditure as consideration for a non-arm's length person's or partnership's rendering of a service or provision of a property to the taxpayer. The time when the expenditure is incurred is determined without reference to new subsection 127(26) dealing with unpaid amounts.

The amount of an expenditure incurred by the taxpayer for the service or property and the capital cost of the property are deemed to be:

1. in the case of a service rendered to the taxpayer, the lesser of the expenditure actually incurred by the taxpayer and the "adjusted service cost" to the supplier of rendering the service; and

2. in the case of a property sold to the taxpayer, the lesser of the capital cost to the taxpayer otherwise determined and the "adjusted selling cost" to the supplier of property.

(The definitions of "adjusted service cost" and "adjusted selling cost" are found in new subsection 127(11.7) of the Act.)

Paragraph 127(11.8)(*c*) of the Act provides that the leasing of a property is considered to be the rendering a service for the purpose of subsection 127(11.6).

ITA
127(11.7)

New subsection 127(11.7) of the Act provides the definitions of "adjusted service cost" and "adjusted selling cost". These definitions apply to expenditures incurred in taxation years that begin after 1995.

"adjusted service cost"

"adjusted service cost" to a supplier of rendering a particular service is the amount determined by the formula:

A - B - C - D - E.

Amount A is the actual cost to the supplier of rendering the particular service. Where a service is rendered directly by an individual personally, the cost to the individual of rendering the service is considered to be nil.

Amount B is equal to the difference between the cost to the supplier for a service rendered by a sub-supplier and the adjusted service cost to the sub-supplier of rendering the service. This amount has the effect of eliminating the mark-up in a service contract where the supplier incurs for the purpose of rendering the particular service an expense for a service rendered by another person or partnership (the sub-supplier) not dealing at arm's length with the supplier.

EXAMPLE

Aco is an R&D performer in Canada. A related corporation (the supplier) performs for Aco, under a contract, a cleaning service that is necessary for the prosecution of SR&ED by Aco. The contract price is $100. The supplier subcontracts out this cleaning service to another related company (the sub-supplier) for $95. The sub-supplier performs the service and incurs a cost of $90 in the process. For simplicity, it is assumed that amounts C, D, and E of the definition of "adjusted service cost" are zero and subsection 127(11.8) has no application.

The adjusted service cost to the supplier is equal to

A - B

where

A is $95, and

B is the difference between $95 and the "adjusted service cost" to the sub-supplier of providing the service.

Having determined the adjusted service cost to the sub-supplier, $90, the adjusted service cost to the supplier can be ascertained; i.e., $90 or ($95 - ($95 - $90)).

The amount of the expenditure incurred by Aco for the cleaning service would be limited to $90 (the lesser of $100 and $90) for ITC purposes.

Amount C is similar to amount B except that it applies to the acquisition of property. Amount C eliminates the mark-up in the selling price of a property between non-arm's length parties.

Amount D reduces the supplier's cost in rendering the particular service by the portion of the cost that relates to remuneration based on profits or a bonus paid or payable to any employee of the supplier.

Amount E reduces the supplier's cost in rendering the particular service by any government assistance, non-government assistance that can reasonably be considered to be in respect of rendering the particular service and that the supplier has received, is entitled to receive or can reasonably be expected to receive.

As new paragraph 127(11.8)(*c*) deems the leasing of a property to be the rendering of a service, this definition is relevant for the determination of the leasing cost of a property between non-arm's length parties. It is intended that the cost to a person or partnership (the lessor) of leasing of a property to another person or partnership (the lessee) be based on the accounting depreciation available with respect to the property to the lessor.

"adjusted selling cost"

The new definition, "adjusted selling cost", is similar to the definition of "adjusted service cost". Both definitions trace the costs incurred by non-arm's length parties in providing a service or a property.

The adjusted selling cost of a particular property to a supplier is the amount determined by the formula

A - B.

Amount A

The value of amount A depends on whether the supplier purchased the particular property from a non-arm's length person or partnership. Paragraph (*a*) of the definition applies in non-arm's length purchases to effectively eliminate any mark-up in the purchase.

Where the particular property is purchased by the supplier from an arm's length person or partnership, paragraph (*b*) of the definition applies. In this case, the adjusted selling cost to the supplier is generally the cost of acquiring the property (i.e., the purchase price).

Paragraph (*b*) also applies where the particular property is created, assembled, or manufactured by the supplier. In this case, the adjusted selling cost to the supplier is the cost to the supplier of "making" the property subject to the rules in paragraphs (*c*) to (*e*) of the definition.

Paragraph (*c*) applies if part of the cost of the particular property to the supplier is attributable to another property acquired from a non-arm's length person or partnership. For example, this paragraph would apply to a component used in the manufacturing of a property where the component is purchased from a non-arm's length seller. In that case, the component's cost to the supplier is the lesser of its actual cost to the supplier and its adjusted selling cost to the non-arm's length seller.

Paragraph (*d*) applies if part of the cost to the supplier of the particular property is attributable to a service rendered by a non-arm's length person or partnership. The cost to the supplier of the service is the lesser of its actual cost to the supplier and the adjusted service cost to the non-arm's length party rendering the service.

Paragraph (*e*) provides that the cost to the supplier of the particular property does not include any remuneration based on profits or bonuses paid or payable to any employee of the supplier.

Amount B

Amount B reduces the cost to a supplier of the particular property by any government assistance or non-government assistance in respect of the property that the supplier has received, is entitled to receive or can reasonably be expected to receive.

ITA
127(11.8)

New subsection 127(11.8) of the Act provides additional rules relating to non-arm's length purchases of goods and services. This subsection applies to expenditures incurred in taxation years that begin after 1995.

New paragraph 127(11.8)(*a*) provides that any cost to a supplier shall not include any amount that would not be a qualified expenditure if the amount were incurred directly by the ultimate purchaser/user of the goods or services.

EXAMPLE

Aco is an R&D performer. In performing its SR&ED, it contracts with a related supplier for the latter to provide a cleaning service for its laboratory. The contract price is $100. The supplier subcontracts out this cleaning service to a second related company, the sub-supplier, for $95. The sub-supplier performs the work at a cost of $90 (which includes a portion, $5, of the rent of the building occupied by the sub-supplier). It is assumed that amounts C, D, and E of the definition of "adjusted service cost" are zero.

This example is similar to the one provided in the commentary on the definition of "adjusted service cost".

Since the cost of the rent of a building would not be a qualified expenditure if it were directly incurred by Aco, the adjusted service cost to the sub-supplier is reduced by $5 under paragraph 127(11.8)(a). As a result, the amount of expenditure incurred by Aco for the service is reduced to $85 for ITC purposes.

New paragraph 127(11.8)(*b*) provides that paragraph 69(1)(*c*) of the Act does not apply in determining the cost of a property. For example, where a R&D performer purchases a property from a non-arm's length person or partnership and that property was originally given to the non-arm's person or partnership, the cost to the R&D performer of the property would be nil because the adjusted

selling cost of the property to the non-arm's length person or partnership would be nil. This result is consistent with the situation where an R&D performer receives the property as a gift directly.

New paragraph 127(11.8)(*c*) provides that the leasing of a property is deemed to be the rendering of a service. It is intended that the cost of leasing of a property be based on the normal accounting depreciation available with respect to the property by the owner of the property.

EXAMPLE

An R&D performer, Aco, leases a machine from a non-arm's length person, Bco, for $1000/month. Bco, which does not own the machine, leased it from another non-arm's length person, Cco, for $900/month. Cco acquired the machine from an arm's length person for $20,400. The life-expectancy of the machine is two years. The normal depreciation method used by Cco is the straight-line method. The machine was leased to Bco immediately after Cco acquired the machine. Bco in turn immediately leased it to Aco.

Pursuant to subsections 127(11.6) and (11.7), the amount of the expenditure incurred by Aco in respect of the lease would be $850/month ($20,400 prorated over 24 months).

Subclause 30(25)

ITA
127(13)

As announced in the 1995 federal budget, where a taxpayer (payer) contracts with another taxpayer (performer) for SR&ED to be performed by the latter and the SR&ED is performed by the latter at a time when the two parties are not dealing at arm's length, the payer's expenditures in respect of the contract would not be qualified expenditures for ITC purposes. In addition, the amount received or receivable by the performer would not be considered to be a contract payment. Qualified expenditures of the performer may be transferred to the payer up to a maximum of the contract amount.

New subsection 127(13) of the Act, which applies to taxation years that begin after 1995, provides for the transfer of qualified expenditures between non-arm's length taxpayers. A partnership may not be a party to such a transfer since under subsection 127(8), a partnership is not considered to be a person for the purpose of subsection 127(13).

To effect such a transfer, the two parties (the transferor and the transferee) must file a joint agreement with Revenue Canada. New subsection 127(15) sets out the filing requirements.

The amount that may be transferred in respect of a taxation year is the least of the following three limits (which are contained in paragraphs 127(13)(*a*) to (*c*)):

(a) the amount specified by the parties in their agreement filed with the Revenue Canada;

(b) the transferor's SR&ED qualified expenditure pool at the end of the year; and

(c) the total of all amounts that would be contract payments (if the two parties were dealing at arm's length) in respect of qualified expenditures incurred by the transferor for the performance of SR&ED for, or on behalf of, the transferee or in respect of amounts that were themselves transferred to the transferor under this subsection in respect of the SR&ED - assuming certain other conditions are met.

The least of the three limits is transferred out of the transferor's SR&ED qualified expenditure pool for the particular year and into the transferee's SR&ED qualified expenditure pool for the transferee's first taxation year ending coincidentally with, or after, the end of the transferor's year in which the transfer is made.

This subsection also provides that, if the sum of the amounts specified in agreements made by a transferor exceed the amount in the SR&ED qualified expenditure pool of the transferor, all the agreements are ineffective. That is, the amount deemed to be transferred would be nil under each agreement.

The following is a more detailed description of the limit in paragraph 127(13)(*c*). To determine this limit in respect of a transferee, it is necessary to ascertain what would have been the contract payment (referred to as the notional contract payment) for SR&ED performed for, or on behalf of, the transferee while the transferor and transferee were not dealing at arm's length. Subparagraph 127(13)(*c*)(ii) provides that the transferee must pay the relevant portion of the contract amount within 180 days after the end of the transferor's taxation year in order for a transfer to take place.

EXAMPLE

A resident corporation, Aco, performs SR&ED for a related resident corporation, Bco, pursuant to a contract. Both Aco and Bco have the same December 31 taxation year end. The contract amount is $1000.

Aco performs all the SR&ED in 1998 and incurs $980 of qualified expenditures. It pays all its SR&ED expenditures in respect of the qualified expenditures in 1998. However, Bco pays Aco only $500 under the contract before June 30, 1999. Aco and Bco file an agreement with Revenue Canada purporting to transfer $980 from Aco to Bco for 1998.

Since Bco has paid $500 only within the stipulated time frame, the third limit in paragraph (c) is $500. Therefore, the amount transferred under the agreement is limited to $500 notwithstanding that the amount specified in the agreement is $980.

In addition, subparagraph 127(13)(*c*)(iii) provides that the notional contract payment must be in respect of

(A) a qualified expenditure incurred by the transferor in the particular year (on the assumption that the Act is read without reference to subsections 78(4) and 127(26) of the Act) that is paid by the transferor within 180 days after the end of the transferor's year, or

(B) an amount transferred under subsection 127(13) to the transferor from another non-arm's length taxpayer that is attributable to the same SR&ED.

This subparagraph ensures that, if the transferor has not performed any SR&ED for the transferee or has not incurred any qualified expenditure (for example, because of the assistance reduction provisions in subsections 127(18) to (21)) the receipt of assistance, no amount can be transferred to the transferee unless another amount has been transferred to the transferor for the particular year from another taxpayer in respect of that SR&ED.

A qualified expenditure is considered paid if the associated expenditure is paid. For example, a qualified expenditure in respect of first term shared-use-equipment or second term shared-use-equipment is considered paid where the full cost of the equipment (determined without reference to section 127) is paid.

EXAMPLE 1

A corporation, Aco, performs SR&ED for a related resident corporation, Bco, pursuant to a contract. Both Aco and Bco have the same December 31 taxation year end. The contract price is $1000 which Bco paid fully in 1998. Aco performed all the SR&ED in 1998 and incurred $980 of qualified expenditures. However, Aco only paid $490 of the qualified expenditures by the 180th day after December 31, 1998. The remaining $490 is paid by Aco on December 31, 1999. Aco and Bco wish to file an agreement with Revenue Canada to transfer qualified expenditures from Aco to Bco for 1998.

One of the conditions for SR&ED qualified expenditures to be transferable is that the transferor must have paid for its qualified expenditures within 180 days after the transferor's taxation year (see subclause 127(13)(c)(iii)(A)(II)). In this case, only half of Aco's qualified expenditures for the SR&ED performed pursuant to the contract between Aco and Bco is paid within the time limit. Accordingly, only half of the contract amount between Aco and Bco ($500) is taken into account in determining the least of the three limits in subsection 127(13). Therefore, Aco is permitted to transfer no more than $500 to Bco (assuming that Aco has at least $10 of qualified expenditures from other SR&ED projects for the 1998 taxation year) notwithstanding the full payment by Bco.

Even though the remaining $490 is paid by Aco at the end of 1999, Aco may not transfer any amount in respect of the $490 of qualified expenditures to Bco for any taxation year.

EXAMPLE 2

A corporation, Cco, performs SR&ED for a related corporation, Dco, pursuant to a contract. Both Cco and Dco have the same December 31 taxation year end. The contract price is $1000 which Dco paid fully in 1998.

Cco performed 4/5 of the SR&ED in 1998 and incurred $784 of qualified expenditures in 1998. However, Cco only paid $392 of the qualified expenditures by the 180th day after December 31, 1998. The remaining $392 was paid by Cco on December 31, 1999.

Cco completed the SR&ED in 1999 and incurred an additional $196 of qualified expenditures in that year. That amount was paid by Cco at the end of that year.

Cco and Dco wish to file an agreement with Revenue Canada to transfer qualified expenditures from Cco to Dco for 1998 and 1999.

Since Cco has paid only $392 by the 180th day after the end of 1998, the third limit for 1998 would be $400 (392/(784 + 196)) x $1,000). Therefore, Cco is permitted to transfer only $400 to Dco for 1998 (assuming it has $8 of qualified expenditures from other SR&ED projects for the 1998 taxation year).

Since only 1/5 or ($196/($784 + $196)) of the contract amount relates to the work done in 1999, the third limit for 1999 is $200. Therefore, Cco cannot transfer more than $200 of qualified expenditures to Dco for 1999 (assuming it has $4 of qualified expenditures from other SR&ED projects for the 1999 taxation year).

It is intended that the rate of refundability (for example, 100% for current expenditures and 40% for capital expenditures for certain Canadian-controlled private corporations) of a transferred amount for the transferee be linked to the character of the qualified expenditure

incurred by the transferor. For example, where a transferor transfers $1000 of qualified expenditures under subsection 127(13), $400 of which relates to expenditures of a capital nature, it is intended that the maximum refundable ITC that a transferee, which is a Canadian-controlled private corporation, may claim not exceed $266 (35% x $600 of current expenditures plus 35% x 40% x $400 of capital expenditures) in any case.

ITA
127(14)

New subsection 127(14) provides a mechanism under which the parties to a transfer made pursuant to subsection 127(13) may identify the character (either capital or current) of the expenditure being transferred. The character of an expenditure is relevant for the purposes of determining a taxpayer's refundable investment tax credit under section 127.1.

ITA
127(15)

Subsection 127(15) of the Act sets out the requirements for filing an agreement under subsection 127(13) for the transfer of qualified expenditures from a transferor to a non-arm's length transferee.

An agreement is deemed not to have been filed with the Minister unless

1) it is in prescribed form; and

2) it is filed

   i) by the income tax return filing-due date of the transferor for the taxation year to which the agreement relates,

   ii) within the period within which the transferor may object to an assessment of tax payable under Part I of the Act for the year, or

   iii) within the period within which the transferee may object to an assessment of tax payable under Part I of the Act for the

first taxation year of the transferee that ends at or after the end of the transferor's taxation year.

This subsection also provides that, if the transferor or the transferee is a corporation, an agreement under subsection 127(13) is not valid unless it is accompanied by a resolution of the corporation's directors, or a document of the corporation's legal administrators, authorizing the agreement to be made.

This subsection further provides that an original, valid agreement between a transferor is superseded by a subsequent valid agreement. However, the earlier agreement remains valid for the purposes of subsection 127(13) if new subsection 127(16) of the Act applies to the original agreement.

This amendment applies to taxation years that begin after 1995.

ITA
127(16)

New subsection 127(16) of the Act applies where the principal purpose of a taxpayer becoming non-arm's length with another taxpayer is to enable the taxpayers to enter into an agreement under subsection 127(13). In that case, the SR&ED qualified expenditure pool of the transferor for the purpose of subsection 127(13) will be reduced by the transferred amount. However, the transferee will not have an addition to its SR&ED qualified expenditure pool.

This amendment applies to taxation years that begin after 1995.

ITA
127(17)

New subsection 127(17) of the Act requires the Minister of National Revenue to make assessments to take into account an agreement filed under subsection 127(13) or (20) even where the assessment is beyond the normal reassessment period.

This amendment applies to taxation years that begin after 1995.

ITA
127(18)

New subsections 127(18) to (21) of the Act set out rules for the reduction of qualified expenditures on SR&ED in respect of which assistance has been received by a taxpayer.

Subsection 127(18) reduces qualified expenditures of a taxpayer (including a partnership) by any government assistance, non-government assistance, or contract payments (collectively referred to as assistance) received directly by the taxpayer. This subsection applies where a taxpayer has received, is entitled to receive, or can reasonably be expected to receive assistance in respect of SR&ED on or before the income tax return filing-due date for a taxation year. The assistance, less all amounts applied under this subsection or subsection 127(19) or (20) for preceding taxation years to reduce qualified expenditures of the taxpayer or some other taxpayer that does not deal at arm's length with the taxpayer, would be used to reduce qualified expenditures of the taxpayer otherwise incurred in the year that can reasonably be considered to be in respect of the SR&ED.

This amendment applies to taxation years that begin after 1995.

EXAMPLE 1

Aco receives $300 of assistance for SR&ED from a government in its 1997 taxation year. It incurs $500 of qualified expenditures before any reduction under subsection 127(18) for the 1997 taxation year.

Subsection 127(18) requires that Aco's qualified expenditures be reduced to $200. As a result, Aco can only claim an ITC based on the $200 amount.

EXAMPLE 2

Bco receives $300 of government assistance for SR&ED in its 1997 taxation year. Bco contracts with its resident subsidiary, Cco, for the latter to perform part of that SR&ED. Bco and Cco have the same December 31 taxation year-end.

Cco completes its portion of the SR&ED in its 1997 taxation year and incurs $480 of qualified expenditures in respect of the SR&ED before any reduction due to assistance. Bco also completes the other part of the SR&ED in its 1997 taxation year and incurs qualified expenditures of $600 for the SR&ED in the year before any assistance reduction.

Under subsection 127(18), Bco's qualified expenditures otherwise incurred in the year, $600, would be reduced by the $300 of assistance received. Therefore, Bco would have only $300 of qualified expenditures. Cco's $480 of qualified expenditures remain unaffected in this case.

EXAMPLE 3

Dco receives a contract payment of $1200 for SR&ED from an arm's length party in its 1997 taxation year. Dco contracts out part of this SR&ED to its subsidiary, Eco, that has the same December 31 taxation year-end.

Eco completes its portion of the SR&ED in its 1997 taxation year and incurs $480 of qualified expenditures in respect of the SR&ED before any reduction due to assistance. Dco incurs qualified expenditures of $200 for the SR&ED in its 1997 taxation year and $400 for the SR&ED in its 1998 taxation year before any assistance reduction. All of the SR&ED is completed by the end of 1998.

Under subsection 127(18), Dco's qualified expenditures otherwise incurred in its 1997 year, $200, would be reduced to nil.

Under subsection 127(19), Eco's $480 of qualified expenditures otherwise incurred in 1997 will also be reduced to nil because of the contract payment received by Dco.

In 1998, subsection 127(18) requires that the difference between $1,200 and $680 (the sum of $200 and $480 that was applied to reduce the qualified expenditures of Dco and Eco for their 1997 taxation years) be applied to reduce the qualified expenditures of Dco otherwise incurred in 1998 in respect of the SR&ED to nil.

Since Dco incurs only $400 more qualified expenditures in 1998 before completing the SR&ED, it would have no qualified expenditures in respect of the SR&ED in 1998. The unapplied amount of the contract payment, $120 or ($1,200 - $680 - $400) would not affect the amount of qualified expenditures of Dco or Eco incurred in respect of other SR&ED.

ITA
127(19)

New subsection 127(19) of the Act provides that government assistance, non-government assistance or contract payments (collectively referred to as assistance) in respect of SR&ED will, in certain cases, be applied to reduce qualified expenditures incurred in respect of the SR&ED by persons or partnerships that do not deal at arm's length with the recipient of the assistance when the SR&ED is performed.

This subsection applies where the assistance (net of amounts applied under subsections 127(18) to (20) in respect of the assistance) is greater than the total qualified expenditures incurred by the recipient and by such non-arm's length persons in respect of the SR&ED. In such cases, the qualified expenditures of the non-arm's length persons are eliminated.

This amendment applies to taxation years that begin after 1995.

ITA
127(20)

New subsection 127(20) of the Act provides a mechanism to allocate the qualified expenditure reduction resulting from government assistance, non-government assistance or contract payments (collectively referred to as assistance) in respect of the SR&ED among the members of a non-arm's length group in situations where subsection 127(19) does not apply to the assistance in respect of a taxation year. For this purpose, each member of the group performs the SR&ED at a time when the member is not dealing at arm's length with the recipient of the assistance. In other words, when the amount of the assistance is less than all of the qualified expenditures of the group on the SR&ED in respect of which the assistance was received. The portion of the assistance that can be allocated is limited by

the amount of those qualified expenditures of the transferee. The allocated amount reduces those qualified expenditures of the transferee.

To make the allocation, the taxpayer and the transferee jointly file an agreement with Revenue Canada. New subsection 127(22) of the Act sets out the conditions for filing.

This amendment applies to taxation years that begin after 1995.

EXAMPLE

Aco, Bco and Cco are related corporations which have the same December 31 taxation year end. Aco contracts out its SR&ED to Bco and Cco. Bco and Cco are each to perform half of the SR&ED in consideration for $500.

Aco receives government assistance of $400 in respect of the SR&ED in June 1998. Bco and Cco each incur $150 of qualified expenditures in respect of the SR&ED in 1998 and $330 in 1999. Bco and Cco pay for all their SR&ED expenditures by the end of each year to which the expenditures relate.

1998

Subsection 127(19) would apply to the government assistance in respect of Aco's 1998 taxation year. As a result, Bco and Cco's qualified expenditures, $150 each, otherwise incurred in 1998 would be reduced to nil.

As there remains $100 of government assistance that has not been applied to reduce qualified expenditures in respect of the SR&ED, that amount would reduce qualified expenditures incurred by Bco and Cco in respect of the SR&ED in 1999.

1999

Subsection 127(19) would not apply in respect of Aco's 1999 taxation year because the amount of government assistance, $400, is less than the sum of: the total amounts previously applied under subsection 127(19), $300; and the total qualified expenditures,

$660, otherwise incurred by Bco and Cco in their taxation years that end in Aco's 1999 taxation year.

Under such a scenario, the companies should allocate the remaining assistance among themselves. Subsection 127(20) permits the three companies to allocate the remaining $100 of assistance to reduce the qualified expenditures of Bco, Cco, or both, which were incurred in 1999.

Aco and Bco may file an agreement with Revenue Canada specifying that all $100 of the remaining assistance be applied to reduce Bco's $330 of qualified expenditures to $230. Consequently, the amount of qualified expenditures incurred by Cco in 1999 would remain at $330.

Where the three companies do not file an agreement under subsection 127(20) or the total of amounts specified in agreements filed under subsection 127(20) by these companies in respect of the SR&ED is less than the remainder of the assistance (i.e., $100), subsection 127(21) would deem Bco and Cco to each have received the unapplied portion of the government assistance. Subsection 127(18) would then apply to reduce both Bco and Cco's qualified expenditures by $100.

ITA
127(21)

New subsection 127(21) of the Act provides rules to supplement subsections 127(19) and (20) and applies to taxation years that begin after 1995.

This subsection applies where a person or partnership (referred to as the recipient) has received, is entitled to receive, or can reasonably be expected to receive any government assistance, non-government or contract payments (collectively referred to as "assistance") in respect of SR&ED; subsection 127(19) does not apply to the assistance in respect of the year; and the recipient does not make any allocation pursuant to subsection 127(20) or does not allocate a sufficient amount pursuant to that subsection.

In such circumstances, the lesser of

(a) the total of all qualified expenditures incurred in respect of the SR&ED by each member of the group (of persons or partnerships that do not deal at arm's length with the recipient when the SR&ED is performed) in its taxation year that ended in the recipient's taxation year, and

(b) the portion of the assistance that has not been applied under subsections 127(18) to (20) for the recipient's year and preceding taxation years

is treated for the purposes of section 127 as being an amount of government assistance received by each member of the group (other than the recipient) in respect of the SR&ED at the end of each member's taxation year that ends in the recipient's year. Therefore, the allocated amounts will reduce each member's qualifying expenditures.

ITA
127(22)

New subsection 127(22) of the Act applies to taxation years that begin after 1995. This subsection sets out the requirements for filing an agreement under subsection 127(20) in which a taxpayer may allocate government assistance, non-government assistance or a contract payment to a non-arm's length person or partnership.

The agreement is valid only if:

1) it is in prescribed form, and

2) it is filed

i) by the income tax return filing-due date of the transferor for the taxation year to which the agreement relates,

ii) within the period within which the transferor may object to an assessment of tax payable under Part I of the Act for the year, or

iii) within the period within which the transferee may object to an assessment of tax payable under Part I of the Act for the first taxation year of the transferee that ends at or after the end of the transferor's taxation year.

This subsection also provides that, where the transferor or the transferee is a corporation, an agreement under subsection 127(20) is not valid unless it is accompanied by a resolution of the corporation's directors, or a document of the corporation's legal administrators, authorizing the agreement to be made.

This subsection further provides that a valid agreement between a transferor and transferee is superseded by a subsequent valid agreement.

ITA
127(23)

New subsection 127(23) of the Act provides that, for the purposes of the rules for allocating government assistance, non-government assistance and contract payments in subsections 127(18) to (22), the taxation year of a partnership is deemed to be its fiscal period and its income tax return filing-due date for a taxation year is deemed to be the day that would be its filing-due date if it were a corporation.

This subsection applies to taxation years that begin after 1995.

ITA
127(24)

New subsection 127(24) of the Act provides a rule against using an arm's length party to circumvent the new non-arm's length R&D contract rules. It applies to taxation years that begin after 1995.

In general, where a person or partnership (the first person) and another person or partnership (the second person) that does not deal at arm's length with the first person enter into a contract for the second person to perform SR&ED on behalf of the first person, the first person would not have any qualified expenditure in respect of the contract amount.

However, for example, where the first person contracts with an arm's length party for the performance of the SR&ED and the SR&ED is then subcontracted by that party to the second person, the first person could, but for this subsection and subsection 245(2) of the Act (the general anti-avoidance rule), attempt to claim a qualified expenditure in respect of the contract with the arm's length party. This rule ensures that the payment made by the first person will not constitute a qualified expenditure. However, the amount received by the arm's length party and the amount received by the second person will retain their character as contract payments.

ITA
127(25)

New subsection 127(25) of the Act provides rules to deal with arrangements to circumvent the reduction of a taxpayer's qualified expenditures by amounts that should be contract payments to the taxpayer. This subsection applies to taxation years that begin after 1995.

Normally, where a person (the payer) contracts with an arm's length person (the performer) directly to perform SR&ED on the payer's behalf in Canada, the payer would generally be entitled to claim qualified expenditures in respect of the contract amount and the performer would be required to reduce its qualified expenditures by the amount of the contract payment.

However, where, for example, the payer first contracts with a non-resident person (without a permanent establishment in Canada) and the non-resident person enters into another contract with the performer under which the performer will perform the SR&ED, the performer could attempt to claim its qualified expenditures incurred in respect of the SR&ED without having to reduce those expenditures by the payment from the non-resident person if the Income Tax Act were read without this new subsection and subsection 245(2) of the Act (the general anti-avoidance rule). This would effectively permit qualified expenditures to be traded among arm's length parties.

New subsection 127(25) provides that, in such cases, the amount received by the second person will be considered to be a contract payment. However, the character of the amount paid by the first person is not affected by this rule.

ITA
127(26)

New subsection 127(26) of the Act provides that, where a taxpayer's expenditure described in paragraph 37(1)(*a*) of the Act is not paid within 180 days after the end of the taxation year in which it is incurred, the expenditure will be deemed to be incurred at the time it is paid.

This rule applies for the purposes of subsections 127(5) to (25) to amounts that are incurred at any time, except amounts that are paid on or before the day that is 90 days after the day this subsection receives Royal Assent.

Notwithstanding the application of this subsection or subsection 78(4) of the Act to an unpaid amount, an unpaid amount that is actually incurred in a taxation year should be identified in the form filed with Revenue Canada, in accordance with paragraph (*e*) of the definition of "qualified expenditure" in subsection 127(9), in that year. Otherwise, a taxpayer may not claim a formerly unpaid amount as a qualified expenditure for the taxation year in which it is paid.

Clause 31

Refundability of Investment Tax Credits

ITA
127.1

Section 127.1 of the Act provides for the refundability of investment tax credits under certain circumstances.

Subclause 31(1)

ITA
127.1(2)

The definition "refundable investment tax credit" in subsection 127.1(2) defines the portion of investment tax credits of a taxpayer that is refundable in a taxation year. Paragraph (*f*) of the definition is amended consequential on the introduction of new

paragraph (*a*.1) of the definition "investment tax credit" in subsection 127(9). This amendment applies to taxation years that begin after 1995.

Subclause 31(2)

ITA
127.1(2.01)

Subsection 127(2.01) provides for the refundability of certain investment tax credits earned by a Canadian-controlled private corporation that is neither a qualifying corporation nor an excluded corporation as defined for the purposes of section 127.1. Subsection 127(2.01) is amended consequential on the introduction of new paragraph (*a*.1) of the definition of "investment tax credit" in subsection 127(9). This amendment applies to taxation years that begin after 1995.

Clause 32

Dividend refunds

ITA
129

Section 129 of the Act allows a private corporation that pays a taxable dividend to obtain a partial refund of the taxes it has paid on its investment income. The dividend refund system is intended to integrate corporate and shareholder taxation: providing comparable tax results for those who invest through Canadian-controlled private holding companies and those who invest directly. Several amendments to section 129, together with the additional refundable Part I tax under new section 123.3 of the Act and changes to the refundable tax imposed under Part IV of the Act, improve and simplify this integration system.

Subclause 32(1)

ITA
129(1)(*a*)

Subsection 129(1) of the Act entitles corporations to receive dividend refunds. Under paragraph 129(1)(*a*), the amount of a corporation's dividend refund for a taxation year is equal to the lesser of: (i) 1/4 of the total of all taxable dividends paid by the corporation in the year while it was a private corporation; and (ii) the corporation's refundable dividend tax on hand (RDTOH) at the end of the year. This amendment increases the dividend refund rate from 1/4 to 1/3. Provided it has enough RDTOH, a corporation may thus claim a refund of $1 for every $3 in taxable dividends it pays while it is a private corporation.

This amendment applies to taxation years that end after June 1995, with a transitional rule for such years that began before July 1995. Under the transitional rule, the amount determined under subparagraph 129(1)(*a*)(i) is the total of 1/4 of the dividends paid before July and 1/3 of the dividends paid after June.

Subclause 32(2)

ITA
129(3)

Definition of "refundable dividend tax on hand"

Subsection 129(3) of the Act defines a corporation's "refundable dividend tax on hand" (RDTOH). Currently, this definition is cumulative: to determine its RDTOH at the end of a taxation year a corporation must total all of the amounts to be added to its RDTOH in respect not only of that year, but also of each previous year. The corporation must then deduct all of its dividend refunds for each previous year since it last became a private corporation. As well, several special adjustments must be made to account for changes to the refundable tax system in 1978, 1987, and 1988.

This amendment simplifies the computation of RDTOH by putting it on an annual basis, with a carryforward of unrefunded RDTOH from the previous year. As a result, the adjustments and special rules in

subsections 129(3.1) to (3.5) of the Act become unnecessary and are repealed. The amendment also reflects the additional 6 2/3% of refundable Part I tax imposed under new section 123.3 of the Act.

Under the amended definition, to compute its RDTOH at the end of a taxation year a corporation first totals three amounts. These are: under paragraph 129(3)(*a*), where the corporation was a Canadian-controlled private corporation (CCPC) throughout the year, an amount (described more fully below) in respect of its Part I tax for the year; under paragraph 129(3)(*b*), any tax payable by the corporation for the year under Part IV of the Act; and under paragraph 129(3)(*c*), the corporation's RDTOH at the end of its preceding taxation year, where the corporation was a private corporation at that time. The corporation then deducts from that total its dividend refund for its preceding taxation year: paragraph 129(3)(*d*). The remainder, if any, is the corporation's RDTOH.

Amended paragraph 129(3)(*a*) adds an amount to a CCPC's RDTOH in respect of its Part I tax for a year. Although the effect of the paragraph is generally comparable to that of the existing provision, two key rate changes should be noted. First, the general rate for Part I RDTOH is increased from 20% to 26 2/3%, reflecting the additional refundable tax imposed under new section 123.3 of the Act. Second, the rate of tax which is assumed to be levied on foreign-source investment income and taxable capital gains is increased from 30% to 36%. In addition, the provision's structure is somewhat simplified. The following notes provide a full description of the paragraph.

The Part I RDTOH addition under amended paragraph 129(3)(*a*) is the least of the amounts determined under three subparagraphs. The starting-point for the first limitation, under subparagraph 129(3)(*a*)(i), is the corporation's "aggregate investment income" for the year, a term defined in amended subsection 129(4) of the Act. Aggregate investment income includes not only certain income from Canadian sources, but also certain foreign-source income. A corporation's Part I RDTOH may be increased with respect to this foreign-source income at the normal 26 2/3% rate, unless foreign tax credits have reduced the effective Canadian tax rate on the income below 26 2/3%. For this purpose, subparagraph 129(3)(*a*)(i) assumes that "foreign investment income" bears Canadian tax at a rate of 36%

before any foreign tax credit. Therefore, in computing the corporation's limit on Part I RDTOH, the subparagraph requires a deduction of an amount equal to the corporation's non-business foreign tax credit less 9 1/3% (36% - 26 2/3%) of its "foreign investment income".

The second limitation, in subparagraph 129(3)(*a*)(ii), effectively caps the Part I RDTOH addition at 26 2/3% of the portion of the corporation's taxable income that has borne Canadian tax at full rates. The amount determined under subparagraph 129(3)(*a*)(ii) is 26 2/3% of a corporation's taxable income for the year, less any amounts that were subject to the lower small-business tax rate under section 125(1) of the Act or that supported a foreign tax credit. These amounts are specified in clauses 129(3)(*a*)(ii)(A), (B), and (C). Clause (A) deducts the least of the amounts determined under paragraphs 125(1)(*a*) to (*c*) in respect of the corporation for the year (i.e., the corporation's income that was eligible for the small business deduction). Clauses (B) and (C) deduct the amount of the corporation's foreign income that has supported foreign tax credits — an amount derived by multiplying the corporation's credits for foreign non-business income tax and its credits for foreign business income tax by 25/9 and 10/4, respectively. Those fractions reflect an assumption that foreign-source non-business income is taxable at a total federal rate of 36%, and foreign-source business income at a rate of 40%.

The final limitation, in subparagraph 129(3)(*a*)(iii), is the corporation's tax for the year payable under Part I of the Act, determined without reference to the corporate surtax imposed under section 123.2 of the Act.

The amended definition of "refundable dividend tax on hand" applies to taxation years that end after June 1995, subject to a transitional rule for years beginning before July 1995. The transitional rule reduces each of the amounts determined under amended subparagraphs 129(3)(*a*)(i) and (ii) by that proportion of 1/4 of the amount that the number of days in the year that are before July 1995 is of the number of days in the year. This reflects the pro-rated introduction of the additional 6 2/3% refundable tax under new section 123.3 of the Act (6 2/3% being 1/4 of 26 2/3%).

Definitions

ITA
129(4)

Subsection 129(4) of the Act currently defines "Canadian investment income" and "foreign investment income" for the purposes of subsection 129(3) of the Act. The subsection is amended, for taxation years that end after June 1995, to replace those definitions with several new terms.

"aggregate investment income"

A corporation's aggregate investment income for a taxation year is defined as the amount, if any, by which the total of certain amounts in respect of taxable capital gains and property income.

Under paragraph (*a*) of the definition, a corporation includes in its aggregate investment income for the year any amount by which the "eligible portion" of its taxable capital gains for the year exceeds the total of the eligible portion of its allowable capital losses and any net capital loss carryovers deducted in computing its taxable income for the year. In general, the eligible portion of the corporation's taxable capital gains and allowable capital losses is the total of the gains or losses that accrued while the property giving rise to the gain or loss was held by a Canadian-controlled private corporation or certain specialty corporations. (Reference may be made to the commentary on the definition of "eligible portion".)

Paragraph (*b*) of the definition includes in aggregate investment income any income of the corporation from property, with four exclusions. The excluded amounts are the following: exempt income; amounts included in income under subsection 12(10.2) of the Act (NISA receipts); dividends received by the corporation that are deductible in computing its taxable income; and income that is treated as property income only because of the deeming rule in paragraph 108(5)(*a*) of the Act (income of a trust beneficiary).

"eligible portion"

The new definition of "eligible portion" reproduces the effect of limitations currently found in the definition of Canadian investment income.

The eligible portion of a corporation's taxable capital gains or allowable capital losses for a taxation year is the total of those portions of the corporation's taxable capital gains or allowable capital losses that cannot reasonably be regarded as having accrued while the property (or a property for which it was substituted) was property of a corporation other than a Canadian-controlled private corporation, an investment corporation, a mortgage investment corporation, or a mutual fund corporation.

These conditions do not, however, apply where the property giving rise to the gain or loss was a designated property as defined in subsection 89(1) of the Act: in respect of designated property, the full amount of a taxable capital gain or allowable capital loss is included in the eligible portion.

"foreign investment income"

A corporation's aggregate investment income includes amounts from foreign sources, as well as amounts from sources in Canada. For the purposes of amended subparagraph 129(3)(*a*)(i) of the Act, it is necessary to determine what part of a corporation's investment income for a taxation year originated outside Canada. The amended definition of "foreign investment income" takes as its starting-point the corporation's aggregate investment income for the year. That amount is modified in three respects. First, every amount of the corporation's income, loss, capital gain, or capital loss from a source in Canada is treated as nil. Second, any deduction of net capital loss carryovers is ignored. Third, the subsection 129(4) definition of "income" or "loss" is read without its paragraph (*a*), to ensure the appropriate treatment of any foreign source property income or foreign-source property loss from a specified investment business. With these modifications, the corporation's aggregate investment income becomes its foreign investment income for the year.

"income" or "loss" from property

This new definition, which replaces existing subsections 129(4.1) and (4.2) of the Act, clarifies what "income" and "loss" from a property mean for the purposes of measuring a corporation's Canadian and foreign investment income and loss. Paragraph (*a*) of the definition specifies that "income" or "loss" includes the income or loss from a specified investment business (SIB) carried on by the corporation in Canada other than income or a loss from a source outside Canada. Canadian-source income and Canadian-source losses from Canadian SIBs are thus treated as being from a property regardless of their actual character. In contrast, since paragraph (*a*) does not extend this special treatment to them, foreign-source income or a foreign-source loss from a Canadian SIB and income or loss from a foreign SIB are treated as property income or losses only if that is in fact what they are. Paragraph (*b*) of the definition provides that no account is to be taken of income or loss from a property that is incident to or pertains to an active business carried on by the corporation, or that is used or held by the corporation principally to gain or produce income from an active business.

Clause 33

Mutual Fund Corporations

ITA
131

Section 131 of the Act sets out special rules relating to the taxation of mutual fund corporations.

Subclause 33(1)

Mutual Fund Corporation - Dividend Refund

ITA
131(5)

Subsection 131(5) of the Act treats a mutual fund corporation as a private corporation for the purposes of section 129 and certain other provisions of the Act. This ensures that a mutual fund corporation

may claim a dividend refund, under section 129, of Part IV tax paid on its dividend income and included in its refundable dividend tax on hand (RDTOH). In its current form, paragraph 131(5)(*a*) provides a complete formula for computing a mutual fund corporation's RDTOH. With changes to the computation of all corporations' RDTOH under subsection 129(3) of the Act, a separate rule for mutual funds is no longer necessary. This amendment replaces paragraph 131(5)(*a*) with a rule providing simply that a mutual fund corporation's RDTOH is to be determined without reference to amended paragraph 129(3)(*a*). The amendment applies to taxation years that end after June 1995.

Subclause 33(2)

Labour-sponsored Venture Capital Corporations

ITA
131(11)

Subsection 131(11) of the Act provides a number of special rules that apply to prescribed labour-sponsored venture capital corporations (LSVCCs). One of these, in paragraph 131(11)(*b*), is that taxable capital gains and allowable capital losses are not taken into account in determining a prescribed LSVCC's refundable dividend tax on hand (RDTOH) under subsection 129(3) of the Act. Changes to subsection 129(3) mean that paragraph 131(11)(*b*) must be amended to preserve this effect. This amendment applies to taxation years that end after June 1995.

Clause 34

"RRSP dollar limit"

ITA
146(1)

Subsection 146(1) of the Act defines "RRSP dollar limit", which is relevant in determining the amount of tax-deductible contributions an individual may make to registered retirement savings plans. The RRSP dollar limit for a year is the maximum amount of new RRSP deduction room which can become available to an individual in that

year. It is defined as the "money purchase limit" (as defined in subsection 147.1(1)) for the preceding year.

The definition of "RRSP dollar limit" is amended so that the limit for 1996 is $13,500, rather than the 1995 money purchase limit. The RRSP dollar limit for years after 1996 continues to be the money purchase limit for the preceding year. As a consequence of amendments to the money purchase limit, the RRSP dollar limit for 1997, 1998 and 1999 will be $13,500, $14,500 and $15,500 respectively. For years after 1999, the limit will be $15,500 indexed to post-1998 increases in the average wage.

Clause 35

Home Buyer's Plan

ITA
146.01(3)

Subsection 146.01(3) of the Act provides that amounts contributed by individuals to their RRSPs may be designated as non-deductible repayments under the Home Buyer's Plan.

Subsection 146.01(3) is amended consequential on the amendment to paragraph 150(1)(*d*) of the Act which changed the tax return filing-due date of certain individuals.

This amendment applies to 1995 and subsequent taxation years.

Clause 36

"money purchase limit"

ITA
147.1(1)

Subsection 147.1(1) of the Act defines "money purchase limit". The definition is relevant for a number of provisions in the Act and the *Income Tax Regulations* relating to deferred income plans. For example, a registered pension plan becomes revocable if a member's

pension adjustment for a year exceeds the money purchase limit for the year. The money purchase limit also provides the basis for the dollar limits on deductible contributions to registered retirement savings plans, pensions payable under defined benefit provisions of registered pension plans and contributions to deferred profit sharing plans.

The definition is amended so that the money purchase limit is reduced to $13,500, $14,500 and $15,500 for 1996, 1997 and 1998, respectively. For 1999 and subsequent years, the money purchase limit will be $15,500 adjusted to reflect increases in the average wage for years after 1998.

Clause 37

Exemptions from Tax

ITA
149

Section 149 of the Act exempts certain taxpayers from tax under Part I of the Act and provides special rules for such taxpayers.

Subclauses 37(1) to (3)

ITA
149(1)(*j*)(ii)

Paragraph 149(1)(*j*) of the Act sets out the criteria which a corporation must satisfy in order to qualify as a non-profit SR&ED corporation for the purposes of the Act.

Clause 149(1)(*j*)(ii)(A) is amended to correct a reference not updated when the *Income Tax Act* was revised by the Statute Revision Commission. The existing incorrect reference to subsection 37(7) of the Act is corrected by changing the reference to subsection 37(8) of the Act. This clause is also amended to clarify that the meaning of the expression "an expenditure on scientific research and experimental development" is assigned by paragraph 37(8)(*a*). These amendments apply to taxation years that end after November 1991.

Current subparagraph 149(1)(*j*)(ii) also provides that a corporation described in paragraph 149(1)(*j*) must expend at least 90% of its income on expenditures for SR&ED directly undertaken by or on behalf of the corporation or on payments to certain entities. This subparagraph is amended to clarify that, for taxation years that begin after June 1995, such a corporation must expend 90% of the corporation's gross revenue for the period minus any penalties and interest that is paid by the corporation pursuant to subsection 149(7.1) of the Act.

Subclause 37(4)

ITA
149(7) and (7.1)

New subsection 149(7) of the Act requires a corporation that is exempt from Part I tax for a taxation year under paragraph 149(1)(*j*) to file a prescribed form containing prescribed information by its income tax return filing-due date for the year. New subsection 147(7.1) of the Act imposes a penalty where the corporation fails to file the form.

This amendment applies to taxation years that end after February 27, 1995. However, if the prescribed form is filed with Revenue Canada within 90 days of Royal Assent to this subsection, the form will be considered to have been filed on time.

New subsection 149(7.1) of the Act imposes a penalty on a corporation for failing to file a prescribed form for a taxation year as required by subsection 149(7). The penalty is the greater of 2% of the corporation's taxable income for the year and $500 multiplied by the number of months (to a maximum of 12) that the form is late.

This amendment applies to taxation years that end after February 27, 1995. However, no penalty will be levied if the prescribed form is filed with Revenue Canada within 90 days of Royal Assent to this subsection.

Subclause 37(5)

ITA
149(8)(*b*)

Subsection 149(8) of the Act provides rules for the purpose of determining whether a corporation qualifies as a non-profit SR&ED corporation under paragraph 149(1)(*j*).

Paragraph 149(8)(*b*) is amended to require the amount of all gifts received by a corporation and all amounts contributed to the corporation that are used for SR&ED be included in determining the corporation's gross revenue.

This amendment applies to taxation years that begin after June 1995.

Subclause 37(6)

ITA
149(9)

Subsection 149(9) of the Act provides rules for computing the income of a corporation for the purpose of determining whether it is exempt from tax under paragraph 149(1)(*j*). This subsection is amended consequential on the amendments to that paragraph requiring that the 90% expenditure test be based on gross revenue and not income.

This amendment applies to taxation years that begin after June 1995.

Clause 38

Tax Returns

ITA
150(1)(*b*) and (*d*)

Subsection 150(1) requires taxpayers to file their income tax returns on or before certain dates. Under paragraph 150(1)(*b*) where a taxpayer has died after October 31 in a taxation year and before May 1 in the following year, the taxpayer's legal representative is permitted to file the return for the taxation year up to 6 months after

the date of death. Paragraph 150(1)(*b*) is amended, in the case of an individual who dies after October in a taxation year and before June 16 of the following year, to extend the date by which the individual's tax return is required to be filed to the later of 6 months after the individual dies and the day on which the return would otherwise be required to be filed. The latter time limit takes into account the extended time limit for filing returns for certain individuals under amended paragraph 150(1)(*d*).

Paragraph 150(1)(*d*) is amended to extend the due date for filing a tax return to June 15 of the calendar year following a taxation year in the case of an individual (other than a trust) who earns income from a business in the taxation year, or the spouse of such an individual. (This rule does not apply, however, where the individual's business is a tax shelter.)

These amendments apply to 1995 and subsequent taxation years.

Clause 39

Assessments

ITA
152(1)(*b*)

Subsection 152(1) of the Act contains rules relating to assessments and reassessments of tax, interest, and penalties payable by a taxpayer and to determinations and redeterminations of tax deemed to have been paid by a taxpayer. Paragraph 152(1)(*b*) is amended to add a reference to new subsection 125.4(3) of the Act under which qualified corporations may be deemed to have paid an amount on account of tax under Part I of the Act as a result of the Canadian film or video production tax credit.

This amendment applies to 1995 and subsequent taxation years.

Clause 40

Payment of Tax

ITA
153

Section 153 of the Act deals with the withholding and remittance of tax on payments listed in that section.

Subclause 40(1)

ITA
153(1.3) and (1.4)

Subsections 153(1.3) and (1.4) of the Act establish the joint and several liability of trustees and similar persons that have substantial control over the affairs of another person that fails to deduct and remit amounts determined under the *Income Tax Regulations* in respect of a payment of salary, wages or other remuneration described in paragraphs 53(1)(*a*) to (*r*) of the Act. The liability arises where the trustee authorizes or causes such a payment to be made.

Subsections 153(1.3) and (1.4) are repealed as more comprehensive joint and several liability rules are introduced in new subsections 227(5) to (5.5) of the Act (discussed below). The repeal of the old rules and the implementation of the new and more comprehensive rules applies to payments made after Royal Assent.

Subclause 40(2)

ITA
153(3.1)

This amendment, which is consequential on the amendments to Part I.2 of the Act dealing with the recovery of Old Age Security benefits contained in this bill, adds new subsection 153(3.1) to the Act. The new subsection provides that where the amount of Part I.2 tax withheld for a taxation year is more than the lesser of the tax payable under that Part and the amounts required to be withheld by that Part, the excess will be considered to be income tax withheld under section 153. This ensures that, for example, such excess

amounts will not adversely affect an individual's instalment requirements under Part I of the Act.

New subsection 153(3.1) applies to 1996 and subsequent taxation years, except that, for the 1996 year, it is modified to take into account the fact that tax will begin to be withheld under Part I.2 of the Act only after June 1996.

Clause 41

Tax Payments by Corporations

ITA
157(3)(*e*)

Subsection 157(3) of the Act allows certain corporations to reduce their monthly tax instalment payments by certain refundable amounts under the Act. Paragraph 157(3)(*e*) is amended to add a reference to new subsection 125.4(3) (the refundable Canadian film or video production tax credit).

This amendment applies to 1995 and subsequent taxation years.

Clause 42

Interest

ITA
161(2.2)(*d*)

Subsection 161(2.2) of the Act (commonly referred to as the contra-interest provision) provides for a reduction in interest payable by a taxpayer for late or deficient income tax instalment payments. Where a taxpayer has remitted tax instalments earlier than required or in a larger amount than required, the taxpayer is credited with notional contra-interest on the early or larger payments for the purpose of this subsection only. That contra-interest then "offsets" interest that is payable in respect of late or deficient payment of income tax for the same year.

As announced in the 1995 budget, the interest rate for underpayments of income taxes will no longer be the same as the interest rate for overpayments of income taxes, except for the purpose of this subsection. The former will be increased by two percentage points per annum effective for interest that is calculated in respect of periods after June 1995.

Subsection 161(2.2) is amended for interest that is calculated in respect of periods after June 1995 in order to ensure that the interest rate used for calculating contra-interest will be the same as the one used for calculating interest on taxes in arrears.

Clause 43

Penalties

ITA
163(2)

Subsection 163(2) of the Act imposes a penalty where a taxpayer knowingly, or in circumstances amounting to gross negligence, participates in or makes a false statement or omission in a return. New paragraph 163(2)(*f*) is added to apply where false information is provided in respect of an amount claimed under new subsection 125.4(3) (the Canadian film or video production tax credit).

This amendment applies to 1995 and subsequent taxation years.

Clause 44

Refunds

ITA
164(3)(*a*) and (*c*)

Subsection 164(3) of the Act provides for the payment of interest on tax refunds. Paragraph 164(3)(*a*) is simplified by providing that no interest is payable until 45 days after the individual's balance-due day

for the year. The definition of "balance-due day" is in subsection 248(1) of the Act.

Paragraph 164(3)(*c*) is amended to provide, in effect, that an individual who has until June 15 of a calendar year to file an income tax return following a taxation year in which the individual or the individual's spouse earned business income, may earn refund interest beginning 45 days after the later of April 30 and the date the return of income is filed - rather than 45 days after June 15. Accordingly, the combined effect of the amendments to paragraphs 164(3)(*a*) and (*c*) is that an individual's refund interest would begin, for example, 45 days after May 10th where the individual's return of income is required to be filed by June 15 but is filed on May 10.

These amendments apply to 1995 and subsequent taxation years.

Clause 45

Objections to Assessments

ITA
165(1)(*a*)(i)

Under subsection 165(1) of the Act a taxpayer has a right to object to an assessment for a taxation year within one year after the taxpayer's balance-due day for the taxation year or within 90 days from the day of mailing of the notice of assessment for the year.

Subparagraph 165(1)(*i*) is amended consequential on the extension of the "filing-due date" of a taxpayer's return of income to June 15 (under amended subsection 150(1) of the Act and the definition of "filing-due date" in subsection 248(1) of the Act).

This amendment applies to 1995 and subsequent taxation years.

Clause 46

Recovery of Old Age Security Benefits

ITA
Part I.2

Part I.2 of the Act provides for the recovery of Old Age Security (OAS) benefits to the extent that a taxpayer's income for a year exceeds an indexed threshold ($53,215 for 1995). Under the current provisions, individuals receive full OAS benefits during a year, regardless of their income level. The calculation of the amount of any excess OAS benefits received is performed when an individual files an income tax return for the year, and the benefits are recovered at that time.

These amendments to Part I.2 of the Act, which generally apply to OAS benefits received after June 1996, modify the structure of the recovery of OAS benefits by providing for tax to be withheld on such benefits as they are paid during the year. The amount withheld from benefit payments during a year will be based on prior years' income. Upon the filing of a return or form (in the case of individuals who are non-resident at any time in the year) a calculation of the actual amount of OAS benefit recovery for the year, based on income for that year, will be performed. Any excess amounts withheld will be applied to any other tax liability of the individual under the Act or refunded. Conversely, where the amounts withheld fall short of the actual liability for the year, individuals will be required to repay the difference.

Definitions

ITA
180.2(1)

Amended subsection 180.2(1) of the Act contains definitions relevant to the calculation of both the amount of OAS benefits to be recovered and the amount of tax to be withheld from payments of these benefits. These definitions apply after June 1996.

"adjusted income"

The definition of "adjusted income" relates to the income base upon which OAS benefits are recovered and tax withheld during a year. This definition provides that an individual's adjusted income is the individual's income under Part I of the Act for the year, with two exceptions. First, in order to prevent circularity in the calculation, deductions in respect of OAS benefits repaid are ignored. Second, gains resulting from foreclosures (under section 79 of the Act) are excluded from income.

It should be noted that, under the scheme of the Act, the provisions of Division B of Part I apply to require both residents and non-residents to calculate their incomes in the same manner. Non-residents may be entitled to certain deductions under Division D in arriving at taxable income. The effect of this structure is that, for the purposes of the definition of "adjusted income" in Part I.2, the calculation of income will be the same regardless of the residency status of the individual.

"base taxation year"

The amount of tax to be withheld from an OAS benefit paid during a month is to be calculated by reference to a preceding year, defined as the "base taxation year". For OAS benefits paid during the first six months of a year, tax will be withheld based on income reported for the second preceding year; for OAS benefits paid during the last six months of a year, withholding will be based on income reported for the immediately preceding year.

"return of income"

The definition of "return of income" is relevant to the calculation of tax to be withheld from OAS payments contained in new subsection 180.2(4) of the Act. If an individual is resident in Canada throughout a year, the definition of "return of income" refers to the income tax return required to be filed under Part I of the Act for the year. In recognition of the fact that an individual may not have been resident in Canada throughout a year, and therefore may not have been required to file an income tax return for the year, the Minister of National Revenue will accept, in lieu of a return, a form containing relevant tax data for that year.

Tax payable

ITA
180.2(2)

Amended subsection 180.2(2) of the Act contains the calculation of the amount of OAS benefits that are to be recovered from an individual in respect of a year. The amount of this repayment is equal to the lesser of the total benefits included in the individual's income for the year and 15% of the individual's adjusted income for the year (as defined in subsection 180.2(1)) in excess of a $50,000 indexed threshold.

If an individual who is not resident in Canada receives OAS benefits, the individual is subject to tax on the payments under Part XIII of the Act, as amended in this bill. In these cases, the formula in amended subsection 180.2(2) takes into account that tax liability, by reducing the rate of the repayment by the rate of tax payable by the individual under Part XIII on OAS benefits. With respect to non-residents, it should also be noted that the general rule that provisions contained in treaties supersede any conflicting provisions that may be contained in domestic legislation, such as the *Income Tax Act*, is not displaced by these amendments. Thus, the provisions of this subsection, and Part I.2 in general, apply to non-residents only to the extent the provisions do not conflict with a tax treaty.

Subsection 180.2(2), as amended, applies to 1996 and subsequent taxation years.

Withholding

ITA
180.2(3)

New subsection 180.2(3) is added to the Act to require that tax be withheld from OAS benefits, beginning with such amounts paid after June 1996.

Amount to be withheld

ITA
180.2(4)

New subsection 180.2(4) of the Act contains the calculation of amounts to be withheld from OAS benefits paid to individuals, starting in July 1996. As noted in the commentary to the definition of "base taxation year", amounts withheld will be based on income for an individual's base taxation year. For OAS benefits paid during the first six months of a year, the base taxation year is the second preceding year; for OAS benefits paid during the last six months of a year, the base taxation year is the immediately preceding year.

The amount to be withheld from a particular OAS benefit payment is generally calculated in the same manner as the OAS tax itself under amended subsection 180.2(2), except that the basis of the withholding calculation is an individual's adjusted income for the base taxation year in relation to the payment (rather than the current year) and the amount is effectively divided into twelve in order to approximate monthly benefit payments.

Two factors enter into the determination of the amount to be withheld from a particular OAS benefit payment - the residency status of the individual during the base taxation year in relation to the payment and whether a return of income (as defined in subsection 180.2(1)) has been filed in respect of that year.

In the case of an individual who was resident in Canada throughout the base taxation year and who has filed a return of income for that year, the amount to be withheld will be based on the individual's adjusted income for that year. Where an individual resident in Canada throughout the base taxation year has not filed a return for that year and the Minister of National Revenue has demanded that a return be filed in respect of that year, the full amount of the payment will be withheld. In the case of an individual resident in Canada throughout the base taxation year where no return has been filed and no demand by the Minister for such a return has been made, no amount will be withheld from the OAS benefit payment.

Where an individual was non-resident at any time in the base taxation year and has not filed the form prescribed by the Minister in respect of that year (as provided for the definition of "return of income" in amended subsection 180.2(1)), the full amount of the OAS benefit payment, less any tax payable under Part XIII of the Act will be withheld. Where such an individual has filed the prescribed form in respect of the base taxation year, the amount withheld will be based on the individual's adjusted income for that year, with the rate reduced to reflect tax payable under Part XIII. The example at the end of the commentary on the amendments to Part I.2 illustrates the effect of these provisions on a non-resident.

Return

ITA
180.2(5)

New subsection 180.2(5) of the Act requires individuals who are liable to the tax in respect of the recovery of OAS benefits for a year, as provided for under amended subsection 180.2(2), to file returns and pay the tax.

For an individual who is resident in Canada throughout the year, the filing required will form part of the regular return of income for the year, as is presently the case, and will be due on the individual's filing-due date for the year. A non-resident will be required to file a prescribed form, as referred to in the definition of "return of income" in amended subsection 180.2(1), which will be due on the non-resident's balance-due day. In both cases, the tax must be paid on or before the individual's balance-due day for the year.

New subsection 180.2(5) applies to 1996 and subsequent taxation years.

Provisions applicable

ITA
180.2(6)

New subsection 180.2(6) of the Act sets out the administrative provisions that apply to Part I.2. It provides that, among other provisions, subsection 153(1.1) of the Act will apply in respect of

amounts required to be withheld under Part I.2. Subsection 153(1.1) allows the Minister of National Revenue to provide for the withholding of a lesser amount than otherwise required, on the grounds of undue hardship. The importation of this provision into Part I.2 will allow individuals for whom the withholding of amounts from OAS benefit payments would result in such hardship, because, for example, of a significant decrease in income between the base taxation year on which the withholding is calculated and the income for the year of receipt, to apply for relief to the Minister.

This amendment applies to 1996 and subsequent taxation years.

EXAMPLE

Mr. A is a resident of the United States, who receives OAS benefits of $300 per month throughout 1996. Mr. A has not filed a prescribed form with the Minister of National Revenue reporting his 1995 income.

The OAS benefit payments that Mr. A receives during the first six months of 1996 will be reduced by the amount of tax under Part XIII of the Act that he is liable to pay on such benefits beginning in 1996. As provided for in Part XIII, the reduction will be 25% of the amount, or $75 on each monthly cheque.

Starting in July 1996, Mr. A. will also be subject to withholding on OAS payments under Part I.2 of the Act. Because in this case, he has not filed the prescribed form in respect of 1995 (the base taxation year), each of Mr. A's monthly OAS payments for the remainder of 1996 will be reduced by the amount of the payment less the $75 of Part XIII tax to which he is subject. Therefore the full amount of Mr. A's remaining 1996 OAS payments will be withheld on account of his tax liability under Parts I.2 and XIII.

In April 1997, Mr. A files a prescribed form under Part I.2, containing information about his 1996 income. On that basis, his adjusted income for 1996 is calculated as $63,215. As a result, the OAS recovery under Part I.2 for 1996 is calculated according to the formula in subsection 180.2(2):

$$A(1 - B) \text{ or } \$1500(.75) = \$1125$$

In this example, A is the lesser of the $3600 in OAS benefits to which Mr. A was entitled for 1996 and 15% of the amount by which his adjusted income for 1996 of $63,215 exceeded the base amount of $53,215 (unindexed in this example); and B is .25, the rate of Part XIII tax applicable.

As a result, Mr A, provided he has no other tax liabilities outstanding, will be entitled to a refund of the excess amounts withheld under Part I.2 in respect of his OAS benefits in 1996. The refund will amount to $225, which is the total withheld from his OAS payments under Part I.2 (6 x ($300 - $75) = $1350) minus tax in the amount of $1125 for which he is liable under Part I.2 for the year.

Clause 47

Large Corporations Tax - Tax Payable

ITA
181.1(1)

Part I.3 of the Act levies an annual tax (generally referred to as the Large Corporations Tax) on a corporation's taxable capital employed in Canada in excess of $10 million. The amendment to 181.1(1) of the Act changes the rate of tax payable under Part I.3 of the Act from 0.2% to 0.225%. This amendment applies to taxation years that end after February 27, 1995, but is subject to a transitional provision which maintains the 0.2% tax rate under Part I.3 for the portion of a corporation's taxation year that falls before February 28, 1995.

Under subsection 125(5.1) of the Act a corporation's business limit for the purpose of the small business deduction is reduced as its Part I.3 tax liability increases. As a result of amended subsection 181.1(1), the reduction in the business limit would increase proportionately with the increase in tax payable under Part I.3. For any taxation years that began before February 28, 1995, a special transitional rule provides that, for the purposes of applying subsection 125(5.1) of the Act, the amount that would be a corporation's relevant tax liability under Part I.3 is to be computed without reference to the increased tax rate in amended subsection 181.1(1). This ensures that a corporation's business limit

is not accelerated simply by virtue of the increased rate. (Note: An amendment to subsection 125(5.1) operates to maintain the same small business deduction phase-out rate for the taxation years beginning after February 27, 1995. Reference may be made to the commentary on that amendment for further information.)

Clause 48

Part IV Tax

ITA
186

Part IV of the Act levies a refundable tax on dividends received by a private or closely-held corporation. The amendments to section 186 of the Act increase the Part IV tax rate from 25% (1/4 of the dividend amount) to 33 1/3% (1/3) and also modify the structure of the section for greater clarity.

The higher Part IV tax rate will apply to any dividend received from an unconnected payer corporation, and will indirectly apply to dividends received from a connected payer corporation to the extent the payer received a dividend refund under section 129 of the Act at the 1/3 rate.

These amendments apply to taxation years that end after June 1995. A transitional rule ensures that the existing 25% tax rate applies to dividends received from unconnected corporations before July 1995, and that losses applied against the Part IV base are used first to offset post-June 1995 dividends, which are subject to tax at the higher rate.

Subclause 48(1)

ITA
186(1) and (1.1)

Tax on assessable dividends

ITA
186(1)

Subsection 186(1) of the Act imposes the refundable Part IV tax on certain dividends received by private corporations and closely-held, or "subject" corporations. This amendment changes the Part IV tax rate from 25% to 33 1/3% for dividends received after June 1995.

Amended subsection 186(1) applies to every corporation that at any time in a taxation year is a private corporation or a subject corporation. Such a corporation pays a tax equal to the amount, if any, by which 1/3 of the assessable dividends it received in the year from unconnected corporations, together with its pro-rata share of the dividend refund received by any connected corporation that paid it an assessable dividend in the year, exceeds 1/3 of any non-capital losses or farm losses it chooses to claim for Part IV purposes.

The definitions of "assessable dividend" and "subject corporation", found in new subsection 186(3) of the Act, do not make any substantive change to the existing law.

Reduction where Part IV.1 tax payable

ITA
186(1.1)

Part IV.1 of the Act levies a 10% tax on certain dividends received by certain corporations. Both Part IV tax and Part IV.1 tax may apply to the same dividend. To relieve this duplication, subsection 186(1.1) of the Act, in effect, deducts from Part IV tax the Part IV.1 tax payable on any dividend figuring in the Part IV tax base. The amendment to subsection 186(1.1) merely shortens and simplifies the provision and is not of a substantive nature.

Subclause 48(2)

Definitions

ITA
186(3)

"assessable dividend"

An assessable dividend is an amount received by a corporation, when it was a private corporation or a subject corporation, as, on account of, in lieu of payment of or in satisfaction of a taxable dividend, to the extent the dividend is deductible under section 112, paragraph 113(1)(*a*), (*b*) or (*d*), or subsection 113(2) of the Act in computing the recipient's taxable income. Assessable dividends are included in computing the amount on which a private or subject corporation must pay Part IV tax.

"subject corporation"

A corporation, other than a private corporation, is a subject corporation if it is resident in Canada and is controlled, through a trust or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts). A subject corporation is liable to Part IV tax on the same basis as a private corporation.

Subclause 48(3)

Deemed private corporation

ITA
186(5)

Subsection 186(5) of the Act provides that a subject corporation (as defined in new subsection 186(3)) is treated as a private corporation for the purposes of section 129 and certain other provisions of the Act. This ensures that a subject corporation may claim a dividend refund, under section 129, of Part IV tax paid on its dividend income and included in its refundable dividend tax on hand (RDTOH). In its current form, subsection 186(5) provides a complete formula for computing a subject corporation's RDTOH. With the changes to the

computation of all corporations' RDTOH under subsection 129(3) of the Act (See the commentary to that provision), a separate rule for subject corporations is no longer necessary. Subsection 186(5) is amended to provide simply that a subject corporation's RDTOH is to be determined without reference to amended paragraph 129(3)(*a*). The amendment applies to taxation years that end after June 1995.

Clause 49

Part VI - Tax on Capital of Financial Institutions

ITA
Part VI

Part VI of the Act levies a tax on the taxable capital employed in Canada of financial institutions. In general terms, a financial institution's taxable capital employed in Canada is the amount of its long-term debt, equity and non-deductible reserves that are considered to be used in connection with its activities carried on in Canada.

Subclause 49(1)

ITA
190.1(1.2)

New subsection 190.1(1.2) of the Act imposes an additional temporary Part VI tax on the taxable capital employed in Canada of financial institutions, other than life insurance corporations. The additional tax is computed as 0.15% of a corporation's taxable capital employed in Canada in excess of its "enhanced capital deduction". Under new section 190.17 of the Act, a corporation's enhanced capital deduction for a taxation year is equal to $400 million unless the corporation is related to another financial institution at the end of the year, in which case, the deduction must be shared by members of the related group in accordance with that section. By virtue of amended paragraph 190.1(3)(*c*) of the Act, the additional tax may not be reduced by tax payable under Part I of the Act.

New subsection 190.1(1.2) applies to taxation years that end after February 27, 1995 and begin before November 1996, and is subject to pro-ration for years that straddle these dates, as well as for short taxation years.

A special transitional rule provides that any increase in a financial institution's Part VI tax liability resulting from the additional tax incurred under new subsection 190.1(1.2) is not to affect the institution's instalment interest obligations under subsection 161(2) of the Act for instalments due before July 1995. Under subsections 157(1) and 161(2) of the Act a taxpayer is liable to pay interest on late or deficient tax instalments in respect of taxes payable under Parts I, I.3, VI and VI.1 of the Act.

Subclause 49(2)

ITA
190.1(3)(*c*)

Pursuant to subsection 190.1(3), a financial institution is permitted to reduce its Part VI tax payable by an amount equal to the total of its Part I tax liability for the year and such amount as it chooses of its unused Part I tax credits and unused surtax credits for the seven preceding and three following taxation years that end after 1991 (or after 1990, where a special election is made).

Paragraph 190.1(3)(*c*) is amended as a consequence of the introduction of the additional temporary Part VI capital tax on financial institutions under subsection 190.1(1.2) to prevent the tax from being reduced by tax payable under Part I, unused Part I tax credits, and unused surtax credits.

This amendment is effective for taxation years that end after February 27, 1995.

Clause 50

Capital Deduction

ITA
190.17

New section 190.17 of the Act contains the rules for determining the amount of a corporation's enhanced capital deduction for the purposes of the new temporary Part VI capital tax on financial institutions (other than life insurance corporations). These new rules parallel the rules in section 190.15 of the Act concerning a corporation's capital deduction for purposes of the basic Part VI tax.

Under subsection 190.17(1) a corporation's capital deduction for a taxation year is $400 million. Where the corporation is related to another financial institution (other than a life insurer) at the end of the year, the corporation must share the capital deduction with other members of the related group. Under subsection 190.17(2) a related corporation may file with the Minister of National Revenue an agreement in prescribed form on behalf of the related group of financial institutions, allocating the $400 million deduction among the members of the group. If such an agreement is not filed, under subsection 190.17(3) the Minister may make such an allocation among the related financial institutions. Where a corporation is a member of two or more related groups, subsection 190.17(4) provides that the least amount allocated to the corporation under subsection 190.17(2) or (3) is the corporation's capital deduction for the year. In addition, subsection 190.17(4) provides that where related financial institutions fail to file an agreement and the Minister makes no allocation, no enhanced capital deduction is available to the members of the related group for the taxation year in question. Finally, the rules in subsections 190.15(5) (dealing with corporations having two or more taxation years in a calendar year) and (6) (relating to Crown corporations) of the Act are incorporated, with any necessary modifications, into new section 190.17 by virtue of subsection 190.17(5).

Section 190.17 applies to taxation years that end after February 27, 1995.

Clause 51

Tax in Respect of Over-Contributions to Deferred Income Plans

ITA
Part X.1

Subsection 204.1(2.1) of the Act imposes a penalty tax in respect of excess contributions made after 1990 to registered retirement savings plans (RRSPs). The amount of tax payable in respect of any month is 1% of an individual's cumulative excess amount at the end of the month.

An individual's cumulative excess amount is defined in subsection 204.2(1.1) of the Act to be the excess of the individual's undeducted RRSP premiums over the amount determined by the formula in paragraph 204.2(1.1)(*b*). In general terms, the amount determined by the formula is the amount of RRSP deduction room available to the individual *plus* a margin of $8,000 (if the individual is not a minor). An individual's undeducted RRSP premiums (as defined in subsection 204.2(1.2)) is the amount of contributions made by the individual to RRSPs after 1990 that have not been deducted or withdrawn.

The amendments to Part X.1 of the Act reduce the overcontribution margin from $8,000 to $2,000, and provide transitional relief for this change. They also provide an additional margin for certain group RRSP contributions, and defer the effect of past service pension adjustments (PSPAs). These amendments to Part X.1 apply for 1996 and subsequent taxation years.

Subclause 51(1)

Cumulative excess amount in respect of RRSPs

ITA
204.2(1.1)(*b*)

The portion of an individual's undeducted RRSP premiums at any time in a year that is subject to the Part X.1 tax is equal to the amount of those premiums minus the amount determined under paragraph 204.2(1.1)(*b*). Paragraph 204.2(1.1)(*b*) contains the following formula:

$$A + B - C + M$$

where

A = the amount of the individual's unused RRSP deduction room carried forward from the previous year,

B = the amount of new RRSP deduction room that becomes available to the individual in the year,

C = the amount of the individual's net past service pension adjustment (net PSPA) for the year, and

M = a margin of $8,000 if the individual is at least 18 years of age at the end of the previous year.

The formula in paragraph 204.2(1.1)(*b*) is amended in a number of ways. First, the overcontribution margin (amount M) is reduced from $8,000 to $2,000.

Second, the formula is amended to eliminate the deduction of net PSPA for the year (amount C). As a result, a PSPA will not cause RRSP contributions to become subject to the penalty tax in the year in which the PSPA arises. (However, PSPAs reduce the unused RRSP deduction room that is carried forward and thus are taken into account for penalty tax purposes in subsequent years.)

Third, the formula is amended to add an amount (amount R) in respect of group RRSP contributions. This group RRSP amount is determined under amended subsection 204.2(1.3). The purpose of this amount is to ensure that, within limits, non-discretionary contributions can be made to a group RRSP on the basis of current year earnings without being subject to penalty tax.

Fourth, the formula is amended to add a transitional amount (amount T). This amount, which is determined under new subsection 204.2(1.5), has the effect of exempting from the penalty tax RRSP contributions made before February 27, 1995 that would otherwise become subject to the tax because of the reduction in the margin from $8,000 to $2,000. This exemption applies until an individual has sufficient RRSP deduction room to deduct the contributions. There is no transitional amount for individuals who had not attained 18 years of age before 1995.

Finally, a technical amendment is made to the description of B in the formula. The amendment clarifies that, where an amount is prescribed in respect of an individual for a year for the purpose of amount B, the prescribed amount is subtracted in determining amount B.

These amendments to paragraph 204.2(1.1)(*b*) apply to 1996 and subsequent taxation years.

Subclause 51(2)

Undeducted RRSP premiums

ITA
204.2(1.2)

Subsection 204.2(1.2) of the Act contains rules for determining the amount of an individual's undeducted RRSP premiums. This amount enters into the computation of the individual's cumulative excess amount in respect of RRSPs under subsection 204.2(1.1).

Subsection 204.2(1.2) is amended to provide that it also applies for the purpose of computing an individual's group RRSP amount under amended subsection 204.2(1.3). Undeducted RRSP premiums are relevant in determining the group RRSP amount for 1996.

Subclause 51(3)

Group RRSP amount

ITA
204.2(1.3)

Subsection 204.2(1.3) of the Act contains rules for determining an individual's net past service pension adjustment (net PSPA) for the purpose of paragraph 204.2(1.1)(*b*). As a consequence of amendments to that paragraph, the rules in subsection 204.2(1.3) are replaced by rules for determining group RRSP amounts for the purpose of paragraph 204.2(1.1)(*b*). This amendment applies to 1996 and subsequent taxation years.

An individual's group RRSP amount for a year is the amount that is needed to ensure that Part X.1 tax does not apply in that year to certain non-discretionary group RRSP contributions made in the year. More specifically, an individual's group RRSP amount at any time in a year is the least of three amounts:

Amount 1: The lesser of

- the amount of the individual's "qualifying group RRSP premiums" (as defined in new subsection 204.2(1.31)) paid by the individual in the year and before that time, to the extent that these premiums are included in determining, under subsection 204.2(1.2), the individual's undeducted RRSP premiums, and

- the "RRSP dollar limit" for the following year (as defined in subsection 146(1)).

Amount 2: The amount determined by the formula

$$L - (E - F)$$

where

L = the amount determined as amount 1,

E = the sum of the individual's unused RRSP deduction room at the end of the preceding year and the new RRSP room that becomes available in the year (before reduction for PSPAs), and

F = if the year is 1997 or later, the individual's group RRSP amount at the end of the preceding year, and

= if the year is 1996, the amount by which the individual's undeducted RRSP premiums at the beginning of 1996 exceed the individual's cumulative excess amount at the end of 1995.

Amount 3: The amount that would be the individual's cumulative excess amount at that time if the individual's group RRSP amount were nil.

Amount 1 is the maximum amount of an individual's group RRSP contributions that may qualify for the special exemption from Part X.1 tax.

Amount 2 is the excess of the amount 1 contributions over the RRSP deduction room that is available in the current year after taking into account group RRSP contributions carried forward from the previous year for deduction in the current year. Although amount 2 will normally be smaller than amount 1, it can be larger. This would occur, for example, where the individual's unused RRSP deduction room at the end of the previous year is negative (because of PSPAs) and the new RRSP room that becomes available in the year is not sufficient to offset this negative amount and allow a full deduction of the group RRSP contributions carried forward from the previous year.

Amount 3 ensures that the group RRSP amount is no larger than is required to prevent Part X.1 tax from applying. Often, it will be the least of the three amounts, because it takes into account the $2,000 margin and payments made to the individual from RRSPs and registered retirement income funds (RRIFs). The reason for including the amount 3 limit is to restrict the amount that is taken into account as quantity F in determining amount 2 for the following year.

The following example illustrates the determination of an individual's group RRSP amount and cumulative excess amount.

EXAMPLE

Facts:

1995

- *Cumulative excess amount at the end of 1995 = 0*
- *Unused RRSP deduction room at the end of 1995 = 0*

1996

- *Undeducted RRSP premiums at the beginning of 1996 = $6,500*
- *RRSP contributions = $10,000*
- *New RRSP deduction room = $7,000*
- *RRSP contributions deducted = $7,000*

1997

- *RRSP contributions = $14,500*
- *New RRSP deduction room = $10,000*

All RRSP contributions are qualifying group RRSP premiums and are included in determining undeducted RRSP premiums. No payments are made to the individual out of an RRSP or RRIF. There are no PSPAs.

Results:

1996

1. *The individual's undeducted RRSP premiums at the end of December 1996 are $16,500, determined as the undeducted RRSP premiums at the beginning of the year ($6,500) plus the RRSP contributions made in the year ($10,000).*

2. *The individual's group RRSP amount at the end of December 1996 is $7,500, which is the least of amounts 1, 2 and 3:*

Amount 1

- *Qualifying group RRSP premiums* *$10,000*
- *RRSP dollar limit for 1997* *$13,500*
- *Lesser of these amounts* *$10,000*

Amount 2

L =	*Amount 1*	*$10,000*
E =	*Unused RRSP deduction room at end of 1995 (nil) plus new RRSP deduction room for 1996 ($7,000)*	*$7,000*
F =	*Undeducted RRSP premiums at beginning of 1996 ($6,500) less cumulative excess amount at end of 1995 (nil)*	*$6,500*
L - (E - F)		*$9,500*

Amount 3

- *Undeducted RRSP premiums at the end of 1996* *$16,500*

minus

- *Paragraph 204.2(1.1)(b) amount (assuming group RRSP amount is nil) = Total of unused RRSP deduction room at end of 1995 (nil), new RRSP deduction room for 1996 ($7,000), $2,000 margin and transitional amount (nil)* *$9,000*

= Cumulative excess amount at end of December 1996 (assuming group RRSP amount is nil) *$7,500*

3. *The individual's cumulative excess amount at the end of December 1996 is equal to amount 3 ($7,500) minus the group RRSP amount ($7,500). The result is nil.*

4. *In determining the individual's group RRSP amount at each time in the year, amount 1 is equal to the amount of the individual's qualifying group RRSP premiums paid to that time, amount 2 is equal to the amount of the premiums minus $500 ($7,000 - $6,500), and amount 3 is equal to the amount of the premiums minus $2,500 ($9,000 - $6,500). Thus, at all times in the year, amount 3 is the least amount and therefore, is the group RRSP amount. This means that the individual's group RRSP amount is nil until such time as the individual's qualifying group RRSP premiums in the year exceed $2,500. After that time, the group RRSP amount is equal to the amount of the excess.*

The individual's cumulative excess amount at each time in the year is equal to amount 3 (the cumulative excess amount assuming the group RRSP amount were nil) minus the group RRSP amount. Since amount 3 and the group RRSP amount are equal, the cumulative excess amount is nil at all times in the year and there is no Part X.1 tax payable in respect of any month in the year.

1997

5. *The individual's undeducted RRSP premiums at the end of December 1997 are $24,000, determined as the undeducted RRSP premiums at the end of 1996 ($16,500), minus the individual's RRSP deductions claimed for 1996 ($7,000), plus the RRSP contributions made in the year ($14,500).*

6. *The individual's group RRSP amount at the end of December 1997 is $12,000, which is the least of amounts 1, 2 and 3:*

Amount 1

• *Qualifying group RRSP premiums*	*$14,500*
• *RRSP dollar limit for 1998*	*$14,500*
• *Lesser of these amounts*	*$14,500*

Amount 2

L = Amount 1	*$14,500*
E = Unused RRSP deduction room at end of 1996 (nil) plus new RRSP deduction room for 1997 ($10,000)	*$10,000*
F = Group RRSP amount at the end of 1996	*$7,500*
L - (E - F)	*$12,000*

Amount 3

• *Undeducted RRSP premiums at the end of 1997*	*$24,000*
minus	
• *Paragraph 204.2(1.1)(b) amount (assuming group RRSP amount is nil) = Total of unused RRSP deduction room at end of 1996 (nil), new RRSP deduction room for 1997 ($10,000), $2,000 margin and transitional amount (nil)*	*$12,000*
= Cumulative excess amount at end of December 1997 (assuming group RRSP amount is nil)	*$12,000*

7. *The individual's cumulative excess amount at the end of December 1997 is equal to amount 3 ($12,000) minus the group RRSP amount ($12,000). The result is nil.*

8. *The group RRSP amount at the end of each other month in 1997 depends on the amount of qualifying group RRSP premiums paid in the year and before the end of the month. If the amount of such premiums does not exceed $2,500, the group RRSP amount is nil. If the amount of such premiums exceeds $2,500, the group RRSP amount is equal to the amount of the excess. There is no cumulative excess amount at the end of any month.*

Qualifying group RRSP premium

ITA
204.2(1.31)

New subsection 204.2(1.31) of the Act defines "qualifying group RRSP premium", which is relevant in determining an individual's group RRSP amount under amended subsection 204.2(1.3).

A qualifying group RRSP premium of an individual is the non-elective portion of an RRSP contribution made to an RRSP that is part of a "qualifying arrangement" (as defined in new subsection 204.2(1.32)), where:

- the contribution was remitted to the RRSP on behalf of the individual by a person who is required to remunerate the individual for services rendered, or by an agent for that person, and

- the contribution is an amount to which the individual is entitled for rendering services to that person, either as an employee or as a self-employed individual.

For this purpose, the elective portion of an individual's RRSP contribution is the portion of the contribution that the individual could have prevented from being paid to the RRSP, by making an election or exercising any other right under the arrangement (or by failing to do one of these things) after starting to participate in the arrangement and within 12 months preceding the payment. However, the elective portion does not include any amount that, had it not been

paid to the RRSP, would have been required to be remitted on behalf of the individual to another RRSP or to a money purchase provision of a registered pension plan.

EXAMPLE 1

An employer has established a group RRSP for its employees. Under the arrangement, the employer is required to withhold 3% of an employee's pay and to remit the amount to the employee's RRSP. The employee can elect at any time to increase the rate of contribution to 5%. The election can be rescinded at any time, in which case the contribution rate becomes 3% again. An employee has elected to have contributions made at the 5% rate. In this case, the portion of each contribution determined using a 3% contribution rate would be a qualifying group RRSP premium.

EXAMPLE 2

An employer has established a group RRSP for its employees. Upon commencing to participate in the arrangement, an employee must make an irrevocable election with respect to the percentage of pay to be contributed to his or her RRSP. All contributions under this arrangement would be qualifying group RRSP premiums.

New subsection 204.2(1.31) applies to 1996 and subsequent taxation years.

Qualifying arrangement

ITA
204.2(1.32)

New subsection 204.2(1.32) of the Act defines a "qualifying arrangement", which is relevant in determining whether an RRSP premium is a qualifying group RRSP premium under new subsection 204.2(1.31).

A qualifying arrangement is an arrangement under which amounts to which two or more individuals are entitled for services rendered to a person (either as employees or as self-employed individuals) are remitted to RRSPs on behalf of the individuals by that person or by

an agent of that person. However, an arrangement is not a qualifying arrangement if one of the main reasons for its existence is to reduce the amount of tax payable under Part X.1.

New subsection 204.2(1.32) applies to 1996 and subsequent taxation years.

Subclause 51(4)

Transitional amount

ITA
204.2(1.5)

New subsection 204.2(1.5) of the Act contains rules for determining an individual's transitional amount at any time. This amount enters into the computation, under subsection 204.2(1.1), of the individual's cumulative excess amount in respect of RRSPs after 1995.

The transitional amount provides an exemption from Part X.1 tax for RRSP contributions made before February 27, 1995 that would otherwise become subject to the tax after 1995 because of the reduction in the overcontribution margin from $8,000 to $2,000. The exemption applies until an individual has sufficient RRSP deduction room to deduct the contributions.

In general terms, an individual's transitional amount for a year is the lesser of $6,000 (the amount by which the margin has been reduced) and the amount needed to ensure that there is no penalty tax on the portion of the individual's pre-February 27, 1995 RRSP contributions that have not been deducted before the year. For this purpose, contributions are treated as being deducted in the order in which they are made.

The transitional amount of an individual at any time in a year depends on the balance of the individual's undeducted pre-February 27, 1995 RRSP contributions at that time. This balance is equal to

(a) the individual's undeducted RRSP premiums determined under subsection 204.2(1.2) with the following modifications:

- RRSP contributions made after February 26, 1995 are not included, and

- amounts received from RRSPs and RRIFs in respect of RRSP contributions made after February 26, 1995 are not subtracted

minus

(b) the total of the amounts deducted by the individual under subsections 146(5) and (5.1) for 1994 and subsequent years, to the extent that the deductions were in respect of RRSP contributions made after the year for which the deduction was claimed (and after February 26, 1995 in the case of a deduction claimed for 1994).

In most cases, the balance of an individual's undeducted pre-February 27, 1995 RRSP contributions at any time in a year will equal the contributions paid before February 27, 1995 that have not been deducted in previous years nor paid to the individual. However, if the individual makes any RRSP contributions after February 26, 1995 and deducts these contributions, the amounts so deducted are applied to reduce the balance. In the case of a contribution that is made in or before the year in which it is deducted, the reduction in the balance occurs through the application of subsection 204.2(1.2) (specifically, paragraph (*b*) of the description of H). For other contributions, namely those made in the 60 days following the year in which they are deducted, the deducted amounts are explicitly subtracted in the computation of the balance — this is quantity (b) in the above description.

If the balance of an individual's undeducted pre-February 27, 1995 RRSP contributions is nil, the transitional amount is also nil. Otherwise, the transitional amount is equal to the lesser of $6,000 and U - V, where

U = the balance of the individual's undeducted pre-February 27, 1995 RRSP contributions, and

V = the sum of the following amounts:

- the individual's unused RRSP deduction room carried forward from the previous year,

- the new RRSP room that becomes available to the individual in the year (before reduction for PSPAs), and

- $2,000.

The amount of unused RRSP deduction room being carried forward may be negative because of PSPAs in previous years. In this case, amount V may also be negative, with the consequence that the transitional amount exceeds the balance of undeducted pre-February 27, 1995 RRSP contributions (subject to the $6,000 cap).

The following examples illustrate the determination of an individual's transitional amount and cumulative excess amount.

EXAMPLE 1

Facts:

1995

- *Undeducted RRSP premiums at the beginning of 1995 = $8,000*
- *RRSP deduction limit = $14,500*
- *RRSP contributions = $14,500 paid in January 1995*
- *RRSP contributions deducted = $14,500*

1996

- *New RRSP deduction room = $13,500*
- *RRSP contributions = $7,500 paid in January 1996*

The individual deducts RRSP contributions in the order in which they are made. None of the contributions is deductible under a provision other than subsection 146(5). There are no contributions to which the special rules for group RRSPs apply. No payments are made to the individual out of an RRSP or RRIF. There are no PSPAs.

Results:

1. *The individual's transitional amount at all times in 1996 is nil. This amount is determined as follows:*

   (a) *Balance of undeducted pre-February 27, 1995 RRSP contributions throughout 1996*

Balance at beginning of 1995	*$8,000*
Add: RRSP contributions made in 1995 before February 27th	*$14,500*
Subtract: RRSP contributions deducted in 1995	*($14,500)*
Balance throughout 1996	*$8,000*

   (b) *Amount to be subtracted from (a)*

Unused RRSP deduction room carried forward from 1995	*nil*
Add: New RRSP deduction room for 1996	*$13,500*
Add: $2,000	*$2,000*
	$15,500

   (c) *Transitional amount throughout 1996*

= the lesser of (a) - (b) and $6,000	*nil*

2. *The individual's cumulative excess amount at the end of January 1996 is nil. This amount is determined as follows:*

(a) *Undeducted RRSP premiums at the end of January 1996*

Undeducted premiums at the beginning 1995	*$8,000*
Add: RRSP contributions made in 1995	*$14,500*
Subtract: RRSP contributions deducted in 1995	*($14,500)*
Add: RRSP contributions made in January 1996	*$7,500*
	$15,500

(b) *Amount determined under paragraph 204.2(1.1)(b) at the end of January 1996*

Unused RRSP deduction room carried forward from 1995	*nil*
Add: New RRSP deduction room for 1996	*$13,500*
Add: $2,000 overcontribution margin	*$2,000*
Add: Group RRSP amount	*nil*
Add: Transitional amount	*nil*
	$15,500

(c) *Cumulative excess amount = (a) - (b)* *nil*

Since the individual makes no further RRSP contributions in 1996, the individual's cumulative excess amount does not change throughout the year. Thus, no Part X.1 tax is payable in respect of any month in the year.

EXAMPLE 2

Facts:

1995

- *Undeducted RRSP premiums at the beginning of 1995 = $8,000*
- *RRSP deduction limit = $3,500*
- *RRSP contributions = $3,500 paid in January 1995*
- *RRSP contributions deducted = $3,500*

1996

- *New RRSP deduction room = $3,800*
- *RRSP contributions = 0*

The individual deducts RRSP contributions in the order in which they are made. None of the contributions is deductible under a provision other than subsection 146(5). There are no contributions to which the special rules for group RRSPs apply. No payments are made to the individual out of an RRSP or RRIF. There are no PSPAs.

Results:

1. *The individual's transitional amount at all times in 1996 is $2,200. This amount is determined as follows:*

   (a) *Balance of undeducted pre-February 27, 1995 RRSP contributions throughout 1996*

Balance at beginning of 1995	*$8,000*
Add: RRSP contributions made in 1995 before February 27th	*$3,500*
Subtract: RRSP contributions deducted in 1995	*($3,500)*
Balance throughout 1996	*$8,000*

   (b) *Amount to be subtracted from (a)*

Unused RRSP deduction room carried forward from 1995	*nil*
Add: New RRSP deduction room for 1996	*$3,800*
Add: $2,000	*$2,000*
	$5,800

   (c) *Transitional amount throughout 1996*

= the lesser of (a) - (b) and $6,000	*$2,200*

The transitional amount is the same throughout the year because no RRSP or RRIF payments are made to the individual in the year. (If RRSP or RRIF payments were made in respect of RRSP contributions made after 1990 and before February 27, 1995, the payments would reduce the balance of the individual's undeducted pre-February 27, 1995 RRSP contributions as well as the individual's transitional amount for the remainder of the year.)

2. *Since the individual makes no RRSP contributions after February 26, 1995 and receives no RRSP or RRIF payments, the amount of undeducted RRSP premiums throughout 1996 is the same as the balance of undeducted pre-February 27, 1995 RRSP contributions, that is, $8,000. The amount determined under paragraph 204.2(1.1)(b) of the Act is also $8,000. Thus, the cumulative excess amount is nil throughout the year and no Part X.1 tax is payable.*

EXAMPLE 3

Facts:

The facts in this example are the same as in example 2, except that the $3,500 RRSP contribution was made on February 28, 1995, rather than in January 1995.

Results:

1. *The individual's transitional amount at all times in 1996 is nil. This amount is determined as follows:*

   (a) *Balance of undeducted pre-February 27, 1995 RRSP contributions throughout 1996*

Balance at beginning of 1995	*$8,000*
Add: RRSP contributions made in 1995 before February 27th	*nil*
Subtract: RRSP contributions deducted in 1995	*($3,500)*
Balance throughout 1996	*$4,500*

(b) Amount to be subtracted from (a)

Unused RRSP deduction room carried forward from 1995	*nil*
Add: New RRSP deduction room for 1996	*$3,800*
Add: $2,000	*$2,000*
	$5,800

(c) Transitional amount throughout 1996

= the lesser of (a) - (b) and $6,000	*nil*

2. *The individual's cumulative excess amount at the end of January 1996 is $2,200. This amount is determined as follows:*

(a) Undeducted RRSP premiums at the end of January 1996

Undeducted premiums at the beginning of 1995	*$8,000*
Add: RRSP contributions made in 1995	*$3,500*
Subtract: RRSP contributions deducted in 1995	*($3,500)*
Add: RRSP contributions made in January 1996	*nil*
	$8,000

(b) Amount determined under paragraph 204.2(1.1)(b) at the end of January 1996

Unused RRSP deduction room carried forward from 1995	*nil*
Add: New RRSP deduction room for 1996	*$3,800*
Add: $2,000 overcontribution margin	*$2,000*
Add: Group RRSP amount	*nil*
Add: Transitional amount	*nil*
	$5,800

(c) Cumulative excess amount = (a) - (b) $2,200

Since the individual makes no RRSP contributions in 1996 and receives no RRSP or RRIF payments in the year, the individual's cumulative excess amount throughout the remainder of the year is the same as at the end of January. This means that the individual is subject to Part X.1 tax on the excess amount of $2,200 in respect of every month. If the individual were to withdraw the excess amount before the end of any month, there would be no tax payable in respect of that month or in respect of any subsequent month in the year.

Clause 52

Tax in Respect of Dispositions of Certain Properties

ITA
Part XI.2

Part XI.2 of the existing Act imposes a tax on institutions and public authorities that dispose of certain types of property in specific circumstances. The title to Part XI.2 is amended as a consequence of

the addition of new section 207.31 of the Act to that Part. Since new section 207.31 imposes a tax on charities and Canadian municipalities, the title to Part XI.2 is amended to remove the reference to institutions and public authorities.

This amendment applies after February 27, 1995.

Clauses 53 and 54

Dispositions of Donated Property - Penalty Tax

ITA
207.31 and 207.4

The addition of new section 207.31 and the amendment to section 207.4 relate to the new provisions regarding gifts of ecologically sensitive land in sections 110.1 and 118.1 of the Act.

New section 207.31 is added to the Act to impose a tax on charities and Canadian municipalities where they dispose of or change the use of property donated to them as an ecological gift without the approval of the Minister of the Environment. The tax is equal to 50% of the value of the property at the time of the disposition or change in use.

Subsection 207.4(1) of the Act requires an institution or public authority that is liable to tax under section 207.3 to file a return without notice or demand, to estimate the tax due and to pay the tax due. Subsection 207.4(1) is amended to extend this requirement to the tax payable under new subsection 207.31.

These amendments apply after February 27, 1995.

Clause 55

Tax on Non-Residents' Canadian Income

ITA
212

Section 212 of the Act imposes a tax of 25% (reduced by many treaties) on certain amounts paid or credited to non-residents by residents of Canada. Paragraph 212(1)(*h*) provides that superannuation and pension benefits are subject to withholding tax, with certain exceptions. Subparagraph 212(1)(*h*)(i) provides an exception for benefits under the Old Age Security Act, while an exception for Canada and Quebec Pension Plan benefits is provided under subparagraph 212(1)(*h*)(ii).

This amendment to paragraph 212(1)(*h*), which applies to payments made after 1995, repeals the two exceptions to the withholding tax contained in subparagraphs 212(1)(*h*)(i) and (ii). It implements the Minister of Finance's intention, announced in August and December of 1994, to make Old Age Security, Canada Pension Plan and Quebec Pension Plan benefits received by non-residents subject to Canadian tax.

Clause 56

Election by Non-Residents

ITA
217

Section 217 of the Act provides an election to a non-resident person who receives certain payments that are subject to non-resident withholding tax under Part XIII of the Act. Under this election, a non-resident may have such payments added in computing taxable income earned in Canada (or in the case of a part-year resident, added in computing taxable income). As a result, such payments will be subject to tax under Part I of the Act instead of Part XIII.

Where an election under section 217 is made, subparagraph 217(*b*)(i) and paragraph 217(*c*) require that Old Age Security, Canada Pension Plan and Quebec Pension Plan benefits that are not subject to tax under Part XIII of the Act be added to the individual's income. These provisions are amended, applicable to 1996 and subsequent taxation years, to remove the references that were required to add such benefits to income. These references are no longer necessary as a consequence of the amendment to subsection 212(1), which provides for the taxation of Old Age Security, Canada Pension Plan and Quebec Plan benefits under Part XIII. As well, the amendments to subparagraph 217(*b*)(i) update the form and language used in the subparagraph.

Clause 57

Withholding Taxes

ITA
227

Section 227 of the Act provides special rules relating to source deductions and non-resident withholding tax under sections 153 and 215 of the Act, respectively, and also deals with the application of certain Parts of the Act to certain persons and entities.

ITA
227(5) and (5.1)

New subsections 227(5) and (5.1) of the Act expand the joint and several liability rules contained in subsections 153(1.3) and (1.4) of the Act which are repealed. The new rules in subsections 227(5) and (5.1) continue to provide that a person who has influence over the property or affairs of another person and who authorizes or causes certain payments to be made by the other person that are subject to deductions at source, is deemed to have made the payment and is jointly and severally liable with the other person for any amount payable under the Act in respect of these payments and for any amount payable in respect of the failure to deduct and remit the amount payable under the Act. The effect of the rules is to secure

the payment of source deductions and to share the responsibility of deducting and remitting taxes payable at source with persons with influence to cause or authorize the payment subject to tax at source.

For example, in cases of financial difficulty, the controls put in place by a secured creditor may be such that payments by an employer have to be approved by the secured creditor before the funds are extended. In such circumstance, it is intended that an extension of credit by the secured creditor to meet net payroll obligations would usually make the secured creditor subject to the rule in subsection 227(5) where source deductions have not been duly remitted.

The new rules clarify that joint and several liability extends to persons not acting in a fiduciary capacity as well as to a person acting with another person. In addition, influencing disbursements is added as an activity which may attract joint and several liability. Interim receivers, secured creditors, monitors and their agents are specifically added to the list of specified persons subject to joint and several liability. In addition, source deductions in respect of payments subject to tax under Part XIII of the Act are subject to the new rules. The joint and several liability will now extend to all amounts payable because of any failure to deduct at source and, in particular, to the obligations to pay interest and penalties for any failure to comply with subsections 135(3) or 153(1), or section 215 of the Act. A specific right to recover amounts paid by the specified person on behalf of the payor is provided in paragraph 227(5)(*c*).

ITA
227(5.2)

New subsection 227(5.2) of the Act provides a new rule for imposing joint and several liability on certain secured creditors who interfere with the remittance of source deductions. Under this new rule it need not be established that a secured creditor actually causes or authorizes a payment - which is subject to source deduction - before joint and several liability arises. It is sufficient to show that an amount is deducted at source from a payment (hereafter referred to as a "gross payment") that the secured creditor has influence over the issuance or clearance of that gross payment and that the secured creditor exercises that influence for the purpose of interfering with the remittance of source deductions. Interference may take place by way

of postponing a remittance, subordinating a remittance in favour of another payment or simply causing a remittance not to be made.

A typical example is the situation of a financial institution that has influential control over a person and that, in the course of providing banking services to the person (usually in financial difficulty) who is liable to deduct certain amounts from the remuneration of its employees, interferes with the remittance of these deductions by preventing the issuance of, stopping or refusing to clear a remittance cheque made to the Receiver General while issuing, clearing, or honouring other cheques made to suppliers or other creditors. This might be done in order to enhance trade receivables and limit the secured creditor's own risks.

Generally, it is not intended that the refusal of a cheque or other means of payment for lack of sufficient funds or other legitimate banking reasons be regarded as influence that is exercised for the purpose of interfering with the payment of source deductions. However, it is intended that a secured creditor that refuses to extend credit in respect of a source deduction payment and that subsequently extends credit in respect of other similar payments made to another party, be considered as exercising influence for the purpose of interfering with source deductions.

Where the circumstances described in new subsection 227(5.2) exist, the secured creditor will be deemed to have made the payment and will become jointly and severally liable with the person making the gross payment to pay all amounts payable in respect of the gross payment and all amounts payable by that person for the failure to deduct and remit the amounts payable. This will include the amount of tax not remitted, interest, and penalties. However, exceptions to this rule are contained in new subsections 227(5.3) and (5.4) of the Act. A specific right to recover amounts paid by the secured creditor on behalf of the person making the gross payment is provided in paragraph 227(5.2)(*f*).

ITA
227(5.3) and (5.4)

New subsections 227(5.3) and (5.4) of the Act provide certain exceptions to the joint and several liability rules which apply to secured creditors. Subsection 227(5.3) deals with the case in which a cheque or other means of payment is stopped or refused by the secured creditor. Joint and several liability will not arise in this case if the secured creditor also stops or refuses all other cheques presented and payments made starting immediately after that day, except cheques or payments made to the Receiver General or cheques certified on or before that day. Using the example of the financial institution that stops a remittance cheque (referred to in the commentary on subsection 227(5.2)), no joint and several liability would arise if the financial institution were to stop or refuse (until payment in full of the amount to be paid or remitted) all other cheques made to any other creditor of the person and presented at any time after the day on which it stopped the cheque payable to the Receiver General.

Similarly, new subsection 227(5.4) provides relief from joint and several liability where a person does not make any other payment or disbursement at or after the time the secured creditor exercises influence in respect of an amount to be paid or remitted by the person to the Receiver General.

New paragraph 227(5.4)(*b*) provides, for greater certainty, that a refusal by a secured creditor to continue to supply property or services because of the non-payment for such property or services will not give rise to joint and several liability.

Under new paragraph 227(5.4)(*c*), court actions such as collection and conservation measures will not be regarded as exercising influence for the purpose of interfering with a remittance. In addition, where a court orders a secured creditor to make a payment in priority to a remittance, the secured creditor will not be regarded as having exercised influence for the purpose of interfering with a remittance.

ITA
227(5.5)

New subsection 227(5.5) of the Act clarifies that a partnership is considered to be a person for the purposes of new subsections 227(5) to (5.4).

The amendments to subsection 227 apply after Royal Assent.

Clause 58

Judicial Authorization - Third Party Information

ITA
231.2(3) and (6)

The Minister of National Revenue must, pursuant to subsection 231.2(2) of the Act, obtain judicial authorization before imposing a requirement that a person provide information related to unnamed third parties. Subsection 231.2(3) sets out the conditions that must be met before such judicial authorization is granted. Paragraphs 231.2(3)(*c*) and (*d*) are repealed in order to simplify those conditions. Following the amendments to subsection 231.2(3), a judge may grant the Minister authorization to impose on a person a requirement that information be provided on an unnamed third party or a group of unnamed persons, subject to such conditions that the judge considers appropriate, if the judge is satisfied that the person or group is ascertainable and that the requirement is made to verify compliance with the Act. The amendment to subsection 231.2(6) of the Act is consequential upon the repeal of paragraphs 231.2(3)(*c*) and (*d*).

These amendments apply after Royal Assent.

Clause 59

Communication of Information

ITA
241(4) and (10)

Unless specifically authorized by the section, section 241 of the Act prohibits a government official from using or communicating any taxpayer information. Subsection 241(4) specifies certain situations where such information may be communicated. This subsection is amended to allow a government official to provide the business number, name, address, telephone number and facsimile number of the holder of the business number to another official of a government department for the purpose of administering an Act of Parliament or a law of a province. This information can be provided only if the holder of the business number is required to provide the information to that government department under that Act of Parliament or provincial law. Under amended subsection 241(10), the definition of "business number" means the number used by the Minister of National Revenue to identify a corporation or partnership, or certain associations or taxpayers.

These amendments apply after Royal Assent.

Clause 60

Definitions

ITA
248

Subsection 248(1) of the Act defines a number of terms which apply for the purposes of the Act, and sets our various rules relating to the interpretation and application of various provisions of the Act.

Subclause 60(1)

ITA
248(1)

"fiscal period"

The definition of "fiscal period" is amended and moved to new section 249.1 of the Act. Accordingly, the definition in subsection 248(1) of the Act is repealed. This amendment applies to fiscal periods that begin after 1994.

Subclause 60(2)

"filing-due date"

Subsection 248(1) of the Act is amended to add the definition of "filing-due date". A taxpayer's filing-due date for a taxation year is the day on or before which the taxpayer's return of income under Part I is required to be filed for the year or would be required to be filed if tax under that Part were payable by the taxpayer for the year.

For example, an individual's filing-due date for a taxation year (a calendar year) is generally April 30 of the following year.

This amendment applies after 1993.

"professional corporation"

The definition of "professional corporation" means a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor. This definition, which is relevant for the purpose of the definition of "fiscal period" in new subsection 249.1(1) of the Act, applies after 1994.

"scientific research and experimental development"

The new definition of "scientific research and experimental development" replaces the definition found in existing subsection 37(7) of the Act. The new definition excludes work in respect of information technology carried on by or on behalf of members of restricted financial institutions, restricted securities

dealers and certain entities in which a restricted financial institution or restricted securities dealer has a direct or indirect interest.

The effect of this exclusion is to prohibit any taxpayer from claiming any SR&ED tax incentives under section 37 or 127 of the Act in respect of such work. For example, a corporation that performs information technology SR&ED for a bank would not be permitted to claim any deduction under section 37 or any ITC in respect of expenditures incurred by it in the performance of the R&D.

The new definition applies to work performed after February 27, 1995. However, for the purposes of paragraphs 149(1)(*j*) and (8)(*b*) of the Act, the new definition does not apply to work performed pursuant to an agreement in writing entered into before February 28, 1995.

Subclause 60(3)

ITA
248(28)

New subsection 248(28) of the Act replaces subsection 4(4) of the Act. Subsection 4(4) generally provides that, unless a contrary intention is evident, no provision should be interpreted to require an amount to be included or deducted more than once in computing a taxpayer's income.

New subsection 248(28) applies to taxation years that end after July 19, 1995. This subsection is broader in scope than subsection 4(4) and is intended to prevent double inclusions or double deductions of an amount in computing income, loss, taxable income, or taxable income earned in Canada or tax payable under any Part of the Act.

It is intended that, where an amount is deducted for a taxation year that is statute-barred and has not been disallowed, the same amount may not be deducted again for a subsequent taxation year (including any year in which it was actually deductible).

Clause 61

Definition - "fiscal period"

ITA
249.1

New section 249.1 of the Act amends the definition of "fiscal period" which was previously in subsection 248(1) of the Act.

New paragraph 249.1(1)(*b*) introduces new restrictions on the timing of fiscal periods. In the case of a business of an individual (other than a testamentary trust or an individual who is exempt from tax because of section 149 or 149.1 of the Act), new subparagraph 249.1(1)(*b*)(i) of the definition provides that where certain conditions exist, a fiscal period may not end after the end of the calendar year in which the period began unless the business is not carried on in Canada. This subparagraph does not, however, apply to a business where the business is carried on by an individual who elects to have the alternative fiscal-period method in new subsection 249.1(4) apply.

New subparagraph 249.1(1)(*b*)(ii) applies to a fiscal period of a partnership if

- an individual (other than a testamentary trust or an individual that is exempt from tax under sections 149 or 149.1),
- a professional corporation, or
- a partnership to which this subparagraph applies

would, if the fiscal period ended at the end of the calendar year in which the period began, be a member of the partnership in the period (unless it is a fiscal period of a business not carried on in Canada). This subparagraph does not, however, apply to a partnership if the partners elect to have the alternative fiscal-period method in new subsection 249.1(4) apply.

In the case of a professional corporation, new subparagraph 249.1(1)(*b*)(iii) provides that its fiscal period cannot end after the end of a calendar year in which the fiscal period began

where the corporation would, if its fiscal period ended at the end of the calendar year in which that period began, be in that period a member of a partnership.

For the purpose of this definition, the activities of a person that is either exempted from tax by section 149 or is a registered charity under section 149.1 are deemed to be a business.

This amendment applies to fiscal periods that begin after 1994.

Not a Member of a Partnership

ITA
249.1(2)

New subsection 249.1(2) of the Act provides that a person or partnership is not, for the purpose of new subparagraph 249.1(1)(*b*)(ii) of the definition of "fiscal period" or new subsection 249.1(4), considered to be a member of a partnership in a fiscal period where the person or partnership would not have a share of any income or loss of the other partnership for the fiscal period if the fiscal period ended at the end of the calendar year in which it began.

This amendment applies to fiscal periods that begin after 1994.

Subsequent Fiscal Periods

ITA
249.1(3)

New subsection 249.1(3) of the Act provides that, where a fiscal period of a business or property of a person or partnership ends at the end of a calendar year, each subsequent fiscal period of the business or property of the person or partnership shall coincide with a calendar year unless new subsection 249.1(7) applies. Where a business of a person or partnership is disposed of to another person or partnership, the fiscal period of the business may change consistent with the application of new subsection 249.1(1) to the purchaser.

This amendment applies to fiscal periods that begin after 1994.

Alternative Fiscal-Period Method

ITA
249.1(4)

New subsection 249.1(4) of the Act provides that the December 31 fiscal period year end requirement in new paragraph 249.1(1)(*b*) does not apply in certain circumstances to a fiscal period of a business carried on by individuals.

New subsection 249.1(4) can apply to a fiscal period of a business carried on, throughout the period of time that began at the beginning of the fiscal period and ended at the end of the calendar year in which the period began, by

- an individual (otherwise than as a member of a partnership), or
- an individual as a member of a partnership, if throughout that period
  - each member of the partnership is an individual, and
  - the partnership is not a member of another partnership.

The business of such an individual (other than an individual who carries on the business as a member of a partnership another member of which is a testamentary trust) does not have to end on December 31 if the individual

- elects in prescribed form to have the "December 31 fiscal-period method" in paragraph 249.1(1)(*b*) not apply, and
- files the election in prescribed form with Revenue Canada by the individual's filing-due date, and with the individual's return of income for the taxation year that includes the first day of the first fiscal period of the business that begins after 1994.

In the case of an individual who carries on a business as a member of a partnership another member of which is a testamentary trust, the time for filing the above-described election is the earliest of the filing-due dates of the members of the partnership. The commentary

on amended subsection 96(3) of the Act discusses special rules that apply to elections filed by members of partnerships.

EXAMPLES:

1. Where election permitted.

Len joins a business as a member of a partnership on July 1, 1996. The only other member of the partnership is a testamentary trust that has a taxation year that ends on November 30, 1996.

The fiscal period of the business begins on July 1, 1996 and both members of the partnership want to have the first fiscal period of the business end on June 30, 1997.

Len's filing-due date for the taxation year in which the business began is June 15, 1997 under paragraph 150(1)(d). The testamentary trust's filing-due date for its taxation year is February 28, 1997 under paragraph 150(1)(c) (i.e., 90 days after the end of the taxation year). Accordingly, Len and the testamentary trust must file their election under this subsection with Revenue Canada by the earliest of those filing-due dates (i.e., February 28, 1997).

2. Where election not permitted.

Dorothy begins to carry on a business on July 1, 1996 as a member of Partnership A. The only other member of the partnership is Partnership B (all the members of which are individuals).

Partnership A must have a fiscal period that ends at the end of 1996 because not all of its members are individuals (i.e., the existence of Partnership B's membership in Partnership A precludes Dorothy and the individual members of Partnership B from electing to have an off-calendar fiscal period for Partnership A).

Partnership B must also have a fiscal period that ends at the end of the calendar year 1996 because it is a member of another partnership (i.e., Partnership A).

This amendment applies to fiscal periods that begin after 1994.

Alternative Method Not Applicable to Tax Shelters

ITA
249.1(5)

New subsection 249.1(5) of the Act provides that the "alternative fiscal-period method" in subsection 249.1(4) does not apply in the case of a business the expenditures of which are, or were, primarily tax shelters.

This amendment applies to fiscal periods that begin after 1994.

Revocation of Election

ITA
249.1(6)

New subsection 249.1(6) of the Act provides that, where an individual elected under subsection 249.1(4) to have an off-calendar fiscal period in respect of a business, the individual may subsequently revoke (in prescribed form) that election for future fiscal periods. The commentary on amended subsection 96(3) of the Act comments on the rules that apply to elections filed by members of a partnership.

This amendment applies to fiscal periods that begin after 1994.

Change of Fiscal Period

ITA
249.1(7)

New subsection 249.1(7) of the Act provides that no change in the time at which a fiscal period ends may be made without the concurrence of Revenue Canada. If Revenue Canada concurs in a request for a change in the fiscal period of a business, any subsequent fiscal period will remain subject to the rules in new subsection 249.1(1) unless that fiscal period is exempted from such rules because of an election filed under new subsection 249.1(4) for the taxation year in which the business began or 1995 (whichever is later). Where, for example, a business of an individual has a fiscal period otherwise ending on December 31, 1996 because of new paragraph 249.1(1)(*b*), or new subsection 249.1(3), and the individual

requests that the fiscal period end on an earlier day in 1996, Revenue Canada may concur in that request, but the business will still have another 1996 fiscal period ending on December 31 of that year because of new paragraph 249.1(1)(*b*). In addition, because of new subsection 249.1(3) the business will have a fiscal period end on December 31 of any subsequent year.

This amendment applies to fiscal periods that begin after 1994.

Clause 62

Interest Rate - Unpaid Excise Duty

Excise Act
110.1(1)(*b*)

Subsection 110.1(1) of the *Excise Act* provides that, where duty under the Act is not paid on time, the person liable to pay duty shall pay a penalty equal to half of one per cent of the duty for each month that the payment is late plus interest at the rate prescribed under the *Income Tax Act* to be charged on unpaid tax. It was announced in the 1995 federal budget that the rate to be charged on unpaid tax under the *Income Tax Act* would be increased by two percentage points. Subsection 110.1(1) of the *Excise Act* is amended to provide that the interest rate to be charged under the subsection will be the rate prescribed from time to time for refunds of overpayments of tax under the *Income Tax Act*. The rate of penalty under the section will remain unchanged.

This amendment applies to interest that is calculated in respect of periods after June 1995.

Clause 63

Judicial Authorization - Third Party Information

Excise Tax Act
102.1(2) and (5)

The Minister of National Revenue must, pursuant to subsection 102.1(1) of the *Excise Tax Act*, obtain judicial authorization before imposing a requirement that a person provide information on unnamed third parties. Subsection 102.1(2) of that Act sets out the conditions that must be met before such judicial authorization is granted. Paragraphs 102.1(2)(*c*) and (*d*) are repealed in order to simplify those conditions. Following the amendments to subsection 102.1(2), a judge may grant the Minister authorization to impose on a person a requirement that information be provided on an unnamed third party or a group of unnamed persons, subject to such conditions that the judge considers appropriate, if the judge is satisfied that the person or group is ascertainable and that the requirement is made to verify compliance with the Act.

The amendment to paragraph 102.1(5)(*a*) of the *Excise Tax Act* is consequential upon the repeal of paragraphs 102.1(2)(*c*) and (*d*) of that Act.

These amendments apply after Royal Assent.

Clause 64

Definition - "taxation year"

Excise Tax Act
123(1)

Subsection 123(1) of the *Excise Tax Act* contains definitions that apply throughout Part IX of that Act relating to the goods and services tax.

The legislation generally defines "taxation year" of a person as being the person's taxation year for federal income tax purposes. Where the person is not a person for income tax purposes

(e.g., a partnership), the taxation year is defined as being the period that would be the person's taxation year for income tax purposes if the person were a corporation. (i.e., the fiscal period chosen for income tax purposes, which may not coincide with the calendar year.)

The amendment to the definition of "taxation year" in the *Excise Tax Act* is consequential on amendments to the *Income Tax Act* which, among other things, generally require that the fiscal periods of individuals, partnerships and professional corporations coincide with the calendar year (reference may be made to the commentary on new section 249.1 of the *Income Tax Act* for further details).

This amendment applies to fiscal periods that begin after 1994.

Clause 65

Remittance

Excise Tax Act
228(2)

Subsection 228(1) of the *Excise Tax Act* provides that a person required to file a goods and services tax return is to report in the return the net tax for the person's reporting period covered by that return. Where the person's net tax is a positive amount, subsection 228(2) of the *Excise Tax Act* provides that the amount is to be remitted not later than the last day for filing the return in question.

The amendment to subsection 228(2) is consequential on the amendment to paragraph 238(1)(*a*) of the *Excise Tax Act* which extends, for eligible registrants, the filing-due date of annual returns to June 15 of the following year. The amendment provides that, in such cases, the net tax has to be remitted by April 30 of that following year.

This amendment applies to reporting periods that begin after 1994.

Clause 66

Filing Requirements

Excise Tax Act
238(1)(*a*)

Subsection 238(1) of the *Excise Tax Act* requires every registrant to file a goods and services tax (GST) return with the Minister for each reporting period of the registrant. Where a registrant is on an annual reporting basis, the return has to be filed within 3 months after the end of the registrant's fiscal year.

The amendment to paragraph 238(1)(*a*) provides that, where the registrant is an individual whose reporting period is a calendar year and who, for income tax purposes, carried on a business in the year and had a filing-due date of June 15 of the following year, the filing-due date of the registrant's (GST) return for the year is also June 15 of the following year. It also clarifies that the reference in that paragraph to a reporting period that would be a fiscal year includes the reporting period that would be a fiscal year except for the fact that subsection 251(1) of the *Excise Tax Act* provides specific rules that, in some cases, trigger shorter reporting periods for persons upon becoming registrants.

This amendment applies to reporting periods that begin after 1994.

Clause 67

Communication of Information

Excise Tax Act
295(1) and (5)

Unless specifically authorized by the section, section 295 of the *Excise Tax Act* prohibits a government official from using or communicating any taxpayer information. Subsection 295(5) specifies certain situations where such information may be communicated. This subsection is amended to allow a government official to provide the business number, name, address, telephone number and facsimile number of the holder of the business number to

another official of a government department for the purpose of administering an Act of Parliament or a law of a province. This information can be provided only if the holder of the business number is required to provide the information to that government department under that Act of Parliament or provincial law. Under amended subsection 295(1), the term "business number" refers to the number used by the Minister of National Revenue to identify a person who is a registrant for purposes of the goods and services tax (GST). The number is also used to identify applicants (other than individuals) for GST rebates.

These amendments apply after Royal Assent.

Clause 68

Interference with Remittance

Excise Tax Act
323.1

New section 323.1 of the *Excise Tax Act* parallels the joint and several liability rules in new subsections 227(5.2) to (5.4) of the *Income Tax Act*. New section 323.1 of the *Excise Tax Act* applies to a secured creditor (as defined by subsection 317(4) of the *Excise Tax Act*) who has influence over the issuance or clearance of a payment or remittance of net tax or other amount required to be paid or remitted by a registrant under Part IX of the *Excise Tax Act* other than tax payable by the registrant on the registrant's own purchases or importations. However, this section applies only where the secured creditor exercises that influence for the purpose of interfering with the payment or remittance either by way of postponing it, subordinating it in favour of another payment, or simply causing the payment or remittance not to be made.

For example, a financial institution that provides banking services to a person who is liable to remit an amount of net tax might interfere with the remittance by stopping or refusing to clear a remittance cheque made to the Receiver General while subsequently honouring cheques made to other creditors. This might be done in order to enhance trade receivables and limit the financial institution's own risks.

Where the circumstances described in new subsection 323.1(1) exist, the secured creditor will become jointly and severally liable with the person to pay or remit to the Receiver General the amount in respect of which the creditor has exercised influence and all other amounts payable because of the failure to make the payment or remittance when required. A specific right to recover from the person any amounts paid by the secured creditor on account of this liability is provided in paragraph 323.1(1)(*e*).

New subsections 323.1(2) and (3) provide exceptions to the joint and several liability rules which apply to secured creditors. Subsection 323.1(2) deals with the case where a cheque or other means of payment is stopped or refused by the secured creditor on any given day. Joint and several liability will not arise in this case if the secured creditor also stops or refuses, starting immediately after that day, all other cheques presented and payments made, except cheques or payments made to the Receiver General or cheques certified on or before that day. Using the example of the financial institution that stops a remittance cheque as referred to above, no joint and several liability would arise if the financial institution were to stop or refuse, until payment in full of the amount to be paid or remitted, all other cheques made to any other creditor of the person that are presented after the day during which the cheque made to the Receiver General was stopped.

Similarly, new subsection 323.1(3) provides relief from joint and several liability where the person does not make any other payment or disbursement at or after the time the secured creditor exercises influence in respect of an amount to be paid or remitted by the person to the Receiver General.

New paragraph 323.1(3)(*b*) provides, for greater certainty, that a refusal by a secured creditor to continue to supply any further property or services to the person until payment for supplies made by the secured creditor to the person is received by the secured creditor will not entail joint and several liability.

Under new paragraph 323.1(3)(*c*), court actions such as collection and conservation measures by secured creditors will not be regarded as exercising influence not to remit. In addition, where a court orders a secured creditor to make a payment in priority to a remittance, the

secured creditor will not be regarded as having exercised influence for the purpose of interfering with the remittance.

New paragraph 323.1(3)(*d*) provides an exception to the rules under subsection 323.1(1) in the case of a bankruptcy. Specifically, it provides that the joint and several liability does not apply after the day a person becomes bankrupt except with respect to amounts arising solely from activities that the person begins to engage in on or after that day and that are unrelated to the bankruptcy.

Under new subsection 323.1(4), the Minister of National Revenue has authority to assess any person for any liability of the person arising under this new section. In addition, the notice of objection and appeal provisions in sections 296 to 311 of the *Excise Tax Act* are made applicable to such assessments.

Section 323.1 applies after Royal Assent.

Clause 69

Transitional Provisions - Persons entitled to retain non-calendar fiscal periods

As a consequence of amendments to the *Income Tax Act*, the fiscal periods of the businesses of certain individuals, partnerships and professional corporations that would have otherwise straddled December 31, 1995 are deemed to end on that day (reference may be made to the commentary on new section 249.1 of the *Income Tax Act* for further details). An exception is provided to enable eligible persons to retain non-calendar fiscal periods by filing an election on or before the filing-due date for their 1995 income tax return.

The *Excise Tax Act* specifically allows an individual or trust that carries on a business with a fiscal period, for income tax purposes, that differs from the individual's or trust's taxation year, to elect to have the fiscal year for GST purposes coincide with the fiscal period of the business. This GST election must be filed before the beginning of the fiscal period since it is necessary for registrants to identify their reporting periods at the beginning of their fiscal year. However, they have until after the end of the fiscal period to decide on their fiscal year-end and file an election for income tax purposes.

The transitional rule recognizes this timing difference by deferring -- from the end of 1995 to the end of 1996 -- the effect, for GST purposes, of the above-mentioned income tax amendments for persons eligible to make the income tax election. Therefore, if such a GST registrant's fiscal year beginning in 1995 would have ended in 1996 based on the existing income tax rules, the registrant's GST reporting periods during that fiscal year will not be affected by the income tax amendments. Subsequently, the registrant's reporting periods will be determined as if the income tax changes took effect in 1996 meaning that the registrant will have a December 31, 1996 year-end and thereafter have fiscal years that coincide with the calendar year.

Clause 70

Transitional Provisions - Financial Institutions

Paragraph 149(1)(*b*) of the *Excise Tax Act* provides a *de minimis* test for determining whether persons earning a significant amount of investment income or income from separate fees or charges for financial services are considered to be financial institutions for purposes of the goods and services tax (GST). A registrant is considered to be a financial institution if such income from financial services exceeded $10 million in its preceding taxation year (determined on a prorated basis for short taxation years). For GST purposes, the taxation year of corporations and partnerships, is the fiscal period of the business of the corporation or partnership.

As a consequence of amendments to the *Income Tax Act*, the fiscal periods of the business of certain corporations and partnerships that would have otherwise straddled December 31, 1995 are deemed to end on that day (reference may be made to the commentary on new section 249.1 of the *Income Tax Act* for further details). An exception is provided to enable eligible persons (which include certain partnerships) to retain non-calendar fiscal periods.

Where an eligible partnership chooses not to make the income tax election to retain non-calendar fiscal periods, the transitional rule under Clause 69 provides that, for GST purposes, the deemed December 31 year-end will occur in 1996 instead of 1995. This means that the partnership would have a short fiscal period, for GST purposes, that begins in 1996 and ends on December 31, 1996. In

the absence of any special rules, the test of whether the partnership is considered to be a financial institution in 1997 would be based on this short period which might not be a representative period. Therefore, the transitional rule in subclause 70(1) ensures that such a partnership will be treated as a financial institution throughout 1997 by reason of the *de minimis* rule only if it is treated as such throughout its short year (based on GST fiscal year ending immediately before the short year) or if it has income from financial services in excess of $10 million in that short year.

Subclause 70(2) provides a similar transitional rule for partnerships and corporations which are not entitled to make the income tax election to retain non-calendar fiscal periods. However, in these cases, the modified *de minimus* test applies for the purpose of determining the partnership's or corporation's status as a financial institution throughout its taxation year beginning on January 1, 1996 since their short taxation year for both income tax and GST purposes ends on December 31, 1995.

These provisions do not apply to individuals because their taxation year is always the calendar year.

Clause 71

Transitional Provisions - Threshold amount

Subsection 249(1) of the *Excise Tax Act* sets out the formula for determining a person's "threshold amount" for the purpose of establishing that person's reporting periods under the goods and services tax. Generally speaking, it is calculated by reference to the total value of the consideration for taxable supplies paid or becoming due to that person in the immediately preceding fiscal year. (Where the preceding fiscal year is less than 12 months, the value of the consideration is grossed up proportionately.) In determining that threshold amount, a person's own taxable supplies are aggregated with those of associated persons.

As a consequence of amendments to the *Income Tax Act*, the fiscal year of certain persons that would have otherwise straddled December 31, 1995 is deemed to end on that day (reference may be made to the commentary on new section 249.1 of the *Income Tax Act*

for further details). Accordingly, that taxation year has less than 365 days. This transitional provision provides special rules for determining the threshold amount in those situations. The person's threshold amount for the fiscal year commencing on January 1, 1997 for those who could have elected to retain their non-calendar year fiscal period and on January 1, 1996 for all others, is the greater of the two following amounts:

(1) the total consideration for taxable supplies (other than the exceptions set out in the formula under subsection 249(1)) becoming due or paid to the person (and the person's associates) in the preceding year without any gross-up, and

(2) the threshold amount for that short fiscal year - determined in the usual manner on the basis of the consideration becoming due or paid to the person (and the person's associates) in the year ending immediately before the short fiscal year.

Clause 72

Interest Rate on Unpaid Assessments

OSFI Act
23(7)

Subsection 23(7) of the *Office of the Superintendent of Financial Institutions Act* provides a method of determining the rate of interest to be charged on unpaid amounts of assessments made under subsections 23(3) and (4) of that Act against financial institutions. The rate is determined by adding 2% to the rate prescribed under the *Income Tax Act* to be charged on unpaid tax. Subsection 23(7) is amended to provide that the rate to be charged under the subsection will be 2% higher than the rate prescribed from time to time for interest on refunds of overpayments of tax under the *Income Tax Act*. This amendment applies to interest that is calculated in respect of periods after June 1995.

Clause 73

Conditional Amendment

OSFI Act
23(7)

Section 10 of Schedule III to *An Act to amend the Financial Administration Act and other Acts in consequence thereof*, chapter 24 of the Statutes of Canada, 1991, amends subsection 23(7) of the *Office of the Superintendent of Financial Institutions Act* (*OSFI Act*). This rule ensures that if *An Act to amend the Financial Administration Act and other Acts in consequence thereof* is passed before this Act, that subsection 23(7) of the *OSFI Act* is amended in accordance with clause 72 (above) rather than section 10 of Schedule III of *An Act to amend the Financial Administration Act and other Acts in consequence thereof.*

Clause 74

Provision of Information

Old Age Security Act
33(2)

Paragraph 33(2)(*a*) of the *Old Age Security Act* permits the provision of information to various government departments and associated agencies where such information is necessary for the administration of that Act.

Paragraph 33(2)(*a*) is amended, effective on Royal Assent, to permit the provision of such information where it is necessary for the administration of the *Income Tax Act*. This amendment is consequential on the amendments in this bill dealing with the recovery of Old Age Security benefits.

Clause 75

Interest Rate on claims against Ship Owners

Can. Shipping Act
723(1)

Subsection 723(1) of the *Canada Shipping Act* provides that interest accrues on claims under Part XVI of that Act (Civil Liability and Compensation for Pollution) at the rate prescribed under the *Income Tax Act* for late payment or overpayment of tax. Subsection 723(1) is amended to provide that the rate that accrues under the subsection will be the rate prescribed for interest on refunds of overpayments of tax under the *Income Tax Act.* This amendment applies to interest that is calculated in respect of periods after June 1995.

DRAFT *INCOME TAX REGULATIONS*

Scientific Research and Experimental Development

1. (1) The portion of subsection 2900(1) of the Income Tax Regulations before paragraph (*a*) is replaced by the following:

(1) For the purposes of this Part and the definition "scientific research and experimental development" in subsection 248(1) of the Income Tax Act, "scientific research and experimental development" means systematic investigation or search carried out in a field of science or technology by means of experiment or analysis, that is

(2) Subsection (1) applies to work performed after February 27, 1995 except that, for the purposes of paragraphs 149(1)(*j*) and (8)(*b*) of the Act, subsection (1) does not apply to work performed pursuant to an agreement in writing entered into before February 28, 1995.

Permanent Establishments

2. (1) The portion of section 8201 of the Regulations before paragraph (*a*) is replaced by the following:

PERMANENT ESTABLISHMENTS

8201. For the purposes of subsections 16.1(1), 34.2(6), 112(2) and 125.4(1), the definition "taxable supplier" in subsection 127(9) and paragraph 260(5)(*a*) of the Act, "permanent establishment" of a person or partnership (referred to in this section as the "person") means a fixed place of business of the person, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse and, where the person does not have any fixed place of business, the principal place at which the person's business is conducted, and

(2) Subsection (1) applies to 1995 and subsequent taxation years, except that in applying section 8201 of the Regulations

(*a*) to the portion of a 1995 taxation year that was in 1994, it shall be read without reference to subsection 34.2(6) and

(*b*) to a taxation year that began before 1996, it shall be read without reference to the words 'the definition "taxable supplier" in subsection 127(9)'.

EXPLANATORY NOTES ON DRAFT *INCOME TAX REGULATIONS*

ITR
2900(1)

Section 2900 of the *Income Tax Regulations* sets out the meaning of terms and expressions relating to scientific research and experimental development for the purposes of the *Income Tax Act.*

Subsection 2900(1) defines scientific research and experimental development for the purposes of the Act. Consequential to the introduction of the definition of "scientific research and experimental development" in subsection 248(1) of the Act, this subsection is amended to refer to that definition in that subsection.

This amendment applies to work performed after February 27, 1995. However, this amendment does not apply to work performed pursuant to an agreement in writing entered into before February 28, 1995 for the purposes of paragraphs 149(1)(*j*) and (8)(*b*) of the Act.

ITR
8201

Section 8201 of the *Income Tax Regulations* prescribes criteria for determining whether a person who is not resident in Canada has a "permanent establishment" for various provisions of the *Income Tax Act.*

This section is amended so that it would also be applicable to partnerships. This amendment applies after 1994.

This section is also amended to apply for the purpose of new subsection 34.2(6) of the Act. This amendment applies after 1994.

This section is further amended to apply to new subsection 125.4(1) of the Act. This amendment applies to 1995 and subsequent taxation years.

Lastly, this section is amended to apply to the definition of "taxable supplier" in subsection 127(9) of the Act. This amendment applies to taxation years that begin after 1995.