Explanatory Notes to Legislative Proposals Relating to Income Tax

Published by
The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance

November 2006

Canada

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Preface

These explanatory notes are provided to assist in an understanding of proposed amendments to the *Income Tax Act* (the "Act"). These notes are divided into three parts: the first Part relating to non-resident trusts and foreign investment entities, the second Part relating to general income tax amendments, and the third Part relating to bijuralism. Theses notes replace those notes released July 18, 2005. In turn, the first part of those 2005 notes replaced the notes released in October 2003. The second part of those 2005 notes replaced the notes released in December 2002 and February 2004 that relate to provisions of the Act, but excluded those dealing with the foreign affiliate rules (i.e. the explanatory notes relating to proposed amendments to sections 17, 93 and 95, and the definition of "qualifying member" in subsection 248(1), of the Act released in December 2002, and Part II of the notes released in February 2004).

The Honourable Jim Flaherty, P.C., M.P.,
Minister of Finance

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 1

Title

The title of this Act is the *Income Tax Amendments Act, 2005*.

Part 1

Foreign Investment Entities and Non-resident Trusts

Clause 2

Income from Business or Property

ITA
12(1)(*k*)

Section 12 of the *Income Tax Act* provides for the inclusion of various amounts in computing a taxpayer's income for a taxation year from business or property. Paragraph 12(1)(*k*) refers to certain dividends required by existing sections 90 to 95 to be so added.

Paragraph 12(1)(*k*) is amended so that it refers to all amounts required to be added in computing income under amended sections 90 to 95, including new sections 94.1 to 94.3 relating to foreign investment entities. For more information, see the commentary on those new sections.

This amendment applies to taxation years that begin after 2006.

Clause 3

Life Insurance Policies - Definitions

ITA
12.2(11)

Subsection 12.2(11) of the Act provides the definitions "anniversary day" and "exempt policy" for the purposes of section 12.2 and paragraph 56(1)(*d*.1) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952.

Subsection 12.2(11) is amended so that it also applies for the purpose of paragraph 94.2(11)(*c*) of the Act. As a result, references to the expressions "anniversary day" and "exempt policy" in paragraph 94.2(11)(*c*) will carry the same meaning as that used in section 12.2.

This amendment applies after 2006.

For more detail on subsection 94.2(11), see the commentary on that provision.

Clause 4

Loan to Non-resident – Controlled Foreign Affiliate

ITA
17(15)

Subsection 17(15) of the Act defines expressions that apply for the purposes of section 17, which provides rules under which imputed interest, in connection with debt owing to a taxpayer from a non-resident person, is included in computing the taxpayer's income. The expression "controlled foreign affiliate" is defined to have the same meaning as it does under subsection 95(1) of the Act, except that for the purpose of section 17, a non-resident corporation must be controlled by Canadian residents in order to be treated as a controlled foreign affiliate of a taxpayer resident in Canada.

The definition “controlled foreign affiliate” in subsection 17(15) is amended so that new paragraph 94.1(2)(*h*) does not apply for the purposes of section 17. As a result, an election under that paragraph, to treat a foreign affiliate of a taxpayer as a controlled foreign affiliate of the taxpayer, does not have effect for the purpose of section 17.

This amendment applies after 2006.

Clause 5

Capital Gain from Disposition of Property

ITA
39(1)(*a*)(ii.3)

Paragraph 39(1)(*a*) of the Act describes a taxpayer’s capital gain for a taxation year from the disposition of property. Under this paragraph, gains from dispositions of specified properties are to be excluded in determining a capital gain. Under subparagraph 39(1)(*a*)(ii.2), the specified properties include specified debt obligations, where subsection 142.4(4) or (5) applies to the disposition, and mark-to-market properties where subsection 142.5(1) applies to the disposition. Under subparagraph 39(1)(*b*)(ii), the same exclusion generally applies with regard to a taxpayer’s capital loss.

New subparagraph 39(1)(*a*)(ii.3) provides a similar exclusion for property in respect of which subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer for a taxation year. Subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities and tracking entities. Because of paragraph 94.2(5)(*b*), this exclusion does not apply to gains from the disposition by a taxpayer of property where the taxpayer is not resident in Canada immediately before the time of the disposition.

This amendment applies to dispositions that occur after 2006.

Clause 6

Convertible Property

ITA
51

Section 51 of the Act generally permits a tax-deferred transfer of property where a taxpayer, pursuant to a right of conversion, exchanges capital property (referred to in the commentary on this section as the “convertible property”) that is a share, bond, debenture or note of a corporation for other capital property that is a share of the capital stock of the corporation.

ITA
51(1)(c)

Paragraph 51(1)(*c*) of the Act provides that, except for the purpose of subsection 20(21), an exchange described in paragraph 51(1)(*a*) or (*b*) is deemed not to be to be a disposition of the convertible property.

Paragraph 51(1)(*c*) is amended to add a reference to subsections 44.1(6), 44.1(7), and 94(2)(*m*).

This amendment applies to taxation years that begin after 1999, except that, for any taxation year of the taxpayer that begins before 2007 in respect of which new paragraph 94(2)(*m*) of the Act does not apply to the taxpayer, paragraph 51(1)(*c*) is to be read without the reference to paragraph 94(2)(*m*).

ITA
51(4)

Subsection 51(4) of the Act provides that subsections 51(1) and (2) will not apply to any exchange to which subsection 85(1) or (2) or section 86 applies.

Subsection 51(4) is amended to provide that subsections 51(1) and (2) also will not apply to any exchange of property if that property was, immediately before the exchange, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to exchanges that occur in taxation years that begin after 2006.

Clause 7

Cost of Certain Property

ITA
52(1)

Section 52 of the Act sets out the rules for determining the cost of certain property for the purposes of measuring any gain or loss on its disposition.

Subject to a number of exceptions, subsection 52(1) of the Act applies where a taxpayer acquires property and a particular amount in respect of its value was included in computing the taxpayer’s income for a taxation year throughout which the taxpayer was resident in Canada (or in computing a non-resident taxpayer’s taxable income earned in Canada under section 115, taxable income under section 114 or an amount from which tax is withheld under Part XIII). In these circumstances, the particular amount is added in determining the cost to the taxpayer of the property for the purposes of determining capital gains and losses in respect of the property.

Where subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer for a taxation year in respect of a property, an amount in respect of the taxpayer’s cost of the property may be included under subsection 94.2(4) in computing the taxpayer’s income from the property. Subsection 52(1) is amended so that it does not apply to add an amount to the cost to a taxpayer of a property where the amount may have been so included under subsection 94.2(4).

This amendment is made, even though a taxpayer’s property that is subject to the mark-to-market rules in subsection 94.2(4) for a taxation year is generally considered not to be (except where subsection 94.2(20) applies to the taxpayer for the taxation year) property a gain from the disposition of which is a capital gain, to deal with the situation where it may become at some later time capital property or where it is capital property to which subsection 94.2(20) applied to the taxpayer for the taxation year. Subsection 52(1) should not apply to cause a “bump” in the cost of a property in respect of income or gains recognized under subsection 94.2(4) because section 94.2 contains its own rules for making adjustments in respect of such income or gains. For more detail, see the commentary on subsections 94.2(12), (13) and (21), and the definition “deferral amount” in subsection 94.1(1).

For more information on the definitions “participating interest” and “foreign investment entity” and section 94.2, see the commentary on those provisions.

This amendment applies to taxation years that begin after 2006.

Clause 8

Adjustments to Cost Base

ITA
53

Section 53 of the Act sets out rules for determining the adjusted cost base (ACB) of property. Certain adjustments are made under this section. Subsection 53(1) provides for additions in computing the ACB of a property, and subsection 53(2) for deductions in computing the ACB of a property.

ITA
53(1)(*d*.1)

Paragraph 53(1)(*d*.1) of the Act, applied together with existing paragraph 94(5)(*a*), provides for an addition in computing the adjusted cost base (ACB) to a taxpayer of the taxpayer's capital interest in a trust to which existing paragraph 94(1)(*d*) applies. Paragraph 53(1)(*d*.1) is amended to ensure that historical ACB additions are maintained, notwithstanding the replacement of the rules in existing section 94.

This amendment applies to taxation years that begin after 2006.

It also applies to taxation years of a taxpayer that begin

- after 2000 if a trust, in which the taxpayer had a capital interest at any time in 2001, makes a valid election under paragraph (*a*) of the coming-into-force provision for new section 94,
- after 2001 if a trust, in which the taxpayer had a capital interest at any time in 2002, makes a valid election under paragraphs (*a*) or (*b*) of the coming-into-force provision for new section 94,
- after 2002 if a trust, in which the taxpayer had a capital interest at any time in 2003, makes a valid election under paragraphs (*a*) to (*c*) of the coming-into-force provision for new section 94,
- after 2003 if a trust, in which the taxpayer had a capital interest at any time in 2004, makes a valid election under paragraphs (*a*) to (*d*) of the coming-into-force provision for new section 94,
- after 2004 if a trust, in which the taxpayer had a capital interest at any time in 2005, makes a valid election under paragraphs (*a*) to (*e*) of the coming-into-force provision for new section 94, and
- after 2005 if a trust, in which the taxpayer had a capital interest at any time in 2006, makes a valid election under paragraphs (*a*) to (*f*) of the coming-into-force provision for new section 94.

Because of the possibility of such an election, amended paragraph 53(1)(*d*.1) refers to paragraph 94(5)(*a*) as it read for taxation years that include December 31, 2000.

ITA
53(1)(*m*) and (*m*.1)

Paragraph 53(1)(*m*) of the Act provides for an addition in computing the ACB to a taxpayer of "offshore investment fund property" to which existing section 94.1 applies. Paragraph 53(1)(*m*) is amended to ensure that the historical ACB additions are maintained, notwithstanding the replacement of the rules in existing section 94.1.

Paragraph 53(1)(*m*) is also amended to provide for an ACB addition in computing the ACB to a taxpayer of a property in respect of which new subsection 94.1(4) has applied to include in respect of the property an amount in computing the taxpayer's income for a taxation year. For more information, see the commentary on section 94.1.

Paragraph 53(1)(*m*.1) is introduced to provide for the ACB additions contemplated by new subsection 94.3(5). For more information, see the commentary on that subsection.

These amendments apply to taxation years that begin after 2006.

ITA
53(2)(*b*.1)

Paragraph 53(2)(*b*.1) of the Act, applied together with existing paragraph 94(5)(*b*), provides for a deduction in computing the ACB to a taxpayer of the taxpayer's capital interest in a trust to which existing paragraph 94(1)(*d*) applies. Paragraph 53(1)(*b*.1) is amended to ensure that historical ACB deductions are maintained, notwithstanding the replacement of the rules in existing section 94.

This amendment applies to taxation years that begin after 2006. It also applies to taxation years of a taxpayer that begin

- after 2000 if a trust, in which the taxpayer had a capital interest at any time in 2001, makes a valid election under the coming-into-force provision for new section 94,
- after 2001 if a trust, in which the taxpayer had a capital interest at any time in 2002, makes a valid election under the coming-into-force provision for new section 94,
- after 2002 if a trust, in which the taxpayer had a capital interest at any time in 2003, makes a valid election under the coming-into-force provision for new section 94,
- after 2003 if a trust, in which the taxpayer had a capital interest at any time in 2004, makes a valid election under the coming-into-force provision for new section 94,
- after 2004 if a trust, in which the taxpayer had a capital interest at any time in 2005, makes a valid election under the coming-into-force provision for new section 94, and
- after 2005 if a trust, in which the taxpayer had a capital interest at any time in 2006, makes a valid election under the coming-into-force provision for new section 94.

Because of the possibility of such an election, amended paragraph 53(2)(*b*.1) refers to paragraph 94(5)(*b*) as it read for taxation years that include December 31, 2000.

ITA
53(2)(*w*)

Paragraph 53(2)(*w*) of the Act is introduced to provide for the ACB reductions contemplated by new subsections 94.3(5) and 94.4(2). For more information, see the commentary on those provisions.

New paragraph 53(2)(*w*) applies to taxation years that begin after 2006.

Clause 9

Death of a Taxpayer

ITA
70(3.1)

Under subsection 70(2) of the Act, the value of certain "rights or things" owned by an individual at the time of the individual's death is required to be included in the individual's income for the year of death. Subsection 70(3) provides that this rule does not apply in connection with "rights or things" transferred to beneficiaries of the deceased within a specified period of time. Subsection 70(3.1) provides that certain property does not constitute a "right or thing" for these purposes.

Subsection 70(3.1) is amended so that a "right or thing" does not include property in respect of which new subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies. New subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities.

This amendment applies to taxation years that begin after 2006.

ITA
70(5.2)

Subsection 70(5.2) of the Act provides rules with respect to the disposition of resource properties and land inventories on the death of an individual.

Subsection 70(5.2) is amended so that it also applies to property in respect of which new subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies. With respect to such property, amended paragraph 70(5.2)(*a*) provides for a deemed disposition, immediately before the death of the individual, for proceeds of disposition equal to the fair market value of the property at that time. New subsection 94.2(3) sets out the conditions for the application of the mark-to-market taxation regime under section 94.2 for participating interests in foreign investment entities.

In the case of a property in respect of which subsection 94.2(3) applied (and subsection 94.2(20) does not apply) for the individual's taxation year in which the individual dies, the proceeds of disposition are included in the value of A in the mark-to-market formula for the taxation year in respect of the property. This formula applies in computing the deceased's income under subsection 94.2(4) for the taxation year of death. The deceased is treated as not having held the interest after death.

Paragraph 70(5.2)(*b*) is amended to provide that properties in respect of which a deemed disposition occurs under paragraph 70(5.2)(*a*) are deemed to have been acquired, by the person who as a consequence of the individual's death acquires the property, at a cost equal to its fair market value immediately before that death.

Where certain resource properties and land inventories held by an individual immediately before death are deemed, under paragraph 70(5.2)(*a*) and (*b*), to have been disposed of by the individual and acquired at a particular cost by another person, new paragraph 70(5.2)(*c*) sets out the conditions under which it will apply, instead of 70(5.2)(*a*) and (*b*), to determine the proceeds of disposition and cost of acquisition resulting from that deemed disposition and that acquisition. In particular, where the conditions in paragraph (*c*) are met, subparagraph 70(5.2)(*c*)(i) applies to determine the deceased individual's proceeds from the deemed disposition under paragraph (*a*) of a land inventory or resource property. In turn, subparagraph 70(5.2)(*c*)(ii) deems the land inventory or resource property to have been acquired at the time of the individual's death at a cost equal to the amount determined under subparagraph (i) in respect of the deemed disposition of the property under paragraph 70(5.2)(*a*).

This amendment applies to taxation years that begin after 2006.

Clause 10

***Inter Vivos* Transfers by Individuals**

ITA
73(1)

Subsection 73(1) of the Act generally provides for a tax-deferred disposition of capital property by an individual (other than a trust) where it is transferred by the individual in circumstances where subsection 73(1.01) applies and a number of other conditions are met.

Subsection 73(1) is amended so that it does not apply to a transfer of property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition "specified participating interest" in subsection 248(1), see the commentary on that definition.

This amendment applies to transfers that occur in taxation years that begin after 2006.

Clause 11

Trusts – Attribution

ITA
75(2) and (3)

Subsection 75(2) of the Act generally provides for the attribution of income derived from certain trust property to a person resident in Canada where the property was received by the trust from the person and can revert to the person (or pass to other persons determined by that person). Subsection 75(3) exempts property held by certain trusts from this attribution rule.

Subsection 75(3) is amended by adding new paragraph 75(3)(*c*.2). New paragraph 75(3)(*c*.2) ensures that subsection 75(2) does not apply to property held by a trust in respect of which all of the contributors are recent immigrants to Canada (i.e., none of the contributors to the trust has been resident in Canada for more than 60 months). The exception is consistent with similar 60-month exemptions in:

- section 94 (see subsection 94(3) and the definitions “connected contributor” and “resident contributor” in subsection 94(1)),
- section 94.1 (see subsection 94.1(3) and the definition “exempt taxpayer” in subsection 94.1(1)), and
- section 94.2 (see subparagraph 94.2(11)(*c*)(*i*)).

New paragraph 75(3)(*c*.2) applies to trust taxation years that begin after 2000 except that, for trust taxation years that begin in 2001, 2002, 2003, 2004, 2005 or 2006, paragraph 75(3)(*c*.2) applies with reference to subsection 94(1) as it reads in its application to taxation years that begin after 2006.

Clause 12

Definition of “Eligible Property”

ITA
85(1.11)

Subsection 85(1.1) of the Act describes the types of property (referred to as “eligible property”) that may be transferred to a corporation under subsection 85(1). Subsection 85(1.11) provides that certain foreign resource property (or an interest in a partnership that derives all or part of its value from one or more foreign resource properties) is not an “eligible property” of a taxpayer in respect of a transfer to a corporation.

Subsection 85(1.11) is amended to provide that a specified participating interest is not an eligible property of a taxpayer in respect of a transfer to a corporation. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to taxation years that begin after 2006.

Clause 13

Share-for-Share Exchange

ITA
85.1(4) and (6)

Subsection 85.1(3) of the Act permits a taxpayer to transfer, on a tax-deferred “rollover” basis, the shares of a foreign affiliate of the taxpayer to another foreign affiliate of the taxpayer. Subsection 85.1(5) provides a similar rollover for shareholders who exchange shares of a foreign corporation for shares of another corporation. Subsections 85.1(4) and (6), respectively, identify circumstances in which subsection 85.1(3) or (5) will not apply.

Subsection 85.1(4) is amended to provide that subsection 85.1(3) does not apply to a disposition at any time by a taxpayer of a property that is a specified participating interest. Subsection 85.1(6) is similarly amended so that subsection 85.1(5) does not apply to an exchanged share that was, immediately before the exchange, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition "specified participating interest" in subsection 248(1), see the commentary on that definition.

These amendments apply to dispositions and exchanges that occur in taxation years that begin after 2006.

Clause 14

Share-for-Share Exchange – Reorganization of Capital

ITA
86(3)

Subsection 86(1) applies where a corporation reorganizes its capital structure by issuing shares to a taxpayer as full or partial consideration for the surrender of all of the taxpayer's shares of the capital stock of the corporation. Where this is the case, the cost of the new shares is determined with reference to the adjusted cost base of the surrendered shares. Subsection 86(3) provides that subsection 86(1) does not apply in any case where subsection 85(1) or (2) applies.

Subsection 86(3) is amended to provide that subsection 86(1) also does not apply to any disposition of property that was, immediately before the disposition, a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition "specified participating interest" in subsection 248(1), see the commentary on that definition.

This amendment applies to dispositions that occur in taxation years that begin after 2006.

Clause 15

Amalgamations – Non-resident Trusts and Foreign Investment Entities

ITA
87(2)(*j*.95)

Section 87 of the Act sets out rules that apply on the amalgamation of two or more taxable Canadian corporations. The amalgamated corporation is generally treated as a continuation of the predecessor corporations for the purposes of the Act.

New paragraph 87(2)(*j*.95) provides that, where there has been an amalgamation of two or more taxable Canadian corporations, the amalgamated corporation is deemed to be a continuation of its predecessor corporations for the purposes of sections 94 to 94.4, which relate to foreign trusts and foreign investment entities. Thus, for example, an amalgamated corporation will be considered to be a "contributor" (as defined in subsection 94(1)) to a trust if any predecessor corporation was a contributor to the trust. In addition, the new corporation's "deferral amount" (as defined in subsection 94.2(1)) in respect of an interest in a foreign investment entity will be determined in the same manner as a predecessor's "deferral amount" in respect of the same interest.

Because of the operation of paragraph 88(1)(*e*.2), new paragraph 87(2)(*j*.95) also applies to windings-up to which section 88 applies.

This amendment applies to taxation years that begin after 2000.

Clause 16

Amounts to be Included in Respect of Share of a Foreign Affiliate

ITA
91

Section 91 of the Act sets out rules for determining, among other things, amounts that a taxpayer resident in Canada is to include in computing its income for a particular year as income from a share of a controlled foreign affiliate of the taxpayer.

ITA
91(1)

Subsection 91(1) of the Act provides that a taxpayer that is resident in Canada must include in computing income an amount in respect of each share owned by the taxpayer of the capital stock of a controlled foreign affiliate of the taxpayer.

Subsection 91(1) is amended so that it does not result in additional income for a taxpayer in respect of shares that are participating interests in a "tracking entity" to which the prescribed rate regime under section 94.1 or the mark-to-market regime under section 94.2 applies by reason of the application of subsection 94.2(9). The shares of a taxpayer in the capital stock of a corporation that is a controlled foreign affiliate of the taxpayer will generally be treated as "exempt interests" (as defined in new subsection 94.1(1)), and therefore not subject to the income inclusions under subsections 94.1(4), 94.2(4) or 94.3(4) of the Act. However, if subsection 94.2(9) applies in respect of those shares (in particular, note that paragraph 94.2(9)(*b*) does not exclude the application of subsection 94.2(9) to an exempt interest that is an interest in a controlled foreign affiliate) either of subsections 94.1(4) or 94.2(4) will apply generally to require an amount to be included in computing the income of the taxpayer. Because of subparagraph 94.3(2)(*b*)(i), the accrual regime in section 94.3 will not apply in respect of an interest to which subsection 94.2(9) applies. The exception provided for such shares under subsection 91(1) is intended solely to prevent any incidence of double taxation that might otherwise arise.

For more details on the application of sections 94.1 to 94.4, see the commentary on those provisions.

This amendment applies to taxation years that begin after 2006.

ITA
91(4)

Subsection 91(4) of the Act provides for a deduction in computing the income of a taxpayer resident in Canada. The deduction is available where the taxpayer has included an amount under subsection 91(1) in computing income in respect of a share of the capital stock of a controlled foreign affiliate of the taxpayer. The deduction is generally determined with reference to foreign taxes payable by the affiliate and a "relevant tax factor". The "relevant tax factor" for a resident taxpayer is designed to permit a deduction for the resident taxpayer that will result in tax relief that is a proxy for a foreign tax credit in respect of foreign taxes payable by a controlled foreign affiliate of the resident taxpayer.

Subsection 91(4) is amended to explicitly link the "relevant tax factor" to the resident taxpayer and the taxation year for which the deduction under subsection 91(4) is claimed. For more detail on the definition "relevant tax factor" in subsection 95(1), see the commentary on that provision.

This amendment applies to the 2002 and subsequent taxation years.

Clause 17

Non-resident Trusts

ITA
94

Overview

Existing Rules

Section 94 of the Act sets out rules that tax certain income earned by certain non-resident trusts. Section 94 generally applies if a person resident in Canada has transferred or loaned property to a non-resident trust that has one or more beneficiaries that are resident in Canada.

Section 94 uses two different methods to impose tax, depending on the terms of the non-resident trust.

If the amount to be distributed to a beneficiary of the trust depends upon a discretionary power, paragraph 94(1)(*c*) deems the trust to be resident in Canada for the purposes of Part I of the Act and deems its taxable income for tax purposes to be the total of its Canadian source income and its foreign accrual property income, if any. Each beneficiary is jointly and severally liable to pay the Canadian tax of the trust. However, the liability can be enforced against a particular beneficiary only to the extent that the beneficiary has received a distribution from the trust or proceeds from the sale of an interest in the trust.

For other non-resident trusts to which section 94 applies, paragraph 94(1)(*d*) provides that it is to be treated in much the same manner that a non-resident corporation is treated. If a Canadian resident beneficiary holds an interest in the trust with a fair market value equal to 10% or more of the total fair market value of all beneficial interests in the trust, the trust is deemed to be a controlled foreign affiliate of the beneficiary. Consequently, the foreign accrual property income rules apply to the trust and the beneficiary, requiring the beneficiary to include a portion of the foreign accrual property income of the trust in income. On the other hand, beneficiaries whose beneficial interests are less than 10% of the total fair market value of all interests in the trust may be subject to tax under the offshore investment fund rules in section 94.1. If section 94.1 does not apply, such beneficiaries are taxed only if trust income becomes payable to them in the year in which it arises.

New Rules

New section 94 of the Act takes a different approach to the taxation of non-resident trusts (NRTs). In general, if a Canadian resident contributes property to a NRT, then the trust is deemed resident in Canada for a number of purposes, and the contributor, the NRT and certain Canadian resident beneficiaries of the trust may all become jointly and severally, or solidarily, liable to pay Canadian tax on the world-wide income of the trust. (The English-language expression “jointly and severally” no longer exists in the civil law of the province of Quebec and has been replaced in that civil law with the expression “solidarily”. In the English-language version of section 94, the expression “solidarily” is added to the expression “jointly and severally”, which latter expression is maintained for common-law purposes. The French-language version of new section 94 uses only the expression “*solidaire*” as this expression is appropriate for both the civil and common-law. These changes ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.)

Except as indicated otherwise, the amendments to section 94 apply to trust taxation years that begin after 2006.

In addition,

- a trust created in 2001 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2001,
- a trust created in 2002 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2002,
- a trust created in 2003 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2003,
- a trust created in 2004 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2004,
- a trust created in 2005 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2005, and
- a trust created in 2006 may elect in writing (by filing the election with the Minister on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2006.

Note that, under the coming-into-force provision for new section 94, any election or form (but for greater certainty, not including returns of income) referred to in new section 94 that would otherwise be required to be filed before 120 days after Royal Assent is deemed to have been filed with the Minister of National Revenue on a timely basis if it is filed with the Minister of National Revenue within 365 days after Royal Assent.

For more detail on filing obligations regarding returns of income, contact the Canada Revenue Agency.

The following table briefly summarizes section 94 and related rules.

Issue	Summary	References
1. Which trusts are subject to the new NRT rules?	A. In general, a trust (other than an exempt foreign trust) will be subject to tax for a taxation year as a trust resident in Canada if a contribution was made to the trust by an entity (other than a recent immigrant to Canada) that is resident in Canada at a specified time (generally, the end of the year).	S. 94(3) "entity" – s. 94(1) "exempt foreign trust" – s. 94(1) "contribution" – s. 94(1) and (2) "resident contributor" – s. 94(1) "specified time" – s. 94(1)
	B. In addition, a trust (other than an exempt foreign trust) will generally be subject to Canadian tax for a taxation year if there is a resident beneficiary under the trust. More specifically if: • a contribution was made by an entity when the entity was resident in Canada (or generally within a 60-month period before the entity became resident in Canada or within a 60-month period after the entity ceased to be resident in Canada), • where the contributing entity is an individual (other than a trust), at the specified time the individual had been resident in Canada for more than 60 months, and	S. 94(3) and (10) "beneficiary" – s. 94(1) "contribution" – s. 94(1) and (2) "connected contributor" – s. 94(1) "entity" – s. 94(1) "non-resident time" - 94(1) "resident beneficiary" – s. 94(1) "specified charity" – s. 94(1) "specified time" – s. 94(1) "successor beneficiary" – s. 94(1)

Issue	Summary	References
	• at the specified time there is an entity (other than a specified charity or successor beneficiary) that is resident in Canada and is a beneficiary under the trust.	
2. Who is responsible for the tax payable by an NRT?	The trust is required to pay tax. If it fails to do so, each contributor referred to in 1(A) and/or each beneficiary referred to in 1(B) is jointly and severally or solidarily liable with the trust for the tax. However, the amount recoverable from an entity that is simply a beneficiary is limited to the beneficiary's recovery limit. Relief is also available in some cases for a contributor whose contribution to the trust is insignificant relative to other contributions made to the trust.	Jointly and severally, or solidarily, liable: paragraphs 94(3)(*d*) and (*e*) Limit to amount recoverable - 94(7) Recovery limit - 94(8) Determination of fair market value - 94(9) Definitions - 94(1)
3. Where the NRT rules apply to a trust for a taxation year, how will the trust's tax liabilities be calculated?	A. Canadian rules generally apply to the trust as if the trust were resident in Canada throughout the year for the purpose of computing the trust's income.	s. 94(3)(*a*) and 94(4)
	B. Explicit rule treats the trust as becoming resident in Canada, with resulting adjustment to cost amount of property.	s. 94(3)(*c*)
	C. Part XII.2 does not apply to the trust. Explicit exemption from Part XIII tax on amounts distributed to the trust, although payer must still withhold. Part XIII will generally apply to amounts (other than exempt amounts) paid or credited by the trust to non-resident beneficiaries	s. 94(3)(*a*)(viii) and (ix) and (4)(*c*) and 215 and 216(4.1) "exempt amount" – s. 94(1)
	D. Flow-through of income to resident and non-resident beneficiaries permitted, subject to special rules in the event that Canadian-source income is distributed to non-residents.	s. 94(3)(*a*)(ix) and 104(7.01) - special rules

Definitions

ITA
94(1)

New subsection 94(1) of the Act defines a number of expressions that apply for the purpose of section 94.

"arm's length transfer"

A loan or transfer of property by an "entity" in respect of a trust will generally not be considered a "contribution" to the trust where the loan or transfer is an "arm's length transfer". In these circumstances, the transferor entity generally will not, because of that loan or transfer, be considered to be a "contributor" to the trust. Accordingly, subsection 94(3) does not apply to a non-resident trust as a consequence only of an "arm's length transfer" in respect of the trust unless a deemed contribution or deemed contributor rule applies. (For more information on the definitions "contribution", "contributor" and "entity" in subsection 94(1), see the commentary on those definitions.)

The definition “arm’s length transfer” also is relevant in applying the rules in new paragraphs 94(2)(*a*) and (*c*). Under those rules, a loan or transfer of property made to an entity other than a particular trust may, in specified circumstances, result in a transfer of property being considered to have been made to the particular trust. (For more information, see the commentary on new subsection 94(2).)

If property transferred or loaned is “restricted property”, the transfer or loan will not be an arm’s length transfer. (For more information on the definition “restricted property”, see the commentary on that definition.)

Under paragraph (*a*) of the definition, a transfer or loan will be an arm’s length transfer only if it is reasonable to conclude that none of the reasons (determined by reference to all the circumstances including the terms of a trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the transfer is the acquisition at any time by any entity of an interest as a beneficiary under a non-resident trust.

Under subparagraphs (*b*)(i) and (ii) of the definition, an arm’s length transfer includes, in general terms, an arm’s length return on investment (conferred by the entity in which the investment is made) and certain payments made by a corporation on a reduction of the paid up capital in respect of shares of a class of the corporation’s capital stock.

Under subparagraph (*b*)(iii) of the definition, an arm’s length transfer includes a transfer to a trust by a “specified charity” (as defined in new subsection 94(1)) in respect of the trust that is made by the specified charity for the purpose of refunding in whole or in Part a gift previously made to the specified charity entity by the trust. For more information on the definition “specified charity”, see the commentary on that definition.

Under subparagraph (*b*)(iv) of the definition, an arm’s length transfer includes a transfer in exchange for which, the recipient transfers or loans property (other than a restricted property) to the transferor, or becomes obligated to so transfer or loan such property, and for which it is reasonable to conclude

- having regard only to the transfer and the exchange that the transferor would have been willing to make the transfer if the transferor dealt at arm’s length with the recipient, and
- that the terms and conditions, and circumstances, under which the transfer was made would have been acceptable to the transferor if the transferor dealt at arm’s length with the recipient,

Under subparagraph (*b*)(v) of the definition, an arm’s length transfer includes a transfer that is made in satisfaction of an obligation that arose because of a transfer to which subparagraph (*b*)(iv) applied, if

- the transfer is not a transfer described in paragraph 94(2)(*g*),
- the transferor would have been willing to make the transfer if the transferor dealt at arm’s length with the recipient, and
- the terms and conditions, and circumstances, under which the transfer was made would have been acceptable to the transferor if the transferor dealt at arm’s length with the recipient.

Under subparagraph (*b*)(vi) of the definition, an arm’s length transfer includes a transfer that is a payment of an amount owing by the transferor under a written agreement the terms and conditions of which, when entered into, were terms and conditions that, having regard only to the amount owing and the agreement, persons dealing at arm’s length with each other would have entered into, if the transfer is not a transfer described in paragraph 94(2)(*g*).

Under subparagraph (*b*)(vii) of the definition, an arm’s length transfer includes a transfer that is a payment made before 2002 to a trust, to a corporation controlled by the trust or to a partnership of which the trust is a majority interest partner, in repayment of or otherwise in respect of a particular loan made by the trust, corporation or partnership, as the case may be, to the transferor.

Finally, under subparagraph (*b*)(viii) of the definition, an arm's length transfer includes a transfer that is a payment made after 2001 to a trust, to a corporation controlled by the trust or to a partnership of which the trust is a majority interest partner, in repayment of or otherwise in respect of a particular loan made by the trust, corporation or partnership, as the case may be, to the transferor in circumstances where either

- they would have been willing to enter the particular loan if they dealt at arm's length with each other and the payment is not a transfer described in paragraph 94(2)(*g*), or
- the payment is made before 2005 in accordance with fixed repayment terms agreed to before June 23, 2000.

The definition "arm's length transfer" generally applies to trust taxation years that begin after 2006. However, where a trust elects, by notifying the Minister in writing on or before its filing-due date for its taxation year that includes the day on which the amending legislation introducing section 94 is assented to, the definition "arm's length transfer" will be read without reference to a loan or transfer of property that is made before 2003 and identified in the election. This electing provision recognizes that the definition "arm's length transfer" in the new rules does not have an equivalent under existing subsection 94(1) of the Act. In particular, a non-resident trust now considered resident by reason of existing subsection 94(1) might not be described in new subsection 94(3) and would no longer be considered resident, which would result in the change in residency rules in subsection 128.1(4) applying. The election, which is found in the coming-into-force provision of the amending legislation, effectively permits a trust to continue to be deemed resident.

"beneficiary"

Under paragraph (*a*) of the new definition "beneficiary" in subsection 94(1), a beneficiary under a trust includes an entity beneficially interested in the trust.

Under paragraph (*b*) of that definition, a beneficiary under a trust also includes an entity (including a person) that would be beneficially interested in the trust if

- each reference in subsection 248(25) to a "person" were read as a reference to an "entity" (as defined by new section 94), and
- for greater certainty, the reference in subparagraph 248(25)(*b*)(ii) to

  (A) "any arrangement in respect of the particular trust" were read as a reference to "any arrangement (including the terms or conditions of a share, or any arrangement in respect of a share, of the capital stock of a corporation that is beneficially interested in the particular trust) in respect of the particular trust", and

  (B) "the particular person or partnership might" were read as a reference to "the particular person or partnership becomes (or could become on the exercise of any discretion by any entity), directly or indirectly, entitled to any amount derived, directly or indirectly, from the income or capital of the particular trust or might".

For the purposes of the Act, the expression "beneficially interested" has the meaning assigned by subsection 248(25) of the Act.

"closely-held corporation"

The definition "closely-held corporation" is relevant in applying subparagraph (*b*)(i) of the definition "arm's length transfer" and the definition "restricted property". (For more information on the definitions " arm's length transfer " and " restricted property " in subsection 94(1), see the commentary on those definitions.)

A closely-held corporation, at any time, means a corporation, other than a corporation in respect of which

- there is at least one class of shares of its capital stock that includes shares prescribed for the purpose of paragraph 110(1)(*d*);
- it is reasonable to conclude that at that time, in respect of each class of shares of the corporation's capital stock that are shares prescribed for the purpose of paragraph 110(1)(*d*), shares of the class are held by at least 150 entities each of whom holds shares, of the class, that have a total fair market value of at least $500 – i.e., in general terms, the shares must be widely-held; and
- it is reasonable to conclude that at that time in no case does a particular entity (or the particular entity together with any other entity with whom the particular entity does not deal at arm's length) hold shares of the capital stock of the corporation
  - that would give the particular entity (or the particular entity together with those other entities) 10% or more of the votes that could be cast under any circumstance at an annual meeting of shareholders of the corporation if the meeting were held at that time, or
  - that have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the corporation.

This amendment generally applies in respect of trusts for taxation years that begin after July 18, 2005. However, a trust may make a special election (provided for in the coming-into-force provision for new section 94) to have the definition as described above apply in respect of it for taxation years that begin after 2006 (or where the trust qualifies to so elect under the coming-into-force provision of new section 94, for its taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004, or after 2005). If the trust does not make the special election, then for its taxation years that begin on or before July 18, 2005, in respect of the trust a closely-held corporation at any time, means a corporation, other than a corporation in respect of which

- there is at least one class of shares of its capital stock that class is not a specified class (within the meaning assigned by subsection 256(1.1),
- it is reasonable conclude that at that time the shares of those classes (other than such a specified class) are held by at least 150 entities each of whom holds shares that have a total fair market value of at least $500, and
- it is reasonable conclude that the total number of issued and outstanding shares of a class (other than such a specified class) held by a particular entity or by any other entity with whom the particular entity does not deal at arm's length is not more than 10% of the total number of the issued and outstanding shares of that class.

Subsection 94(16) is an anti-avoidance provision that applies in determining whether a corporation is a closely-held corporation at any time. For more detail, see the commentary on that provision.

"connected contributor"

The definition "connected contributor" is relevant in determining whether a beneficiary is, at a particular time, a "resident beneficiary" (as defined in new subsection 94(1)) under a non-resident trust. Under new paragraph 94(3)(*d*) of the Act, such a resident beneficiary can, to an extent, be liable for the trust's income tax. For more information, see the commentary on subsections 94(3) and (7) to (10), subparagraph 152(4)(*b*)(vi) and subsections 160(2.1) and (3).

A connected contributor at a particular time is any entity, including an entity that has ceased to exist, that is a "contributor" (as defined in new subsection 94(1)) to the trust at that time, other than

- an individual who was resident in Canada for a period of, or periods the total of which is, not more than 60 months (but not including a trust or an individual who before that time was never non-resident), or
- an entity all of whose contributions to the trust made at or before that time occurred at a "non-resident time" (as defined in new subsection 94(1)) of the entity.

For more information on the definitions “contributor”, “resident beneficiary” and “non-resident time” in subsection 94(1), see the commentary on those definitions.

In the context of the definition “connected contributor”, reference should also be made to new paragraphs 94(2)(*a*) to (*m*) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(*n*) to (*q*), subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94 and may apply to deem an entity to be a connected contributor to a trust), and paragraphs 94(2)(*r*) to (*u*) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94). Reference should also be made to new subsection 94(10), which applies where a contributor becomes resident in Canada within 60 months after making a contribution to a trust.

“contribution”

Where a “contribution” is made at or before a particular time to a non-resident trust by an entity, that entity will be considered to be a “contributor” at the particular time and, in certain cases, will be jointly and severally or solidarily liable under subsection 94(3) for the trust’s income taxes. (For more detail on the expression “solidarily “, please refer to the introductory commentary above on new section 94.) For more information on subsection 94(3), see the commentary on that subsection.

Under paragraph (*a*) of the definition, a “contribution” to a trust by a particular entity means a loan or transfer of property (in this commentary referred to as a “transfer”) by the entity to the trust (other than an “arm’s length transfer”, as defined in new subsection 94(1)).

Under paragraphs (*b*) and (*c*) of the definition “contribution”, a contribution is also considered to have been made by a particular entity where

- the particular entity makes a particular transfer (other than an “arm’s length transfer”) as part of a series of transactions or events that includes another transfer (other than an arm’s length transfer), to the trust, by another entity; or
- the particular entity becomes obligated to make a particular transfer (other than a transfer that would, if it were made, be an “arm’s length transfer”) as part of a series of transactions or events that includes another transfer (other than an arm’s length transfer), to the trust, by another entity.

In these circumstances, the other transfer is considered to be a contribution to the trust by the particular entity only to the extent that the other transfer can reasonably be considered to have been made in respect of the particular transfer or the particular entity’s obligation to make the particular transfer, as the case may be. In either case, a contribution is considered to be made at the time of the other transfer.

There are a number of rules that have the effect of applying the definition “contribution” more broadly than would otherwise be the case. See the commentary on new paragraphs 94(2)(*a*) to (*m*) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(*n*) to (*q*) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(*r*) to (*u*) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

The definition “contribution” applies to all loans and transfers, irrespective of when made.

“contributor”

A “contributor” to a trust at any time means an “entity” (as defined in new subsection 94(1)), including an entity that has ceased to exist, that at or before that time has made a “contribution” (as defined in new subsection 94(1)) to the trust. The definition “contributor” is significant primarily for the purposes of the definitions “resident contributor” and “connected contributor” in new subsection 94(1). For more information, see the commentary on those definitions.

Reference should be made in this context to new paragraphs 94(2)(*a*) to (*m*) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(*n*) to (*q*) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(*r*) to (*u*) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

"eligible trust"

An "eligible trust" can qualify as an exempt foreign trust under paragraph (*h*) of the definition "exempt foreign trust" where it meets the conditions imposed by that paragraph. An eligible trust may also qualify as an "exempt taxpayer" under subsections 94(1) and 94.1(1). For more detail, see the commentary on those subsections.

An eligible trust at any time means a trust other than a trust

- created or maintained for charitable purposes,
- governed by an employee benefit plan,
- described in paragraph (a.1) of the definition "trust" in subsection 108(1),
- governed by a salary deferral arrangement,
- operated for the purpose of administering or providing superannuation, pension, retirement or employee benefits,
- the amount of income or capital that any entity may receive directly from the trust at any time as a beneficiary under which depends on the exercise by any entity of, or the failure by any entity to exercise, a discretionary power; however, note that, if a trust so elects, for its taxation years that begin on or before July 18, 2005, this description of the trust is replaced in respect of the trust with "a trust that has at or before that time been a personal trust", or
- has elected in writing filed with the Minister in a timely fashion that the definition "exempt foreign trust" not apply to it.

"entity"

The expression "entity" is defined to include an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust.

"excluded property"

The expression "excluded property" is relevant to determining whether a property is restricted property. In particular, paragraph 94(14)(*c*) suspends a property's status as restricted property where that property is an excluded property. For more detail on the definition "restricted property" and subsection (14), see the commentary on those provisions.

Excluded property, at any time, means a particular property held, loaned or transferred, as the case may be, at that time by a particular entity if at that time:

- the particular property is at that time a share of the capital stock of the corporation, a specified fixed interest in the trust, or an interest as a limited partner in the partnership;
- it is reasonable to conclude that there are at least 150 persons each of whom holds at that time property that at that time is identical to the particular property, and has a total fair market value of at least $500;
- the total of all amounts each of which is the fair market value, at that time, of the particular property (or of identical property that is held, at that time, by the particular entity or an entity with whom the particular entity does not deal at arm's length) does not exceed 10% of the fair market value, at that time, of the particular property or of identical property held by any entity; and
- the particular property or property that is identical to it is listed on a prescribed stock exchange and can normally be acquired by and sold by members of the public in the open market.

“exempt amount”

The expression “exempt amount” is relevant in determining whether Part XIII tax applies to a non-resident person in respect of an amount paid or credited after 2003 by a trust to which subsection 94(3) applies. In general terms, Part XIII tax will not apply to such amounts if they are exempt amounts.

Three kinds of amounts may qualify as an exempt amount in respect of a particular taxation year of a trust. The first is any amount paid or credited (within the meaning assigned by Part XIII) by the trust before 2004.

The second is an amount that is paid or credited by the trust and referred to in paragraph 104(7.01)(*b*) in respect of the trust for the particular taxation year. For more detail on paragraph 104(7.01)(*b*), see the commentary on that provision.

The third type of exempt amount arises only in respect of trusts created before October 30, 2003 and to which no contributions have been made on or after July 18, 2005. In respect of such trusts, an exempt amount also means an amount (other than an amount included in computing an exempt amount in respect of any other taxation year of the trust) that is described in subparagraph 212(1)(c)(i) and paid in the particular taxation year (or within 60 days after the end of the particular taxation year) by the trust directly to a qualifying beneficiary under the trust. In this regard, a qualifying beneficiary means a beneficiary (determined without reference to subsection 248(25)) who is a natural person none of whose interests as a beneficiary under the trust was ever acquired for consideration (determined by reference to subsection 108(7)).

For more detail on subsection 108(7), see the commentary on that provision.

“exempt foreign trust”

An “exempt foreign trust” includes a number of different types of non-resident trusts that are exempt from the application of new subsection 94(3). The expression refers to the following types of non-resident trusts:

(*a*) a non-resident trust the current income (determined with reference to amended subsection 108(3)) or capital from which can be provided only to one or more physically or mentally infirm dependent individuals, provided that each such individual is at all times that they are a beneficiary under the trust during the trust’s current taxation year, non-resident and that any property settled on the trust could reasonably be considered, at the time it was settled, to be necessary for the maintenance of those individuals;

(*b*) a non-resident trust created as a consequence of the breakdown of a marriage or common-law partnership of two individuals, the current income (determined with reference to amended subsection 108(3)) or capital from which can be provided only for the maintenance of non-resident beneficiaries of the trust who were, during that marriage or common-law partnership, children of both of the individuals, if the beneficiaries are under 21 years of age (or under 31 years of age and enrolled in a specified educational institution) and each contribution (as defined in section 94) to the trust was to provide for the maintenance of those children – note the different description of the conditions in subparagraph (*b*)(i) of that definition that apply for taxation years that begin on or before July 18, 2005;

(*c*) certain non-resident trusts that own or administer a university described in paragraph (*f*) of the definition “total charitable gifts” in subsection 118.1(1) and that could qualify under that definition as a recipient permitted for the purposes of the tax credit for charitable gifts;

(*d*) certain non-resident trusts established exclusively for charitable purposes (as those purposes are defined in the laws of Canada);

(*e*) a non-resident trust that is governed by an employee profit sharing plan (as defined in subsection 248(1)), by a retirement compensation arrangement (as defined in subsection 248(1), or by a foreign retirement arrangement (as defined in subsection 248(1));

(*f*) certain foreign trusteed employee benefit plans if

- at all times that the trust exists it is operated exclusively for the purposes of providing employee benefits,
- throughout the trust's current taxation year it is maintained for the benefit of natural persons, the majority of whom are non-resident,
- the only benefits provided by the trust are in respect of
  - qualifying services (as defined in subsection 94(1)),
  - (only in respect of taxation years ending before 2009) particular services rendered before Announcement Date to an employer by an employee if the employee had a right before Announcement Date to receive the benefits in respect of the particular services pursuant to a written agreement entered into before Announcement Date, and (where the employee was resident in Canada on Announcement Date), a copy of which was filed with the Minister, or
  - a combination of the two, and
- if the year is after 2006, the trust holds no restricted property throughout that year or, where the year is before 2007, the trust does not hold any restricted property in the year other than property that was restricted property of the trust before Announcement Date.
- (*g*) a non-resident trust (other than a trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1) or a prescribed trust) that at all times since it was created has been operated exclusively for the specific purposes described below, is resident in a particular country other than Canada and has been exempt – because it is operated for these specific purposes - from paying income tax to the government of that country. The specific purposes are administering or providing superannuation or pension benefits, where those benefits are primarily in respect of services rendered in that particular country by natural persons who were non-resident at the time the services were rendered– as a result, certain trusteed foreign pension plans or similar arrangements are intended to qualify as an exempt foreign trust under this provision;

(*h*) a non-resident trust that is an eligible trust (as defined in subsection 94(1)) and whose only beneficiaries with rights to receive income or capital directly from the trust are qualifying investors (as defined in subsection 94(1)) in respect of the trust if either

- there are at least 150 qualifying investors in respect of the trust each of whom holds specified fixed interests (as defined in subsection 94(1)) in the trust worth at least $500, and the only resident contributors (as defined in subsection 94(1)) to the trust that hold more than 10% of the interests of any class of specified fixed interests in the trust are specified contributors (as defined in subsection 94(1)) to the trust, or
- in any other case, each resident contributor (other than an "indirect contributor" as defined in subsection 94(1)) to the trust is a specified contributor to the trust, a copy of the current terms of the trust (and any other required information in prescribed form) has been filed with the Minister of National Revenue by or on behalf of the trust, and at no time in the current taxation year of the trust, where the time of determination is after 2006, does the trust hold restricted property (or if the time of determination is before 2007, the trust holds no restricted property that was not restricted property held by it before Announcement Date); and

(*i*) a prescribed trust or prescribed class of trusts. (At the present time, it is not anticipated that any trust or class of trusts will be prescribed for this purpose).

A trust that qualifies as an exempt foreign trust under paragraph (*f*) of the definition "exempt foreign trust" will be a non-resident entity for purposes of the foreign investment entity rules in subsections 94.1 to 94.4. If the trust has not held restricted property at any time on or after July 18, 2005, it will qualify, under paragraph (*a*) of the definition "foreign investment entity" in subsection 94.1(1) for relief from treatment as a foreign investment

entity ("FIE"). However, if the trust has held restricted property on or after July 18, 2005, then in order to avoid status as a FIE, it would have to rely upon paragraphs (*b*) or (*c*) of the "foreign investment entity" definition, as paragraph (*a*) of that definition would not apply to it. Where the trust is a FIE, a Canadian resident beneficiary (other than an "exempt taxpayer" within the meaning assigned by subsection 94.1(1)) under the trust would be expected to be a taxpayer to whom subsection 94.1(3) or 94.2(9) applies for a taxation year of the beneficiary in respect of their interest (i.e., "participating interest", as defined in subsection 94.1(1)) in the trust.

Paragraphs (*f*) and (*g*), as described in general terms above, of the definition "exempt foreign trust" apply in respect of a trust for its taxation years that begin after July 18, 2005, unless the trust elects under paragraph (*j*) of the coming-into-force provision of new section 94. Where this election is made, those paragraphs apply, as described in general terms above, to the trust for taxation years that begin after 2006 (or such earlier year as has been elected, under the coming into force provisions for new section 94, that section 94 apply to the trust). Where the election is not made, for taxation years that begin on or before July 18, 2005, paragraphs (*f*) and (*g*) apply to the trust at a particular time as set out in paragraph (*j*) of that coming-into-force provision, which in general terms is as follows:

- in the case of paragraph (*f*), throughout the taxation year that includes the particular time, the trust must be
- a non-resident trust that is governed by an employee benefit plan (as defined in subsection 248(1)) or a trust described in paragraph (*a*.1) of the definition trust in subsection 108(1),
- maintained primarily for the benefit of non-resident individuals,
- hold no restricted property, and
- provides no benefits, other than benefits in respect of services described in clauses (iv)(A) to (D) of the definition;
- in the case of a paragraph (*g*), at all times from the time it was created until the particular time, the trust must be a non-resident trust
- operated exclusively for the purpose of administering or providing superannuation, pension, retirement or employee benefits, and
- that meets the conditions stipulated under paragraph (*g*) of the definition regarding its beneficiaries (and their rights), its property, its jurisdiction of residence, and its liability for tax under the laws of that jurisdiction;

Paragraph (*h*), as described in general terms above, of the definition "exempt foreign trust" applies in respect of a trust for its taxation years that begin after 2006 (or such earlier year as has been elected, under the coming into force provisions for new section 94, that section 94 apply to the trust). However, if the trust elects under paragraph (*w*) of the coming-into-force provision of new section 94, paragraph (*h*) of the definition applies to the trust, for its taxation years that begin on or before July 18, 2005, as described in paragraph (*w*) of that coming-into-force provision, which in general terms is as follows:

- under subparagraph (*h*)(i) of the definition, the trust must be a non-resident trust that is an "eligible trust" (as defined in subsection 94(1)) under which each beneficiary's (determined without regard to subsection 248(25)) interest is a specified fixed interest, under which there are at least 150 such beneficiaries each of whom holds a specified fixed interest in the trust worth at least $500, and to which the only "resident contributors" (as defined in subsection 94(1)) to the trust that hold more than 10% of the interests of any class of beneficial interests in the trust are "specified contributors" (as defined in subsection 94(1)) to the trust, and
- under subparagraph (*h*)(ii) of the definition, the trust must be a non-resident trust that is an eligible trust under which each beneficiary's interest is a specified fixed interest, each resident contributor (other than an indirect contributor) to which is a specified contributor and by or on behalf of which a copy of the current terms of the trust (and any other required information in prescribed form) has been filed with the Minister of National Revenue;

Paragraph (*h*) is intended to apply to non-resident investment trusts that are legitimately commercial. Such a trust is intended to be treated as a foreign investment entity under sections 94.1 to 94.4 of the Act. A Canadian resident investor (other than an "exempt taxpayer" within the meaning assigned by subsection 94.1(1)) in the trust would be expected to be a taxpayer to whom subsection 94.1(3) or 94.2(9) applies for a taxation year of the investor in respect of their investment in the trust.

For more detail on the expressions "specified fixed interest" and "qualifying investor" defined in subsection 94(1), and the definitions "foreign investment entity" and "participating interest," see the commentary on those provisions.

"exempt service"

The definition "exempt service" is relevant to new paragraph 94(2)(*f*), which deems the provision of certain services (other than exempt services) to be a transfer of property.

An exempt service means a service rendered at any time by an entity (the "service provider") to, for or on behalf of, another entity (a "recipient") if either

- the recipient is at that time a trust and the service relates to the administration of the trust, or
- the following conditions apply in respect of the service, namely

    (i) the service is rendered in the service provider's capacity at that time as an employee or agent of the recipient,

    (ii) in exchange for the service the recipient transfers or loans property, or becomes obligated to transfer or loan property, and

    (iii) it is reasonable to conclude

        (A) having regard only to the service and the exchange that the service provider would have been willing to carry out the service if the service provider had dealt at arm's length with the recipient, and

        (B) that the terms and conditions, and circumstances, under which the service was provided would have been acceptable to the service provider if the service provider had dealt at arm's length with the recipient.

"exempt taxpayer"

The definition "exempt taxpayer" is relevant in determining whether a taxpayer is a "specified contributor" to a trust.

Except as indicated below, tax-exempt persons to which subsection 149(1) applies are generally qualifying exempt taxpayers. However, retirement compensation arrangements and qualifying environmental trusts for which alternative income tax rules are provided under Parts XI.3 and XII.4, and insurers to which paragraph 149(1)(*t*) applies, are not qualifying exempt taxpayers.

An exempt taxpayer also includes a Canadian resident trust (determined without reference to subsection 94(3)) that is an eligible trust (as defined in subsection 94(1)) under which the only beneficiaries that may for any reason receive, at or after the particular time and directly from the trust, any of the income or capital of the trust are persons that are both qualifying investors (as defined in subsection 94(1)) and qualifying exempt taxpayers described above.

For more detail on the definition "qualifying investor" in subsection 94(1), see the commentary on that provision.

“indirect contributor”

The definition “indirect contributor” in subsection 94(1) applies in determining whether certain foreign pooled fund investment trusts trust may qualify as exempt foreign trusts under paragraph (*h*) of the definition “exempt foreign trust” in subsection 94(1). Clause (*h*)(ii)(B) of the “exempt foreign trust” definition imposes upon a trust that seeks to so qualify the requirement that all of its resident contributors be specified contributors (as defined in subsection 94(1)); however, this requirement does not apply to indirect contributors to the trust.

An indirect contributor to a particular trust, at any time, means a particular entity that

- is, at that time, a contributor to the trust, but would not be a contributor to the trust if this section were read without reference to paragraphs (*b*) and (*c*) of the definition “contribution” (as defined in subsection 94(1)) and paragraphs (2)(*l*), (*n*) and (*o*) and has no rights to receive directly from the trust any of the income or capital of the trust; and
- has at or before that time made a contribution to the trust
  - because of a transfer of property to the trust by a another entity that is a qualifying investor in respect of the trust in the case where the particular entity would not, at that time, be a contributor to the trust because of that transfer if new section 94 were read without reference to paragraph 94(2)(*l*) at that time, or
  - because of a transfer of property by an entity to the trust in exchange for property acquired from the trust which acquisition was a transfer described in subparagraph 94(2)(*g*)(ii) or because of a transfer of property to the trust that is deemed by paragraph 94(2)(*q*) to have been made by an entity because of the acquisition by that entity of a specified fixed interest in the trust from another entity in the case where
    - the particular entity would not, at that time, be a contributor to the trust if section 94 were read without reference to paragraphs 94(2)(*n*) and (*o*) at that time, and
    - each interest as a beneficiary under the trust that is relevant in determining whether the particular entity is, at that time, a contributor to the trust is, at that time, a specified fixed interest in the trust that is held, at that time, by a qualifying investor in the trust.

“non-resident time”

The definition “non-resident time” is relevant in determining whether a contributor to a trust is a “connected contributor” and whether the “look-through” rule in paragraph 94(2)(*l*) applies in determining whether an entity has made a contribution (i.e., is a contributor).

The “non-resident time” of an entity in respect of a contribution to a trust and a particular time means a time (referred to in this commentary as the “contribution time”) at which the entity made a contribution to a trust, that is before the particular time and at which the entity was non-resident. However, such a time will qualify as a non-resident time only if the entity was non-resident (or not in existence) throughout a specified period.

As indicated in the coming-into-force provision for new section 94 of the Act, where the contribution time occurs before June 23, 2000, the specified period is the period that begins 18 months before the end of the trust’s taxation year that includes the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual’s death; and
- the particular time.

Where the contribution time occurs after June 22, 2000 and the trust arose on and as a consequence of the death of an individual, the specified period is the period that begins 18 months before the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual's death; and
- the particular time.

Where the contribution time occurs after June 22, 2000 and the trust did not arise on and as a consequence of the death of an individual, the specified period is the period that begins 60 months before the contribution time and ends at the earliest of

- 60 months after the contribution time;
- where the entity is an individual, the date of the individual's death; and
- the particular time.

The measurement of the specified period by reference to any particular time is to ensure that the contributing entity and the trust may treat the contribution time as a non-resident time for the purposes of applying subsection 94(3) at a specified time (as defined in subsection 94(1)) in respect of the trust for a taxation year of the trust (generally, the end of that taxation year) if at the end of that particular year the contributor still has not become resident in Canada within the 60-month period after the contribution time.

However, new subsection 94(10) ensures that such a contributor will, for the purposes of the definition "connected contributor", be considered to have made the contribution at a time other than a non-resident time if the contributor becomes resident in Canada within the 60-month period after the contribution time. As a result, at each such specified time in respect of the trust for taxation year of the trust (generally, the end of that taxation year) following the contribution, there would be a connected contributor to the trust and, if there were a resident beneficiary under the trust, subsection 94(3) would also apply in respect of those years.

Amended subparagraph 152(4)(*b*)(vi) of the Act ensures that a reassessment of a taxpayer arising out of the application of subsection 94(10) may be undertaken by the Canada Revenue Agency within 3 years after the end of the taxpayer's normal reassessment period for the taxpayer's relevant taxation year.

For more information on new subsection 94(10) and amended subparagraph 152(4)(*b*)(vi), see the commentary on those provisions.

"promoter"

The definition "promoter" is relevant in applying new paragraph 94(2)(*s*), which provides that a transfer to a trust will not be considered a contribution where certain conditions, described in that paragraph, are met. For this purpose a promoter means an entity that establishes, organizes or substantially reorganizes the undertakings of the trust. For more information on paragraph 94(2)(*s*), see the commentary on that paragraph.

"qualifying investor"

The definition "qualifying investor" is relevant in applying paragraphs (*g*) and (*h*) of the definition "exempt foreign trust" in subsection 94(1), the definition "significant interest" in subsection 94.1(1), and the definitions "exempt taxpayer" in subsections 94(1) and 94.1(1).

A qualifying investor in respect of a trust at a particular time means an entity that is at the particular time a beneficiary (in this definition, determined without reference to subsection 248(25)) under the trust whose only interest as a beneficiary under the trust is, at all times that the interest exists during the trust's taxation year that includes the particular time, a specified fixed interest (as defined in subsection 94(1)) of the entity in the trust.

For more information on the definition "specified fixed interest" in subsection 94(1), see the commentary on that paragraph.

“qualifying services”

The definition “qualifying services” is relevant in applying paragraph (*f*) of the definition “exempt foreign trust” in subsection 94(1).

In general terms, “qualifying services” are

- services rendered by an employee of an employer while the employee was non-resident,
- services rendered to an employer other than services that were rendered primarily in Canada, in connection with a business carried on by an employer in Canada or a combination of these services,
- services rendered in a particular calendar month by an employee of the employer which employee
    - was resident in Canada no more than 60 months during the 72 month period that ends at the end of the particular month, and
    - became a member of, or a beneficiary under the plan or trust under which benefits in respect of the services may be provided (or a similar plan or trust for which the plan or the trust was substituted) before the end of the calendar month following the month in which the employee became resident in Canada, or
- any combination of services that are qualifying services described above.

“resident beneficiary”

Under new subsection 94(3), a particular trust is generally treated as resident in Canada for a particular taxation year of the trust if there is a ”resident beneficiary” under the particular trust at a “specified time” (generally, the end of the particular year). Under new paragraph 94(3)(*d*), each resident beneficiary can be jointly and severally or solidarily liable with the particular trust for the particular trust’s income tax liabilities under the Act for the particular year. (For further information with respect to the expression “solidarily “, please refer to the introductory commentary on new section 94.) See also the commentary on subsection 94(3).

A resident beneficiary at a particular time under a trust is an entity (other than an entity that is at that time a “specified charity” or a “successor beneficiary” in respect of the trust) that, at that time, is a beneficiary under the trust, if, at that time,

- the entity is resident in Canada; and
- there is a “connected contributor” to the trust.

The expressions “connected contributor”, “specified charity”, “specified time” and “successor beneficiary” are defined in new subsection 94(1). For further information, see the commentary on those definitions.

“resident contributor”

Under new subsection 94(3), a trust is generally treated as resident in Canada for a particular taxation year of the trust if there is a “resident contributor” to the trust at a “specified time” in respect of the trust for the particular taxation year (generally, the end of the particular year). Under new paragraph 94(3)(*d*), a “resident contributor” can be jointly and severally or solidarily liable with the trust for the trust’s income tax liabilities under the Act for the particular year. (For further information with respect to the expression “solidarily “, please refer to the introductory commentary above on new section 94.)

A “resident contributor” at any time means an entity that is, at that time, resident in Canada and a “contributor” (as defined in new subsection 94(1)) to the trust. However, an exemption from treatment as a resident contributor is provided for a contributor who is:

- an individual who was resident in Canada for a period of, or periods the total of which is, not more than 60 months (but not including a trust or an individual who before that time was never non-resident); and
- an individual, if the trust is an *inter vivos* trust that was created before 1960 by a person who was non-resident when the trust was created and the individual made no contribution after 1959 to the trust.

In the context of this definition, reference should also be made to new paragraphs 94(2)(*a*) to (*m*) (which extend the circumstances in which a transfer is considered to occur for the purposes of section 94), new paragraphs 94(2)(*n*) to (*q*) and subsections 94(11) to (13) (which generally extend the circumstances in which a contribution is considered to be made for the purposes of section 94) and paragraphs 94(2)(*r*) to (*u*) (which generally narrow the circumstances in which a contribution is considered to be made for the purposes of section 94).

"restricted property"

The expression "restricted property" is relevant in applying a number of provisions in respect of non-resident trusts, including the definitions in subsection 94(1) of "arm's length transfer" and "exempt foreign trust". The definition "restricted property" is intended to serve as an anti-avoidance provision.

More specifically, restricted property means

- under paragraph (*a*) of the definition, a particular share (or a right to acquire a share) of the capital stock of a particular closely-held corporation if the particular share (or right), or a property for which the particular share (or right) was substituted, was at any time acquired as part of a transaction or series of transactions under which either a specified share of the capital stock of a closely-held corporation was acquired by any entity in exchange for, as consideration for, or upon conversion of any property or (effective for taxation years beginning after Announcement Date) a share of a closely-held corporation that was not a specified share becomes a specified share;
- under paragraph (*b*) of the definition, an indebtedness (or a right to acquire indebtedness) owing by another entity if
    - the other entity is a closely-held corporation,
    - the indebtedness (or right), or a property for which the indebtedness (or right) was substituted, was at any time acquired as part of a transaction or series of transactions under which either a specified share of the capital stock of a closely-held corporation was acquired by any entity in exchange for, as consideration for, or upon conversion of any property or (effective for taxation years beginning after Announcement Date) a share of a closely-held corporation that was not a specified share becomes a specified share, and
    - the amount of any payment under a right (for taxation years that begin after July 18, 2005, whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any entity or individual) to receive, in any manner whatever and from any entity, amounts in respect of the indebtedness), or the value of such a right, is, directly or indirectly, determined primarily by reference to any one or more of the criteria, in respect of one or more properties of the other entity (or an entity with which the other entity does not deal at arm's length), identified in any of clauses (b)(iii)(A) to (D) of the definition; and
- under paragraph (*c*) of the definition, any property the fair market value of which is derived in whole or in part, directly or indirectly, from a particular share, indebtedness or right described in paragraph (*a*) or (*b*) of the definition.

New subsection 94(14) may apply in some circumstances to suspend a property's characterization as restricted property. For more details, see the commentary on that provision. For more detail on the definition "excluded property" in subsection 94(1), see the commentary on that provision.

"specified charity"

The expression "specified charity" is used in the definitions "arm's length transfer" and "resident beneficiary" in new subsection 94(1). An arm's length transfer includes a refund, from a specified charity in respect of a trust to the trust, of a gift previously made by the trust to the charity. A resident beneficiary under a trust does not include a specified charity. For more information, see the commentary on those definitions.

A specified charity in respect of a trust at any particular time means a person (in this commentary referred to as a "charity") that at that time is described in any of paragraphs (*a*) to (*e*) and (*g*.1) of the definition "total charitable gifts" in subsection 118.1(1). However, a specified charity does not include:

- a charity that does not, at a particular time, deal at arm's length with a "specified entity" in respect of the trust; or
- a charity that did not, at any "specified prior time" in respect of the charity, deal at arm's length with a specified entity in respect of the trust.

For this purpose, a "specified prior time" in respect of a charity is defined in paragraph (*c*) of the definition "specified charity" as meaning any time, before the particular time, at which

- an amount was payable to the charity as a beneficiary under the trust,
- an amount was received by the charity on the disposition of the charity's interest in the trust, or
- a benefit was received or enjoyed by the charity from or under the trust.

Paragraph (*d*) of the definition "specified charity" defines a "specified entity" in respect of a trust at any time to mean

- an entity that is at that time beneficially interested in the trust, a contributor to the trust, a person related to a contributor to the trust, a trustee of the trust, an entity that could reasonably be considered to have influence over the operation of the trust or the enforcement of its terms, or an entity that could reasonably be considered to have influence over the selection or appointment of an entity referred to above, or
- any group at least one of the members of which is described immediately above.

"specified contributor"

The expression "specified contributor" is used in paragraph 94(2)(*r*) and paragraph (*h*) of the definition "exempt foreign trust" in new subsection 94(1).

Paragraph (*h*) of the definition "exempt foreign trust" is intended to ensure that investors in commercial investment trusts are subject to the regime for foreign investment entities in new sections 94.1 to 94.4 of the Act. Where a particular investor in such a commercial investment trust sells or has redeemed a beneficial interest in the trust, paragraph 94(2)(*r*) may apply to ensure that the acquisition of that interest by the particular investor will, after the sale or redemption, not be treated as a contribution to the trust.

For taxation years in respect of which new section 94 applies to a trust, the definition is relevant in applying both paragraph 94(2)(*r*) and the definition "exempt foreign trust". For earlier taxation years, the definition "specified contributor" will generally only be relevant in determining whether an investor in the trust has ceased to be a contributor to the trust because of paragraph 94(2)(*r*).

An entity can only qualify as a specified contributor to a trust at any time if, at that time, it is both a beneficiary (generally determined without reference to subsection 248(25)) under, and a contributor to, the trust.

If this condition is met and that time is both before February 17, 1999 and immediately before a sale or redemption of the entity's interest as a beneficiary under the trust, then the entity will be a specified contributor in respect of that interest for the purpose of applying paragraph 94(2)(*r*) to that sale or redemption. If paragraph 94(2)(*r*) applies, then in applying section 94 to the entity after the sale or redemption, the entity is treated as not having made any contribution to the trust in respect of its acquisition of that interest.

For a particular entity that is a beneficiary under a trust at a particular time that is after February 16, 1999, the particular entity will be a specified contributor to the trust at the particular time only if

- it is, at the particular time, a contributor to the trust;
- at all times that it is a beneficiary under the trust, its interest as a beneficiary is a "specified fixed interest" (as defined in subsection 94(1)) in the trust;

- the trust is identified, in a timely fashion, by or on behalf of the particular entity, in prescribed form or a copy of the terms of the trust that apply at the particular time has, together with a prescribed form, been filed, in a timely fashion, with the Minister by or on behalf of the trust; and
- where the particular entity is not an "exempt taxpayer" (as defined in subsection 94(1)), it is reasonable to conclude, in respect of any contribution made by it to the trust after February 16, 1999 and on before the particular time, that
  - no consideration was received (other than property received by the particular entity that is the particular entity's interest as a beneficiary under the trust),
  - none of the reasons (determined by reference to all the circumstances including the terms of the trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the contribution is the acquisition at any time by any entity (other than the particular entity) of a right as a beneficiary (here as defined generally in subsection 94(1)) under the trust (other than the acquisition by any such entity of an interest as a beneficiary under the trust from the particular entity for consideration equal to the fair market value of that interest) to receive, at any time and directly from the trust, income or capital of the trust, and
  - the fair market value of the particular contribution is equal to the fair market value, at the time of the particular contribution, of the particular entity's interest as a beneficiary under the trust acquired as a result of the particular contribution.

Where the particular entity qualifies at any time as a specified contributor, the sale or redemption, immediately after that time, of its interest as a beneficiary under the trust may result, as described above, in the application of paragraph 94(2)(*r*). In addition, if the particular entity is a resident contributor to a non-resident commercial investment trust, that was seeking to meet, at that time, the requirements of paragraph (*h*) of the definition "exempt foreign trust", the particular entity's contributions to the trust would not alone cause the trust to fail to meet those requirements (ignoring subsection 94(16) of the Act).

Note, however, that an entity will not qualify as a specified contributor to a trust if at any time after February 16, 1999, the entity (or another entity with which it does not deal at arm's length) contributes restricted property to the trust. As a result, even if the contribution of restricted property were in consideration for the acquisition of an interest as a beneficiary under the trust, paragraph 94(2)(*r*) would not apply, to expunge the contribution, upon the sale or redemption of the interest in the trust. Moreover, the entity's status as a resident contributor to the trust may jeopardize the trust's ability to qualify as an exempt foreign trust.

"specified controlled foreign affiliate"

A "specified controlled foreign affiliate" of a particular entity at any time means an entity that would, at that time, be a controlled foreign affiliate of the particular entity if the particular entity were resident in Canada at that time. The definition is used for the purpose of the definition "specified party".

"specified fixed interest"

The expression "specified fixed interest" is relevant in applying paragraphs 94(2)(*q*) and (*r*), the definition "specified contributor" in subsection 94(1), the definition "significant interest" in subsection 94.1(1), and the definition "qualifying investor" in subsection 94(1), which in turn is relevant in applying paragraph (*b*) of the definitions "exempt taxpayer" in subsections 94(1) and 94.1(1), and paragraph (*h*) of the definition "exempt foreign trust" in subsection 94(1). These provisions are intended to apply only to commercial investment trusts.

A specified fixed interest at any time of an entity in a trust means an interest of the entity as a beneficiary under the trust, if

- the interest was issued by the trust,
- the interest includes, at that that time, rights of the entity as a beneficiary under the trust to receive, at or after that time and directly from the trust, income and capital of the trust,

- no amount of income or capital of the trust that any entity may receive directly from the trust at any time as a beneficiary under the trust depends on the exercise by any entity of, or the failure by any entity to exercise, a discretionary power – in very general terms, no entity may hold a power to appoint beneficiaries under the trust, and
- the only manner in which any part of the interest may cease to be the entity's is by way of a disposition (determined without regard to paragraphs (*i*) of the definition "disposition" in subsection 248(1) and 248(8)(*c*)) of the interest resulting from a transfer (generally determined without reference to the extended transfer rules in section 94), including (under paragraph 94(2)(*m*)) a deemed transfer upon the redemption of the interest.

For taxation years that begin on or before July 18, 2005, a trust may elect to have an alternative definition of "specified fixed interest" apply in respect of the trust. Where that election is made, a specified fixed interest at any time of an entity in a trust means a capital interest (as defined in subsection 108(1) of the Act) of the entity in the trust, if

- the interest was issued by the trust;
- the interest includes, at that time, a right of the entity as a beneficiary under the trust to receive, at or after that time and directly from the trust, income or capital of the trust;
- no right of the entity as a beneficiary under the trust to income or capital of the trust may cease, other than because of a specified transaction or event, to be a right of the entity; and
- the trust has never been a personal trust.

"specified party"

New subsection 94(8) of the Act provides a rule for calculating an entity's recovery limit for the purpose of determining under subsection 94(7) of the Act the extent of an entity's limitation on liability arising under a provision referred to in new paragraph 94(3)(*d*). A "specified party" in respect of a particular entity at any time means an entity that is at that time:

- under paragraph (*a*) of the definition, an individual who is a spouse or common-law partner of the particular entity;
- under paragraph (*b*) of the definition, a "specified controlled foreign affiliate" (as described in the commentary immediately above) of the particular entity, or of a spouse or common-law partner of the particular entity;
- under paragraph (*c*) of the definition, an entity for which it is reasonable to conclude that the benefit referred to in subparagraph 94(8)(*a*)(iii) of the Act (i.e., a benefit received or enjoyed under a trust) was conferred either
    - in contemplation of the entity becoming after that time a "specified controlled foreign affiliate" of an entity referred to in subparagraph (*b*)(i) or (ii) of the definition, or
    - to avoid or minimize a liability under this Part that arose, or that would otherwise have arisen, because of the application of subsection (3) with respect to the particular entity; or
- under paragraph (*d*) of the definition, a corporation in which the particular entity is a shareholder, if the corporation is or was beneficially interested in a trust, and the particular entity is a beneficiary under the trust solely because of the application of paragraph (*b*) of the definition "beneficiary" in subsection 94(1) to the particular entity in respect of the corporation.

"specified property"

New subsection 94(9) can affect the calculation of the amount of a "contribution" (as defined in new section 94) to a trust of "specified property". For this purpose, "specified property" means:

- a share of the capital stock of a corporation, an interest as a beneficiary under a trust, an interest in a partnership, or an interest in any other entity;
- a right to acquire any of the above (effective for taxation years beginning after Announcement Date, this definition has been amended to clarify that such right includes a right that is immediate or future, absolute or contingent, conditional or subject to the exercise of any discretion by any entity); or
- any other property deriving its value primarily from property described above.

"specified share"

A specified share means a share of the capital stock of a corporation other than a share that is prescribed for the purpose of paragraph 110(1)(*d*). This expression is relevant to the definition "restricted property" in subsection 94(1). For more information, see the commentary on the definition "restricted property".

"specified time"

A specified time, in respect of a trust for a taxation year of the trust, means

- if the trust exists at the end of the taxation year, the time that is the end of that taxation year; and
- if the trust ceases to exist after October 30, 2003, the time, in that taxation year that is immediately before the time at which the trust ceases to exist.

This expression is relevant in determining whether paragraph 94(3)(*a*) applies to deem the trust to be resident in Canada, for the taxation year, for a number of purposes. It also applies in respect of subsections 94(7) and (10). For more detail, see the commentary on those provisions.

"successor beneficiary"

The expression "successor beneficiary" is used in the definition "resident beneficiary" in new subsection 94(1). A resident beneficiary under a trust does not include a successor beneficiary. The interest of a successor beneficiary in a trust that is a foreign investment entity may, in certain circumstances, also be exempt from the application of those rules to the interest – for more detail, see the commentary on the definition "specified interest" in subsection 94.1(1).

A successor beneficiary in respect of a trust at a particular time means an entity that is a beneficiary under the trust solely because of a right of the beneficiary to receive any of the trust's income or capital, if under that right the entity may so receive that income or capital only on or after the death after that time of a specified individual. For this purpose a specified individual is an individual who is, at that time, alive and a contributor to the trust, an individual related to a contributor to the trust, or an individual who would have been related to a contributor to the trust if every individual who was alive before that time were alive at that time.

"trust"

A definition "trust" is provided for the purpose of applying section 94. The definition clarifies that a reference to a trust in that section includes an estate.

Rules of Application

ITA
94(2)

New subsection 94(2) of the Act sets out a number of rules for use in applying section 94. These rules are primarily relevant for the purposes of determining whether a transaction constitutes a "contribution" of property to a trust. These rules are also relevant for the purposes of subsections 94(7) to (9) and the amended reporting rules in subsections 162(10.1) and 163(2.4) and section 233.2.

Paragraphs 94(2)(*a*) to (*m*) include rules that deem certain loans or transfers, the granting of options and the provision of services to be transfers of property to an entity. A deemed transfer will be considered to be a contribution to a trust if the transfer falls within the criteria of the definition "contribution" in subsection 94(1)

or the deemed contribution rules. In this regard, it should be noted that a transfer or loan, unless it is deemed to be a contribution under a provision of section 94, will not be considered a contribution if it is an "arm's length transfer" (as defined in new subsection 94(1)). In addition, paragraphs 94(2)(*r*) to (*u*), may apply to deem certain transfers not to be contributions.

The rules in subsection 94(2) generally apply to taxation years of trusts that begin after 2006, but in some cases relief is provided with regard to transactions or events that occur before June 23, 2000 or October 11, 2002. In addition, trusts created in 2001, created in 2002, created in 2003, created in 2004, created in 2005 or created in 2006 may elect in writing (by filing the election with the Minister of National Revenue on or before the trust's filing-due date for the trust's taxation year in which the amending legislation is assented to) to have new section 94 of the Act apply to its taxation years that begin in 2001, 2002, 2003, 2004, 2005 and 2006, as the case may be.

Deemed Transfers

Paragraph 94(2)(*a*) of the Act generally applies to indirect loans or transfers of property to a trust through transfers to other entities. Paragraph (*a*) deems a transfer of property (other than an "arm's length transfer", as defined in new subsection 94(1) or a transfer to which paragraph 94(2)(*c*) applies) to be a direct transfer to a trust if the property is transferred from one entity to another and, as a result of the transfer, the fair market value of the property of the trust increases or the liabilities of the trust decrease. Where paragraph (*a*) applies, paragraph 94(2)(*b*) deems the fair market value of property deemed transferred under paragraph 94(2)(*a*) to be the total of all amounts each of which is the absolute value of an increase in the fair market value of the trust property or a decrease in the liabilities of the trust because of the transfer.

Paragraph 94(2)(*c*) also applies to indirect loans or transfers of property to a trust. Paragraph (*c*) deems a transfer or loan of property (other than an "arm's length transfer") from an entity to another entity to be a direct transfer to a trust where the trust holds property the fair market value of which is derived from property held by the other entity. Paragraph 94(2)(*d*) deems the fair market value of property deemed transferred under paragraph 94(2)(*c*) to be the fair market value of the property referred to in subparagraph (2)*(c)*(i).

Paragraph 94(2)(*e*) deems a particular entity that provides a guarantee or other financial assistance to another entity to have transferred property to that other entity. Any property given to the particular entity by the other entity in exchange for the guarantee or other financial assistance is deemed to have been transferred to the particular entity in exchange for the property deemed by subparagraph (*e*)(i) to have been transferred. Under subparagraph 94(2)(*h*), the fair market value of the property deemed by subparagraph (*e*)(i) to have been transferred is deemed to be the fair market value of the assistance.

Paragraph 94(2)(*f*) applies where any service (other than an exempt service, as defined in subsection 94(1)) is rendered after June 22, 2000 by an entity to, for or on behalf of another entity. In these circumstances, the entity rendering the service is deemed to have transferred property to the other entity. Any property given to the particular entity by the other entity in exchange for the service is deemed to have been transferred to the particular entity in exchange for the property deemed by subparagraph (*f*)(i) to have been transferred. For more information on the definition "exempt service", see the commentary on that definition.

Under paragraph 94(2)(*h*), the fair market value of the property deemed under subparagraph 94(2)(*f*)(i) to have been transferred is deemed to be equal to the fair market value of the services rendered.

For greater certainty, paragraph 94(2*)(g*) provides that a corporation is considered to transfer shares that it issues. Similar rules, also contained in paragraph 94(2)(*g*), apply to interests in a trust acquired otherwise than from a beneficiary under the trust, interests in a partnership acquired otherwise than from a member of the partnership, or interests in an other entity acquired otherwise than from an entity having an interest in the other entity, as well as to debt issued to an entity by another entity and a right (granted after June 22, 2000 by the entity from which the right was acquired) to acquire or to be loaned property.

As noted above, paragraph 94(2)(*h*) is relevant to determining the fair market value of property deemed under subparagraphs 94(2)(*e*)(i) and (*f*)(i) to have been transferred.

Paragraph 94(2)(*i*) deems an entity to have become obligated at a particular time to transfer property to another entity where the entity becomes obligated to do an act (*e.g.*, the rendering of a service) that would constitute the transfer of a property to another entity if the act were to occur. This rule is generally relevant for the purposes of paragraph (*c*) of the definition "contribution" in subsection 94(1).

Paragraph 94(2)(*j*) applies, for the purpose of applying at any time the definition "non-resident time" in subsection (1), if a trust acquires property of an individual as a consequence of the death of the individual. In these circumstances, paragraph 94(2)(*j*) deems the individual to have transferred the property to the trust immediately before the individual's death.

Paragraph 94(2)(*k*) applies where a particular entity loans or transfers property to another entity at the direction of or with the acquiescence of a second entity (the "specified entity"). In these circumstances, if it is reasonable to conclude that one of the reasons for the transfer is to avoid or minimize a liability of any entity under Part I of the Act that arose, or that would otherwise have arisen, because of the application of subsection (3), the transfer is deemed to be a transfer made jointly by the particular entity and the specified entity.

Paragraph 94(2)(*k.1*) applies where a particular entity loans or transfers property, at any time after Announcement Date, to another entity at the direction of or with the acquiescence of a second entity (the "specified entity"). In these circumstances, if it is reasonable to conclude that one of the reasons for the loan or transfer is to provide benefits in respect of services rendered by a person as an employee of the specified entity, the transfer is deemed to be a transfer made jointly by the particular entity and the specified entity.

Paragraph 94(2)(*l*) also applies where a particular entity loans or transfers property to another entity at the direction of or with the acquiescence of a specified entity. In these circumstances, the transfer is deemed to be a transfer made jointly by the particular entity and the specified entity if

- the transfer is made at a time that is not, or would not be, if the transfer or loan were a contribution of the specified entity, a "non-resident time" (as defined in new subsection 94(1)) of the specified entity, and
- either
  - the particular entity is at the time of the transfer a controlled foreign affiliate of the specified entity (or would be a controlled foreign affiliate of the specified entity if the specified entity were resident in Canada), or
  - it is reasonable to conclude that the transfer was made in contemplation of the particular entity becoming after the time of the transfer a controlled foreign affiliate of the specified entity (or a controlled foreign affiliate of the specified entity if the specified entity were resident in Canada).

The expression "controlled foreign affiliate" is defined in subsection 248(1) of the Act as having the meaning given in subsection 95(1).

Paragraph 94(2)(*m*) deems a particular entity to have transferred, at a particular time, a particular property or particular part of it, as the case may be, to a corporation or a second entity (described below) if

- the particular property is a share of the capital stock of a corporation held at the particular time by the particular entity, and as consideration for the disposition at or before the particular time of the share, the particular entity received at the particular time (or became entitled at the particular time to receive) from the corporation a share of the capital stock of the corporation, or
- the particular property (or property for which the particular property is substituted property) was acquired, before the particular time, from the second entity by any entity, in circumstances that are described by any of subparagraphs 94(*g*)(i) to (vi) (generally, the issuance by the second entity of a financial instrument) and at the particular time,
  - the terms or conditions of the particular property change,

- the second entity redeems, acquires or cancels the particular property or the particular part of it,
- where the particular property is a debt owing by the second entity, the debt or the particular part of it is settled or cancelled, or
- where the particular property is a right to acquire or to be loaned property, the particular entity exercises the right.

Deemed Contributions

Paragraph 94(2)(*n*) applies where a particular trust makes a contribution to another trust. If this is the case, the contribution is deemed to have been made jointly by the particular trust and each other entity that is a contributor to the particular trust.

Paragraph 94(2)(*o*) applies where a partnership makes a contribution to a trust. Where this is the case, the contribution is deemed to have been made jointly by the partnership and by each entity that is a partnership member (other than a limited partner) at the time of the contribution. However, if a partnership has contributed to a trust, a limited partner of the partnership may also be considered to have made a contribution to the trust in respect of a transfer or loan made by the limited partner or another entity if any of the rules in subsection 94(2) so provide.

Paragraph 94(2)(*p*) provides, subject to paragraph 94(2)(*q*) and subsection 94(9), that the amount of a contribution to a trust at the time it was made is deemed to be the fair market value at that time of the property that was the subject of the contribution. The rule is useful for the purposes of new paragraph 94(2)(*u*), subsections 94(7) and (8), as well as the reporting penalty provisions in amended subsections 162(10.1) and 163(2.4). The rule is relevant because a contribution is defined by reference to a loan or transfer, rather than by reference to the property that was the subject of the transfer or loan.

Paragraphs 94(2)(*q*) and (*r*) apply to dealings in a "specified fixed interest" (as defined in new subsection 94(1)) in a trust and in a right, issued by the trust, to acquire such an interest. The rules for specified fixed interests apply in respect of commercial investment trusts. For more detail, see the commentary on the definitions "specified fixed interest" and "specified contributor" in subsection 94(1) and on paragraph (*h*) of the definition "exempt foreign trust" in subsection 94(1).

Paragraph 94(2)(*q*) deems an entity, that at any time acquires a specified fixed interest in a trust (or a right, issued by the trust, to acquire such an interest) from another entity (other than the trust), to have made a contribution to the trust at that time. The amount of the contribution is deemed to be the fair market value at that time of the specified fixed interest.

Transfers deemed not to be contributions

Paragraph 94(2)(*r*) generally applies where a particular entity has made a contribution (e.g., because of paragraph 94(2)(*q*)) to a trust because of acquiring a specified fixed interest in the trust or a right to acquire such an interest, or has acquired a specified fixed interest in a trust as a consequence of making a contribution to the trust, and at a later time the interest or right, as the case may be, is transferred, for arm's length consideration, to another entity (i.e., upon a sale of the interest or right, of if the other entity is the trust that issued the interest or right, upon a redemption of the interest or right). In these circumstances, the particular entity is deemed, for the purpose of applying section 94 at any time after the later time, not to have made the contribution in respect of the specified fixed interest, or right, that is the subject of the sale if immediately before the later time (i.e., the time of the sale or redemption) the particular entity is specified contributor to the trust.

Paragraph 94(2)(*s*), in very general terms, provides that a transfer of property to a trust by a particular entity that is a manager or promoter of the trust, in exchange for an interest as a beneficiary under the trust, will not be considered a contribution of the particular entity to the trust while the beneficial interest is acquired and held by the particular entity because of a requirement imposed under securities laws. Paragraph 94(2)(*s*) will be relevant in the relatively rare circumstance that a commercial investment trust cannot rely on the exemption for exempt foreign trusts in order to avoid the application of subsection 94(3). Paragraph 94(2)(*s*) will apply in determining

under that subsection whether the trust has a resident contributor or connected contributor (i.e., and hence, a resident beneficiary).

More specifically, under paragraph 94(2)(*s*), a transfer to a trust by a particular entity is deemed not to be, at a particular time, a contribution to the trust if

- the particular entity has transferred, at or before the particular time and in the ordinary course of business of the particular entity, property to the trust,
- the transfer is not an arm's length transfer, but would be an arm's length transfer if the definition "arm's length transfer" in subsection 94(1) were read without reference to paragraph (a), and subparagraphs (b)(i) to (iii) and (v) to (viii), of that definition,
- it is reasonable to conclude that the particular entity was the only entity that acquired, in respect of the transfer, an interest as a beneficiary under the trust,
- the particular entity was required, under the securities law of a country or of a political subdivision of the country in respect of the issuance of beneficial interests by the trust, to acquire the interest because of the particular entity's status at the time of the transfer as a manager or promoter (as defined in subsection 94(1)) of the trust,
- at the particular time the trust is not an exempt foreign trust, but would be at that time an exempt foreign trust if it had not made an election under paragraph (g) of the definition "eligible trust", and
- the particular time is before the earliest of
  - the first time at which the trust becomes an exempt foreign trust,
  - the first time at which the particular entity ceases to be a manager or promoter of the trust, and
  - the time that is 24 months after the first time at which the total fair market value of consideration received by the trust in exchange for beneficial interests (other than the particular entity's interest referred to in subparagraph 94(2)(*s*)(iii)) in the trust is greater than $500,000.

Paragraph 94(2)(*t*) generally expunges a contribution of shares or indebtedness of a Canadian corporation from the corporation to a trust if the corporation issued (in circumstances described in subparagraph 94(2)(*g*)(i) or (v)) the shares or the debt to the trust (or to another entity in circumstances that resulted in the Canadian corporation being deemed by paragraph 94(2)(*c*) to have transferred particular property to the trust) and the trust or the other entity later sells the shares or indebtedness in circumstances in which the parties to the sale deal with each other on an arm's length basis.

However, the application of 94(2)(*t*) will not effect the application of 94(2)(*c*) or (*g*) in respect of the original transfer by the corporation to the trust or the other entity: such transfers will continue to be treated as transfers under section 94. In addition, the application of 94(2)(*t*) will not expunge the status as a contribution to the trust of a transfer made by an entity and involving the corporation (e.g., an entity that transferred property to the corporation, and hence the trust, because of the application of paragraph 94(2)(*c*) and (*m*)).

More specifically, under paragraph 94(2)(*t*) a transfer, by a Canadian corporation of particular property (i.e., a share or debt), that is at a particular time a contribution by the Canadian corporation to a trust, is deemed not to be, after the particular time, a contribution by the Canadian corporation to the trust if

- either the trust acquired the particular property before the particular time from the Canadian corporation in circumstances described in subparagraph 94(2)(g)(i) or (v), or another entity acquired property before the particular time from the Canadian corporation in circumstances described in subparagraph 94(2)(g)(i) or (v) and because of that acquisition the Canadian corporation was deemed by paragraph 94(2)(c) to have transferred the particular property to the trust;

- as a result of a transfer (i.e., a sale of, or a redemption by the Canadian corporation of, the issued shares or debt) at the particular time by any entity (referred to in the paragraph as the "seller") to another entity (referred to in the paragraph as the "buyer") the trust ceases to hold all of its property that is shares of the capital stock of, or debt issued by, the Canadian corporation or the trust ceases to hold property that is property the fair market value of which is derived in whole or in part, directly or indirectly, from shares of the capital stock of, or debt issued by, the Canadian corporation;
- the purchaser deals at arm's length immediately before the particular time with the Canadian corporation, the trust and the seller;
- in exchange for the sale, the purchaser transfers or becomes obligated to transfer property (which property is referred to in the paragraph as the "consideration"), to the seller; and
- it is reasonable to conclude
  - having regard only to the sale and the consideration that the seller would have been willing to make the sale if the seller dealt at arm's length with the buyer,
  - that the terms and conditions made or imposed in respect of the exchange are terms and conditions that would have been acceptable to the seller if the seller dealt at arm's length with the buyer, and
  - that the value of the consideration is not, at or after the particular time, determined in whole or in part, directly or indirectly, by reference to shares of the capital stock of, or debt issued by, the Canadian corporation.

Paragraph 94(2)(*u*) applies to a transfer, before October 11, 2002, to a personal trust by an individual (other than a trust) of particular property. Where the conditions in subparagraphs 94(2)(*u*)(i) and (ii) are met, the transfer of the particular property is deemed not to be a contribution of the particular property by the individual to the trust. Paragraph 94(2)(*u*) is intended to provide relief to individuals that have transferred a relatively small amount of property to a trust (e.g., the initial settlement of a coin on the trust) where the individual can reasonably be considered not to have been involved with the use of the trust as part of what is commonly referred to as an estate freeze (i.e., see the condition in clause 94(2)(*u*)(ii)(A) that the trust never have acquired from the individual restricted property).

The conditions in subparagraphs 94(2)(*u*)(i) and (ii) are that

- the individual identifies the trust in prescribed form filed with the Minister on or before the individual's filing-due date for the individual's 2003 taxation year (or a later date that is acceptable to the Minister), and
- the Minister is satisfied that
  - the individual (and any entity not dealing at any time at arm's length with the individual) has never loaned or transferred, directly or indirectly, restricted property to the trust,
  - in respect of each contribution (determined without reference to paragraph 94(2)(*u*)) made before October 11, 2002 by the individual to the trust, none of the reasons (determined by reference to all the circumstances including the terms of the trust, an intention, the laws of a country or the existence of an agreement, a memorandum, a letter of wishes or any other arrangement) for the contribution was to permit or facilitate, directly or indirectly, the conferral at any time of a benefit (for greater certainty, including an interest as a beneficiary under the trust) on

    (I) the individual,

    (II) a descendant of the individual, or

    (III) any entity with whom the individual or descendant does not, at any time, deal at arm's length, and

- the total of all amounts each of which is the amount of a contribution (determined without reference to paragraph 94(2)(*u*)) made before October 11, 2002 by the individual to the trust does not exceed the greater of

  (I) 1% of the total of all amounts each of which is the amount of a contribution (determined without reference to paragraph 94(2)(u)) made to the trust before October 11, 2002, and

  (II) $500.

The examples below illustrate the operation of subsection 94(2) and the definition "contribution" in subsection 94(1).

Example 1

Donald is a long-term resident of Canada. In 2007, Donald pays higher than fair market value consideration for a property acquired from a corporation. A non-resident trust holds shares in the corporation. The fair market value of those shares increases because of the transaction.

Results

1. *Under paragraph 94(2)(a), Donald is considered to have transferred property to the trust in these circumstances. The exception for arm's length transfers does not apply.*
2. *As a consequence, Donald is considered to have made a contribution to the trust, which results in Donald being a contributor and a resident contributor to the trust.*

Example 2

1. *Lucie, a long-term resident of Canada, transfers property to Canco on condition that Canco direct Canco's wholly-owned foreign subsidiary (Foreignco-1) to transfer properties to another corporation (Foreignco-2) for consideration that is less than fair market value.*
2. *Shares of the capital stock of Foreignco-2 are held by a non-resident trust.*
3. *The fair market value of the Foreignco-2 shares increases as a result of the increase in the fair market value of the property owned by Foreignco-2.*

Results

1. *The transfers to Canco and to Foreignco-2 are part of the same series of transactions.*
2. *Because of paragraph 94(2)(a), the transfer to Foreignco-2 is considered to be a transfer by Foreignco-1 to the trust. Because of paragraph 94(2)(l), the transfer by Foreignco-1 to the trust is considered to be jointly made by Foreignco-1 and Canco. (This would also be the result under paragraph 94(2)(k), if it was intended to avoid or minimize a liability under Part I.) The exception for arm's length transfers does not apply.*
3. *Canco is considered to have made a contribution to the non-resident trust because of paragraph (a) of the definition "contribution" in new subsection 94(1). Lucie is considered to have made a contribution to the trust under paragraph (b) of that definition. Both Lucie and Canco are therefore contributors and resident contributors to the trust.*
4. *Foreignco-1 is also a "contributor" to the trust, but is not a "resident contributor" as long as it does not become resident in Canada.*

Liabilities of Non-resident Trusts and Others

ITA
94(3)

New subsection 94(3) of the Act applies to a non-resident trust (other than an "exempt foreign trust", as defined in subsection 94(1)) for a taxation year where, at a "specified time" in respect of the trust for the taxation year (generally, the end of the taxation year), there is a "resident contributor" to the trust or a "resident beneficiary" under the trust. All of these defined expressions are explained in detail in the commentary on new subsection 94(1).

Where subsection 94(3) applies to a non-resident trust for a taxation year, the trust is deemed to be resident in Canada throughout the year for the purposes specified in paragraph 94(3)(*a*). Except to the extent otherwise provided by subsection 94(4), a trust is deemed to be resident in Canada for a taxation year under subsection 94(3):

- for the purposes of applying section 2, in computing the trust's income for the year and computing the trust's liability for tax under Part I – with the result that the trust is subject to tax under that Part on its world-wide income for the year (including, for example, its income determined as a result of deemed dispositions under subsections 104(4) to (5.2) or 128.1(4) and, for example, in determining whether a foreign affiliate of the trust is its controlled foreign affiliate and whether it has FAPI);
- for the purpose of subsection 111(9), with the result that in determining the trust's losses for the taxation year, subsection 111(9) will not apply in computing its taxable income for the year;
- for the purpose of applying clause 53(2)(*h*)(i.1)(*B*) – with the result that the adjusted cost base to a beneficiary of the beneficiary's interest in a trust to which this clause applies is computed in the same way as for interests in trusts resident in Canada;
- for the purpose of applying the definition "non-resident entity" in subsection 94.1(1) – with the result that a beneficiary's interest in the trust is not treated as an interest of a beneficiary in a foreign investment entity for the purposes of new sections 94.1 to 94.4;
- for the purposes of applying subsections 104(13.1) to (29), and 107(2.1) and (2.002) and section 115 – with the result that the tax treatment of beneficiaries under the trust generally accords with the tax treatment available to beneficiaries under trusts that are resident in Canada;
- for the purposes of determining the obligation of the trust to file a return under sections 233.3 and 233.4 – with the result that the trust is required to file information returns under sections 233.3 (information return on foreign property holdings the total cost of which exceeds $100,000) and 233.4 (information return on foreign affiliates);
- for the purpose of determining the liability of the trust for tax under Part XIII – with the result that the trust is exempt from Part XIII tax on amounts paid or credited to it (for more detail, see the commentary to subsection 94(4));
- for the purpose of applying Part XIII in respect of an amount (other than an exempt amount) paid or credited by the trust to any person;
- for the purpose of determining after July 18, 2005 whether a foreign affiliate of a taxpayer (other than the trust) is a controlled foreign affiliate of the taxpayer; and
- for the purpose of determining the rights and obligations of the trust under sections 150 to 180 – with the result that various administrative provisions in the Act apply in the same way as to other trusts resident in Canada. (These provisions include those with regard to the filing of returns, assessments, tax payments, arrears interest, refund interest, instalment interest, penalties, refunds and appeals.)

A trust to which subsection 94(3) applies is deemed to be resident in Canada throughout the year for the above purposes, including the computation of its income and its taxable income and section 2 of the Act. Section 2 of the Act imposes on every person resident in Canada at any time in a taxation year an obligation to pay an income tax on that person's taxable income for the year.

Under paragraph 1 of the resident article in Canada's income tax treaties, a reference in such a treaty to a "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation in that State by reason of the person's domicile, residence, place of management or any other criterion of a similar nature. A person, in this context, would generally include a trust because of the definition "person" in Canada's income tax treaties. Because a trust to which subsection 94(3) applies is deemed to be resident of Canada and is liable to tax in Canada on its taxable income, it will be considered a resident of Canada under paragraph 1 of the resident article in Canada's income tax treaties, whether it is also considered to be resident, under the applicable treaty, in another country or not.

A trust that is also resident of the other contracting state under a particular treaty would be a dual resident under the treaty. In the event of dual residency under an income tax treaty, the tie-breaker rules in the resident article applicable to individuals would not apply. The Canada Revenue Agency has expressed the view that in this context, the term "individual" is to be interpreted to mean natural person and not a trust. The Agency has indicated that this interpretation would generally prevail across most if not all of Canada's income tax treaties if the definition "person" in the particular treaty under consideration makes reference to both an "individual" and a "trust". Even if a trust were considered an individual for the purpose of an income tax treaty, it is clear from the context of the tie-breaker rule applicable to individuals that it is intended to apply only to natural persons. This is because expressions such as "personal home", "centre of vital interest" and "habitual abode" used in the tie-breaker rules have meaning only in reference to natural persons and would not be of use in clarifying the residence of a trust for the purpose of a treaty.

In this regard, paragraph 94(3)(*b*) applies for the purposes of applying subsections 20(11) and (12) and section 126 in respect of the trust. Paragraph 94(3)(*b*) allows a trust to elect for the special rules in that paragraph to apply in determining the trust's eligibility for a foreign tax credit. If the trust elects for a taxation year,

- the trust's income for the taxation year (other than the portion of the income that is from sources inside Canada or that is from a source, outside Canada, that is a business carried on by the trust outside Canada) is deemed, for the purposes of subsections 20(11) and (12) and section 126,
    - to be income of the trust from sources (other than a business carried on by the trust) in a particular country (other than Canada) in which the trust is resident (determined without reference to this subsection), and
    - not to be from any other source; and
- in determining the income or profits tax paid by the trust for the taxation year to the government of the particular country the trust can pool the total of all amounts each of which is the amount of an income or profits tax that was paid by the trust for the particular taxation year to the government of a country (other than Canada) and that can reasonably be regarded as a tax paid on the trust's income for the taxation year (other than the portion of the income that is from sources inside Canada or that is from a source, outside Canada, that is a business carried on by the trust outside Canada).

Paragraph 94(3)(*b*) also provides that in determining the non-business income tax (as defined by subsection 126(7)) paid by the trust for a taxation year to the government of a country other than Canada no amount shall be included to the extent that it can reasonably be regarded as attributable to income from a source in Canada.

Paragraph 94(3)(*c*) provides that a non-resident trust that becomes subject to subsection 94(3) for a particular taxation year, after not being subject to either new subsection 94(3) or existing paragraph 94(1)(*c*) for the preceding year is deemed, immediately before the end of the preceding taxation year, to have disposed of each property (other than property described in any of subparagraphs 128.1(1)(*b*)(i) to (iv)) held by the trust at that time for proceeds of disposition equal to its fair market value at that time. The trust is also deemed to have, at the beginning of the particular taxation year, acquired each of those properties so disposed of at a cost equal to its proceeds of disposition

Note, in this regard, that, because of paragraph 94(4)(*d*), subsection 128.1(1) will not apply in the preceding taxation year only because of the application of paragraph 94(3)(*a*).

Paragraph 94(3)(*c*) is intended to ensure – in a manner similar to that for taxpayers that migrate to Canada – that certain gains or losses that accrued on certain property of the trust while the trust was non-resident are not subject to taxation in Canada.

Paragraph 94(3)(*c*) also complements the rule in subsection 94(6), which applies where a non-resident trust ceases to be an "exempt foreign trust" (as defined in subsection 94(1)). In this case, subsection 94(6) establishes the beginning of a new "stub" taxation year. If subsection 94(3) applies for that "stub" year, paragraph 94(3)(*c*) would be applicable with regard to the properties held by the trust at the beginning of that "stub" year.

Example 1

A trust is created in 2007. The trust is not at any time an exempt foreign trust. At the end of its 2007 taxation year, the trust is non-resident and there are no resident contributors to the trust and no resident beneficiaries under the trust.

On February 1, 2008, John makes a contribution to the trust. At the end of the trust's 2008 taxation year, John is a resident contributor to the trust, and the trust is non-resident.

On July 1, 2009 the sole trustee of the trust moves to Canada, becomes resident in Canada at that time and remains resident in Canada throughout the remainder of the year. Immediately before the trustee became resident in Canada, the trustee was non-resident and John remained a resident contributor to the trust.

Results

Trust's 2007 Taxation Year

1. *Subsection 94(3) does not apply to deem the trust to be resident in Canada in computing its income for its 2007 taxation year.*

Trust's 2008 Taxation Year

2. *Paragraph 94(3)(a) applies to deem the trust to be resident in Canada, throughout its 2008 taxation year, for a number of purposes, including the computation of its income. Because the trust was non-resident throughout its 2007 taxation year, paragraph 94(3)(c) also applies to deem the trust to have disposed of its property (other than certain properties described in subparagraphs 128.1(1)(b)(i) to (iv)) for fair market value proceeds immediately before the end of its last 2007 taxation year and to have reacquired those properties at a cost equal to that fair market value at the beginning of the 2008 taxation year. Because of paragraph 94(4)(d), the application of the deemed residency rule in paragraph 94(3)(a) will not cause the trust to become resident in Canada for purposes of subsection 128.1(1).*

Trust's 2009 Taxation Year

3. *Because the trustee of the trust becomes resident in Canada on July 1, 2009, paragraph 128.1(1)(a) will apply to deem the trust to have a taxation year-end immediately before the change of residency. At the end of this first 2009 taxation year of the trust, paragraph 94(3)(a) applies to deem the trust to be resident in Canada, throughout that first 2009 taxation year, for a number of purposes, including the computing of its income. However, paragraph 94(3)(c) will not apply because the trust was resident in Canada (i.e. because of the application of paragraph 94(3)(a) to the trust's 2008 taxation year) throughout the year preceding the 2009 taxation year.*
4. *Paragraph 128.1(1)(a) also applies to deem the trust to have a new taxation year at the time the trustee becomes resident in Canada on July 1, 2009. Because the trust is resident in Canada at the end of this second 2009 taxation year, paragraph 94(3)(a) does not apply to deem the trust to be resident in Canada in computing its income for that year.*
5. *As the trust is resident in Canada for the first 2009 taxation year (i.e., the 2009 taxation year discussed in #3 above), subsection 128.1(1.1) suspends the application of the deemed disposition and re-acquisition rules in paragraphs 128.1(1)(b) and (c) that would otherwise apply in respect of the end of that first 2009 taxation year because of the trust becoming resident in Canada on July 1, 2009. This ensures that the trust does not realize at the end of that first 2009 taxation year any accrued gains or losses of the trust solely because the basis of the trust's residency in Canada changes.*

6. Note that where subsection 128.1(1.1) applies to a trust, it suspends only the application of paragraph 128.1(1)(b) (as a result paragraph 128.1(1)(c) also has no application) to the trust. If the trust becomes resident in Canada, it would continue to be subject to paragraph 128.1(1)(a). Also note that paragraph 94(4)(d) ensures that the application of paragraph 94(3)(a) to the trust will not affect the determination of whether the trust becomes resident in Canada for the purposes of subsection 128.1(1).

Paragraph 94(3)(*d*) imposes liabilities for a taxation year on entities who are "resident contributors" or "resident beneficiaries". Where subsection 94(3) applies to a trust for a taxation year, each of these entities is jointly and severally, or solidarily, liable with the trust in respect of the trust's obligations under sections 150 to 180. Typically, the most significant obligation in this context is the obligation to pay tax instalments pursuant to section 156. However, the extent of the liability imposed by paragraph 94(3)(*d*) is limited by new subsection 94(7). For more information, see the commentary on subsections 94(7) to (9).

The expression "solidarily liable" is added to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

Paragraph 94(3)(*e*) imposes liabilities for a taxation year on each entity that is a beneficiary under the trust and was a person from whom an amount would be recoverable at the end of 2006 under subsection 94(2) (as it read in its application to taxation years that began before 2007) in respect of the trust if the entity had received before 2007 amounts described under paragraphs 94(2)(*a*) or (*b*) in respect of the trust (as those paragraphs read in their application to taxation years that began before 2007). Where subsection 94(3) applies to the trust for a taxation year, each of these entities is, to the extent of the entity's recovery limit for the year, jointly and severally, or solidarily, liable with the trust in respect of the trust's obligations under sections 150 to 180. Note that where a trust created in 2001, 2002, 2003, 2004, 2005 or 2006 has elected under the coming-into force of new section 94 to have new section 94 apply to it for its taxation years that begin in 2001, 2002, 2003, 2004, 2005 or 2006, as the case may be, paragraph 94(3)(*e*) does not apply to it (i.e., because "old" section 94 would never have applied to it).

Note that subsection 94(3) generally does not result in the creation of any obligations for a trust that is subject to subsection 94(3) to withhold tax under Part XIII or to pay any tax under Part XIII.2 in respect of distributions of income earned by the trust from Canadian sources to non-resident beneficiaries.

Instead, the rules in new subsection 104(7.01) are designed so that there will be a reasonable level of Part I tax in respect of Canadian-source income received by the trust in the event the trust also distributes that income to non-resident beneficiaries in their capacity as beneficiaries. For more information, see the commentary on subsection 104(7.01).

In addition, in the event that the trust pays or credits an amount to a non-resident and that amount is not referred to in paragraph 104(7.01)(*b*) in respect of the trust for the taxation year, the non-resident will continue to be liable for any Part XIII tax on the amount, except to the extent that the amount is described in paragraph (*b*) of the definition "exempt amount" in subsection 94(1), or paid or credited before 2004.

Excluded Provisions

ITA
94(4)

New subsection 94(4) of the Act provides that the rules in paragraph 94(3)(*a*) treating non-resident trusts as resident in Canada do not apply for the purposes of:

- the definitions "arm's length transfer", "exempt taxpayer" and "exempt foreign trust" in subsection 94(1) – thus ensuring that there is no circularity in applying those definitions due to fact that those definitions impose a requirement that a trust be non-resident;
- subsections 70(6) and 73(1) and paragraph 107.4(1)(c) (other than, for transfers to trusts that occurred before February 28, 2004, subparagraph 107.4(1)(c)(i)), and paragraph (f) of the definition "disposition" in subsection 248(1) – thus ensuring that rules allowing in some cases for a rollover of property on transfers to a Canadian resident trust generally do not apply to transfers to a trust otherwise deemed to be resident in Canada by subsection 94(3));
- determining whether subsection 107(5) applies to a distribution on or after July 18, 2005 of property to the trust;
- in determining whether an amount can be attributed, under subsection 75(2), to the trust. (This rule had earlier been proposed through a modification to subsection 75(2));
- determining whether the exception, under paragraph 94(14)(b), to property that is restricted property is available in respect of property held by a non-resident trust;
- paragraph (a) of the definition "mutual fund trust" in subsection 132(6) – making it clear that a trust deemed to be resident in Canada by subsection 94(3) will not be treated as a mutual fund trust for any purpose;
- determining, for taxation years that begin after July 18, 2005, whether a partnership is a "Canadian partnership" (as defined in subsection 102(1) of the Act); and
- determining whether, in applying subsection 128.1(1), the trust becomes resident in Canada at a particular time and determining whether, in applying subsection 128.1(4), the trust ceases to be resident in Canada at a particular time – thus ensuring that the deeming of a trust to be resident under paragraph 94(3)(*a*) does not apply to affect a determination of whether a trust has changed residence at any time (e.g., upon a change of trustees or upon a change of residence of trustees).

Note that paragraphs 94(4)(*d*) and (*e*) are generally suspended, for a brief transitional period, in their application to a trust that is subject without interruption to "old" and "new" sections 94. That transitional period starts immediately before the end of the trust's last taxation year that began before 2007 and for which it was deemed resident by "old" section 94 and ends immediately after the beginning of the trust's first taxation year that begins after 2006 (i.e., its first taxation year in respect of which "new" section 94 applies). This is intended to ensure that section 128.1 does not apply to a trust solely because of the transition between the old and new NRT regimes. The suspension of paragraphs 94(4)(*d*) and (*e*) does not apply, however, where in the transitional period a change in the trustees of the trust occurred (e.g., the number of trustees changed, the residency of any of the trustees changed, or any of the trustees was replaced).

Furthermore, except as otherwise permitted under subsection 216(4.1) of the Act, paragraphs 94(3)(*a*) and 94(4)(*c*) do not relieve a payer of Canadian-source income from the obligation to withhold amounts under section 215 in connection with amounts paid to a trust deemed to be resident in Canada by subsection 94(3). This is so even though such a trust is not itself liable for Part XIII tax on amounts paid or credited to it, because of the application of subparagraph 94(3)(*a*)(viii). The trust would be expected to apply for a refund of such tax, which would be given, except to the extent that there are any outstanding liabilities of the trust with regard to Part I tax.

Deemed Cessation of Residence

ITA
94(5)

New subsection 94(5) of the Act deems a trust to have ceased to be resident in Canada at the earliest time in a specified period at which there is neither a "resident contributor" to the trust nor a "resident beneficiary" under the trust. For this purpose, the specified period is the period that would (if the Act were read without reference to subsection 128.1(4)) be a taxation year of the trust

- that immediately follows a taxation year of the trust throughout which it was resident in Canada,
- at the beginning of which there was either a resident contributor to the trust or a resident beneficiary under the trust, and
- at the end of which the trust is non-resident.

For more information on the expressions "resident contributor" and "resident beneficiary", as defined in new subsection 94(1), see the commentary on those provisions.

Where subsection 94(5) applies, the cessation of residence in Canada of a trust results in the application of subsection 128.1(4). Under that subsection, a taxation year of the trust is deemed to have ended immediately before the earliest time in the specified period described above. At that deemed taxation year-end, the criteria in subsection 94(3) are satisfied. Accordingly, the trust will be subject to tax under Part I on its worldwide income for that year because it is considered under subsection 94(3) to be resident in Canada throughout that year. Under new paragraph 94(3)(*d*), each "resident beneficiary" or "resident contributor" at the time of that deemed taxation year end can be jointly and severally, or solidarily, liable with the trust for the trust's income tax liabilities under the Act for that year. (For more detail on the expression "solidarily", please refer to the introductory commentary above on new section 94.)

Becoming or Ceasing to be an Exempt Foreign Trust

ITA
94(6)

New subsection 94(6) of the Act generally provides that, if a trust becomes or ceases to be an "exempt foreign trust" (as defined in new subsection 94(1)) at any time, the trust's taxation year is deemed to have ended immediately before that time, a new "stub" taxation year is deemed to have begun at that time and the trust is deemed not to have established a fiscal period before that time. However, subsection 94(6) does not apply where a trust ceases to be an exempt foreign trust because it becomes resident in Canada.

Subsection 94(3) may apply in respect of the later "stub" taxation year of the trust if the criteria set out in that subsection are satisfied at a "specified time" in respect of the trust for the taxation year (generally, the end of the taxation year). Where this is the case, the trust would be subject to tax under Part I on its world-wide income for that later "stub" year because it would be considered under subsection 94(3) to be resident in Canada for that year.

Limit to Amount Recoverable

ITA
94(7) and (8)

New subsection 94(7) of the Act allows for a limitation of the amount that may be recovered from an entity that would otherwise be jointly, severally, or solidarily, liable for the entire amount of a trust's tax obligations under the Act. Subsection 94(7) applies to an entity (other than an entity that is deemed, by subsection 94(12) or (13), to be a contributor or a resident contributor to the trust) in respect of a particular taxation year of the trust where three conditions are satisfied.

The first condition is satisfied in respect of a particular taxation year of the trust:

- where, under subparagraph 94(7)(*a*)(i), the entity is jointly and severally, or solidarily, liable with the trust only because the entity was a "resident beneficiary" (as defined in new subsection 94(1)) under the trust at a specified time in respect of the trust for the particular year, or
- where, under subparagraph 94(7)(*a*)(ii), at a specified time in respect of the trust for, the total amount (determined with reference to paragraph 94(2)(*b*), (*d*), (*h*), (*p*) and (*q*) and subsection 94(9)) of contributions made to the trust by the entity (or by another entity not dealing at arm's length with the entity) is not more than the greater of $10,000 and 10% of the total amount of all contributions to the trust.

The second condition, under paragraph 94(7)(*b*), requires that the entity have filed on a timely basis all information returns required to be filed by the entity in respect of the trust under section 233.2 (or on any later day that is acceptable to the Minister of National Revenue). However, the second condition need not be satisfied if the first condition is satisfied because the total determined under subparagraph 94(7)(*a*)(ii) (in respect of the entity and all entities not dealing at arm's length with it) is $10,000 or less.

The third condition, under paragraph 94(7)(*c*), is satisfied in respect of an entity and a particular taxation year of the trust where it is reasonable to conclude that each transaction or event that occurred before the end of the particular year at the direction of, or with the acquiescence of, the entity satisfied the following conditions:

- none of the purposes of the transaction or event was to enable the entity to avoid or minimize any liability under a provision referred to in paragraph 94(3)(*d*) in respect of the trust, and
- the transaction or event was not part of a series of transactions or events any of the purposes of which was to enable the entity to avoid or minimize any liability under a provision referred to in paragraph 94(3)(*d*) in respect of the trust.

There are a number of transactions or events, or series of transactions or events, that may result in a failure to satisfy the third condition (e.g., an artificial dilution of an entity's relative contribution to the trust (i.e., below the 10% level); or corporate distributions that have the effect of avoiding or minimizing the impact of the three-year rule described in subsection 94(9)).

Reference should be made in this context to the definition "contribution" in subsection 94(1), as well as to related rules in subsection 94(2).

Where subsection 94(7) applies to an entity in respect of a taxation year of a trust, the amount recoverable at any time from the entity in respect of the year is limited to the person's "recovery limit", determined under subsection 94(8), in respect of the trust and the year.

Under subsection 94(8), the amount of the recovery limit that applies to a particular entity at any particular time is calculated as follows:

- ADD amounts received or receivable after 2000 and before the particular time by the particular entity on the disposition of all or part of the particular entity's interest as a beneficiary under the trust, or by another entity that was, at the time the amount became receivable, a specified party (as defined in subsection 94(1)) in respect of the particular entity on the disposition of all or part of the specified party's interest as a beneficiary under the trust;
- ADD an amount (other than an amount described in the paragraph above) made payable by the trust after 2000 and before the particular time to the particular entity because of the interest of the particular entity as a beneficiary under the trust, or another entity (that was, at the time the amount became payable, a specified party in respect of the particular entity) because of the interest of the specified party as a beneficiary under the trust;
- ADD the fair market value of benefits received or enjoyed, after 2000 and before the particular time, under the trust by the particular entity (or an entity that was, at the time the benefit was received or enjoyed, a specified party in respect of the particular entity), not otherwise taken into account above;

- ADD the maximum amount that would be recoverable from the particular entity at the end of 2006 under subsection 94(2) (as it read in its application to taxation years that began before 2007) if the trust had had tax payable under Part I of the Act at the end of 2006 in excess of the total of the amounts described in respect of the entity under paragraphs 94(2)(a) and (b) (as they read in their application to taxation years that began before 2005),
  - except to the extent that the amount so recoverable is in respect of an amount that is included in the particular entity's recovery limit because of subparagraph 94(8)(a)(i) or (ii), and
  - except where the trust was created in 2001, 2002, 2003, 2004, 2005 or 2006 and new section 94 applies to the trust for its 2001, 2002, 2003, 2004, 2005 and 2006 taxation years, as the case may be, because of an election by the trust in the coming-into-force provision;
- ADD the total amount (determined with reference to paragraphs 94(2)(b), (d), (h), (p) and (q) and subsection 94(9)) of contributions made to the trust by the particular entity, to the extent that this amount exceeds the total of the first four amounts;
- SUBTRACT previous recoveries by the Canada Revenue Agency ("CRA") under subsection 94(3) (or under subsection 94(1) as it read in its application to taxation years that began before 2007, except where the trust was created in 2001, 2002, 2003, 2004, 2005 or 2006 and new section 94 applies to the trust for its 2001, 2002, 2003, 2004, 2005 and 2006 taxation years, as the case may be, because of an election by the trust in the coming-into-force provision) from the particular entity in respect of the trust and the year or a preceding taxation year of the trust;
- SUBTRACT previous recoveries by the CRA under subsection 94(3) (or under subsection 94(1) as it read in its application to taxation years that began before 2007, except where the trust was created in 2001, 2002, 2003, 2004, 2005 or 2006 and new section 94 applies to the trust for its 2001, 2002, 2003, 2004, 2005 and 2006 taxation years, as the case may be, because of an election by the trust in the coming-into-force provision) from a specified party in respect of the particular entity in respect of the trust and the year or a preceding taxation year of the trust; and
- SUBTRACT the amount, if any, by which the particular entity's tax payable under this Part for any taxation year in which an amount described in any of subparagraphs 94(8)(a)(i) to (iii) was paid, became payable, was received, became receivable or was enjoyed by the particular entity exceeds the amount that would have been the particular entity's tax payable under this Part for that taxation year if no such amount were paid, became payable, were received, became receivable or were enjoyed by the particular entity in that taxation year.

For more information on subsections 94(11) to (13), or the expression "specified party" as defined in subsection 94(1), see the commentary on those provisions.

Determination of Contribution Amount

ITA
94(9)

Subsection 94(9) affects the calculation of the amount of a "contribution" (as defined in new subsection 94(1)) to a trust of "specified property" (as defined in new subsection 94(11)) for the purpose of determining whether the "recovery limit" limitation applies to a contributor to the trust and of determining the amount of that recovery limit.

The amount of a contribution to a trust because of a transfer to the trust of specified property is deemed by subsection 94(9) to be the greater of:

- the amount, otherwise determined, at that time of the contribution; and
- the amount that is the greatest fair market value of the specified property (or of substituted property) in the period that begins immediately after that time and ends at the end of the third calendar year after that time.

For more information on the expression "specified property" as defined in new subsection 94(1), see the commentary on that provision.

Subsection 94(9) allows for a reasonable opportunity for recovery of tax by the CRA in the context of a transaction or series of transactions involving the transfer of specified property. Consider, for example, an estate freeze under which common shares in the capital stock of a corporation are transferred directly or indirectly to a non-resident trust. Because of the difficulties associated with valuing the common shares at the time of the transfer, it is appropriate to provide for a valuation as described above.

In conjunction with new subsection 94(9), subparagraph 152(4)(*b*)(vi) of the Act is amended to ensure that a reassessment of a taxpayer arising out of the application of subsection 94(9) can be undertaken by the CRA within 3 years after the normal reassessment period of the taxpayer in respect of the taxpayer's relevant taxation year.

Where Contributor Becomes Resident in Canada Within 60 Months after Contributing

ITA
94(10)

New subsection 94(10) of the Act applies to determine whether there is a "connected contributor" (as defined in new subsection 94(1)) to a trust for the purposes of section 94, including in applying the definition "resident beneficiary" (as defined in new subsection 94(1)). Under new paragraph 94(3)(*d*) of the Act, a resident beneficiary can, to an extent, be liable for the trust's income tax under Part I of the Act. For more information, see the commentary on those definitions and subsections 94(3) and (7) to (9).

A "contribution" (as defined in new subsection 94(1)) to a trust by a contributor is considered to have been made at a time other than a "non-resident time" (as defined in subsection 94(1)) if the contributor becomes resident in Canada at any time within the period (referred to in this commentary as the "60-month post period") 60 months after the time of the contribution. However, to facilitate the administration of the definition "non-resident time", paragraph (*b*) of the definition "connected contributor" and subsection 94(3), the definition "non-resident time" is drafted so that such a contributor and the trust may, subject to subsection 94(10), treat the time of the contribution as a non-resident time for the purposes of applying the definition "connected contributor" and subsection 94(3) at a "specified time" (as defined in new subsection 94(1)) in respect of the trust for any particular trust taxation year if at the specified time the contributor still has not become resident in Canada within the 60-month post period.

Subsection 94(10) deems (for the purpose of applying section 94 at each specified time, in respect of a trust for a taxation year of the trust, that is before the particular time at which the contributor becomes resident in Canada within the 60-month post period) the contribution to have been made at a time other than a non-resident time of the contributor if:

- in applying the definition "non-resident time" as of each of those specified times, the particular contribution was made at a non-resident time of the contributor; and
- in applying the definition "non-resident time" at the particular time, the contribution is made at a time other than a non-resident time of the contributor.

Where subsection 94(10) applies, the contributor will be considered a "connected contributor" to the trust and, if, as a result, there was a "resident beneficiary" at a specified time in the relevant prior taxation year of the trust, the trust and the resident beneficiary would, because of subsection 94(3), generally be jointly and severally, or solidarily, liable for Part I tax on the trust's income for the year. (For more details on the expression "solidarily", please refer to the introductory commentary above on new section 94.)

Subparagraph 152(4)(*b*)(vi) of the Act is amended to ensure that a reassessment of a taxpayer arising out of the application of subsection 94(10) can be undertaken by the Canada Revenue Agency within 3 years after the normal reassessment period of the taxpayer in respect of the taxpayer's relevant taxation year.

Deemed Contributor or Resident Contributor

ITA
94(11) to (13)

Subsections 94(11) to (13) provide a set of related anti-avoidance rules that apply where it is reasonable to conclude that one of the reasons for a loan or transfer of property from a trust (the "original trust"), that is deemed under paragraph 94(3)(a) to be resident in Canada (or, except where the trust was created in 2001, 2002, 2003, 2004, 2005 or 2006 and elects under the coming-into-force provision of new section 94 to have that section apply for its 2001, 2002, 2003, 2004, 2005 and 2006 taxation years, was deemed resident because of subsection (1) as it read in its application to taxation years that began before 2007 or would have been so deemed under either of those provisions if they had applied without regard to the period of time in which a contributor to the trust was resident in Canada), to another trust (the "transferee trust") is to avoid or minimize the liability, of any entity under Part I of the Act, that arose, or that would otherwise have arisen, because of the application of subsection (3) (or, except where the trust was created in 2001, 2002, 2003, 2004, 2005 or 2006 and elects under the coming-into-force provision of new section 94 to have that section apply for its 2001, 2002, 2003, 2004, 2005 and 2006 taxation years, as the case may be, because of subsection (1) as it read in its application to taxation years that began before 2007).

Where such a loan or transfer is made at a particular time, the original trust is deemed, under subsection 94(12), to be a resident contributor to the transferee trust for the purpose of applying this section in respect of the transferee trust.

Where such a loan or transfer is made at a particular time, an entity that is at that time a contributor to the original trust is deemed, under subsection 94(13), to be a contributor to the transferee trust and a connected contributor to the transferee trust (if at that time the entity is also a connected contributor to the original trust). For more information on the definitions "contributor" and "connected contributor" in subsection 94(1), see the commentary on those definitions.

Subsection 94(7) of the Act, generally provides that the liability of a "resident contributor" is limited by that contributor's recovery limit, as determined by reference to subsections 94(7) to (9). However, subsection 94(7) does not apply to an entity that is deemed, by subsection 94(12) or (13), to be a contributor or a resident contributor to the trust. For more information on the definition "resident contributor" or subsections 94(3) and (7) to (9), see the commentary on those provisions.

Restricted Property

ITA
94(14)

Subsection 94(14) of the Act operates to suspend, in limited circumstances, a particular property's status as restricted property.

Paragraph 94(14)(*a*) is, in general terms, intended to apply only to preferred shares of the capital stock of a corporation that are issued by the corporation only for money. More specifically, paragraph 94(14)(*a*) provides that a particular property, that is or will be at any time held, loaned or transferred, as the case may be, by an entity, is not restricted property held, loaned or transferred, as the case may be, at that time by the entity if

- the particular property is a share of a specified class (as defined in subsection 256(1.1)) of shares of the capital stock of a corporation,
- the particular property was issued by the corporation in exchange for, or as consideration for, money and no other property, and
- no other property (other than identical shares issued by that corporation) was acquired by any entity as part of that issuance.

Paragraph 94(14)(*b*) provides that a particular property (identified in prescribed form filed with the Minister of National Revenue) that is at any time held, loaned or transferred by the entity will not be treated as restricted property held, loaned or transferred at that time by the entity if

- the particular property (or property for which the particular property is, or is to be, substituted property) was not, and will not be, at any time acquired, held, loaned or transferred by the entity (or any entity with whom the entity does not at any time deal at arm's length) in whole or in Part for the purpose of permitting any change in the value of the property of a corporation (that is, at any time, a closely-held corporation) to accrue directly or indirectly in any manner whatever to the value of property held by a non-resident trust; and
- the Minister is satisfied that this is the case with respect to the property (and property, if any, for which it is to be substituted).

The prescribed form in which the particular property is identified must be filed by the entity's filing-due date (or another date acceptable to the Minister) for the entity's taxation year that includes that time. The other date will generally be a date later than the entity's relevant filing due-date, but in circumstances in which the entity has no filing-due date, the other date is intended to provide the Minister with the ability to choose a filing deadline for the prescribed form.

Paragraph 94(14)(*c*) provides that property is not restricted property of an entity where it is, at that time, an excluded property.

For more details on the definitions "restricted property", "closely-held corporation" and "excluded property", see the commentary on those provisions.

Arm's Length Dealing and Related Persons

ITA
94(15)

Subsection 94(15) of the Act ensures that the rules in section 251 are applicable in determining whether entities deal at arm's length with each other or are related to each other. The subsection provides in effect, that for the purposes of section 94, when determining whether a particular entity and another entity are related to each other or deal, at any time, with each other at arm's length, each reference in section 251 to the word "person" is to be read as a reference to the expression "entity" (as defined in subsection 94(1)).

Anti-Avoidance – 150 Entities or Persons

ITA
94(16)

Subsection 94(16) is an anti-avoidance provision that is relevant to the application of the definition "closely-held corporation" in subsection 94(1), paragraph (*h*) of the definition "exempt foreign trust" in subsection 94(1), and the definition "excluded property" in subsection 94(1). These definitions, respectively, provide for different results based, in part, on the condition that there be at a particular time at least 150 shareholders of the capital stock of a corporation, at least 150 beneficiaries under a trust, or at least 150 persons that hold property (identical to a particular property) issued by a trust, corporation or limited partnership.

Subsection 94(16) provides that, if it can reasonably be considered that one of the main reasons that an entity is at any time a shareholder of a corporation, holds a capital interest in a trust, or holds a property is to cause the applicable above condition to be met in respect of the corporation, the trust or – in the case of the condition in the definition "excluded property" – the particular property (or an identical property), the condition is deemed not to have been met with respect to the corporation, the trust or the particular or identical property.

Where subsection 94(16) applies in respect of a particular time and in respect of the corporation or trust, in the case of the corporation, it would be treated at that time as a closely-held corporation and in the case of the trust, it would not be treated at that time as an exempt foreign trust. In the case of the definition “excluded property”, the particular property and the identical property would not be excluded property.

For more detail on the definitions “closely-held corporation”, “excluded property” and “exempt foreign trust”, see the commentary on those definitions.

Clause 18

Foreign Investment Entities

ITA
94.1

Overview

Existing Rules

Existing section 94.1 of the Act applies where a taxpayer has invested in an offshore investment fund and one of the main reasons for the investment is to reduce or defer the tax liability that would have applied to the income generated from the underlying assets of the fund if such income had been earned directly by the taxpayer. In these circumstances, existing section 94.1 generally requires an amount to be included in computing the taxpayer’s income from the investment. This amount is determined, in general terms, by multiplying the cost amount of the taxpayer’s investment by a factor based on interest rates prescribed under Part XLIII of the *Income Tax Regulations*.

New Rules

Section 94.1 is replaced by provisions in new sections 94.1 to 94.4, which contain rules governing the tax treatment of interests in foreign investment entities (FIEs), tracking entities and foreign insurance policies.

In computing a taxpayer’s income for a taxation year, new subsection 94.1(4) will generally require an amount to be included in computing the taxpayer’s income from the investment. This amount will be determined, in general terms, by multiplying the designated cost of the taxpayer’s investment by a factor based on interest rates prescribed under paragraph 4301(*b*) of the *Income Tax Regulations*.

If a taxpayer elects and has sufficient information to comply, either new subsection 94.2(4) or 94.3(4) will apply in place of the rules in subsection 94.1(4) for computing income from the investment. However, in the case of interest in a tracking entity, subsection 94.3(4) will not be available, and in the case of an interest in a foreign insurance policy, only subsection 94.2(4) will apply.

Under subsection 94.2(4), a taxpayer must take into account the annual increase or decrease in the fair market value of the taxpayer’s interest in computing the taxpayer’s income from the interest.

Under subsection 94.3(4), a taxpayer is required to include the taxpayer’s share of the FIE’s income for each FIE taxation year that ends in the taxpayer’s taxation year.

Section 94.4 is designed to prevent double taxation with respect to amounts included in income under any of sections 94.1 to 94.3.

New sections 94.1 to 94.4 apply to taxation years that begin after 2006.

Note that under the coming-into-force provision for new sections 94.1 to 94.4, an election or form (but for greater certainty not including a return of income) referred to in any of new sections 94.1 to 94.3 of the Act made by a taxpayer is deemed to have been filed with the Minister of National Revenue

(i) on a timely basis if it is filed with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year that includes the day of Royal Assent, and

(ii) in the taxpayer's return of income for the taxpayer's taxation year identified by the taxpayer in the election, if it is filed with the Minister of National Revenue in writing in the taxpayer's return of income for the taxpayer's taxation year that includes the day of Royal Assent.

For more detail on filing obligations in respect of returns of income, contact the Canada Revenue Agency.

The table below provides an overview of new sections 94.1 to 94.3 and related provisions.

Issue	**Summary**	**References**
1. Who is subject to the new FIE rules?	A. All taxpayers, except exempt taxpayers. Except as indicated in (C), below, FIE rules do not apply to non-resident taxpayers.	S.94.1(3), 94.2(3), (9) and (11). "Exempt taxpayer" (s.94.1(1)). Non-resident taxpayers: see also s.94.1(3) and 94.2(5).
	B. Partnerships with members resident in Canada must allocate FIE income to those members.	Section 96, including exception in s. 96(1.9). See also s. 94.2(6) for application to cases where partnership members become resident in Canada.
	C. Controlled foreign affiliates.	New s. 95(2)(*g*.3).
2. What property is subject to the new FIE rules?	A. If subsection 94.1(3) applies, Participating interests (other than exempt interests) in foreign investment entities. However, if no taxation year of a FIE has ended in the taxpayer's taxation year, the FIE rules do not apply to the taxpayer for the taxpayer's year in respect of the FIE.	S. 94.1(3) and the following definitions in s. 94.1(1): "entity", "non-resident entity", "foreign investment entity", "exempt interest" and "participating interest".
	B. If 94.1(3) does not apply, interests in tracking entities for which subsection 94.2(9) applies. Section 94.3 not available for such interests.	S. 94.1(4) and 94.2(3) and (9). The definition "tracking entity" in 94.2(1) See also amended s. 91(1).
	C. Interests in certain foreign insurance policies. This property is subject only to s. 94.2, not s. 94.1, 94.3 and 94.4.	S. 94.2(3), (10) and (11).
3. What is the difference in the tax treatment of FIE interests between ss. 94.1, 94.2 and 94.3?	A. Section 94.1. Investor's income inclusion based on a prescribed rate of return.	S. 94.1(4).
	B. Section 94.2. Full appreciation/decline in fair market value of the investment is recognized on an annual basis.	S. 94.2(4). S. 94.2(20).
	C. Section 94.3. Investor includes its "share" of a FIE's income (e.g., does not include FIE's share of unrealized gains).	S. 94.3(4).

Issue	Summary	References
4. How will foreign affiliates of taxpayers resident in Canada be treated under new FIE rules?	Subject to s. 94.2(9) (interests in tracking entities), a taxpayer's share of the capital stock of a controlled foreign affiliate is exempt from the new FIE rules. In certain cases, a taxpayer can elect to have a foreign affiliate treated as a controlled foreign affiliate. Otherwise, the FIE rules will apply to the interest in the affiliate.	Paragraph (*a*) of the definition "exempt interest". Paragraphs 94.1(2)(*h*) and (*i*).
5. If a non-resident corporation that is a FIE pays out dividends, how are these dividends taxed?	A. General principle: existing rules apply.	Existing s. 90 and 113.
	B. Relief provided to prevent double taxation. This relief applies to taxable distribution from other FIEs (e.g., trusts).	S. 94.4.
6. In what circumstances is a taxpayer subject to any of sections 94.1 to 94.3, respectively?	A. Requirement to use s. 94.1 where insufficient information to use s. 94.2 or s. 94.3.	S. 94.1(4), 94.2(3), 94.3(3).
	B. Election to use s. 94.2 available – interest must have readily ascertainable fair market value.	S. 94.2(2) and (3).
	C. Requirement to use s. 94.2 in the case of interests in foreign insurance policies.	S. 94.2(3), (10) and (11).
	D. Election to use s. 94.3 available (but not if 94.2(9) applies to the interest) – must have sufficient information.	S. 94.3(2) and (3).

Definitions

ITA
94.1(1)

New subsection 94.1(1) of the Act defines a number of expressions for the purpose of section 94.1. These definitions are also relevant for the purposes of sections 94.2 and 94.3.

"arm's length interest"

The definition "arm's length interest" is relevant in determining whether a taxpayer's particular participating interest is, under paragraph (*e*) of the definition "exempt interest" in subsection 94.1(1), an exempt interest and whether an interest has at any time a "readily obtainable fair market value" as defined in subsection 94.2(1). For more information, see the commentary on those definitions.

A particular participating interest in a particular non-resident entity is an arm's length interest at any time only if

- either
  - it is reasonable to conclude that there are at least 150 persons each of which holds participating interests in the particular non-resident entity that, at that time, are identical to the particular participating interest, and have a total fair market value of at least $500, or
  - participating interests, in the non-resident entity, that are identical to the participating interest are listed on a prescribed stock exchange, and those interests have, at that time, a "readily obtainable fair market value" (as that term is defined in subsection 94.2(1)),

- the total of all amounts each of which is the fair market value, at that time, of the particular participating interest or of a participating interest in the non-resident entity that is identical to the particular participating interest and that is held, at that time, by the taxpayer or an entity or individual with whom the taxpayer does not deal at arm's length does not exceed 10% of the total of all amounts each of which is the fair market value, at that time, of a participating interest in the non-resident entity that is held, at that time, by any entity or individual and that is identical to the particular participating interest, and
- it is reasonable to conclude that the participating interests in the non-resident entity that are identical to the particular participating interest can
  - normally be acquired and sold by members of the public in the open market, or
  - can be acquired from and sold to the non-resident entity by members of the public.

"beneficiary"

A reference in sections 94.1 to 94.4 to a "beneficiary" carries, except for the purpose of paragraph 94.2(11)(*e*) (i.e., a beneficiary in respect of an interest in an insurance policy), the meaning assigned by subsection 94(1). For more information, see the commentary on the definition "beneficiary" in subsection 94(1).

"carrying value"

In applying sections 94.1 to 94.4 in respect of a taxpayer, the "carrying value" of a property held by a particular entity at any time means:

- the fair market value of the property at that time, if
  - the particular entity is an entity (referred to in this note as the "first entity") in which the taxpayer holds at that time a participating interest or is another entity in which the first entity holds at that time a direct or indirect interest,
  - the taxpayer elects, by notifying the Minister in writing in the taxpayer's return of income for the taxpayer's taxation year that includes that time to have this paragraph apply to all of the particular entity's property, and
  - the property is property that is valued for the purpose of the entity's "financial statements" (as defined in subsection 94.1(1)) as of that time; and
- in any other case, the amount at which the property is valued for the purpose of the entity's financial statements as of that time.

The carrying value of property is relevant primarily for the purpose of determining whether a non-resident entity is a FIE. For more information, see the commentary on the definitions "foreign investment entity" and "financial statements".

It should also be noted that paragraph 94.1(2)(*j*) provides a "look-through" rule that can affect the properties considered to be owned by an entity and the carrying values of the entity's properties. In particular, the rule in paragraph 94.1(2)(*j*) can impute to an entity both ownership of property otherwise owned by certain other entities in which the entity has a significant interest, and the "net accounting income" (as defined in subsection 94.1(1)) and certain business activities of such other entities derived from such property. For the purposes of the look-through rule, the time at which the determination of carrying value is made is the end of the last "taxation year" (as defined in subsection 94.1(1)) of the first tier non-resident entity (whether lower tier entities share the same taxation year or not) that ends in a relevant taxation years of an electing taxpayer. For more information, see the commentary to new paragraph 94.1(2)(*j*) and the definition "taxation year".

“designated cost”

In computing a taxpayer’s income for a taxation year from a participating interest of the taxpayer in a non-resident entity, where subsection 94.1(4) applies, the taxpayer will be required to include the amount, determined under that subsection, in computing the taxpayer’s income from the investment. That amount is determined by multiplying the “designated cost” of the taxpayer’s investment by a factor based on the interest rate prescribed under paragraph 4301(*b*) of the *Income Tax Regulations*.

The designated cost to a taxpayer at any time of a participating interest held at that time by the taxpayer in a non-resident entity, is determined, in general terms, as follows:

- ADD the cost amount to the taxpayer of the participating interest at that time (determined without reference to certain provisions of the Act),
- ADD the amount of any previous income inclusions, of the taxpayer in respect of the participating interest, arising because of the application of subsection 94.1(4) for a previous taxation year that ends after 2006,
- ADD, if the participating interest was an offshore investment fund property (as defined in subsection 94.1(1) as it read in its application to taxation years that began before 2007) of the taxpayer at the end of the taxpayer’s last taxation year that began before 2007, certain amounts required to be included in computing the designated cost under “old” subsection 94.1(2),
- ADD, if the participating interest was acquired by the taxpayer before 2007, and was not an offshore investment fund property of the taxpayer at the end of the taxpayer’s last taxation year that began before 2007, the amount, if any, by which the fair market value of the participating interest at the end of that last taxation year exceeds the cost amount to the taxpayer of the participating interest at the end of that last taxation year,
- ADD, if one or more particular amounts has been made available by a person to another person after the last 2006 taxation year of the non-resident entity and before that time for the main purpose of increasing the value of the taxpayer’s participating interest, the total of all amounts each of which is the amount, if any, by which each particular amount exceeds any increase in the cost amount to the taxpayer of the participating interest because of that particular amount,
- ADD, if the participating interest is acquired by the taxpayer after 2006, the amount, if any, by which the fair market value of the participating interest at the time it was so acquired exceeds the cost amount to the taxpayer of the participating interest at the time it was so acquired, and
- SUBTRACT, if the participating interest was last acquired by the taxpayer before 2007, and was not an offshore investment fund property (as defined in subsection 94.1(1) as it read in its application to taxation years that began before 2007) of the taxpayer at the end of the taxpayer’s last taxation year that began before 2007, the amount, if any, by which the cost amount to the taxpayer of the participating interest at the end of that last taxation year exceeds the fair market value of the participating interest at the end of that last taxation year.

“entity”

An entity includes an association, a corporation, a fund, a joint venture, an organization, a partnership, a syndicate and a trust. It does not include a natural person.

“exempt business”

The definition “exempt business” is relevant in determining whether a “non-resident entity” (as defined in subsection 94.1(1)) is carrying on an “investment business” (as defined in subsection 94.1(1)) and whether the non-resident is not a FIE. An investment business does not include an exempt business.

An exempt business of an entity at any time, in general terms, is a business — other than a business carried on by the entity principally with entities or individuals with whom the entity does not deal at arm's length, a business carried on by a trust that is an exempt foreign trust because of paragraph (*h*) of the definition "exempt foreign trust" in subsection 94(1), and a business carried on by the entity as a member, of a partnership, that is not a qualifying member of the partnership, or that would not be such a qualifying member if the entity were a person — that is carried on by the entity at that time and that, throughout the period (in its taxation year that includes that time) is

- carried on by the entity as a foreign bank, a trust company, a credit union or an insurance corporation , or
- a business the principal purpose of which is to derive income from certain real estate businesses, certain leasing or licensing businesses, or businesses involved in the development of foreign and Canadian resource properties and timber resources.

The reference in this definition to a "permanent establishment" is intended to carry the meaning of that expression assigned by proposed section 8202 of the *Income Tax Regulations*. Proposed section 8202 of the Regulations was released in draft form as part of the February 27, 2004 release of draft technical amendments.

The reference in this definition to a "qualifying member" of a partnership is intended to carry the substantive meaning of that expression assigned by proposed subsection 248(1) of the Act, contained in the December 20, 2002 legislative proposals relating to income tax. For more detail on the proposed definition "qualifying member" in subsection 248(1) of the Act, see that provision and its commentary in the legislative proposals and explanatory notes published on February 27, 2004.

For more information generally, see the commentaries on the definitions "foreign investment entity" and "investment business" in subsection 94.1(1).

"exempt interest"

The FIE income inclusion rules under any of subsections 94.1(4), 94.2(4) or 94.3(4) apply to a taxpayer for a year generally only where subsection 94.1(3) applies to the taxpayer. Subsection 94.1(3) will not apply to a taxpayer for a particular taxation year of the taxpayer in respect of a participating interest of the taxpayer in a non-resident entity if at the end of a taxation year of the non-resident entity that ends in the particular taxation year the taxpayer's participating interest is an "exempt interest". An exempt interest of a taxpayer in a non-resident entity is defined to mean at any time a particular participating interest of the taxpayer in the non-resident entity if any of the following applies:

- the non-resident entity is a controlled foreign affiliate of the taxpayer (including an affiliate that is a controlled foreign affiliate because of an election under new paragraph 94.1(2)(*h*)), a "qualifying entity" (as defined in subsection 94.1(1)) that is a foreign affiliate (other than a controlled foreign affiliate) of the taxpayer in respect of which the taxpayer has a qualifying interest (within the meaning assigned by paragraph 95(2)(*m*)), or a partnership;
- the taxpayer is a financial institution (as defined in subsection 142.2(1)) and the participating interest is a mark-to-market property (as defined in that same subsection) or a property described in an inventory of a business of the taxpayer, which inventory is valued, in computing the taxpayer's income from the business, in accordance with section 1801 of the *Income Tax Regulations*;
- the participating interest is a right
  - under an agreement referred to in subsection 7(1), to acquire a share of the capital stock of the non-resident entity,
  - granted by the non-resident entity, or another entity with which the non-resident entity does not deal at arm's length,

  - acquired by the taxpayer, at a time when the taxpayer dealt at arm's length with the entity that granted the right, and
  - acquired by the taxpayer solely because the taxpayer was an employee of the non-resident entity, or another entity with which the non-resident entity does not deal at arm's length;
- the non-resident entity is an entity — other than a trust that is an exempt foreign trust because of paragraph (*h*) of the definition "exempt foreign trust" in subsection 94(1) — all or substantially all of the carrying value of the property of which is attributable to the carrying value of properties that are shares of the capital stock of a corporation (that is not a foreign investment entity) that employs the taxpayer or that is related to another corporation that employs the taxpayer, and an amount that is all or substantially all of the non-resident entity's "payable net accounting income" (as defined in subsection 94.1(1)) becomes payable (as determined under paragraph 94.1(2)(*o*)) by it to its interest holders within specified times, and the taxpayer's share of that amount is included in computing the taxpayer's income for the taxpayer's taxation year that includes the time at which it became payable;
- it is reasonable to conclude that the taxpayer had no tax avoidance motive (determined by reference to paragraphs 94.1(2)(*k*) to (*n*)) in respect of the particular participating interest, and
  - the particular participating interest is an "arm's length interest" (as defined in subsection 94.1(1)) of the taxpayer, the non-resident entity is resident (determined by reference to paragraph 94.1(2)(*g*)) in a country in which there is a prescribed stock exchange, and participating interests in the non-resident entity that are identical to the particular participating interest are listed on a prescribed stock exchange, or
  - the non-resident entity is governed by the laws of one or more countries (other than a prescribed country) with which Canada has entered into a tax treaty (or governed by the laws of a political subdivision of such a country), the non-resident entity exists, was (unless the entity was continued in any jurisdiction) formed or organized, or was last continued, under those laws, while it is governed by the laws of a country (or of is political subdivision), the non-resident entity is under the tax treaty with that country resident in that country, and either

    (I) the participating interest is an arm's length interest of the taxpayer, or

    (II) the non-resident entity is, under the tax treaty with the United States of America, resident in the United States of America, and throughout the period, in the taxpayer's taxation year that includes that time, during which the taxpayer is resident in Canada, the taxpayer is a citizen of the United States of America and is liable for and subject to income tax in the United States of America for that taxation year because of that citizenship;
  - the taxpayer's participating interest is a share, of the capital stock of a corporation resident in Canada, the rights under which include a right to acquire a share in a non-resident corporation, such that the participating interest would not be a participating interest in a non-resident entity if paragraph (*d*) of the definition "participating interest" were read without reference to rights to acquire shares of the capital stock of a non-resident corporation. However, the taxpayer's participating interest will qualify as an exempt interest under this provision only if the participating interest is convertible into, exchangeable for, or a right to acquire only property that, if the conversion, exchange or right were exercised by the taxpayer at that time, would be a participating interest, in the non-resident corporation, that is at that time an exempt interest (determined without reference to paragraph (*f*) of the definition "exempt interest") of the taxpayer, or

- the non-resident entity, is during the period in its taxation year that the taxpayer held the participating interest, a testamentary trust that is an estate that arose on and as a consequence of the death of an individual, and the time is no more than 12 months after the death (or, such time as the Minister considers reasonable in the circumstances, if the taxpayer applies to the Minister within the 12 months after the death of the individual).

The definition "exempt interest" is also relevant in applying subsection 94.2(9) in determining whether subsection 94.1(4) or 94.2(4) will apply to a taxpayer's interest in a "tracking entity" (as defined in subsection 94.2(1)). However, note that a taxpayer's interest in a controlled foreign affiliate, or a qualifying entity (other than a partnership), will not avoid being subject to subsection 94.2(9) solely because it is an exempt interest. For more information, see the commentary on those provisions.

"exempt property"

The definition "exempt property" is relevant in determining whether a property is an "investment property"(as defined in subsection 94.1(1)) and whether a "non-resident entity" (as defined in subsection 94.1(1)) is not a FIE. Except for the purposes of applying the definitions "investment business" in subsection 94.1(1) and "tracking entity" in subsection 94.2(1), investment property does not include exempt property.

In general terms, exempt property of a particular entity means at any time, in determining whether a particular taxpayer's interest in the particular entity is a participating interest in a FIE,

- under paragraph (*a*) of the definition, a property, of the particular entity, that is at that time used or held principally in a business (other than an investment business) carried on by the particular entity or a related entity,
- under paragraph (*b*) of the definition, indebtedness (that would be "excluded property", as defined in subsection 95(1), of the particular entity if certain assumptions applied) owing by a debtor to the particular entity, where the particular entity and the debtor are foreign affiliates of the taxpayer or of another entity of which the taxpayer is a controlled foreign affiliate and in respect of which the taxpayer or the other entity, as the case may be, has a qualifying interest (as defined in subsection 95(2)(*m*)).

In addition, under paragraph (*c*) of the definition, exempt property means a property acquired by the particular entity within the 36 months preceding that time (or where written application has been made to the Minister of National Revenue by the taxpayer within 36 months of having acquired the property, within such longer period as the Minister considers reasonable in the circumstances) as a result of qualified activities. Those activities are

- the issuance of a debt or a participating interest in the particular entity;
- the disposition of property used in a business (other than an investment business) carried on by the particular entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(*b*)) to the particular entity;
- the disposition of a participating interest in another entity all or substantially all of the fair market value of the property of which is attributable to property used principally in a business (other than an investment business) carried on by the other entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(*b*)) to the other entity; and
- the accumulation of income of the particular entity derived from a business (other than an investment business) carried on by the particular entity or an entity related (otherwise than by reason of a right referred to in paragraph 251(5)(*b*)) to the particular entity.

The qualified activities also must have been undertaken for the purpose of

- acquiring property to be used principally in or making expenditures for the purpose of earning income from a business (other than an investment business) carried on by the entity or an entity related to the entity, or
- acquiring a participating interest that is a significant interest in another entity all or substantially all of the fair market value of the property of which is attributable to property used or held principally in the course of earning income from a business, other than an investment business, carried on by the other entity.

“exempt taxpayer”

The rules in new sections 94.1 to 94.4 do not apply in respect of periods during which a taxpayer is an exempt taxpayer. For more information, see the commentary on paragraph 94.1(3)(*a*) and subsections 94.2(9) and (10).

An individual is an “exempt taxpayer” for a taxation year where the individual, before the end of the year, was a resident of Canada for a period of, or periods the total of which is, 60 months or less. (Individuals who have never been non-resident cannot fall within the 60-month exception.) This 60-month exemption for new immigrants to Canada is similar to an exemption in the rules for non-resident trusts in existing section 94.

Except as indicated below, tax-exempt entities to which subsection 149(1) applies are also exempt taxpayers. Retirement compensation arrangements and qualifying environmental trusts for which alternative income tax rules are provided under Parts XI.3 and XII.4 and insurers to which paragraph 149(1)(*t*) applies are not exempt taxpayers.

An exempt taxpayer also includes a Canadian resident pooled fund trust (including a trust deemed resident by subsection 94(3)) under which the only beneficiaries that may for any reason receive, at or after the particular time and directly from the trust, any of the income or capital of the trust are persons that are both qualifying investors (as defined in subsection 94(1)) and the qualifying exempt taxpayers. Qualifying exempt taxpayers are for this purpose, tax-exempt entities to which subsection 149(1) applies, other than retirement compensation arrangements and qualifying environmental trusts for which alternative income tax rules are provided under Parts XI.3 and XII.4 and insurers to which paragraph 149(1)(*t*) applies. For more detail on the definition “qualifying investor” in subsection 94(1), see the commentary on that provision.

The express reference to tax-exempt entities is generally of significance for the purposes of calculating Part I tax only in the context of the narrow circumstances to which new subsection 94.2(17) applies. That subsection contemplates a case where a taxpayer ceases to be an “exempt taxpayer” and subsequently becomes an “exempt taxpayer”. However, the reference to tax-exempt entities may also be of significance in the context of Part XI (foreign property limits), given that the application of sections 94.1 to 94.4 has an impact on the cost amount of participating interests in FIEs.

“financial statements”

The definition “financial statements” is relevant primarily for the purpose of determining whether a non-resident entity is a FIE. For more information, see the commentary on the definitions “foreign investment entity” and “carrying value”.

In general, the financial statements, for a taxation, of an entity will be the balance sheet and statement of income provided by the entity to its investors if they are prepared in accordance with generally accepted accounting principles used for the taxation year in Canada or in accordance with generally accepted accounting principles that are substantially similar (including by reference to paragraph 94.1(2)(*b*)) to those used for the taxation year in Canada. Taxpayers, will however, be allowed to elect to treat an unconsolidated balance sheet and statement of income of an entity as its financial statements if they are prepared in accordance with those principles (or would be so prepared if those principles did not require consolidation).

More precisely, in applying sections 94.1 to 94.4 to a taxpayer, the financial statements, of a particular entity for a particular taxation year of the entity, are

- the balance sheet and the statement of income of the particular entity, if
  - the particular entity is an entity (referred to in this note as the "first entity") in which the taxpayer holds, in the particular taxation year, a participating interest or is another entity in which the first entity has, in the particular taxation year, a direct or indirect interest,
  - the taxpayer elects (in the taxpayer's return of income for the taxpayer's taxation year in which the particular taxation year ends) to have this paragraph apply in respect of the particular entity and the participating interest, and
  - that balance sheet and statement of income would be prepared in accordance with generally accepted accounting principles used in Canada for the particular year or in accordance with generally accepted accounting principles that are substantially similar to those used in Canada if those principles did not require consolidation; and
- in any other case, the balance sheet and statement of income of the particular entity, if that balance sheet and statement of income are prepared for the particular taxation year in accordance with generally accepted accounting principles used for the taxation year in Canada or in accordance with generally accepted accounting principles that are substantially similar to those used for the taxation year in Canada.

"foreign bank"

The definition "foreign bank" has the same meaning as in subsection 95(1). The expression is used in the definition "exempt business".

"foreign investment entity"

Under subsection 94.1(3), the new tax regime for FIEs in sections 94.1 to 94.4 generally applies only to participating interests in a "foreign investment entity" as defined in subsection 94.1(1).

A non-resident entity (as defined in subsection 94.1(1)) at any time will be a FIE at that time, unless any one of the following exceptions applies to the non-resident entity:

- at the end of its taxation year that includes that time, it is an "exempt foreign trust" (as defined in new subsection 94(1)) other than a trust that is an exempt foreign trust because of any of paragraphs (*a*) to (*g*) of that definition,
- at the end of its taxation year that includes that time, the carrying value of all of its investment property is not greater than one-half of the carrying value of all of its property, or
- throughout its taxation year that includes that time, its principal undertaking was the carrying on of a business that is not an investment business.

The new rules are designed so that, in the case of partnerships, members' shares of incomes and losses are allocated in accordance with section 96 (including new subsection 96(1.9), described in the commentary below).

For more information generally, see the commentary on the definitions "entity", "exempt interest", "non-resident entity", "investment property" and "carrying value" in subsection 94.1(1) and "exempt foreign trust" in subsection 94(1). See also the commentary on paragraphs 94.1(2)(*a*), (*b*), (*e*) and (*h*) to (*j*) and paragraph 96(1)(*d*).

“investment business”

The expression “investment business” is relevant in determining whether a non-resident entity is a FIE or a “qualifying entity”, as defined in subsection 94.1(1). An “investment business” of an entity at any time, means a business (other than a business that is at that time an exempt business) carried on by the entity (including, for greater certainty, a business carried on by the entity as a member of a partnership) at that time, if the principal purpose of the business is to derive any of the following income or profits:

- income (including interest, dividends, rents, royalties or any similar return on investment or any substitute for such a return) from property,
- income from the insurance or reinsurance of risks,
- income from the factoring of trade accounts receivable, or
- profits from the disposition of investment property.

“investment property”

The expression “investment property” includes a list of specified properties. Most of the specified properties (e.g., shares, partnership interests, real estate and resource properties) are also specified in the definition of the same expression in subsection 95(1). In addition to the properties also specified in the definition in subsection 95(1), “investment property” held by a particular entity includes:

- an interest in an organization, fund or other entity;
- intellectual property;
- most derivative financial products; and
- interests, options and rights in respect of the above properties.

It should be noted, however, that investment property of an entity does not include

- except for the purpose of applying the definition “investment business” in subsection 94.1(1) or the definition “tracking entity” in subsection 94.2(1), an “exempt property” (as defined in subsection 94.1(1)),
- except for the purpose of applying the definition “qualifying entity”, a “significant interest” (as defined in subsection 94.1(1)) in a “qualifying entity” (as defined in subsection 94.1(1)), an interest in a qualifying entity that has a significant interest in the entity, and debt owing by qualifying entities in which the entity has a significant interest or by a qualifying entity that has a significant interest in the entity,
- certain exempt commodities and futures in respect of those exempt commodities, and
- property that is owned by a corporation resident in Canada.

The definition is relevant for the purpose of the determining whether a non-resident entity is a FIE. For more information, see the commentary on the definitions “investment business”, “qualifying entity”, “significant interest”, and “exempt property” in subsection 94.1(1).

“net accounting income”

The net accounting income of an entity for a taxation year means the amount that is its net income, before income taxes and extraordinary items, for the year reported in its financial statements for the year. For more information, see the commentary on the definition “financial statements” in subsection 94.1(1).

“non-resident entity”

One of the requirements for an entity to be a FIE to which sections 94.1 to 94.4 apply is that the entity be a “non-resident entity”. In this regard, it should be noted that, under proposed subparagraph 94(3)(*a*)(iv), certain trusts that would otherwise be non-resident are deemed (for certain limited purposes including the definition “non-resident entity”) to be resident in Canada for taxation years in which the trust has a resident contributor or a resident beneficiary. For more information, see the commentary to new subsection 94(3).

In addition to non-resident corporations and trusts, a "non-resident entity" includes at any time any other type of entity that at that time

- exists, was (unless the entity was continued in any jurisdiction) formed or organized, or was last continued under the laws of a country or a political subdivision of a country other than Canada, or
- is governed under the laws of a country or a political subdivision of a country other than Canada.

"participating interest"

A "participating interest" in an entity means a share of the capital stock of corporation, a specified interest (as defined in subsection 94.1(1)) in a trust and an interest in any other type of entity.

It also includes a property that is (under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently) convertible into, exchangeable for, or confers a right to acquire

- such a share, specified interest or other interest, or
- a property (other than money) the fair market value of which is determined primarily by reference to the fair market value of such a share, interest as a beneficiary or other interest in an entity.

For a related rule that applies in determining whether an interest is a participating interest, see the commentary on paragraph 94.1(2)(*s*).

"payable net accounting income"

The payable net accounting income, of an entity for a taxation year of the entity, means its net income, after income taxes and extraordinary items, for the year reported in its "financial statements" (as defined in subsection 94.1(1)) for the year.

This definition is relevant in determining whether an interest in a non-resident entity is an "exempt interest" (as defined in subsection 94.1(1)) in the entity. In particular, it is relevant in applying paragraph (*d*) of the definition "exempt interest" in subsection 94.1(1) and paragraphs 94.1(2)(*m*) and (*n*).

"qualifying entity"

A "qualifying entity" in a period means a particular entity that is a partnership or a corporation all or substantially all of the "carrying value" (as defined in subsection 94.1(1)) of the property of which is, throughout the period, attributable to the carrying value of property that is:

- property other than "investment property" (as defined in subsection 94.1(1)),
- investment property that is a participating interest in or debt of another entity if the other entity is an entity whose principal undertaking is the carrying on of a business that is not an investment business and the particular entity has either a significant interest in the other entity or a strategic interest in the other entity,
- investment property in respect of which the particular entity establishes that the property or proceeds from the disposition of the property is to be used by the particular entity for the purpose of acquiring property described in the two paragraphs above, or
- investment property that is held by the particular entity if the particular property (or other property for which the particular property is substituted property) was last acquired by the particular entity within 36 months before the end of the period (or, where applicable conditions are met, within such longer period as the Minister considers reasonable in the circumstances), as a result of qualifying activities.

For this purpose, qualifying activities are

- the issuance of a debt or a participating interest in the entity,
- the disposition of property described in any of paragraphs (*a*) to (*c*) of the definition "qualifying entity", and
- the accumulation of income of the entity.

The qualifying activities must also have been made for the purpose of acquiring property that, if owned by the entity, would be property described in paragraph (*a*) to (*c*) of the definition of "qualifying entity".

For the purpose of applying this definition, an entity will be considered to have a strategic interest in another entity where the entity participates in or has established a plan of action for participating in the management and control of the other entity by reason of its status as a holder of a significant number (not to be confused with the "significant interest" definition) of participating interests in the other entity (in comparison with the number of participating interests held by each holder of interests in the entity) or an agreement with other such significant interest holders.

In establishing if an entity actively participates in or exercises a significant influence over the governance or the management of an other entity the following facts (among others) will be considered:

- whether the entity, alone or in alliance with others, appoints members of the board of directors and management;
- whether the entity, alone or in alliance with others, significantly influences the appointment of members of the board of directors and management; and
- whether the entity, alone or in alliance with others, is actively involved in the strategic planning for the entity.

In determining if an entity is carrying out a plan of action for the purpose of obtaining its objective of actively participating in or exercising significant influence over the governance or the management of another entity, all factors will be considered. For example, an entity's board-approved plan of action, board minutes, investment studies and other material relating to the strategic investment will be considered. As well, evidence that increasing numbers of shares of the other entity are being bought or that property is being sold in order to raise money to acquire such shares will be considered important factors. The entity's investment history and patterns will also be considered.

Finally, it should be noted that under paragraph 94.1(2)(*r*), the definition "qualifying entity" in subsection (1) does not apply in determining whether a taxpayer has a participating interest in a FIE, if the Minister sends a written demand to a taxpayer requesting additional information for the purpose of enabling the Minister to determine whether an entity is a qualifying entity, and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

For more information, see the commentary on paragraph 94.1(2)(*r*) and on the definitions "carrying value", "significant interest" and "investment property" in subsection 94.1(1).

"significant interest"

An entity is considered to have a significant interest in a corporation, partnership, or trust if the entity or a group of entities comprised of the entity and entities related to the entity holds shares or interests in the corporation, partnership or trust that have a fair market value equal to 25% or more of the fair market value of all the shares or interests in the corporation, partnership or trust and,

- in the case of a corporation, the entity or the group of entities comprised of the entity and the entities related to the entity has shares entitling the entity to cast at least 25% of votes at an annual shareholders' meeting of the corporation, or
- in the case of a trust, for taxation years that begin after Announcement Date, the only beneficiaries that may for any reason receive, at any time and directly from the trust, any of the income or capital of the trust are persons that are qualifying investors (as defined by subsection 94(1)) in respect of the trust.

In these circumstances, the entity's significant interest will be its share of the capital stock of the corporation, its interest as a member of the partnership or its interest as a beneficiary under the trust, as the case may be. For more detail on the definition "qualifying investor" in subsection 94(1), see the commentary on that provision.

“specified interest”

The definition “specified interest” applies in determining whether an entity or individual has a “participating interest” (as defined in subsection 94.1(1)) in a non-resident entity that is a trust. A specified interest at any time of an entity or individual in a trust, means, an interest of the entity or individual as a beneficiary under the trust if

- The trust is at that time an exempt foreign trust because of paragraph (*h*) of the definition “exempt foreign trust” in subsection 94(1). As a result, an interest in a foreign commercial investment trust or in certain employee remuneration arrangements will generally be subject to the income computation requirements in sections 94.1 to 94.4 if the trusts are FIEs or tracking entities; or
- The entity or individual may for any reason receive, as a beneficiary under the trust, at or after that time any of the income or capital of the trust directly from the trust. However, such an interest will, under paragraph (*b*) of the definition “specified interest”, not be treated as a participating interest if
  - the entity or individual would at that time be a successor beneficiary (as defined by subsection 94(1)) under the trust, if in applying the definition “successor beneficiary” to the entity or individual, as the case may be, contributors whose contributions were 10% or less of all contributions to the trust at that time were ignored, or
  - every amount of income and capital of the trust that the entity or individual may receive at or after that time depends at and after that time on the exercise — after that time, in favour of the entity or individual, and by any other entity or individual — of a discretionary power.

“specified party”

The definition “specified party” is relevant in determining whether a taxpayer has an avoidance motive in respect of a participating interest in a FIE. This determination is relevant to applying the definition “exempt interest” in subsection 94.1(1). For more information, see the commentary on the definition “exempt interest”.

A specified party in respect of a particular individual or particular entity, as the case may be, means another individual or other entity that does not deal at arm’s length with the particular individual or the particular entity, as the case may be.

“taxation year”

The “taxation year” of a non-resident entity that is a corporation or an individual is generally determined in accordance with subsection 249(1) and paragraph 250.1(*a*). Where the non-resident entity is not an individual or a corporation, this definition provides that the entity’s taxation year means:

- in respect of a business or property of the non-resident entity for which the accounts of the non-resident entity are ordinarily made up, the period that would be determined under section 249.1 in respect of the non-resident entity if the non-resident entity were a corporation, and
- in any other case, a calendar year.

“trust”

A definition of “trust” is provided for the purpose of applying section 94.1. The definition clarifies that a reference to a trust in that section includes an estate.

Rules of Application

ITA
94.1(2)

Subsection 94.1(2) sets out a number of rules for the purposes of applying sections 94.1 to 94.4 in respect of a particular participating interest, in a particular non-resident entity, held by a taxpayer in a particular taxation year of the taxpayer (and in respect of any other participating interests in the particular non-resident entity that are identical to the participating interest and that are held by the taxpayer in the particular taxation year). These rules are relevant, for example, in determining whether the particular non-resident entity is a FIE and whether the particular participating interest is an "exempt interest".

Determining Whether Entity is a FIE

New paragraph 94.1(2)(*a*) contains rules for applying the financial statements (as defined in subsection 94.1(1)) of an entity in determining whether a particular non-resident entity, in which a taxpayer holds a particular participating interest, is a FIE.

If the financial statements of an entity (referred to in this note as the "first entity") for a taxation year (referred to in the commentary on paragraph 94.1(2)(*a*) as the "specified year") of the first entity reflect property, indebtedness, income or losses of another entity, then in determining whether a particular non-resident entity is a FIE:

- the business and non-business activities for the specified year carried on by the other entity, the net accounting income for the specified year determined for the other entity from those activities, and the property and indebtedness for the specified year owned by or owed by, as the case may be, the other entity are deemed for the specified year to be carried on by, determined for, owned by or owed by, as the case may be, the first entity, and
- an exempt business of the other entity at any time in the specified year is, if it is a business the activities of which are deemed by subparagraph 94.2(*a*)(i) to be carried on by the first entity, deemed to be an exempt business of the first entity at that time in the specified year.

Paragraph 94.1(2)(*a*) is relevant in applying, for example, the definition "carrying value" in subsection 94.1(1), when determining whether the non-resident entity is a FIE because of the carrying value of its investment property.

For more information, see the commentary on the definitions "carrying value", "foreign investment entity" and "investment property" in subsection 94.1(1). See also, the commentary on paragraph 94.1(2)(*b*), for more information on determining whether accounting principles are substantially similar to Canadian GAAP, and the commentary on paragraph 94.1(2)(*j*), for more information on the look-through rule for significant interests.

GAAP Substantially Similar to Canadian GAAP

Paragraph 94.1(2)(*b*) provides that generally accepted accounting principles used for a taxation year in the United States of America or in countries that are members of the European Union are, for greater certainty, considered to be substantially similar to those used in Canada for that taxation year.

Designated Cost

Paragraph 94.1(2)(*c*) applies in determining, at any time in a particular taxation year, the designated cost to a taxpayer of a participating interest of the taxpayer that is a specified interest (as defined by subsection 94.1(1)) in a trust. However, the rule only applies where the trust is not an exempt foreign trust (as defined by subsection 94(1)).

Under paragraph 94.1(2)(c), the designated cost to the taxpayer of a participating interest in a trust that is not an exempt foreign trust is deemed to be the greater of two amounts. The first amount is the designated cost, determined without reference to paragraph 94.1(2)(*c*), at that time to the taxpayer of the participating interest. The second amount is the total of all amounts each of which is

- in the case of property that is restricted property (within the meaning of section 94), held by the trust in respect of the particular participating interest, the fair market value of the restricted property, to the extent that it is reasonable to consider that the restricted property is held for the purpose of satisfying the rights of the taxpayer, or
- the amount that would be the cost amount (as determined under paragraph (*b*) of the definition “cost amount” in subsection 108(1)) at that time to the taxpayer of the participating interest if
  - a reference to property in the description of A in the formula in the definition of “cost amount” were read without reference to property that is restricted property held by the trust for the purpose of satisfying the rights of the taxpayer in respect of the particular participating interest,
  - the value of B in the formula in that definition were nil,
  - the value of C in the formula in that definition were 1, and
  - the value of D in the formula in that definition were the number of persons resident in Canada that hold a participating interest in the trust and that are identified by the taxpayer in the taxpayer’s return of income for the particular taxation year.

Characterization of Income from FIE Interest

Paragraph 94.1(2)(*d*) provides a special rules for determining whether a taxpayer’s income for a taxation year from the application of subsection 94.1(4) or 94.3(4) will be treated as income from a source outside Canada. Paragraph 94.1(2)(*d*) provides that in applying subsections 94.1(4) and 94.3(4) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in those subsections to “as income from property from a property that is the participating interest” is to be read as a reference to the expression “as income from property from a property that is a source outside Canada that is the participating interest”. However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the particular taxation exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

Paragraphs 94.2(2)(*e*) and (*f*) provide similar rules that apply with respect to subsection 94.2(4). For more detail, see the commentary on those paragraphs.

The application of paragraph 94.1(2)(*d*) and paragraphs 94.2(2)(*e*) and (*f*) in respect of a participating interest of a taxpayer will not be relevant in determining a taxpayer’s eligibility for a foreign tax credit under section 126 of the Act. In this regard, see the commentary below on subsections 94.3(2) and 126(1.2). Rather, these paragraphs provide relief to trusts resident in Canada that hold participating interests in a FIE and that make payable to their non-resident beneficiaries all or part of the trusts’ incomes arising under any of subsections 94.1(4), 94.2(4) or 94.3(4). Where paragraph 94.1(2)(*d*) or 94.2(2)(*e*) or (*f*) applies and the terms of the trust permit amounts of deemed income of the trust to be made payable to beneficiaries, the amounts of such trust income arising under any of subsections 94.1(4), 94.2(4) or 94.3(4) and made payable to non-resident beneficiaries of the trust may qualify for reduced withholding if the non-resident beneficiary is resident in a country with which Canada has entered into a tax treaty and the tax treaty contains a provision permitting such a reduction in withholding.

Investment Business

Under paragraph 94.1(2)(*e*), a determination of whether the principal undertaking of an entity for a taxation year of the entity is the carrying on of a business that is not an investment business is made by reference to:

- subject to the rules below, all the relevant facts and circumstances that relate to the undertakings of the entity and that are within the knowledge of the taxpayer or knowledge of which would, upon diligent inquiry made by the taxpayer, be obtainable by the taxpayer,
- if the taxpayer elects, by reference to the entity's "net accounting income" (as defined in subsection 94.1(1)) from investment property and investment businesses, or
- if the taxpayer elects, by reference to the entity's gross revenue from investment property and investment businesses.

Under subparagraph 94.1(2)(*e*)(iii), if the Minister of National Revenue sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine whether the principal undertaking of the entity is in that taxation year the carrying on of a business that is an investment business, and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand, the principal undertaking of the entity for that taxation year is deemed to be the carrying on of a business that is an investment business.

Arm's Length and Related

Under paragraph 94.1(2)(*f*), in determining whether an entity or natural person and another entity or natural person are related to each other or deal at arm's length with each other, a person referred to in section 251 includes an entity.

Residence of an Entity - Special Case

New paragraph 94.1(2)(*g*) of the Act applies in determining whether a taxpayer's participating interest (as defined in subsection 94.1(1)) in a FIE is an "exempt interest"(as defined in subsection 94.1(1)). Paragraph 94.1(2)(*g*) provides that in applying subparagraph (*e*)(i) of the definition "exempt interest", if the FIE is not a corporation, a partnership or a trust, it is deemed not to be resident in a particular country, unless

- the particular country is a country other than a prescribed country,
- the FIE is governed, and exists, was (unless the FIE was continued in any jurisdiction) formed or organized, or was last continued under the laws of, the particular country or of a political subdivision of the particular country, and
- the FIE is liable, under the laws of the particular country, to pay an income or profits tax imposed by the government of the particular country on all of its income, profits or gains.

If the paragraph 94.1(2)(*g*) applies so that the FIE is not considered resident in a particular country for the purpose of subparagraph (*e*)(i) of the definition "exempt interest", then the taxpayer would not be able to rely upon that paragraph in order to qualify the participating interest as an exempt interest.

Entity Treated as Controlled Foreign Affiliate

New paragraph 94.1(2)(*h*) of the Act permits a taxpayer to make an irrevocable election to treat a foreign affiliate, of the taxpayer, that is a foreign investment entity (including an affiliate the shares of which are held by the taxpayer's controlled foreign affiliate) as a controlled foreign affiliate of the taxpayer for a particular taxation year and subsequent taxation years. This one-time election is available only if:

- the taxpayer elects in prescribed form in the taxpayer's tax return for the taxation year ("the election year") for which the election is to first take effect,

- either
  - the taxpayer holds a participating interest in the foreign affiliate and a taxation year of the foreign affiliate ends (or the first taxation year of the foreign affiliate begins) in the taxpayer's election year, or
  - a controlled foreign affiliate of the taxpayer holds a participating interest in the foreign affiliate and a taxation year of the foreign affiliate ends (or the first taxation year of the foreign affiliate begins) in a taxation year of the controlled foreign affiliate that ends in the taxpayer's election year,
- the taxpayer has a "qualifying interest" (as defined in paragraph 95(2)(*m*)) in the affiliate, and
- the taxpayer has not made any other election under paragraph (*h*) in respect of the foreign affiliate.

However, under paragraph 94.1(2)(*i*), described in the commentary below, the election may be rendered invalid in the event that the taxpayer cannot provide sufficient information to the Minister of National Revenue for the Minister to be able to determine amounts required to be included in the taxpayer's income under section 91. In addition, the election ceases to have effect if the corporation ceases to be a foreign affiliate of the taxpayer.

In the period during which an election under paragraph 94.1(2)(*h*) is effective, a foreign affiliate of a taxpayer is deemed to be a controlled foreign affiliate of the taxpayer. As a result, a share issued by the affiliate to the taxpayer would be an "exempt interest" under the definition in subsection 94.1(1). Sections 94.1 to 94.4 generally would not apply to the taxpayer's participating interest in the affiliate where that affiliate is a FIE. However, the foreign accrual property income (FAPI) rules would apply and the taxpayer would be required to include in income under section 91 a percentage of any FAPI derived by the affiliate in the year. In addition, notwithstanding an election under paragraph 94.1(2)(*h*), the FIE rules may still apply in the event that a taxpayer's interest in a controlled foreign affiliate is a participating interest to which subsection 94.2(9) applies.

Demand for Information – CFA election

Under paragraph 94.1(2)(*i*), an election made by a taxpayer (or in the case of a taxpayer that is a partnership, a member of it) under paragraph 94.1(2)(*h*) is, other than for the purposes of applying paragraph 94.1(2)(*i*) and subparagraph 94.1(2)(*h*)(iii), deemed never to have been made, if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to make a determination referred to in one of those paragraphs, and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

The determination referred to in paragraph 94.1(2)(*i*) concerns an amount that would, if the Act were read without reference to that paragraph, be required to be added or deducted (otherwise than under subsection 104(13)) in computing the taxpayer's income for the year because of the application of section 91 and an election under paragraph 94.1(2)(*h*) in respect of a foreign affiliate.

Look-through Rule – Significant Interests

New paragraph 94.1(2)(*j*) applies in determining whether a particular non-resident entity is a foreign investment entity (FIE) and, in some circumstances, in determining whether the particular non-resident entity is a qualifying entity. A particular non-resident entity is a FIE at any time if none of the exceptions found in paragraphs (*a*) to (*c*) of the definition "foreign investment entity" applies to it. In this regard, paragraph 94.1(2)(*j*) will be, where it applies, relevant in determining whether paragraphs (*b*) and (*c*) of that definition apply to a non-resident entity.

Paragraph 94.1(2)(*j*) will apply in respect of a taxpayer's participating interest in a particular non-resident entity if the taxpayer has made a valid election under 94.1(2)(*j*) in respect of the participating interest and a specified entity (i.e., the particular non-resident entity or another entity in which the particular non-resident entity has, directly or indirectly, an interest)) has a "significant interest" (as defined in subsection 94.1(1)) in another entity ("the other entity") that is a corporation, partnership or trust. In this case, and provided that the financial statements of the specified entity do not reflect property or indebtedness of the other entity, then in determining whether the particular non-resident entity is a FIE (and, where the taxpayer so stipulates in the election, a qualifying entity):

- In determining the carrying value of the specified entity's property, the carrying values of its participating interests in the other entity are deemed to be nil. Debt owing to the specified entity by the other entity (other than debt acquired in the ordinary course of a business other than an investment business of the specified entity) is also deemed to have a carrying value to the specified entity of nil, and the net accounting income of the specified entity is also deemed to be nil to the extent that it is derived from debt or participating interests of the specified entity that are deemed to be nil.
- The specified entity is deemed to own the property of the other entity. Each such deemed owned property is deemed to have a carrying value to the specified entity based on the product obtained by multiplying the property's carrying value to the other entity by the specified entity's proportional ownership of the other entity's property. In general terms, this proportional ownership is the quotient obtained by dividing:
  - the amount that is the fair market value of the specified entity's shares and certain debt issued by the other entity, by
  - the amount that is the total fair market value of shares and certain debt issued by the other entity.
- In general terms, the activities carried on by the other entity (including an exempt business of the other entity) using the property deemed to be owned by the specified entity, and the other entity's net accounting income derived from those activities, are deemed to be those of the specified entity to the extent of that proportional ownership.

If the taxpayer notifies the Minister of National Revenue in writing of its intention to value the specified entity's property at its fair market value in accordance with paragraph (*a*) of the definition "carrying value" in subsection 94.1(1), the property of the other entity must also be valued on that basis to the extent that paragraph 94.1(2)(*j*) applies to deem the property to be property of the specified entity.

If there are tiers of entities each of which has a significant interest in the other, paragraph 94.1(2)(*j*) operates to deem each higher tier entity to own properties of the immediately lower tier entities on an iterative basis. For example, assume a non-resident entity (Foreignco-1) owns 100% of the shares in Foreignco-2, which in turn owns 100% of shares in Foreignco-3 and that Foreignco-1, Foreignco-2 and Foreignco-3 have identical taxation year-ends. The carrying values from properties in Foreignco-3 would, under paragraph 94.1(2)(*j*), become the carrying values of properties in Foreignco-2. Because paragraph 94.1(2)(*j*) operates on an iterative basis, the carrying value of those properties would be considered to be the carrying values of properties held by Foreignco-1.

The example below illustrates the operation of paragraph 94.1(2)(*j*).

Example

1. *Jean, who resides in Canada, holds shares in Foreignco, a non-resident corporation that is not a controlled foreign affiliate of Jean. Foreignco's principal activity is the carrying on of investment activities on behalf of its shareholders. Foreignco prepares its financial statements in accordance with accounting principles substantially similar to generally accepted accounting principles used in Canada.*
2. *The carrying values of Foreignco's assets at the end of its taxation year ending in Jean's year are as follows:*

Guaranteed investment certificate	*$10,000*
Shares of XYZ Inc. in which Foreignco has a significant interest	*$20,000*
Shares of ABC Inc. in which Foreignco does not have a significant interest	*$ 5,000*
Cash	*$ 4,000*
Total assets	*$39,000*

3. *XYZ Inc. owns assets at that time that are used in the course of carrying on an active business, with a carrying value of $80,000. It also has investment property with a carrying value of $15,000.*
4. *The fair market value of the shares of XYZ Inc. held by Foreignco is $40,000 while the fair market value of all the issued and outstanding shares of XYZ Inc. is $100,000 at that time.*

Results

1. *The guaranteed investment certificate, cash, and the shares of XYZ Inc. and ABC Inc. are all investment property by virtue of the definition "investment property" in subsection 94.1(1).*
2. *However, since Foreignco owns a significant interest in XYZ Inc., the special look-through rule in new paragraph 94.1(2)(j) applies. Under this look-through rule the carrying value of Foreignco's shares in XYZ Inc. is deemed to be nil. Instead, Foreignco is deemed to own a portion of the property that XYZ Inc. owns.*
3. *The carrying value of the XYZ property deemed to be owned by Foreignco is 40% of its carrying value to XYZ, since Foreignco's percentage ownership of shares is 40%.*
4. *Consequently, the carrying values of the investment property of Foreignco are:*

Guaranteed investment certificate	*$10,000*
Shares of XYZ Inc.	*nil*
Shares of ABC Inc.	*$ 5,000*
Cash	*$ 4,000*
Investment property of XYZ Inc. (40% of $15,000)	*$ 6,000*
Total	*$25,000*

5. *The total carrying value of the assets of Foreignco is:*

Investment property (see above)	*$ 25,000*
Assets of XYZ Inc. (other than investment property) (40% of $80,000)	*$ 32,000*
Total	*$ 57,000*

6. *As a result, Foreignco is not a FIE because less than 50% of the carrying value of its property is investment property.*

Tax Avoidance Motive

New paragraph 94.1(2)(*k*) of the Act sets out the conditions under which a taxpayer will be considered to have a tax avoidance motive in respect of a participating interest in a FIE. Subject to new paragraphs 94.1(2)(*m*) and (*n*) (described in the commentary below), a tax avoidance motive will be considered to exist only if it is reasonable to conclude that the main reasons for the taxpayer acquiring, holding or having the particular participating interest were to permit the taxpayer to achieve the following two objectives:

- to derive a benefit the value of which can be attributed principally, directly or indirectly, to income derived from investment property, to profits or gains from the disposition of investment property, or to an increase in value of investment property, and
- the deferral or reduction of the amount of tax payable on that income or those profits or gains.

Factors Considered in Tax Avoidance Motive

New paragraph 94.1(2)(*l*) of the Act sets out factors to be considered in determining whether there is a tax avoidance motive for a taxpayer acquiring an interest in a non-resident entity. Those factors are similar to the ones in existing subsection 94.1(1). However, the form and the terms and conditions governing the taxpayer's interest in a non-resident entity are to be taken into account as well. Note that a tax avoidance motive may exist whether the non-resident entity is resident in a "tax haven" or not. The factors are as follows:

- the nature, organization and operation of the non-resident entity and any FIE in which it or a specified party (as defined in subsection 94.1(1)) in respect of it has a direct or indirect interest,
- the nature, organization and operation of any FIE in which the taxpayer or a specified party in respect of the taxpayer has a direct or indirect interest,
- the form of and the terms and the conditions governing the direct or indirect interests described above,
- the extent to which and the time at which the particular non-resident entity, or an entity in which a direct or indirect interest described above is held, is subject to an income or profits tax on its income, profits and gains,
- the extent to which and the time at which an entity that holds a direct or indirect interest described above is subject to an income tax or profits tax on the entity's share of the income, profits and gains of the entity in which the direct or indirect interest is held, and
- the amount of tax that would have been payable by the taxpayer under this Part had the taxpayer earned the income or realized the profits or gains in respect of the investment property referred to in subparagraph 94.1(2)(*k*)(i) at the time that the income was earned, or the profits or gains were realized, by the entities that owned or held the investment property.

No Tax Avoidance Motive

New paragraphs 94.1(2)(*m*) and (*n*) provide two situations where a taxpayer will not be considered to have a tax avoidance motive in respect of a participating interest in a non-resident entity held by the taxpayer in a taxation year:

- if the non-resident entity (and each other foreign investment entity, in which the non-resident entity has a direct or indirect interest) makes payable (determined by reference to paragraph 94.1(2)(*o*)) all or substantially all of its “payable net accounting income” (as defined in subsection 94.1(1)) for its taxation year that ends in the particular taxation to its interest holders within 120 days after the end of its taxation year, and the taxpayer’s share of that amount is included in computing the taxpayer’s income, profit or gains for the taxpayer’s taxation year that includes the time at which the amount became payable, and
- if the non-resident entity is a “Regulated Investment Company” for the purposes of sections 851(b) and 852(a) of the United States *Internal Revenue Code* or a “Real Estate Investment Trust” for the purposes of sections 856(c) and 857(b) of that Code, and the taxpayer includes, in computing the taxpayer’s income for that taxation year of the taxpayer, the amount of income that became payable (determined by reference to paragraph 94.1(2)(*o*)) by the particular non-resident entity to the taxpayer in that taxation year of the taxpayer.

For more detail on the definition “payable net accounting income” in subsection 94.1(1), see the commentary on that definition.

Amounts Payable

Under paragraph 94.1(2)(*o*), an amount is deemed not to have become payable at any time to an entity or individual unless it was paid on or before that time to the entity or individual, as the case may be, or the entity or individual, as the case may be, was entitled on or before that time to enforce payment of it. This rule is relevant in applying paragraph (*d*) of the definition “exempt interest” in subsection 94.1(1), paragraphs 94.1(2)(*m*) and (*n*), the definition “mark-to-market formula” in subsection 94.2(1), and subsection 94.4(2).

Demands for Information

Under paragraphs 94.1(2)(*p*) to (*r*) a number of provisions in section 94.1 will not apply in respect of a taxpayer’s participating interest in a non-resident entity, if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to make a determination referred to in one of those paragraphs, and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

The determinations referred to in paragraph 94.1(2)(*p*) to (*r*) are in respect of the definitions “exempt property”, “foreign investment entity” and “qualifying entity” in subsection 94.1(1), respectively.

Participating Interests – Special Case

Paragraph 94.1(2)(*s*) applies in determining whether an interest is a participating interest. Under that paragraph, if at any time a taxpayer has a participating interest in a particular foreign investment entity and the taxpayer has at that time a participating interest (referred to in that paragraph and this commentary as the “indirect participating interest”) in another non-resident entity solely because the particular foreign investment entity has at that time a participating interest in that other non-resident entity, then the indirect participating interest is deemed not to be a participating interest of the taxpayer at that time.

Paragraph 94.1(2)(*s*) provides relief only where the conditions attached to a taxpayer's participating interest in a FIE are such that the interest may also be a participating interest in another non-resident entity in which the FIE holds an interest and in which the taxpayer does not directly hold an interest. Paragraph 94.1(2)(*s*) would not apply to a participating interest where the taxpayer holds the participating interest directly in the other non-resident entity – in these circumstances, the taxpayer would be required to determine whether the participating interest in the other non-resident entity is a participating interest in a FIE.

Application of the FIE Rules to Taxpayers That Are Authorized Foreign Banks

Paragraph 94.1(2)(*t*) applies to ensure that authorized foreign banks are subject to the FIE rules in computing their income. In particular, an authorized foreign bank that holds a participating interest in a non-resident entity at any time in a taxation year is deemed, for the purposes of subsections 94.1(4), 94.2(5) to (8) and (12), 94.3(4) and 94.4(2), to be resident in Canada throughout the taxation year. For more detail on a related amendment to section 115, see the commentary below on that provision.

Identical Properties

Paragraph 94.1(2)(*u*) provides that identical properties that were held and are disposed of by a taxpayer will be treated as having been disposed of in the order in which they were actually acquired by the taxpayer. As a result, various acquisitions that are deemed to occur under the Act (e.g., section 47) are not to be taken into account. This measure is relevant primarily for the purpose of determining the amount to be added or deducted from a taxpayer's income for a taxation year under subsection 94.2(4), especially with reference to the "deferral amount" referred to in the description of D in the "mark-to-market formula" for the year (as those expressions are defined in subsection 94.2(1)).

Anti-avoidance: 150 persons

Paragraph 94.1(2)(*v*) is an anti-avoidance provision that is relevant to the application of the definition "arm's length interest" in subsection 94.1(1). Paragraph (*a*) of that definition imposes the condition that at least 150 persons hold participating interests that are identical to a particular participating interest in order for the particular participating interest to be considered an arm's length interest in respect of a taxpayer.

Paragraph 94.1(2)(*v*) provides that, if it can reasonably be considered that one of the main reasons that an entity or individual holds, at any time, a participating interest is to cause the condition in paragraph (*a*) of the definition "arm's length interest" to be met at that time in respect of the participating interest or an identical participating interest, the condition is deemed not to have been met at that time in respect of the participating interest or identical participating interest.

For more detail on the definition "arm's length interest", see the commentary on that definition.

Qualification of Partnership Interest as Exempt Interest

New paragraph 94.1(2)(*w*) will deem a taxpayer's interest in a partnership (that would otherwise be an exempt interest because of subparagraph (1)(*a*)(iii) of that term's definition in subsection 94.1(1)) not to be an exempt interest where either:

- the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine the application of sections 94.1 to 94.4 to the partnership in respect of a participating interest of the partnership, and information sufficient to make the determination is not received by the Minister within 120 days (or within any longer period that is acceptable to the Minister) after the Minister sends the demand, or
- the taxpayer has elected that subparagraph (*a*)(iii) of the definition "exempt interest" not apply.

Conditions for Application of Tax Regime for Foreign Investment Entities

ITA
94.1(3)

New subsection 94.1(3) of the Act sets out the common conditions for the application of the FIE income inclusion rules in subsections 94.1(4) (prescribed rate of return regime), 94.2(4) (mark-to-market regime) and 94.3(4) (accrual regime). For the prescribed rate of return, accrual or mark-to-market regimes to apply to a taxpayer for a particular taxation year of the taxpayer in respect of a participating interest held in the particular year by the taxpayer in a non-resident entity (other than a tracking interest or a foreign insurance product – for more information see the commentary on subsection 94.2(3)), all of the following conditions set out in subsection 94.1(3) must be satisfied:

- the taxpayer is not an "exempt taxpayer" for the taxpayer's particular taxation year;
- the taxpayer held the participating interest at the end of a taxation year of the non-resident entity that ends in the taxpayer's particular taxation year; and
- at the end of that taxation year of the non-resident entity, the interest was a participating interest in a FIE and was not an exempt interest.

Income Inclusion – Prescribed Rate of Return Regime

ITA
94.1(4)

Subsection 94.1(4) applies to a taxpayer resident in Canada for a taxation year of the taxpayer in respect of a participating interest in a non-resident entity if subsection 94.1(3) or 94.2(9) applies (and subsections 94.2(3) and 94.3(3) do not apply) to the taxpayer for the taxation year in respect of a participating interest.

Where subsection 94.1(4) applies, the taxpayer is required to include (as income from property from a property that is the participating interest) in computing the taxpayer's income for that taxation year the total of all amounts each of which, is in respect of each month in that taxation year, at the end of which month the taxpayer holds the participating interest, the product obtained by multiplying

- the designated cost (as defined in subsection 94.1(1)), to the taxpayer of the participating interest, at the end of the month,

by

- the quotient obtained when the rate of interest prescribed, in respect of amounts required by this Act to be paid by the Minister, for the quarterly period that includes that month is divided by 12.

For this purpose, the rate of interest will be that determined under paragraph 4301(*b*) of the Regulations. That rate, in very general terms, is the 3-month average Treasury bill rate + 2 percentage points.

For more information on the definition "designated cost" in subsection 94.1(1), see the commentary on that definition. For more information on subsection 94.2(3), see the commentary on that subsection.

ITA
94.1(5)

New subsection 94.1(5) applies where a taxpayer disposes of an interest in a non-resident entity at a particular time in a particular taxation year. If subsection 94.1(4) applied, for the purpose of computing the taxpayer's income, for any taxation year of the taxpayer that began on or before the particular time, in respect of the participating interest, the taxpayer may be permitted to deduct an amount equal to the lesser of

- the amount, if any, by which the total of the taxpayer's income inclusions under subsection 94.1(4) in respect of the interest (since its last acquisition by the taxpayer) exceeds the total deductions available to the taxpayer in respect of the interest under paragraph 94.4(2)(*a*), and
- the greater of
  - the taxpayer's capital loss for the particular taxation year from the disposition of the participating interest (determined without reference to paragraph 94.1(5)(*a*) and subparagraph 40(2)(*g*)(i)), and
  - where the participating interest is not an interest in an exempt foreign trust, the capital loss of the taxpayer for the particular taxation year from the disposition of the participating interest if the adjusted cost base to the taxpayer of the participating interest were equal to the designated cost to the taxpayer of the participating interest determined under paragraph 94.1(2)(*c*) (determined without reference to paragraph 94.1(5)(*a*) and subparagraph 40(2)(*g*)(i)).

Where a deduction is claimed by the taxpayer under paragraph 94.1(5)(*a*) in computing the taxpayer's income for the particular taxation year, the taxpayer's capital loss for the taxation year from the disposition of the participating interest (determined without reference to paragraph 94.1(5)(*b*) and subparagraph 40(2)(*g*)(i)) is reduced by the amount of that deduction.

Foreign Investment Entities – Mark-to-market

ITA
94.2

New section 94.2 of the Act sets out new rules for the taxation of interests in FIEs where subsections 94.1(4) and 94.3(3) do not apply.

Except as otherwise indicated, section 94.2 applies to taxation years that begin after 2006.

Definitions

ITA
94.2(1)

New subsection 94.2(1) of the Act sets out a number of definitions and provides that those definitions and the definitions in subsection 94.1(1) apply for the purposes of section 94.2.

"deferral amount"

The deferral amount of a taxpayer generally represents the gain or loss (in the event that the interest was capital property, one half of the gain or loss) in respect of the interest accrued to the time when the interest first became subject to the rules in section 94.2. The expression "deferral amount " in respect of a participating interest of a taxpayer in an entity applies principally for the purpose of determining the value of D in the "mark-to-market formula" (as defined in subsection 94.2(1)) for a taxation year of the taxpayer in respect of the participating interest. That formula applies in determining, under subsection 94.2(4), a taxpayer's income or loss (or capital gain or capital loss) from the participating interest for a taxation year. Subsection 94.2(4) generally provides for the recognition of a deferral amount in respect of a participating interest on the disposition of the interest. Because of paragraph 94.1(2)(*u*), identical participating interests are considered to be disposed of in the order in which they were acquired.

For a participating interest, in a non-resident entity, acquired after the beginning of the taxpayer's first taxation year that began after 2006, the deferral amount will be nil in the typical cases where the rules in section 94.2 apply to the interest for the year in which the interests were acquired.

The deferral amount is calculated, in conjunction with subsections 94.2(5) and subsection 128.1(4), so that gains and losses accruing while a taxpayer is not resident in Canada are ignored for the purposes of section 94.2, except in the unusual case where an interest in a FIE is taxable Canadian property.

Additional rules affecting the calculation of the deferral amount are contained in subsections 94.2(6) and (14) to (18), as described in the commentary below.

"gross-up factor"

The definition "gross-up factor" for a particular deferral amount is 1, except where the 1/2 factor is relevant in computing the deferral amount because the property is capital property. In the latter case, the "gross-up factor" is 2 (i.e., the reciprocal of the 1/2 factor). For more information on the relevance of this definition, see the commentary on subsection 94.2(12).

"mark-to-market formula"

The definition "mark-to-market formula" provides a formula that applies, for a taxation year of a taxpayer in respect of a participating interest of the taxpayer, in determining, under subsection 94.2(4), a taxpayer's income or loss (or, where subsection 94.2(20) applies in respect of the participating interest, the capital gain or capital loss) from the participating interest for a taxation year.

The amount determined under the formula for a taxpayer's taxation year in respect of a participating interest in a non-resident entity is computed as follows:

- [A] ADD the proceeds of disposition in the year from any disposition by the taxpayer in the year of the interest (other than a disposition arising from the application of subsection 128.1(4) or 149(10), given that the value of B would take into account the fair market value of the interest at the time of such deemed dispositions);
- [B] ADD, where the taxpayer held the interest at the end of the year, the fair market value of the interest at that time (determined before taking into account the FIE's liability in respect of any amount payable from the FIE in respect of the interest);
- [C] ADD the total payments received by the taxpayer in the year from the FIE, other than payments included in the value of A;
- [D] ADD, where the taxpayer so elects for a year during which the taxpayer did not dispose of the interest, any positive deferral amount in respect of the interest;
- [D] ADD, where the taxpayer disposed of the interest in the year and the election referred to above has not been previously made, the deferral amount in respect of the interest - the value of D will reduce the amount determined under the formula in the event that the deferral amount is a negative amount;
- [E] SUBTRACT either
  - the cost of the interest on any acquisition in the year of the interest (disregarding acquisitions arising because of the application of subsection 128.1(4) or 149(10), given that these acquisitions are taken into account in the value of F), or
  - if the participating interest is an interest in a life insurance policy, the cost at which the taxpayer is deemed by paragraph (11)(*f*) to acquire the interest;
- [F] SUBTRACT, where the taxpayer acquired the interest before the beginning of the year, the fair market value of the interest at the beginning of the year.

Ignoring the descriptions of D and G, the mark-to-market formula in effect determines the net increase or decrease in the fair market value of a taxpayer's participating interest in a non-resident entity for a taxation year.

The value of D represents a taxpayer's accrued gain or loss when a participating interest first becomes subject to section 94.2. The amount of this accrued gain or loss (or one half of it, in the event so provided in paragraph (*b*) of the definition "deferral amount" in subsection 94.2(1)) is included in computing income under the description of D, but only for the taxation year in which the interest is disposed of unless the taxpayer elects for earlier recognition of a positive deferral amount. (An earlier recognition of a positive deferral amount may be beneficial for a taxpayer, particularly where section 94.4 applies.) Where the taxpayer is a trust, a disposition may occur as a consequence of the application of the 21-year deemed disposition rule. See, in this regard, new subsection 104(4.1).

For more detail, see the commentary on subsections 94.2(3) and (4) and the definitions "deferral amount" and "gross-up factor" in subsection 94.2(1).

"proceeds of disposition"

The definition "proceeds of disposition" has been added to clarify that, in the case of a disposition of an interest in a life insurance policy, proceeds of disposition are defined by subsection 148(9). In any other case, the proceeds of disposition are defined by section 54.

"readily obtainable fair market value"

The definition "readily obtainable fair market value" is relevant in determining whether a taxpayer may elect to have subsection 94.2(3) (and, as a result, subsection 94.2(4)) apply for a taxation year in respect of a particular participating interest (as defined in subsection 94.1(1)) of the taxpayer in a non-resident entity (as defined in subsection 94.1(1)).

In general terms, the readily obtainable fair market value of a particular participating interest is, if one of two sets of conditions is met, its fair market value.

The first set of conditions requires, in respect of the particular participating interest that:

- participating interests that are identical to the particular participating interest be listed on a prescribed stock exchange throughout the period, in the taxpayer's taxation year that includes that time, during which the taxpayer held the particular participating interest,
- the particular participating interest would, at that time, be an arm's length interest of the taxpayer (determined without regard to the 10% limitation that normally applies under paragraph (*b*) of the definition "arm's length interest" in subsection 94.1(1)),
- there be a regularly published price of the amount (or of the average of the amounts each of which is the amount) at which participating interests that are identical to the particular participating interest last traded on that stock exchange on each of the latest 10 consecutive "trading days" (as defined in subsection 94.2(1)) of the participating interests on that stock exchange, and
- within the 30-day period that begins before the particular time there are at least 10 trading days of the identical participating interests on that stock exchange.

Note that, under paragraph 94.2(2)(*b*), where the identical participating interests are listed on more than one prescribed stock exchange, the taxpayer may generally elect which of the exchanges will be used in applying the definition "readily obtainable fair market value". For more information, see the commentary on paragraph 94.2(2)(*b*).

Where the first set of conditions are not met, the second set of conditions requires that the identical participating interests have, throughout the period, in the taxpayer's taxation year that includes that time, during which the taxpayer held the particular participating interest, conditions attached that require the non-resident entity to accept at the demand of the holders of the participating interests (or that require the holders of the participating interests to accept, at the demand of the non-resident entity), at a price ("the redemption price") determined and payable in accordance with the conditions, the surrender in whole or in part of the participating interests. In addition, the second set of conditions requires that the redemption price be determined by reference to the fair market value, at the time the participating interest is surrendered (or such other time that is set out in the terms of the participating interest at the time it was issued and that is within 60 days of the time that the participating interest is surrendered), of the property of the non-resident entity, and be a price that would have been acceptable to entities dealing at arm's length with one another.

"reconciliation amount"

The reconciliation amount in respect of a participating interest of a taxpayer is relevant in determining what adjustments, if any, to the cost of the interest may be required under subsection 94.2(12) and what amounts, generally, may be included or deductible, under subsection 94.2(21), by the taxpayer in computing the taxpayer's income for a taxation year in which the interest is disposed of. For more detail, see the commentary on subsections 94.2(12) and (21).

The reconciliation amount at a particular time in a taxation year of a taxpayer in respect of a participating interest of the taxpayer, means, in very general terms the amount (including a negative amount) that is the difference between the taxpayer's economic loss in respect of the interest (while the taxpayer held the interest and subsection 94.2(4) applied to it) and the taxpayer's deductions, in computing income, under sections 94.2 or 94.4 (net of income inclusions under section 94.2)) in respect of the interest.

More specifically, the reconciliation amount at a particular time in a taxation year in respect of a participating interest is the amount (including a negative amount) determined by the formula "A – B".

Under the formula, "A" is the positive amount (for more detail, see section 257 of the Act) determined by subtracting from the cost of the participating interest to the taxpayer (determined without reference to section 94.2) the proceeds of disposition from the last disposition in the taxation year by the taxpayer of the participating interest.

Variable "B" is the positive amount determined by

- ADDING all amounts, in respect of the participating interest, that are, in computing the taxpayer's income for the taxation year or a preceding year, deducted under paragraph 94.4(2)(*a*) or deducted (or that would, if this Act were read without reference to subsection 94.2(20), have been deducted) under subsection 94.2(4), and
- SUBTRACTING all amounts in respect of the participating interest, that are, in computing the taxpayer's income for the taxation year or a preceding year, included, or that would if this Act were read without reference to subsection 94.2(20) have been included, under subsection 94.2(4).

For this purpose, a specified year means, if paragraph 94.2(12)(*a*) deems the taxpayer to have acquired the participating interest at a time in the taxation year, a preceding taxation year, and in any other case, the taxation year that includes the particular time or a preceding taxation year.

For more detail, see the commentary on subsections 94.2(4), (12) and (21) and 94.4(2).

“tracking entity”

The definition “tracking entity” is relevant in determining whether subsections 94.1(4) and 94.2(4) will apply for a taxation year of a taxpayer in respect of a participating interest, held by the taxpayer at the end of the year, in a non-resident entity. If the non-resident entity is, at the end of a taxation year of the non-resident entity that ends in the taxpayer’s year, a tracking entity, and the other conditions described in subsection 94.2(9) are met, such that subsection 94.2(9) applies, then either of subsections 94.1(4) or 94.2(4) would generally apply for the year. Subsection 94.3(4) will not apply for the year in respect of the interest.

A particular non-resident entity is a tracking entity in respect of a particular participating interest of a taxpayer in the non-resident entity if either of paragraph (*a*) or (*b*) of the definition applies.

Under paragraph (*a*) of the definition, the particular non-resident entity is a tracking entity if

- the tracked properties described in paragraph 94.2(9)(*d*) in respect of the particular participating interest are at that time owned by the particular non-resident entity,
- the total fair market value at that time of those tracked properties is less than 90% of the total fair market value at that time of all property owned at that time by the particular non-resident entity, and
- the total fair market value at that time of those tracked properties that are at that time investment property exceeds 50% of the total fair market value at that time of those tracked properties.

Under paragraph (*b*) of the definition, the particular non-resident entity will be a tracking entity if

- any of the tracked property described in paragraph 94.2(9)(*d*) in respect of the participating interest is not at that time owned by the particular non-resident entity,
- the particular non-resident entity (or an entity with which the particular non-resident entity does not deal at arm’s length) owns property that is at that time investment property, and
- it is reasonable to conclude that that investment property (or property that may be substituted for that investment property) may be used, or give rise to property used, to satisfy, directly or indirectly, the right referred to in paragraph 94.2 (9)(*d*) in respect of the particular participating interest.

Note that an election under paragraph 94.1(2)(*j*) is relevant only in determining whether an entity is a “foreign investment entity” (and where stipulated, a “qualifying entity”), as those expressions are defined in subsection 94.1(1). Thus the determination of whether property is owned or not by an entity is made, for the purposes of the definition “tracking entity”, without regard to that election.

Note also that the exclusion of “exempt property” from being treated as ”investment property” (as those expressions are defined in subsection 94.1(1)) does not apply for the purposes of the definition “tracking entity”.

For more information on the application of this definition, see the commentary on subsections 94.1(4) and 94.2(3) and (9). For more information on paragraph 94.2(1)(*j*) and the definitions “exempt property” and “investment property in subsection 94.1(1), see the commentary on those provisions.

“trading day”

The definition “trading day” is relevant in applying paragraph (*a*) of the definition “readily obtainable fair market value” in subsection 94.2(1). A trading day of a participating interest on a prescribed stock exchange, means a day on which the participating interest trades on that stock exchange.

Rules of Application

ITA
94.2(2)

New subsection 94.2(2) of the Act provides rules of application for the purpose of section 94.2.

Application

Paragraph 94.2(2)(*a*) provides that the rules in subsection 94.1(2) also apply for the purposes of section 94.2.

Readily Obtainable Fair Market Value

Paragraph 94.2(2)(*b*) applies for the purpose of paragraph (*a*) of the definition "readily obtainable fair market value" in subsection 94.2(1), referred to in the commentary above, in respect of a particular participating interest in a non-resident entity held by a taxpayer in a taxation year. Where participating interests in the non-resident entity that are identical to the particular participating interest are listed on more than one prescribed stock exchange, the references in that definition to a prescribed stock exchange shall be read as a reference to the prescribed stock exchange in respect of which the taxpayer files an election with the Minister of National Revenue.

If the taxpayer does not so elect or participating interests that are identical to the particular participating interest are no longer listed on the stock exchange identified in the taxpayer's election referred, the references in that definition to a prescribed stock exchange shall be read as a reference to the prescribed stock exchange chosen by the Minister of National Revenue.

Restrictions on Application of Mark-to-market Rules

Paragraph 94.2(2)(*c*) provides that the mark-to-market regime in subsection 94.2(4) will not apply to a taxpayer in respect of certain participating interests of the taxpayer. The rule applies if the taxpayer has been subject to subsection 94.2(4) in respect of a participating interest because of an election in respect of the interest where the interest has a readily obtainable fair market value and subsection 94.2(3) ceases to apply. For example, paragraph 94.2(2)(*c*) would apply where the interest (other than a foreign insurance policy) ceases to have a readily obtainable fair market value or the Minister fails to receive, in response to a demand under paragraph 94.2(2)(*d*), information satisfactory to make a determination of whether the interest has a readily obtainable fair market value.

Where paragraph 94.2(2)(*c*) applies the taxpayer will become subject to 94.1(4) in respect of the participating interest if 94.1(3) continues to apply to the taxpayer in respect of the participating interest.

Note that if, subsection 94.2(4) applies to a taxpayer for a taxation year in respect of a participating interest in a tracking entity and in the immediately following year the interest ceases to be an interest in a tracking entity and becomes subject to subsection 94.1(3), then the taxpayer may elect to have subsection 94.2(4) apply for that immediately following year. In this regard, see the commentary on clause 94.2(3)(*b*)(ii)(B).

Paragraph 94.2(2)(*d*) provides that paragraph 94.2(3)(*b*) does not apply to a taxpayer for a particular taxation year in respect of a participating interest held in the particular taxation year by the taxpayer in a non-resident entity if the Minister sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine whether the participating interest has a readily obtainable fair market value and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand.

Characterization of Income from FIE Interest

Paragraphs 94.2(2)(*e*) and (*f*) provide special rules for determining whether a taxpayer's income for a taxation year from the application of subsection 94.2(4) will be treated as income from a source outside Canada. Paragraph 94.2(2)(*e*) provides that in applying subparagraph 94.2(4)(*a*)(i) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in that paragraph to "as income from property that is the participating interest" shall be read as a reference to "as income from property that is a source outside Canada that is the participating interest". However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the particular taxation exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

Paragraph 94.2(2)(*f*) provides that in applying subparagraph 94.2(4)(*b*)(i) to a taxpayer (that is a trust) for a particular taxation year of the taxpayer and in respect of a participating interest of the taxpayer in a non-resident entity, the reference in that paragraph to "a capital gain for the year" shall be read as a reference to "a capital gain for the year from a source outside Canada and". However, this special rule applies only if the portion of the net accounting income of the non-resident entity, from sources outside Canada, for its last taxation year that ends in the particular taxation year exceeds 90% of the total net accounting income of the non-resident entity for that last taxation year.

The application of paragraphs 94.2(2)(*e*) and (*f*) (and a related rule in paragraph 94.1(2)(*d*)) in respect of a participating interest of a taxpayer will not be relevant in determining a taxpayer's eligibility for a foreign tax credit under section 126 of the Act. In this regard, see the commentary below on subsections 94.3(2) and 126(1.2). Rather, paragraph 94.2(2)(*e*) and (*f*) provide relief to trusts resident in Canada that hold participating interests in a FIE and that make payable to their non-resident beneficiaries all or part of the trusts' incomes arising under subsection 94.2(4). Where paragraph 94.2(2)(*e*) or (*f*) applies and the terms of the trust permit amounts of deemed income of the trust to be made payable to beneficiaries, the amounts of such trust income arising under subsection 94.2(4) that become payable to non-resident beneficiaries of the trust may qualify for reduced withholding if the non-resident beneficiary is resident in a country with which Canada has entered a tax treaty and the tax treaty contains a provision permitting such a reduction in withholding.

Where paragraphs 94.2(2)(*e*) and (*f*) do not apply, income and capital gains arising under subsection 94.2(4) are from a source inside Canada.

Mark-to-market

ITA
94.2(3) and (4)

Subsection 94.2(3) of the Act sets out those circumstances where, subject to paragraphs 94.2(2)(*c*) and (*d*) and 94.2(5)(*b*), subsection 94.2(4) applies to a taxpayer in respect of a participating interest in a non-resident entity. For the mark-to-market regime in subsection 94.2(4) to apply for a taxation year, subsection 94.2(3) must apply for the year.

Except as described above, subsection 94.2(3) will apply to a taxpayer for a particular taxation year in respect of a participating interest, in a non-resident entity, held by the taxpayer in the year if either:

- paragraph 94.2(11)(*a*) (foreign insurance policies) applies to the taxpayer for the year in respect of the interest; or
- subsection 94.1(3) or 94.2(9) (interests in tracking entities) applies to the taxpayer in respect of the interest, the interest has at all times in the year at which the taxpayer held it a readily obtainable fair market value (as defined in subsection 94.2(1)), subsection 94.3(3) has never applied to the taxpayer for a taxation year in respect of the participating interest or in respect of an identical participating interest that was held by the taxpayer at any time when the taxpayer held the participating interest and either
    - the taxpayer elects, generally in the first taxation year of the taxpayer in which the taxpayer is subject to subsection 94.1(3) or 94.2(9) in respect of the participating interest (or an identical interest), to have subsection 94.2(3) apply to the participating interest or identical interest, or
    - subsection 94.2(3) applied in respect of an identical participating interest that was held by the taxpayer at any time when the taxpayer held the participating interest.

In effect, where a taxpayer has validly elected for the mark-to-market regime to apply to a participating interest for a taxation year, that regime will continue to apply to the interest and to any identical interests that are held by the taxpayer in that taxation year or a future taxation year until either all of the interests are no longer held by the taxpayer or any one of the conditions for applying subsection 94.2(3) to the interests is not met (e.g., subsection 94.1(3) and 94.2(9) no longer apply in respect of the interests or the interests no longer have a readily obtainable fair market value).

Example

1. *Libby acquires 101 shares of the capital stock of ABC Inc. in 2008. At all times ABC is a FIE (and not a tracking entity) and shares of its capital stock are participating interests that do not qualify as exempt interests. ABC's taxation years end on December 30. ABC has issued only one class of shares, the shares of which are identical to each other. Libby is not an exempt taxpayer.*
2. *Subsection 94.1(3) applies to Libby in respect of her ABC shares for each of her taxation years at the end of which she holds the shares. Assume that the shares have a readily obtainable FMV. In her return of income for her 2008 taxation year, Libby elects under clause 94.2(3)(b)(iii)(B) to have the rules in section 94.2 apply to the shares. Assume that subsection 94.2(20) does not apply in respect of the ABC shares at any time.*
3. *In February 2009, Libby sells 100 of her ABC shares and continues to hold the remaining 1 share on December 30, 2009.*
4. *In January 2010, Libby acquires another 200 shares of the capital stock of ABC.*
5. *In November 2011, Libby disposes of all (i.e., 201) of her ABC shares and holds no ABC shares on December 30, 2011.*
6. *In July 2012, Libby buys 1000 shares of the capital stock of ABC. Libby continues to hold the shares on December 30, 2012.*

Results

1. *For her 2008 taxation year, Libby reports as income from property the amount determined under subsection 94.2(4) for the year in respect of her 100 ABC shares.*
2. *For her 2009 taxation year, clause 94.2(3)(b)(iii)(A) applies in respect of her remaining ABC share and Libby must report as income from property the amount determined under subsection 94.2(4) for the year in respect of that share.*
3. *For her 2010 taxation year, clause 94.2(3)(b)(iii)(A) applies in respect of Libby's 201 ABC shares and she reports as income from property the amount determined under subsection 94.2(4) for the year in respect of those shares.*
4. *For her 2011 taxation year, subsection 94.2(3) does not apply to Libby (because Libby holds no shares in ABC at ABC's taxation year-end that ends in Libby's 2011 taxation year) in respect of the shares that she sold in November 2011.*
5. *For her 2012 taxation year, clause 94.2(3)(b)(iii)(A) will not apply in respect of any of the 1000 ABC shares she acquired in 2012. Libby must elect under clause 94.2(3)(b)(iii)(B) if she wishes to have the mark-to-market regime apply in respect of the shares.*

Note that under subclause 94.2(3)(*b*)(iii)(B)(II) a taxpayer may elect, to have subsection 94.2(3) apply, in a year other than the first taxation year in which subsection 94.1(3) or 94.2(9) applies to the taxpayer in respect of the participating interest or an identical interest, if the election is made in the taxpayer's return of income for a taxation year in which subsection 94.1(3) applies and that taxation year immediately follows a taxation year for which the interest is subject to subsection 94.2(9) (i.e., an interest of the taxpayer in a tracking entity).

Where subsection 94.2(3) applies (and subsection 94.2(20) does not apply) to a taxpayer's participating interest in a non-resident entity, subparagraph 94.2(4)(*a*)(i) requires the taxpayer to include in computing income as income from property (in this regard, see the commentary on paragraph 94.2(2)(*e*)) from a property that is the participating interest the positive amount resulting from the operation of the mark-to-market formula for the taxation year in respect of the participating interest. Under subparagraph 94.2(4)(*a*)(ii), the absolute value of any negative amount resulting from the operation of the same formula may be deducted in computing the taxpayer's income as a loss from property from a property that is the participating interest. (Note, however, that losses in respect of foreign insurance polices are denied because of clause 94.2(4)(*a*)(ii)(A). Instead, as described in the commentary to the definition "mark-to-market formula" in subsection 94.2(1), the denied losses are carried forward to offset later income inclusions.)

Where both subsections 94.2(3) and 94.2(20) apply to a taxpayer's participating interest in a non-resident entity, subparagraph 94.2(4)(*b*)(i) deems the taxpayer to have a capital gain for the year from the disposition of capital property (in this regard, see the commentary on paragraph 94.2(2)(*f*)), that is the participating interest, in the taxation year equal to the positive amount determined under the mark-to-market formula for the taxation year in respect of the participating interest plus or minus the positive or negative deferral amount included in "D" in that same formula in respect of the participating interest for the year. Subparagraph 94.2(4)(*b*)(ii) deems the taxpayer to have capital losses in the year equal to the negative amount determined under the mark-to-market formula for the taxation year in respect of the participating interest plus or minus the negative or positive deferral amount included in "D" in that same formula in respect of the participating interest for the year.

The example below illustrates the operation of subsection 94.2(4) and the mark-to-market formula for a taxation year in respect of a participating interest.

Example

1. *Leonard acquires a 1% interest in ABC Inc. in 2001 for $500. On December 31, 2002, it is capital property to Leonard. ABC is not a FIE in respect of the taxpayer at any time before 2008. Subsection 94.2(20) does not apply at any time in respect of the interest. ABC's taxation year-end is June 30.*
2. *ABC becomes a FIE in April 2008 and remains a FIE at all subsequent times. Leonard elects under subparagraph 94.2(3)(b)(iii) to have the rules in section 94.2 apply. Leonard's interest in ABC does not qualify as an "exempt interest".*
3. *The fair market values of Leonard's participating interest at the beginning and at the end of 2008 are $800 and $1,000 respectively.*
4. *Leonard disposes of his shares on December 15, 2009 for $1,200. ABC does not make any distributions to Leonard during his period of ownership.*

Results

1. *No amount is included in Leonard's income for 2007 under any of sections 94.1 to 94.3. For 2008, Leonard is required to include $200 in income under subparagraph 94.2(4)(a)(i).*
2. *The $200 inclusion is determined under the mark-to-market formula and subparagraph 94.2(4)(a)(i) as follows:*
   - *"A" is nil, since no participating interest in ABC is disposed of in 2008,*
   - *"B" is $1,000, the fair market value of the participating interest at the end of 2008,*
   - *"C" is nil since no payments are received in 2008,*
   - *"D" is nil since no participating interest is disposed of in 2008 and no election was otherwise made,*
   - *"E" is nil since no participating interest in ABC is acquired in 2008, and*
   - *"F" is $800, the fair market value of the participating interest at the beginning of 2008.*
3. *Although Leonard's participating interest has appreciated by $500 since the time of its acquisition, only $200 is required to be included in income under section 94.2 for 2008.*
4. *For 2009, the amount included in income under the mark-to-market formula and subparagraph 94.2(4)(a)(i) is $350, computed as follows:*
   - *"A" is $1,200, the proceeds of disposition of the participating interest,*
   - *"B" is nil since Leonard does not own any participating interest in ABC at the end of 2009,*
   - *"C" is nil since no payments or distributions were received in 2009,*
   - *"D" is $150, the deferral amount in respect of the interest – the "deferral amount" is one half (the one-half factor applies because Leonard's interest in ABC is capital property held by Leonard on December 31, 2006) of the amount by which $800 (the fair market value of the interest at the beginning of 2006 which is the first year in respect of which section 94.2 applies to the interest) exceeds $500 (the cost amount of the interest),*
   - *"E" is nil since no participating interest in ABC is acquired in 2009, and*
   - *"F" is $1,000, the fair market value of the participating interest at the beginning of 2009.*

Non-resident Periods Excluded

ITA
94.2(5)

New subsection 94.2(5) of the Act provides special rules dealing with the application of section 94.2 for a taxation year to persons who are not resident in Canada throughout the year.

Under paragraph 94.2(5)(*a*), the amounts determined under section 94.2 are generally determined as if the taxation year of the taxpayer excludes the period in the year during which the taxpayer is not resident in Canada. This rule, in conjunction with section 128.1, generally ensures that the increases and decreases in fair market values that are relevant in determining income inclusions and deductions under section 94.2 are the increases and decreases occurring while the taxpayer is resident in Canada. However, this rule does not affect the calculation of the taxpayer's deferral amount: paragraph (*b*) of the definition "deferral amount" in subsection 94.2(1) (in conjunction with subsection 128.1(1)) already ensures that gains or losses accruing prior to becoming resident in Canada are not taken into account for the purposes of computing a taxpayer's deferral amount in respect of a participating interest in a FIE, except in the unusual case where the FIE interest is taxable Canadian property.

Paragraph 94.2(5)(*a*) also ensures that subsection 94.2(4) does not apply to a taxpayer for a taxation year throughout which the taxpayer is not resident in Canada.

Under paragraph 94.2(5)(*b*), subsection 94.2(3) generally does not apply to a taxpayer at a particular time if the taxpayer is not resident in Canada at the particular time. This has relevance for the purposes of a number of new provisions, including subparagraph 39(1)(*a*)(ii.3). This subparagraph has the effect of excluding, from a taxpayer's capital property, a property in respect of which subsection 94.2(3) applies (and subsection 94.2(20) does not apply). Paragraph 94.2(5)(*b*) ensures that a non-resident taxpayer cannot claim that a taxable Canadian property consisting of a FIE interest is not capital property on the basis of subparagraph 39(1)(*a*)(ii.3). (Note: non-resident taxpayers are generally subject to Canadian income tax on taxable capital gains from their dispositions of taxable Canadian properties.)

Paragraph 94.2(5)(*c*) applies in the unusual case where an individual changes his or her Canadian residence status more than once in the same calendar year. For example, an individual might cease to be resident in Canada near the beginning of a calendar year but become resident in Canada later in the same year. In the event that such an individual is considered not to reside in Canada during a period in the calendar year, the individual's period of non-residence would be included within the individual's taxation year and the rule in paragraph 94.2(5)(*a*) would have no effect. In order to not tax gains accrued while an individual was non-resident and to not provide relief for losses accrued during the same period, paragraph 94.2(5)(*c*) provides that:

- for the *purposes* of section 114, the individual's income or loss from the individual's period of non-residence is determined without reference to section 94.2, and
- in *computing* the individual's taxable income under section 114,
  - there is to be deducted the increase in the fair market value of an interest in a FIE to which subsection 94.2(4) applies during the non-resident period (this fair market value appreciation would be reflected in the amount determined under the mark-to-market formula (as defined in subsection 94.1(1)) in respect of the interest in computing the taxpayer's income), and
  - there is to be added the decline in the fair market value of an interest in a FIE to which subsection 94.2(4) applies that accrued during the non-resident period (this fair market value decline would be reflected in the amount determined under the mark-to-market formula in respect of the interest in computing the taxpayer's income).

The example below illustrates the operation of paragraph 94.2(5)(*c*).

> ***Example***
>
> *Bernard emigrates from Canada on February 1, 2007 in order to start permanent employment elsewhere. Due to unexpected changes in circumstances, he returns to Canada on December 1, 2007. Bernard owns an interest in a FIE to which section 94.2 applies. The fair market value of the interest in 2007 increases from $100 (January 1, 2007), to $105 (February 1, 2007), to $108 (December 1, 2007) and to $107 (December 31, 2007). It is assumed that Bernard establishes that he did not reside in Canada from February 1, 2007 to December 1, 2007.*
>
> ***Results***
>
> 1. *Under section 94.2(4), the amount included in computing Bernard's income for 2007 is equal to $7 (B = 107, F = 100).*
> 2. *Paragraph 94.2(5)(c) permits a deduction for the purposes of paragraph 114(a) equal to $3 (i.e., $108 - $105) equal to the appreciation in the fair market value of the interest while Bernard was not resident in Canada. As a consequence, Bernard's taxable income in respect of the FIE interest for 2007 is $4 (i.e., $7 minus $3).*

Foreign Partnerships – Change of Residence of Member

ITA
94.2(6) to (8)

New subsections 94.2(6) to (8) of the Act provide special rules for partnerships having non-resident members. These subsections are analogous to rules in existing subsections 96(8) and (9) and are designed, in general terms, to prevent partnership losses that accrue while no partnership member is resident in Canada from being used in Canada. A further rule for partnership members is set out in new subsection 96(1.9).

More specifically, subsection 94.2(6) applies where a partnership begins to have members who reside in Canada. Under subsection 94.2(7), a corresponding rule applies in a similar fashion where a partnership ceases to have members who reside in Canada. In either case, for the purposes of determining amounts under section 94.2 portions of the fiscal period of the partnership in which no member is resident in Canada will generally be disregarded.

Where subsection 94.2(6) applies to a partnership at any time, the deferral amount for a FIE interest held by the partnership immediately before that time is computed with reference to the fair market value and the cost amount of the interest. However, if a negative deferral amount is otherwise determined with respect to the interest, the deferral amount is deemed to be nil.

As a consequence of subsections 94.2(6) and (7), amounts added or deductible under subsection 94.2(4) for a partnership in respect of a FIE interest will generally reflect increases or decreases in fair market value while the partnership has members resident in Canada. However, once the interest is disposed of, an amount reflecting gains accruing before any member became resident in Canada will be recognized because of the application of subsection 94.2(4).

Subsection 94.2(8) contains an anti-avoidance rule, which is aimed at preventing the insertion of nominal Canadian resident partners for tax planning purposes. This rule is parallel to the rule in existing subsection 96(9).

Subsection 94.2(8) also contains a "look-through" rule. It allows for the "look-through" of one or more tiers of partnerships for the purposes of determining whether a person is a member of a partnership.

Participating Interests in a Tracking Entity

ITA
94.2(9)

New subsection 94.2(9) of the Act is an anti-avoidance rule intended to prevent the circumvention of subsection 94.1(3) through the use of a participating interest in a “tracking entity” (as defined in subsection 94.2(1)). Where subsection 94.2(9) applies with regard to an interest in a tracking entity for a taxation year, subsection 94.1(4) will apply to the taxpayer for that year unless subsection 94.2(3) applies for that year in respect of the interest.

Subsection 94.2(9) applies to a taxpayer (other than an exempt taxpayer, as defined in subsection 94.1(1)) for a particular taxation year of the taxpayer in respect of a particular participating interest of the taxpayer in a non-resident entity (and any participating interests of the taxpayer in the non-resident entity that are identical to the particular participating interest) if

- *subsection* 94.1(3) does not apply to the taxpayer for the particular taxation year in respect of the particular participating interest;
- the particular participating interest is, at the end of a taxation year of the non-resident entity that ends in the particular taxation year, held by the taxpayer, and generally not an “exempt interest” (as defined in subsection 94.1(1)); however, note that an interest of a taxpayer in a controlled foreign affiliate of the taxpayer or a “qualifying entity” (as defined in subsection 94.1(1)) will not qualify as an exempt interest for this purpose, with the result that subsection 94.2(9) may apply to such interests;
- the non-resident entity is, at the end of that taxation year of the non-resident entity, a “tracking entity” (as defined in subsection 94.2(1)) in respect of the particular participating interest;
- at any time in the particular taxation year, the amount of any payment under a right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any entity or individual) to receive, in any manner whatever and from any entity, amounts in respect of the particular participating interest or any identical interests, or the value of such a right, is, directly or indirectly, determined primarily by one or more of the following criteria in respect of one or more properties (such property or properties together referred to in subsection 94.2(9) and the definition “tracking entity” in subsection 94.2(1) as “tracked property” or “tracked properties”):
  - production from the property, use of the property, gains from the disposition of the property, profits from the disposition of the property, fair market value of the property,
  - income from the property, profits from the property, revenue from the property, cash flow from the property, or
  - any other criterion similar to any of the above criteria; and
- throughout each taxation year of the non-resident entity that ends in the particular taxation year, all or substantially all of the fair market value of all the tracked properties in respect of the particular participating interest cannot be attributed, either directly or indirectly, to the fair market value of all tracked properties in respect of the particular participating interest (throughout the period that those properties are tracked properties in respect of the particular participating interest) that:
  - are shares of the capital stock of a particular foreign affiliate of the taxpayer that would, if those shares were held by the taxpayer throughout the period (the “tracked property period”) that those shares are tracked properties in respect of the particular participating interest, be, throughout the tracked property period, a qualifying interest (within the meaning assigned by paragraph 95(2)(*m*)) of the taxpayer in the particular foreign affiliate, and a participating interest of the taxpayer in a qualifying entity, and
  - are not tracked properties in respect of a participating interest in a non-resident entity of an entity that is not related to the taxpayer.

It should be noted that tracked properties can include any property, whether owned by the non-resident entity or not. For example, if the fair market value of shares issued by a non-resident entity were tracked to the worldwide price of gold bullion, the tracked properties in question would be the worldwide supply of gold bullion. Whether subsection 94.2(9) applies in this case or not would typically depend on whether the non-resident entity is a tracking entity, as defined in subsection 94.2(1).

Treatment of Foreign Insurance Policies

ITA
94.2(10) and (11)

New subsection 94.2(10) of the Act applies if a taxpayer (other than an exempt taxpayer, as defined in subsection 94.1(1)) holds, at any time in a particular taxation year of the taxpayer, an interest in a foreign insurance policy. For this purpose, a foreign insurance policy is one that is not issued by an insurer in the course of carrying on in Canada a business the income from which is subject to tax under Part I.

Subsection 94.2(11) sets out the treatment under section 94.2 of an interest in the foreign insurance policy. Where subsection 94.2(10) applies, paragraph 94.2(11)(*a*) provides, subject to paragraph 94.2(11)(*c*), that

- it applies to the interest, with the result that, in conjunction with paragraph 94.2(3)(a), the mark-to-market rules in subsection 94.2(4) apply to the interest, and
- no amount shall be included or deducted, as the case may be, under section 12.2, paragraphs 56(1)(d) and (j) and 60(*a*) and (*s*) and sections 138.1 and 148 in respect of the interest for the purpose of computing the taxpayer's income for the particular taxation year.

Paragraph 94.2(11)(*b*) generally provides that, where a taxpayer (other than an exempt taxpayer) holds an interest in a foreign insurance policy, for the purposes of subsections 94.2(1) to (3) and paragraph (4)(*a*) (and a corresponding foreign property reporting rule in subsection 233.3(1)) the particular interest is deemed to be a participating interest in a non-resident entity. However, the mark-to-market regime under subsection 94.2(4) applies differently to insurance policies in three respects:

- first, no deferral amount is calculated with regard to insurance policies,
- second, losses are not deductible, but instead can be used to offset future income amounts otherwise arising under subsection 94.2(4) (as to the treatment of losses, see the commentary on the definition "mark-to-market formula" in subsection 94.2(1)), and
- third, the interest will not be a participating interest for the purposes of subsection 94.2(20), so that paragraph 94.4(2)(b) will not apply to amounts determined under the mark-to-market formula in respect of the interest.

Paragraph 94.2(11)(*b*) applies to treat an interest in an insurance policy as a participating interest only for the limited purposes identified in that paragraph (i.e., subsections 94.2(1) to (3), paragraph (4)(*a*) and the corresponding foreign property reporting rule in subsection 233.3(1)). For example, the interest will not be a participating interest for the purpose of subsection 94.2(19) or, as mentioned above, for the purpose of 94.2(20).

Paragraph 94.2(11)(*c*) provides that paragraphs 94.2(11)(*a*) and (*b*) do not apply to a taxpayer in respect of an insurance policy in the following situations:

- Where the taxpayer is an individual and the interest in the policy was acquired more than five years before the taxpayer became resident in Canada. However, this exception does not apply if premiums in excess of the level originally contemplated under the policy have been paid within 5 years of the policyholder becoming resident in Canada or while the policyholder was resident in Canada.
- Under the terms and conditions of the policy, the policyholder is entitled to receive only benefits payable as a consequence of the occurrence of the risks insured under the policy, an experience rated refund of premiums for a year and a return of premiums previously paid upon the surrender, cancellation or termination of the policy.

- The taxpayer can establish to the satisfaction of the Minister of National Revenue that
  - the interest in the policy was, on the anniversary day (as defined in subsection 12.2(11)) of the policy that occurs in the taxation year, an exempt policy (as defined in subsection 12.2(11)) or a prescribed annuity contract (as defined in section 304 of the *Income Tax Regulations* – in this regard, it is intended that amendments be proposed to section 304 of the Regulations to reflect this change), or
  - an appropriate amount of income has been included in the taxpayer's income under section 12.2 in respect of the policy.

In the event that subsection (4) applies to a taxpayer for a particular taxation year in respect of an interest in an insurance policy held by the taxpayer at the beginning of the particular taxation year and subsection (4) did not apply to that taxpayer in respect of that interest in the taxpayer's preceding taxation year, paragraph 94.2(11)(*d*) provides that the taxpayer is deemed to have acquired the interest in the insurance policy at the beginning of the particular taxation year at a cost equal to the fair market value of the interest at the beginning of the particular taxation year plus (where the taxpayer elects) the amount by which

- the total of all amounts each of which is a premium paid before the beginning of the particular taxation year in respect of the interest by the taxpayer, to the extent that the premium was
  - paid at a time when the taxpayer was resident in Canada and not an exempt taxpayer,
  - cannot be refunded (otherwise than on termination or cancellation of the policy), and
  - not paid in respect of a benefit described in any of subparagraphs (*c*)(i) to (vii) of the definition "premium",

exceeds

- the total of
  - the fair market value at the beginning of the particular taxation year of the interest, and
  - the total of all amounts each of which is an amount received before the beginning of the particular taxation year in respect of the interest by the taxpayer at a time when the taxpayer was resident in Canada and not an exempt taxpayer.

New paragraph 94.2(11)(*e*) provides that for the purposes of the subsection and subsections 94.2(1) to (4), certain amounts in respect of an interest in an insurance policy are to be determined without reference to benefits under the policy that are paid, payable or anticipated to be payable as a consequence only of the occurrence of the risks insured under the policy. Those amounts are

- the fair market value of the interest,
- the proceeds of disposition of the interest, and
- each amount paid to a beneficiary in respect of the interest.

Paragraph 94.2(11)(*f*) provides, for the purposes of subsection 94.2(1) to (4) that:

- a payment of a premium under an insurance policy by the taxpayer is deemed to be an acquisition of a Part of an interest in the policy to the extent that the premium cannot be refunded and is not a premium in respect of a benefit described in any of subparagraphs (*c*)(i) to (vii) of the definition premium in subsection 148(9),
- a payment made by the taxpayer in respect of a principal amount of a loan made under the policy is deemed to be an acquisition of a part of an interest in the policy to the extent that the loan was included in the amount in respect of the interest determined for (*c*) in applying the definition mark-to-market formula in subsection (1) for the year in which the loan was made, and
- any other amount paid by the taxpayer to acquire an interest in an insurance policy from any other entity or individual is deemed to be an acquisition of an interest in an insurance policy.

Paragraph 94.2(11)(*g*) provides that for the purposes of subsections 94.2(1) and (4), if paragraph 94.2(11)(*d*) has deemed the taxpayer to have acquired an interest at a particular time, in computing the taxpayer's proceeds of disposition from the taxpayer's first disposition of the interest after the particular time, the taxpayer is deemed, in addition to any other proceeds of disposition from the disposition of the interest, to be entitled to receive an amount of proceeds from the disposition of the interest equal to the amount by which

- the total of the fair market value of the interest at the particular time and the total of all amounts received before the particular time in respect of the interest by the taxpayer at a time when the taxpayer was resident in Canada and not an exempt taxpayer,

exceeds

- the total of all premiums paid before the particular time in respect of the interest by the taxpayer (to the extent that the premiums were paid at a time when the taxpayer was resident in Canada and not an exempt taxpayer, cannot be refunded and were not paid in respect of a benefit described in any of subparagraphs (*c*)(i) to (vii) of the definition "premium" in subsection 148(9).

Paragraph 94.2(11)(*h*) provides that if the interest in an insurance policy is held by the taxpayer at the end of a particular taxation year, subsection 94.2(4) applies for the purpose of computing the taxpayer's income for the particular taxation year in respect of the interest and subsection 94.2(4) does not apply for the following taxation year, the cost to the taxpayer of the participating interest at or after the beginning of the following taxation year shall be determined as if the taxpayer had acquired the participating interest at the beginning of the following taxation year at a cost equal to the amount by which

- the sum of
    - the fair market value at the end of the particular taxation year of the interest, and
    - the amount determined under subparagraph 94.2(4)(*a*)(ii) in respect of the interest for the particular taxation year if that subparagraph were read without its clause (A),

exceeds

- the amount that would, if paragraph 94.2(11)(*g*) had applied at the end of the particular taxation year in respect of the interest, be determined at the end of the particular taxation year in respect of the interest by the formula under that paragraph.

Subsections 94.2(10) and (11) apply for taxation years that begin after 2006.

Example

Assume that David, a long-term resident of Canada, pays premiums of $10,000 to an offshore insurer for a life insurance policy in 2002. The policy's fair market value is $9,000 and $10,700 at the end of 2007 and 2008 (respectively).

Results

1. *For 2007, no income amount is determined under paragraph 94.2(4)(a) because the cost of the policy exceeds the fair market value at the end of 2007. The cost to David of the policy is deemed to be $10,000 ($9,000 + $1,000).*
2. *The loss for the year 2007 is $1,000. ($9,000 – $10,000). No claim in respect of the loss is permitted under clause 94.2(4)(a)(ii)(A) of the Act. The amount of the denied loss is equal to $1,000 and is included under G in the mark-to-market formula in subsection 94.2(1) in year 2008.*
3. *For 2008, the amount included in income under paragraph 94.2(4)(a) (after the application of the mark-to-market formula) is $700 (= $10,700 ("B"), minus $9,000 ("F"), minus $1,000 ("G")).*
   It is possible that the cash surrender value of a policy may be less than its fair market value.

Change of Status

ITA
94.2(12)

New subsection 94.2(12) of the Act provides rules for determining the cost of a participating interest held by a taxpayer in a non-resident entity where the taxpayer holds the participating interest at the end of a particular taxation year and subsection 94.2(4) applied for the purpose of computing the taxpayer's income for that particular taxation year in respect of the participating interest and subsection 94.2(4) does not apply for the purpose of computing the taxpayer's income for the following taxation year in respect of the participating interest. In general terms, the cost of the participating interest is the amount that would be the taxpayer's cost plus or minus the amounts included or deducted in computing the taxpayer's income in respect of the participating interest under the foreign investment entity rules.

More specifically, where subsection 94.2(12) applies, the cost of the participating interest to the taxpayer, at all relevant times in the future, is deemed to be the amount, if any, by which

- the total of
  - the cost of the participating interest to the taxpayer, otherwise determined, and
  - the amount, if any, by which the amount determined under subparagraph 94.4(2)(*a*)(ii) in respect of the participating interest for the taxpayer's last taxation year to which subsection 94.2(4) applies to the participating interest exceeds the amount determined under paragraph 94.4(2)*(a*) in respect of the particular interest for the particular taxation year,

  exceeds

  - the amount, if any, by which
    - the total of the amount determined under paragraph 94.4(2)(*a*) and clause 94.4(2)(*a*)(ii)(B) for the particular year in respect of the participating interest,

exceeds

- the amount determined under clause 94.4(2)(*a*)(ii)(A) for the particular year in respect of the participating interest.

In addition, subsection 94.2(12) provides that in computing, after the end of the particular year in respect of the participating interest, the adjusted cost base to the taxpayer of the particular interest, paragraph 94.4(2)(*b*) shall not apply to the taxpayer in respect of the particular interest.

For more detail, see the commentary on paragraphs 53(1)(*m*.1) and 53(2)(*w*), the definitions “deferral amount”, “mark-to-market formula” and “reconciliation amount” in subsection 94.2(1), and subsection 94.2(4).

Cost of Participating Interest

ITA
94.2(13)

New subsection 94.2(13) provides a rule for determining the cost of a participating interest in an entity that is disposed of (other than a disposition deemed to arise because of subsection 128.1(4) or 149(10)) by the taxpayer in a taxation year. This new subsection applies in cases where subsection 94.2(4) applies to the taxpayer in respect of the participating interest for the taxation year in which the participating interest is disposed of.

New subsection 94.2(13) provides that the cost of the participating interest to the taxpayer is deemed to be (except for the purpose of section 94.2) the fair market value of the property at the time of the disposition. In identifying property for these purposes, identical properties of a taxpayer are considered to be disposed of on a “first in, first out” basis, as a consequence of the application of paragraph 94.1(2)(*u*). Where a participating interest is disposed of in a taxation year and subsection 94.2(4) does not apply to the taxpayer in respect of the participating interest for that taxation year, the cost to the taxpayer of the participating interest is determined under subsection 94.2(12).

Under new paragraph (*c*.2) of the definition “cost amount” in subsection 248(1), the cost determined at a particular time for a property under subsection 94.2 (13) is also the “cost amount” of the property at the particular time.

Deferral Amount where Same Interest Reacquired

ITA
94.2(14)

New subsection 94.2(14) of the Act generally provides that a “deferral amount” in respect of a property of a taxpayer is deemed to be nil, after the property has been disposed of by the taxpayer at a time when the mark-to-market rules in subsection 94.2(4) applied to the property. This is of relevance to property that is reacquired by a taxpayer. However, subsection 94.2(14) is subject to the rules in subsections 94.2(15) to (18).

It should be noted that identical properties of a taxpayer are considered to be disposed of on a “first in, first out” basis as a consequence of the application of paragraph 94.1(2)(*u*).

Fresh-start re Change of Status of Entity

ITA
94.2(15)

New subsection 94.2(15) of the Act applies where a taxpayer’s participating interest in an entity was initially subject to the rules in subsection 94.2(4) and ceases to be subject to those rules (otherwise than because of the taxpayer having become an “exempt taxpayer”). For example, subsection 94.2(15) could apply where an entity ceases to be a FIE.

In these circumstances, the deferral amount in respect of the participating interest is determined without reference to previous applications of subsections 94.2(4) and (14). This rule is relevant only in the event that the same participating interest of the taxpayer again becomes subject to the rules in subsection 94.2(4).

Parallel "fresh-start" rules are contained in subsection 94.2(16) and (17). All of these "fresh-start" rules are expected to be only rarely involved, given that more than one change in status of an investment or a taxpayer is required for the rules to become relevant. For more information on the "deferral amount" defined in subsection 94.2(1), see the commentary on that definition.

Fresh-start after Emigration of Taxpayer

ITA
94.2(16)

New subsection 94.2(16) of the Act affects the calculation of the "deferral amount" in respect of a participating interest in an entity for a taxpayer who has ceased to reside in Canada. It is relevant in the event that, at a subsequent time, the taxpayer becomes resident in Canada again.

In these circumstances, the deferral amounts in respect of the taxpayer's FIE interests are determined without reference to the previous application of subsections 94.2(4) and (14).

For further detail, see the commentary on the related fresh-start rule in subsection 94.2(15).

Fresh-start re Change of Status of Tax-exempt Entity

ITA
94.2(17)

New subsection 94.2(17) of the Act affects the calculation of the "deferral amount" in respect of an interest in an entity for a taxpayer that initially was not an "exempt taxpayer" under paragraph (*a*) or (*b*) of that definition in subsection 94.1(1) and then subsequently obtains that status.

In these circumstances, the deferral amounts in respect of the FIE interests of the taxpayer are determined without reference to previous applications of subsections 94.2(4) and (14).

For further context, see the commentary on the related fresh-start rule in subsection 94.2(15). In addition, it should be noted that amended subsection 149(10) applies to changes of tax-exempt status for taxpayers that are corporations. Where subsection 149(10) applies, the rules in subsection 94.2(17) do not apply.

Superficial Dispositions

ITA
94.2(18)

New subsection 94.2(18) of the Act applies where a taxpayer disposes of a participating interest in an entity in respect of which a negative amount is determined under the description of D in the formula in subsection 94.2(4). This would be the case where there is a negative deferral amount associated with the interest. In these circumstances, the deferral amount is instead generally deemed to be nil if, during the period beginning 30 days before the disposition and ending 30 days after the disposition, identical property is acquired by the taxpayer or certain related persons.

Subsection 94.2(18) operates in a manner similar to the "superficial loss" rules for capital properties and is intended to prevent the premature realization of losses in respect of a property in which a taxpayer effectively retains an economic interest. "Superficial loss" has the same meaning as assigned in section 54, except that the definition for the purposes of subsection 94.2(18) does not contain the exception for transactions covered by subsection 40(3.4).

Property substituted for the particular property is, in these circumstances, considered to have the deferral amount associated with the property disposed of.

Determination of Capital Dividend Account

ITA
94.2(19)

New subsection 94.2(19) provides rules that deem a positive or negative deferral amount in respect of a disposition of what would, but for section 94.2, be a capital property of a taxpayer that is a corporation resident in Canada, to be a taxable capital gain or an allowable capital loss, as the case may be, and twice such an amount to be a capital gain or capital loss of the corporation, as the case may be, for the purposes of computing the capital dividend account of the corporation. This rule ensures that 1/2 of a capital gain or a capital loss that is attributable to a deferral amount is reflected in the capital dividend account of a corporation.

Application of Paragraph 94.3(4)(*b*)

ITA
94.2(20)

New subsection 94.2(20) of the Act provides a special rule that requires a taxpayer to report, as capital gains or losses under paragraph 94.2(4)(*b*) rather than as income or losses from property under paragraph 94.2(4)(*a*), amounts determined under the "mark-to-market formula" for a particular year in respect of a participating interest of the taxpayer in a non-resident entity.

This rule applies where two conditions are met. The first condition is that the participating interest of the taxpayer would, if the Act were read without reference to section 94.2, be a capital property of the taxpayer at the last time in the particular taxation year at which the taxpayer held the participating interest.

The second condition is that all or substantially all of the amount required to be added or deducted under the mark-to-market formula for the taxation year in respect of the participating interest, in a particular non-resident entity, can be attributed to

- capital gains or capital losses from the disposition of capital property (other than a participating interest in a foreign investment entity) by the particular non-resident entity or by any foreign investment entity in which the particular non-resident entity has a direct or indirect interest, and
- increases or decreases in the fair market value of capital property (other than a participating interest in a foreign investment entity) of the particular non-resident entity or of any foreign investment entity in which the particular non-resident entity has a direct or indirect interest.

In the event that any entity in a chain or tier of entities holds capital properties that are particular participating interests in foreign investment entities, changes in value of the particular participating interests and gains or losses from the disposition of those interests are ignored in applying the "all or substantially all" requirement. Instead, the requirement would be computed with regard to gains or losses from the disposition of, or changes in value in, capital properties of the foreign investment entities. This is intended to prevent the use of intermediary entities, contrary to the intent of subsection 94.2(20), as a means of triggering the application of paragraph 94.2(4)(*b*).

Reconciliation

ITA
94.2(21)

New subsection 94.2(21) applies where a taxpayer disposes of an interest in a non-resident entity at a particular time in a particular taxation year. If subsection 94.2(4) applies for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest, in computing that income the taxpayer may be required to include an amount of income (or to have capital gains) or may be permitted to deduct as a loss (or to have capital losses) determined with regard to the reconciliation amount (as defined in subsection 94.1(1)) at that time in respect of the participating interest.

More specifically, under paragraph 94.2(21)(*a*), where paragraph 94.2(4)(*a*) applies for the particular taxation year, and subsection 94.2(20) has never applied for a preceding taxation year, in respect of the participating interest,

- there may be deducted, as a loss from property from a property that is the participating interest, the positive reconciliation amount, if any, at that time in respect of the participating interest, and
- there shall be included, as income from property from a property that is the participating interest, the absolute value of the negative reconciliation amount, if any, at that time in respect of the participating interest.

In any other case where subsection 94.2(4) applies for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest, paragraph 94.2(21)(*b*) provides that

- the taxpayer is deemed to have a capital loss for the taxation year from the disposition in the taxation year of capital property that is the participating interest equal to the positive reconciliation amount, if any, in respect of the participating interest, and
- the taxpayer is deemed to have a capital gain for the taxation year from the disposition in the taxation year of capital property that is the participating interest equal to the absolute value of the negative reconciliation amount, if any, in respect of the participating interest.

Where a taxpayer disposes of a participating interest in a taxation year of the taxpayer and subsection 94.2(21) does not apply (i.e., because subsection 94.2(4) does not apply for the purpose of computing the taxpayer's income for the particular taxation year in respect of the participating interest), subsection 94.2(12) may apply to adjust, with reference to the reconciliation amount in respect of the interest, the taxpayer's adjusted cost base (or cost) of the interest.

For more detail, see the commentary on subsection 94.2(12) and the definition "reconciliation amount" in subsection 94.2(1).

Foreign Investment Entities – Accrual

ITA
94.3

New section 94.3 of the Act sets out new rules for the taxation of interests in FIEs where subsections 94.1(4) and 94.2(3) do not apply.

Section 94.3 applies to taxation years that begin after 2006.

Definitions

ITA
94.3(1)

New subsection 94.3(1) of the Act sets out a number of definitions and provides that those definitions and the definitions in subsections 94.1(1) and 94.2(1) apply for the purposes of section 94.2.

"fresh-start year"

The definition "fresh-start year" is relevant to calculating a taxpayer's "income allocation" (as defined in subsection 94.3(1)) in respect of a non-resident entity. In general terms, a fresh-start year of an entity in respect of a taxpayer that holds a participating interest in the entity means a taxation year of the entity at the end of which it becomes an entity in respect of which subsection 94.1(3) may apply to the taxpayer in respect of the participating interest.

For more detail, see the commentary on subsection 94.3(4) and on the definition "income allocation" in subsection 94.3(1).

“income allocation”

The definition “income allocation” applies in determining the amount to be included, under “A” of the formula in subsection 94.3(4), in computing a taxpayer’s income or loss for the taxpayer’s taxation year in respect of a property that is a participating interest of the taxpayer in a non-resident entity.

A taxpayer’s income allocation (in respect of a participating interest in a non-resident entity held by the taxpayer at the end of a particular taxation year of the non-resident entity that ends in a taxation year of the taxpayer) is determined by the formula set out in that definition. In general terms, the taxpayer’s income allocation is the proportion of the non-resident entity ‘s income for the particular taxation year (“A” in the formula) that the fair market value of the interest (“B” in the formula) is of the fair market value of all participating interests in the non-resident entity (“C” in the formula). (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition “participating interest” in subsection 94.1(1) were read without reference to its paragraph (*d*).)

The calculation of a taxpayer’s income allocation in respect of a non-resident entity depends on a calculation of income for the non-resident entity in accordance with rules set out in paragraphs (*a*) to (*l*) of “A” in the formula. This permits taxpayers to make independent calculations of a non-resident entity ‘s income for the purpose of determining income allocations under section 94.3 for the non-resident entity’s “fresh-start year” (as defined in subsection 94.3(1)) in respect of the taxpayer and subsequent years.

The special rules that apply in calculating a non-resident entity’s income in respect of a taxpayer that is a participating interest holder for the non-resident entity’s fresh-start year and subsequent years are as follows:

(*a*) Subject to three exceptions, the non-resident entity is generally treated as having been a taxpayer resident of Canada throughout its existence. First, this rule does not apply for the purposes of subsection 107.4(1) and paragraph (*f*) of the definition “disposition” in subsection 248(1), with the result that where the non-resident entity is a trust, property that is transferred to the non-resident entity is considered to have been transferred to the non-resident entity under subsection 69(1) at its fair market value. Second, this rule does not apply for the purpose of section 91, with the result that the non-resident entity will not itself be required to include an amount in respect of foreign accrual property income in computing the non-resident entity’s income under the “income allocation” definition. It should be noted, however, that the non-resident entity will not be able to rely on subparagraph (*a*)(i) of the definition “exempt interest” in section 94.1 as a basis for an exemption from the FIE regime for a participating interest of the non-resident entity in a controlled foreign affiliate of it or of the investor taxpayer. Thus the non-resident entity will have FIE income for purposes of the “income allocation” definition in respect of its participating interest in the controlled foreign affiliate. Third, this rule does not apply for the purpose of subparagraph 94.3(2)(*b*)(ii) with the result that subsection 94.1(4) or 94.2(4) (rather than section 94.3) potentially applies in computing its income in the event that the non-resident entity owns a participating interest in another non-resident entity that is a FIE.

(*b*) Each property held by the non-resident entity at the beginning of the fresh-start year is deemed to have been disposed of for its fair market value immediately before that time and reacquired for the same amount at that time.

(*c*) Each discretionary deduction permitted in computing the non-resident entity’s income for its fresh-start year and subsequent taxation years is deemed to have been claimed to the extent designated by the investor taxpayer. Thus, in calculating an income allocation in respect of the non-resident entity, the investor taxpayer will be permitted to claim deductions such as capital cost allowance.

(*d*) The non-resident entity is assumed to have deducted the greatest amounts permissible, for its taxation year preceding the fresh-start year, under sections 20, 138 and 140. These amounts are added in computing the non-resident entity's income for the fresh-start year, but appropriate deductions under these sections can be claimed for the fresh-start year and subsequent taxation years. In the context of the reserve for life insurers under subsection 138(3), it is intended that paragraph (*c*) of the definition "reported reserve" in subsection 1408(1) of the Regulations be amended so that the non-resident entity can have a "reported reserve".

(*e*) The non-resident entity is deemed not to have been in existence before the fresh-start year for the purposes of sections 37, 65 to 66.4 and 66.7. As a consequence, the scientific research and resource expenditure pools to which these sections refer are ignored, to the extent that these pools were generated before the fresh-start year.

(*f*) The non-resident entity is not permitted to deduct any amount under subsection 20(11) or (12) in respect of its foreign tax. However, foreign tax will be taken into account because the non-resident entity's specified tax allocation (as defined under subsection 94.3(1)) can offset amounts otherwise included in income under subsection 94.3(4). Further, if the non-resident entity is a trust, no amount is considered deductible under subsection 104(6) in determining its income for the year. Double taxation for the investor taxpayer is avoided through the application of new section 94.4. In addition, no deemed disposition day under subsection 104(4) is determined in respect of the trust, whether the non-resident entity falls outside the restricted meaning of "trust" for this purpose under subsection 108(1) or not.

(*g*) Where the non-resident entity has an interest in another non-resident entity, there is no "deferral amount" taken into account in computing the non-resident entity 's income pursuant to new subsection 94.2(4). (The fresh-start rule described above eliminates the need for a "deferral amount".)

(*h*) Participating interests in controlled foreign affiliates of the investor taxpayer or of the non-resident entity are not treated as "exempt interests" of the non-resident entity. As a result, the FIE rules and not the FAPI rules apply in respect of such interests in computing the non-resident's income under the income allocation rules.

(*i*) Where the non-resident entity has net capital gains for the particular taxation year, the amount to be included in computing the non-resident entity's income in respect of the capital gains is the amount, if any, by which the amount determined under subparagraph 3(*b*)(i) exceeds the amount determined under subparagraph 3(*b*)(ii) in respect of the non-resident entity for the year.

(*j*) Where the non-resident entity has net capital losses for the particular taxation year the amount deductible in computing the non-resident entity's income in respect of capital losses (other business investment losses) is the amount, if any, by which the amount determined under subparagraph 3(*b*)(ii) exceeds the amount determined under subparagraph 3(*b*)(i) in respect of the non-resident entity for the year.

(*k*) Where the non-resident entity has business investment losses for the year the amount deducted in computing the non-resident entity's income for the year in respect of business investment losses is the amount of its allowable business investment losses for the year.

For further details, see the related commentary on the definitions "foreign investment entity", "non-resident entity" and "exempt interest" in subsection 94.1(1) and "loss allocation" and "specified tax allocation" in subsection 94.3(1).

“loss allocation”

The definition “loss allocation” applies in determining the amount to be included, under “B” of the formula in subsection 94.3(4), in computing a taxpayer’s income or loss for the taxpayer’s taxation year in respect of a property that is a participating interest of the taxpayer in a non-resident entity. A taxpayer is entitled, under the formula in subsection 94.3(4), to deduct the taxpayer’s loss allocation in respect the participating interest.

In general, a taxpayer’s loss allocation in respect of a participating interest, in a non-resident entity, held by the taxpayer at the end of a particular taxation year of the non-resident entity that ends in a taxation year of the taxpayer, is the proportion of the non-resident entity ‘s net loss for the particular taxation year that the fair market value of the taxpayer’s participating interest in the non-resident entity is of the fair market value of all participating interests in the non-resident entity. More specifically, a taxpayer’s loss allocation is determined as follows:

- ADD the amount of the entity’s total losses for the particular taxation year from businesses and properties, the amount, if any, by which the amount determined under subparagraph 3(*b*)(ii) exceeds the amount determined under subparagraph 3(*b*)(i) in respect of the entity for the particular taxation year, and the amount of the entity’s allowable business investment losses for the particular taxation year,
- SUBTRACT the amount determined under paragraph 3(*c*) for the entity for the particular taxation year (i.e., the total amount of its income from businesses and properties and taxable capital gains in excess of allowable capital losses, for the particular taxation year), and
- MULTIPLY any positive remainder by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity. (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition “participating interest” in subsection 94.1(1) were read without reference to its paragraph (*d*).)

The determination of a taxpayer’s loss allocation is subject to the same special rules that apply for the purposes of computing a taxpayer’s “income allocation” (as defined in subsection 94.3(1)). For more detail, see the commentary on the definition “income allocation”.

“specified tax allocation”

The definition “specified tax allocation” applies in determining the amount to be included, under “C” of the formula in subsection 94.3(4), in computing a taxpayer’s income or loss for the taxpayer’s taxation year in respect of a property that is a participating interest of the taxpayer in a non-resident entity. A taxpayer is entitled to deduct, under C of the formula in subsection 94.3(4), the taxpayer’s specified tax allocation in respect of the participating interest

A taxpayer’s specified tax allocation in respect of a participating interest, in a non-resident entity, held by the taxpayer at the end of a particular taxation year of the non-resident entity that ends in a taxation year of the taxpayer, means the total of all amounts each of which is the amount determined, in respect of the particular taxation year, by the formula set out in the definition.

More specifically, the taxpayer’s specified tax allocation is the product obtained by the following:

- MULTIPLY, if the taxation year of the taxpayer begins after 2006, the income or profits tax paid by the non-resident entity in respect of the particular taxation year, to the extent that that tax can reasonably be considered to be in respect of the income or profits of the non-resident entity included in computing the amount determined in respect of the non-resident entity and the participating interest under the description of “A” in the definition “income allocation” for the particular taxation year or any of the 5 taxation years of the non-resident entity that precede the particular taxation year and that end after 2006, BY

- the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity. (Note that subsection 94.3(4) is unavailable in respect of a particular interest that would not be a participating interest if the definition "participating interest" in subsection 94.1(1) were read without reference to its paragraph (*d*), AND
- MULTIPLY any positive remainder by the taxpayer's relevant tax factor (as defined by subsection 95(1)) for that taxation year of the taxpayer.

Income or profits tax is normally expected to be tax that is paid by an entity to a foreign government. However, it could also include income tax paid to the government of Canada or a province with respect to income earned by the entity from Canadian sources. In each case, only income or profits tax payable for taxation years of entities that end in a taxation year of a taxpayer that begins after 2006 is taken into account.

Rules of Application

ITA
94.3(2)

New subsection 94.3(2) of the Act sets out rules that apply in applying section 94.3 of the Act.

Paragraph 94.3(2)(*a*) provides that the rules of application in subsection 94.1(2) apply in section 94.3.

Paragraph 94.3(2)(*b*) identifies a number of circumstances in which subsection 94.3(3) (and hence subsection 94.3(4)) is not available, even though the conditions in paragraphs 94.3(3)(*a*) to (*e*) may be met, for a particular taxation year of a taxpayer in respect of a particular participating interest, in a non-resident entity, held in the particular taxation year by the taxpayer. More specifically those circumstances are:

- where, either of subsection 94.2(3) or subsection 94.2(9) (tracked interests) applies to the taxpayer in respect of the particular participating interest for the particular taxation year,
- where the taxpayer is itself a FIE,
- where the Minister of National Revenue sends a written demand to the taxpayer requesting additional information for the purpose of enabling the Minister to determine if an amount with respect to the particular participating interest would be required under subsection 94.3(4) to be added (or permitted under that subsection to be deducted) in computing the income of the taxpayer for the taxation year, and information sufficient to make the determination is not received by the Minister within 120 days (or within such longer period as is acceptable to the Minister) after the Minister sends the demand,
- where the particular participating interest is an interest that would not, at each time at which a taxation year of the non-resident entity ends, be a participating interest, in the non-resident entity, if the definition "participating interest" were read without reference to paragraph (d) of that definition – that is, without reference to the rule which deems a property that is convertible into, exchangeable for, or confers a right to acquire a participating interest in a FIE or a property the fair market value of which is determined primarily by reference to the fair market value of participating interests in the FIE, to be a participating interest,
- where subsection 94.3(3) applied for a taxation year (the "preceding taxation year") that ended before the particular taxation year of the taxpayer in respect of the particular participating interest, and did not apply for a taxation year of the taxpayer that was after the preceding taxation year and before the particular taxation year in respect of the particular participating interest. For example, where a taxpayer has sufficient information to apply the accrual regime in one year and in the subsequent year does not. The accrual regime would be unavailable to the taxpayer in respect of the interest and any identical interests in the subsequent year (because of paragraph 94.3(3)(e)) and any of the following years (because of subparagraph 94.3(2)(b)(v)),

- where any of the participating interests in the non-resident entity in respect of which the accrual regime might otherwise be available are not identical to the particular participating interest — that is, the accrual regime is available in respect of participating interests in a non-resident entity only to the extent that all participating interests in the non-resident entity are identical (ignoring interests that are participating interests in the non-resident entity solely because of paragraph (d) of the definition “participating interest” in subsection 94.1(1)), or
- where any amount of income or capital of the trust that any entity or individual may receive directly from the trust at any time as a beneficiary under the trust depends on the exercise by any entity or individual of, or the failure by any entity or individual to exercise, a discretionary power.

Accrual

ITA
94.3(3) and (4)

Subsection 94.3(3) provides that the accrual regime is available, subject to the limitations set out in paragraph 94.3(2)(*b*), to a taxpayer for a particular taxation year of the taxpayer in respect of a particular participating interest, in a non-resident entity, held in the particular taxation year by the taxpayer if

- subsection 94.1(3) applies to the taxpayer for the particular taxation year in respect of the particular participating interest;
- either
  - subsection 94.3(3) applied in respect of an identical participating interest that was held by the taxpayer at any time when the taxpayer held the particular participating interest, or
  - the taxpayer has elected that subsection 94.3(3) apply in respect of the particular participating interest, by notifying the Minister in writing in the taxpayer’s return of income filed on or before the taxpayer’s filing-due date for the first taxation year of the taxpayer for which
    - subsection 94.1(3) applies to the taxpayer in respect of the particular participating interest, or
    - subsection 94.2(9) does not apply to the taxpayer in respect of the particular participating interest and that immediately follows a taxation year for which subsection 94.2(9) applied to the taxpayer in respect of the particular participating interest;
- neither subsection 94.1(4) (i.e., the prescribed rate regime) nor 94.2(3) (i.e., the mark-to-market regime) applied to the taxpayer for a taxation year (referred to in this commentary as the “preceding taxation year”) that ended before the particular taxation year in respect of the particular participating interest (or in respect of an identical participating interest that was held by the taxpayer at any time when the taxpayer held the particular participating interest), unless subsection 94.2(9) applied for that preceding taxation year to the taxpayer in respect of the particular participating interest (or the identical participating interests);
- the particular participating interest is, at each time in the particular taxation year at which the taxpayer held the particular participating interest and at which a taxation year of the non-resident entity ends, capital property of the taxpayer; and
- the taxpayer files, with the taxpayer’s return of income filed on or before the taxpayer’s filing-due date for the particular taxation year, prescribed information in prescribed form. It is contemplated that the prescribed information required would include: the entity’s financial statements (as defined in subsection 94.1(1)); capital cost allowance schedules; capital gains and capital loss calculations; a detailed calculation of the taxpayer’s specified tax allocation and any income allocation or loss allocation; a reconciliation of the entity’s income reported in its financial statement income with its income computed under “A” of the formula in the “income allocation” provisions; and a description of reserves claimed.

If subsection (3) applies to a taxpayer resident in Canada for a particular taxation year of the taxpayer in respect of a participating interest in a non-resident entity, in computing the taxpayer's income for the particular taxation year, subsection 94.3(4) will apply in computing the taxpayer's income or loss for the particular taxation year from property from a property that is the participating interest. More specifically, under paragraph 94.3(4)(*a*), the taxpayer's income from property from a property that is the participating interest, is the positive amount, if any, determined as follows:

- ADD the taxpayer's "income allocation" in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year;
- SUBTRACT the taxpayer's "loss allocation" in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year;
- SUBTRACT the taxpayer's specified tax allocation in respect of the participating interest for each taxation year of the non-resident entity that ends in the particular taxation year; and
- SUBTRACT the net cumulative positive balance determined under paragraph 94.3(4)(*b*) in respect of the taxpayer for such property in respect of preceding taxation years of the non-resident entity.

Where a negative amount results in applying the formula under paragraph 94.3(4)(*a*), paragraph 94.3(4)(*b*) may permit a deduction of the negative amount, as a loss from property from a property that is the participating interest, in computing the taxpayer's income for the particular taxation year. However, the deduction is limited by net cumulative positive balance determined under subparagraph 94.3(4)(*b*)(ii) in respect of the taxpayer for such property in respect of preceding taxation years of the non-resident entity.

An unused loss allocation is treated as a loss from property and is carried forward to offset the total amount otherwise required to be included in computing the taxpayer's income from property under subsection 94.3(4) for a subsequent taxation year of the non-resident entity. For more detail, see the commentary on the definition "loss allocation" in subsection 94.3(1).

The following examples illustrate the operation of subsection 94.3(4).

Example 1

Canco owns shares in the capital stock of FIE-1, which like Canco has a calendar taxation year. Canco's income (loss) allocations for 2007, 2008, 2009, 2010 and 2011 are ($100), $25, $90, ($20) and $50, respectively. FIE-1 pays no income or profits taxes.

Results

1 The amount included under paragraph 94.3(4)(a) in Canco's income for 2007 is nil (B = $100). The amount determined under paragraph 94.3(4)(b) for 2007 is $100, which can be carried forward to 2008.

2. The amount included under paragraph 94.3(4)(a) in Canco's income for 2008 is nil (A = $25, D = $100). The amount determined under paragraph 94.3(4)(b) for 2008 is $75, which can be carried forward to 2009.

3. The amount included under paragraph 94.3(4)(a) in Canco's income for 2009 is $15 (A = $90, D = $75). The amount determined under paragraph 94.3(4)(b) for 2009 is nil.

4. The amount included under paragraph 94.3(4)(a) in Canco's income for 2010 is nil (B = $20, D = $0). The amount deductible under paragraph 94.3(4)(b) is $15 (= the lesser of $20 and $15). The remaining $5 unused loss allocation can be carried forward to 2011.

5. The amount included under paragraph 94.3(4)(a) in Canco's income for 2011 is $45 (A = $50, D = $5).

Example 2

Canco owns shares in the capital stock of FIE-1, which like Canco has a calendar taxation year. Canco's income (loss) allocations for, 2007, 2008, 2009, 2010 and 2011 are: ($100), ($125), ($175), $300 and $150. FIE-1 pays no income or profits taxes.

Results

1. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2007 is nil (B = $100). The amount determined under subparagraph 94.3(4)(b)(i) for 2007 is $100 (= B), which can be carried forward to 2008.*
2. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2008 is nil (B = $125,D = $100). The amount determined under subparagraph 94.3(4)(b)(i) for 2008 is $225 (= B+D), which can be carried forward to 2009.*
3. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2009 is nil (B = $175, D = $225). The amount determined under subparagraph 94.3(4)(b)(i) for 2009 is $400 (= B+D).*
4. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2010 is nil (A = $300, D = $400). The amount deductible under paragraph 94.3(4)(b) is nil (= the lesser of $100 and nil). The remaining $100 unused loss allocation (= D - A) can be carried forward to 2011.*
5. *The amount included under paragraph 94.3(4)(a) in Canco's income for 2011 is $50 (A = $150, D = $100).*

Example 3

1. *Canco, FIE-1 and ABC Inc. each have taxation years that coincide with calendar years and each issue only one class of shares.*
2. *Canco is a corporation resident in Canada that holds 20% of the shares of the capital stock of FIE-1.*
3. *FIE-1 owns 75% of the shares of the capital stock of ABC Inc.*
4. *ABC Inc. is not a FIE, but would be a controlled foreign affiliate of FIE-1 if FIE-1 were resident in Canada. Although ABC Inc. is a foreign affiliate of Canco, it is not a controlled foreign affiliate of Canco.*
5. *FIE-1 earns $5,000 in interest income in 2007. It also receives a dividend of $1,000 from ABC Inc. FIE-1 pays no income or profits taxes.*
6. *The fair market value of FIE-1's shares in ABC Inc. increases by $6,500 in 2007.*

Results

1. *Under the definition "income allocation" in subsection 94.3(1), Canco is required to compute its share of FIE-1's income. For this purpose, FIE-1's income is generally computed as if FIE-1 were resident in Canada. Canco is required, under "A" of the formula in paragraph 94.3(4)(a), to include in computing income its income allocation in respect of its shares in the capital stock of FIE-1.*
2. *FIE-1's income, in computing Canco's income allocation, includes the $5,000 of interest income (as per paragraph 12(1)(c)). However, the $1,000 dividend from ABC Inc. is disregarded because of paragraph (g) of "A" in the definition "income allocation".*
3. *Section 91 of the Act is not applicable in computing Canco's income allocation in respect of its shares in FIE-1 because of paragraph (a) of "A" in the definition "income allocation".*
4. *Since ABC Inc. is not a FIE, sections 94.1 to 94.4 are not applicable to FIE-1's interest in ABC Inc. in computing Canco's income allocation in respect of is shares in FIE-1.*
5. *Canco's income allocation, therefore, is $1,000 (i.e., 20% x $5,000). This amount is included under "A" of the formula in paragraph 94.3(4)(a).*

Example 4

Same facts as in example 3, except that ABC Inc. is itself a FIE.

Results

1. *Because of subparagraph 94.3(2)(b)(ii), the accrual regime will not apply in the calculation of FIE-1's income in respect of its interest in ABC Inc. Instead, FIE-1 may rely upon subsections 94.2(3) and (4), and if not applicable, subsection 94.1(4). Assume that FIE-1 qualifies, and so elects, to have subsection 94.2(3) apply to it in respect of its interest in ABC Inc. Thus, the mark-to-market regime under subsection 94.2(4) will apply to determine its FIE income from the interest.*
2. *For the purpose of computing Canco's income allocation in respect of its shares in FIE-1, FIE-1's income would include the $5,000 of interest (as per example 3), but not include any share of foreign accrual property income (as per example 3). However, FIE-1's income would include the $1,000 dividend paid in addition to its gain determined under subsection 94.2(4) in respect of its participating interest in ABC Inc. This gain so determined is $7,500, which is equal to the $6,500 increase in the value of the shares plus the $1,000 dividend paid. However, for the purposes of computing Canco's income allocation, a deduction for the $1,000 dividend is permitted for FIE-1 because section 94.4 would have permitted the deduction if FIE-1 had been resident in Canada.*
3. *Consequently, Canco's income allocation in respect of its shares of the capital stock of FIE-1 is equal to $2,500 [i.e., ($5,000 + $7,500 + $1,000 - $1,000) x 20%)]. This amount is required to be included in computing Canco's income under subsection 94.3(4).*

Example 5

In 1999, Mireille (a resident of Canada) purchased a 30% participating interest in an entity (FIE-1) that is a FIE. The rate of foreign tax applicable to FIE-1's income is 20%. FIE-1's taxation years coincide with calendar years. For the purposes of computing Mireille's income or loss in respect of the interest under subsection 94.3(4), the income (loss) and the foreign tax of FIE-1 for taxation years 2007 to 2010 are as follows:

Year	***2007***	***2008***	***2009***	***2010***	***Total***
Income (loss)	*$ 100,000*	*($120,000)***	*$95,000*	*$130,000*	*$205,000*
Foreign tax paid*	*$20,000*	*Nil*	*Nil*	*$21,000*	*$41,000*

** Assume foreign tax paid in the same taxation year as liability arose.*

*** Assume that an equivalent amount is carried forward under the laws of the relevant foreign jurisdiction to reduce FIE-1's tax liabilities after 2008.*

Results

Mireille's income allocations, loss allocations and specified tax allocations are shown in the table below, as are the resulting income inclusions and deductions under subsection 94.3(4). The specified tax allocations in the table below are obtained by multiplying the related figures in the above table by 30% (Mireille's percentage interest) and 2.2 (specified tax factor for Mireille). For example, for 2007, Mireille's specified tax allocation is $13,200 ($20,000 x 30% x 2.2)

Year	***2007***	***2008***	***2009***	***2010***
A. Income/Loss allocation	*$30,000*	*($36,000)*	*$28,500*	*$39,000*
B. Specified tax allocation	*($13,200)*	*nil*	*nil*	*($13,800)*
C. Loss allocation (used)	*nil*	*($16,800)*	*nil*	*nil*
D. Carry-forward offset used	*nil*	*nil*	*($19,200)*	*nil*
E. Loss allocation/ tax allocation to carry-forward	*nil*	*($19,200)*	*nil*	*nil*
Amount included in income under subsection 94.3(4) (A - B - C - D)	*$16,800*	*nil*	*$9,300*	*$25,200*
Amount deducted in computing income under subsection 94.3(4) (D + C + B - A)	*nil*	*($16,800)*	*nil*	*nil*

Adjusted Cost Base

ITA
94.3(5)

New subsection 94.3(5) of the Act provides for adjustments to the adjusted cost base (ACB) of a participating interest in an entity held by a taxpayer.

Paragraph 94.3(5)(*a*) provides for an addition to the ACB of a taxpayer of a participating interest, in a non-resident entity, at any time of the amount that is the total of the amount included in computing the taxpayer's income under paragraph 94.3(4)(*a*) for a taxation year of the taxpayer that ended before that time and the product obtained when the amount determined under paragraph (*i*) of the description of "A" in the definition "income allocation" in subsection 94.3(1) (taxable capital gains of the non-resident entity) in respect of the taxpayer and the participating interest for a particular taxation year of the non-resident entity that ended in a taxation year of the taxpayer that ended before that time and at the end of which particular taxation year the taxpayer held the participating interest is multiplied by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity.

Conversely, paragraph 94.3(5)(*b*) provides for a reduction to the ACB of a taxpayer of a participating interest, in a non-resident entity, at any time, of the total of three amounts. The first is the amount deducted, as a loss from a property that is the participating interest, under paragraph (4)(*b*) in computing the taxpayer's income for a taxation year of the taxpayer that ended before that time. The second and third amounts are the product obtained when the amount determined under paragraph (*j*) or (*k)*, as the case may be, of the description of A in the definition "income allocation" (allowable capital losses of the non-resident entity and allowable business investment losses of the non-resident entity) in respect of the taxpayer and the participating interest for a particular taxation year of the non-resident entity that ended in a taxation year of the taxpayer that ended before that time and at the end of which particular taxation year the taxpayer held the participating interest is multiplied by the percentage that the fair market value of the interest represents of the fair market value of all participating interests in the entity.

For more information, see the commentary on new paragraphs 53(1)(*m*.1) and 53(2)(*w*).

Prevention of Double Taxation

ITA
94.4

New section 94.4 provides rules to eliminate double taxation of income where an amount of income of a non-resident entity, in respect of which any of sections 94.1 to 94.3 has applied in calculating the income for a year of a holder of an interest in the non-resident entity, becomes payable (determined by reference to paragraph 94.1(2)(*o*)) to that interest holder.

Subsection 94.4(1) provides that the definitions in subsections 94.1(1) and 94.2(1), and the rules of application in subsection 94.1(2), apply in section 94.4.

Under subsection 94.4(2), where an amount becomes payable (at a particular time in a particular taxation year of a taxpayer that begins after 2006 or in a preceding taxation year of the taxpayer that begins after 2006) to the taxpayer from a non-resident entity in respect of a participating interest in the entity held by the taxpayer (otherwise than as consideration for the disposition of the interest), and the taxpayer is resident in Canada at the particular time, a deduction is permitted to offset (against any income included in respect of the interest under subsection 94.1(4), 94.2(4) or 94.3(4)) any net income inclusion resulting from the amount payable.

The permitted deduction under subsection 94.4(2) for the taxpayer's taxation year is equal to the lesser of two amounts. The first amount is the amount, if any, by which the total of those amounts payable that are included in computing the taxpayer's income for any of those years, exceeds the total of all amounts each of which

- is deductible in respect of the participating interest in any of those preceding years under paragraph 94.4(2)(*a*), or
- would, if subsection 94.3(3) applies to the taxpayer in respect of the participating interest for any of those taxation years, and the value of D in the definition "specified tax allocation" in subsection 94.3(1) were the taxpayer's relevant tax factor (as defined by subsection 95(1)) minus 1, be the specified tax allocation of the taxpayer in respect of the participating interest for each taxation year of the particular entity that ends in one of those taxation years for which subsection 94.3(3) applied to the taxpayer in respect of the participating interest.

As a result, in computing the portion of the amounts payable that may be used in computing a deduction under subsection 94.4(2), an adjustment is made to account for the extent to which the accrual system under the FIE regime has already recognized a possible incidence of taxation at Canadian-equivalent rates in the non-resident entity.

The second amount is the amount, if any, by which the total of

- the amounts included (or that, but for subsection 94.2(20), would have been included) in respect of the participating interest under subsection 94.1(4) or 94.2(4) in computing the taxpayer's income for the taxation year or a preceding taxation year, and
- the amounts required by paragraph 94.3(5)(*a*) to be added in computing at the particular time the adjusted cost base to the taxpayer of the participating interest

exceeds the total of all amounts each of which is an amount, in respect of the participating interest,

- that is required by paragraph 94.3(5)(*b*) to be deducted in computing at the particular time the adjusted cost base to the taxpayer of the participating interest,
- that is deducted (or that, but for subsection 94.2(20), would have been deducted) under subsection 94.2(4) in computing the taxpayer's income for any of those taxation years, or
- that is deducted under paragraph 94.4(2)(*a*) in computing the taxpayer's income for any of those preceding taxation years.

The amount deductible from income under paragraph 94.4(2)(*a*) in respect of the interest must also be deducted in computing after the particular time the adjusted cost base of the interest. For more information, see the commentary on new paragraph 53(2)(*w*).

The example below illustrates the operation of subsection 94.4(2).

Example

1. *A taxpayer resident in Canada, Canco, purchases a 20% interest in Foreignco, a non-resident corporation. Foreignco is a FIE. Participating interests in Foreignco do not qualify as "exempt interests". Both Canco and Foreignco have taxation years that coincide with calendar years. Subsection 94.1(4) applies to Canco in respect of the interest.*
2. *Canco's income under subsection 94.1(4) in respect of its participating interest in Foreignco for 2007 is $100,000. Foreignco pays a dividend of $50,000 to Canco in 2007. Canco includes the dividend in income pursuant to section 90 and claims a deduction of $20,000 in computing its taxable income pursuant to subsection 113(1). No foreign withholding taxes were paid by Canco on the $50,000 dividend.*

Results

1. *Canco's deduction from income under subsection 94.4(2) is equal to $50,000, being the lesser of the income inclusion as a result of the payment ($50,000) and the amount of the income inclusion under subsection 94.1(4) ($100,000).*
2. *The result would generally be the same if the $50,000 dividend were instead paid in a subsequent year.*

Example

1. *A taxpayer resident in Canada, Canco, purchases a 20% interest in Foreignco, a non-resident corporation. Foreignco is a FIE. Participating interests in Foreignco do not qualify as "exempt interests". Both Canco and Foreignco have taxation years that coincide with calendar years. Subsection 94.1(4) applies to Canco in respect of the interest.*
2. *Canco's income under subsection 94.1(4) in respect of its participating interest in Foreignco for 2007 is $100,000. Foreignco pays a dividend of $50,000 to Canco in 2007. Canco includes the dividend in income pursuant to section 90 and claims a deduction of $20,000 in computing its taxable income pursuant to subsection 113(1). No foreign withholding taxes were paid by Canco on the $50,000 dividend.*

Results

1. *Canco's deduction from income under subsection 94.4(2) is equal to $50,000, being the lesser of the income inclusion as a result of the payment ($50,000) and the amount of the income inclusion under subsection 94.1(4) ($100,000).*
2. *The result would generally be the same if the $50,000 dividend were instead paid in a subsequent year.*

Subsection 94.4(3) is designed to provide relief in circumstances where – because of having made, in computing its income for a taxation year, a deduction under subsection 94.4(2) in respect of a distribution from a FIE – a taxpayer does not have sufficient Part I tax payable for the year against which to claim a foreign tax credit under subsection 126(1) in respect of taxes paid to the government of a foreign country on that amount distributed from the FIE. Subsection 94.4(3) is applicable if

- one or more particular amounts become payable to a taxpayer in a taxation year of the taxpayer,
- the taxpayer includes the particular amounts in computing its income for the taxation year, and
- the particular amounts are included in computing, in respect of a participating interest of the taxpayer, an amount deducted by the taxpayer under subsection 94.4(2) in computing the taxpayer's income for the taxation year.

Where these conditions are met, subsection 94.4(3) provides that the taxpayer may deduct in computing the taxpayer's income for the taxation year the amount of the product determined by the formula "A x B" set out in subsection 94.4(3).

Under the formula, A will generally be the taxpayer's relevant tax factor (as defined by subsection 95(1)) for the taxation year. However, A is nil where the taxpayer is a corporation and the particular amounts are income from a share of the capital stock of a foreign affiliate of the taxpayer; in effect, the deduction under subsection 94.4(3) is not available in these circumstances, as the extent of any relief available to the taxpayer is not otherwise determined under section 126, but rather section 113.

Variable B in the formula is the lesser of two amounts. The first amount is 15% of the total of all amounts, if any, determined under subparagraph (2)(*a*)(ii) in computing the amount deductible by the taxpayer, in respect of the particular participating interest and the particular amounts, under subsection (2) in computing the taxpayer's income for the taxation year. In general terms, this will be the amount by which, in respect of the participating interest, income inclusions under the FIE regime for the taxation year exceed deductions from income made under the FIE regime for the taxation year. The second amount is the portion of the foreign tax paid in respect of the particular amounts that would - if the taxpayer had not made a deduction under subsection 94.4(2) - otherwise have been creditable by the taxpayer under subsection 126(1) for the taxation year.

Subsection 94.4(3) is relevant where a FIE distribution is made in respect of a taxpayer's participating interest and the distribution is subject to non-business income tax imposed by the government of a country in which the FIE is resident. Because of new subsection 126(1.2) of the Act, described in the commentary below, a taxpayer is not entitled to a tax credit under subsection 126(1) in respect of non-business income tax paid by a taxpayer in respect of the distribution if the taxpayer made a deduction under subsection 94.4(3) in respect of the amount distributed.

Clause 19

Foreign Affiliates

ITA
95

Section 95 of the Act defines a number of terms and provides certain rules relating to the taxation of resident shareholders of foreign affiliates.

Definitions

ITA
95(1)

Subsection 95(1) of the Act sets out definitions that are relevant for the purposes of sections 90 to 95.

Subsection 95(1) is amended so that these definitions do not apply for the purposes of sections 94 to 94.4, except where the definition applies for the purposes of the Act as a whole because of subsection 248(1). This amendment applies to taxation years that begin after 2006.

As set out below, various definitions in subsection 95(1) are also being amended.

"controlled foreign affiliate"

In computing the income for a taxation year of a taxpayer resident in Canada, subsection 91(1) of the Act requires the inclusion of a specified percentage of the foreign accrual property income (FAPI) of any controlled foreign affiliate of the taxpayer. In order to eliminate overlap between the FAPI rules and the rules for foreign investment entities in sections 94.1 to 94.4, the latter rules generally do not apply in respect of a taxpayer's interest in a controlled foreign affiliate of a taxpayer resident in Canada. An election is provided under new paragraph 94.1(2)(*h*) under which a foreign affiliate of a taxpayer can be treated as the taxpayer's controlled foreign affiliate.

The definition "controlled foreign affiliate" is amended to refer to foreign affiliates that are deemed by paragraph 94.1(2)(*h*) to be controlled foreign affiliates.

This amendment applies to taxation years that begin after 2006.

"foreign accrual property income"

The FAPI of a controlled foreign affiliate of a taxpayer resident in Canada must be allocated to the taxpayer in accordance with subsection 91(1) of the Act. Under its definition in subsection 95(1), FAPI includes certain amounts that would be included in the affiliate's income under existing subsection 94.1(1) if that subsection were read in the manner specified in the description of C of the definition.

Existing section 94.1 is being repealed. Accordingly, the description of C in the definition "foreign accrual property income" is also repealed. There are, however, special rules in new paragraph 95(2)(*g*.3) with regard to the application of sections 94.1 to 94.4 to a foreign affiliate. Amounts determined under paragraph 95(2)(*g*.3) will be included in FAPI under the description of "A" in the definition "foreign accrual property income". For detail on paragraph 95(2)(*g*.3), see the commentary on that paragraph.

This amendment applies to taxation years that begin after 2006.

"relevant tax factor"

The definition "relevant tax factor" in subsection 95(1) of the Act is used in determining the Canadian tax relief provided in respect of foreign taxes imposed on the earnings of a foreign affiliate of a taxpayer or a foreign investment entity in which the taxpayer has a "participating interest" (as defined in subsection 94.1(1)). The existing definition provides that the relevant tax factor for a corporation (or a partnership all the resident members of which are corporations) is the reciprocal of the basic corporate tax rate (i.e., 1/.38, or 2.63). The factor for individuals and other partnerships is 2.

As part of a series of amendments reflecting recent and planned reductions in income tax rates, the definition "relevant tax factor" is amended. The relevant tax factor for a corporation (or a partnership all the resident members of which are corporations) will take account of the "general rate reduction percentage" provided in section 123.4 of the Act. For example, if a corporation's taxation year is the calendar year, its relevant tax factor for 2003 will be 1/(.38 – .05), or 3.03.

Similarly, to take account of decreasing personal income tax rates, the relevant tax factor for individuals and other partnerships is increased to 2.2.

These amendments apply to the 2002 and subsequent taxation years.

Foreign Investment Entities

ITA
95(2)

Subsection 95(2) of the Act provides rules for determining the income of a foreign affiliate of a taxpayer resident in Canada. Subsection 95(2) is amended to clarify that these rules do not apply in applying sections 94 to 94.4 of the Act.

New paragraph 95(2)(*g*.3) provides rules for the purpose of computing the foreign accrual property income of a particular foreign affiliate of a particular taxpayer for a particular taxation year of the particular foreign affiliate, in respect of the particular taxpayer if the particular foreign affiliate holds a property that is a participating interest in a particular non-resident entity in the particular taxation year. In this case, the amount required under sections 94.1 to 94.4 to be included (or that may be deducted) in computing the particular foreign affiliate's foreign accrual property income, in respect of the particular taxpayer, from a property that is the participating interest, is to be computed as if

- the particular affiliate were a taxpayer resident in Canada throughout the particular year,
- subparagraph (*a*)(i) of the definition "exempt interest" in subsection 94.1(1) applied to the particular foreign affiliate in respect of the participating interest only where
  - the particular foreign affiliate is a controlled foreign affiliate of the particular taxpayer at the end of the particular taxation year, and
  - the particular non-resident entity is a controlled foreign affiliate of the particular taxpayer at the end of the particular non-resident entity's taxation year that ends in the particular year,
- an exempt interest of a particular affiliate in a non-resident entity included a participating interest
  - that is held, in the particular taxation year, by the particular foreign affiliate, and
  - that is, throughout the period in the particular year during which the particular affiliate held the participating interest, used or held by the particular foreign affiliate principally for the purpose of gaining or producing income from a business that is not an investment business,
- a "fresh-start year" (relevant in computing the foreign affiliate's "income allocation" and "loss allocation" under the accrual regime in section 94.3) of the particular non-resident entity in respect of the particular affiliate were its taxation year (at the end of which the particular affiliate holds an interest in it and it is a foreign investment entity and at any time in which the particular affiliate is a CFA of the Canadian taxpayer) that ends in a taxation year of the particular affiliate that begins after 2006 and that immediately follows a taxation year of the particular non-resident entity in respect of which subsection 94.1(3) would not have been applicable to the foreign affiliate,
- the Canadian taxpayer (rather than the particular affiliate) were required to make a number of the elections, designations, notifications and provisions of information under sections 94.1 to 94.4 in connection with the particular affiliate's participating interests in foreign investment entities. In addition, the Minister in sending a demand for information to the particular affiliate under subparagraph 94.1(2)(e)(iii) or 94.3(2)(b)(iii), or any of paragraphs 94.1(2)(i) or (p) to (r) or 94.2(2)(d), is required to send the demand also to the Canadian taxpayer in connection with the particular affiliate's participating interests in foreign investment entities,

- the particular affiliate's "deferral amount" determined under the definition of that expression in subsection 94.2(1) does not include the portion of the amount that can reasonably be considered to have accrued during the period that the particular affiliate was not a foreign affiliate of the Canadian taxpayer and certain other specified persons, and
- the reference in subsection 94.2(19) to the expression "in computing the capital dividend account of the corporation" were read in respect of the affiliate as a reference to the expression "in computing the amount prescribed to be the particular affiliate's exempt surplus and taxable surplus in respect of the taxpayer".

This amendment applies to taxation years that begin after 2006.

Application Rules - Foreign Affiliates

ITA
95(5), (6) and (7)

Subsections 95(5) to (7) of the Act contain special rules of application that apply for purposes of the foreign affiliate and controlled foreign affiliate regimes.

These subsections are amended so that they do not apply for purposes of the non-resident trust and foreign investment entity regimes in new sections 94 to 94.4.

These amendments apply to taxation years that begin after 2006

Clause 20

Partnerships and their Members

ITA
96

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

Computing Partnership Income

ITA
96(1)(*d*)

Under subsection 96(1), the income earned and losses incurred by a partnership are generally calculated at the partnership level and attributed to partners in accordance with their respective interests in the partnership.

Paragraph 96(1)(*d*) is amended by adding a new subparagraph (iii). The new subparagraph applies where partnership property includes a participating interest in a particular non-resident entity. Pursuant to that subparagraph, sections 94.1 to 94.4 are to apply to the partnership for the particular taxation year in respect of the participating interest

- where the taxpayer is resident in Canada and, at the end of the particular non-resident entity's taxation years that end in the particular taxation year of the partnership, the particular non-resident entity is not a controlled foreign affiliate of the partnership, as if the participating interest were not an exempt interest that is described by subparagraph (*a*)(i) of the definition "exempt interest" in subsection 94.1(1),
- where the taxpayer is a foreign affiliate (the "foreign affiliate") of another taxpayer resident in Canada at the end of the foreign affiliate's taxation years that end in a particular taxation year of the other taxpayer, as if, in computing the foreign accrual property income of the foreign affiliate in respect of the other taxpayer for those taxation years of the foreign affiliate,
    - subparagraph (*a*)(i) of the definition "exempt interest" in subsection 94.1(1) applied only where
        - the foreign affiliate is a controlled foreign affiliate of the other taxpayer at the end of the foreign affiliate's taxation years that end in the particular taxation year of the other taxpayer, and

    - the particular non-resident entity is a controlled foreign affiliate of the partnership at the end of the particular non-resident entity's taxation years that end in the foreign affiliate's taxation years that end in the other taxpayer's particular taxation year, and
  - where the participating interest is, throughout the period, in the particular taxation year, during which the participating interest was the partnership's property, property used or held by the partnership principally for the purpose of gaining or producing income from a business that is not an investment business (within the meaning assigned by section 95), the participating interest were an exempt interest (as defined by subsection 94.1(1)) of the partnership;
- as if the "fresh-start year" (relevant in computing the partnership's "income allocation" and "loss allocation" under the accrual regime in section 94.3) of the particular non-resident entity in respect of the partnership were its taxation year (at the end of which the partnership holds an interest in it and it is a foreign investment entity)
  - that ends in a taxation year of the particular affiliate that begins after 2006,
  - that begins immediately after the preceding taxation year of the particular non-resident entity, at the end of which the particular non-resident entity was not a foreign investment entity or at the end of which the partnership property did not include a participating interest in the particular non-resident entity (other than an exempt interest), and
  - at the end of which the particular non-resident entity is a foreign investment entity in which the partnership owns a participating interest that is not an exempt interest;
- as if an election under paragraph 94.1(2)(*h*) – to treat a foreign affiliate of the partnership as its controlled foreign affiliate – is to be made by a member of the partnership and not by the partnership;
- as if subparagraph 94.1(2)(*h*)(ii) were read as:
  - the non-resident entity is
    - where the taxpayer is a partnership and an election under paragraph 94.1(2)(*h*) is being made for the purpose of computing the income from the partnership of a member of the partnership that is a taxpayer resident in Canada, a foreign affiliate of the partnership and of the member in respect of which the partnership and the member has a qualifying interest (within the meaning assigned by paragraph 95(2)(*m*)) at the end of the non-resident entity's taxation years referred to in clause 96(1)(*d*)(iii)(A), or
    - where the taxpayer is a partnership and an election under paragraph 94.1(2)(*h*) is being made for the purpose of computing the income from the partnership of a member of the partnership that is a foreign affiliate of another taxpayer resident in Canada, a foreign affiliate of the partnership and of the other taxpayer resident in Canada in respect of which the partnership and the other taxpayer has a qualifying interest (within the meaning assigned by paragraph 95(2)(*m*)) at the end of the non-resident entity's taxation years referred to in clause 96(1)(*d*)(iii)(B);
- as if the requirement in subparagraph 94.1(2)(*h*)(iii) were the requirement that an entity that was at any time a member of the taxpayer not having made, in respect of the taxpayer, any other election under paragraph 94.1(2)(*h*) in respect of the non-resident entity;
- as if a member of the partnership (rather than the partnership) is required to make a number of the elections, designations, notifications and provisions of information under sections 94.1 to 94.4 in connection with the partnership's participating interests in non-resident entities. In addition, the Minister in sending a demand for information to the particular affiliate under subparagraph 94.1(2)(*e*)(iii) or 94.3(2)(*b*)(iii), or any of paragraphs 94.1(2)(*i*), (*p*) to (*r*), (*w*) or 94.2(2)(*d*), is required to send the demand also to the member in connection with the partnership's participating interests in non-resident entities.

This amendment applies to fiscal periods that begin after 2006.

Application of sections 94.1 and 94.2

ITA
96(1.9)

New subsection 96(1.9) of the Act is relevant where an "exempt taxpayer" (in general, an individual who has been resident in Canada for fewer than 60 months or certain persons exempted by subsection 149(1) from tax on their taxable incomes) is a member of a partnership and the partnership invests in a foreign investment entity. In these circumstances, the exempt taxpayer's share of the partnership's income or loss is computed without regard to sections 94.1 to 94.4. For further details on the application of section 94.2 to partnerships, see the commentary on new subsections 94.2(6) to (8).

This amendment applies to fiscal periods of partnerships that begin after 2006.

Agreement or Election of Partnership Members

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 a 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, generally for taxation years that end after February 27, 2000, to apply for the purposes of an election under subsections 14(1.01) and (1.02) of the Act in respect of the disposition of an eligible capital property.

Subsection 96(3) is also amended so that

- after 2004, it applies for the purposes of elections under new sections 94.1 to 94.3 and paragraph 95(2)(*g*.3), and
- after December 20, 2002, it applies for the purposes of elections under subsection 13(4.2) of the Act.

Application of Foreign Partnership Rule

ITA
96(9)

Subsection 96(8) of the Act provides rules that apply where, at a particular time, a Canadian resident becomes a member of a partnership, or a person who is a member of such a partnership becomes a resident of Canada. Where, immediately before the particular time no member of the partnership was resident in Canada, these rules apply in computing the income of the partnership for fiscal periods ending after the particular time. In general terms, the rules in subsection 96(8) are designed to prevent losses accrued while a partnership had no Canadian resident partners from being used to reduce Canadian income tax liabilities.

Subsection 96(9) provides that, where one of the main reasons that there is a member of the partnership who is resident in Canada is to avoid the application of subsection 96(8), that member will, for the purpose of applying subsection 96(8), be considered not to be resident in Canada.

Subsection 96(9) is amended to provide an explicit look-through rule for the purposes of subsection 96(8) so that members of partnerships may be identified through one or more tiers of partnerships that are members of other partnerships. Amended subsection 96(9) is consistent with new subsection 94.2(8).

This amendment applies to partnership fiscal periods that begin after June 22, 2000.

Clause 21

Contributions of Property to a Partnership

ITA
97(2)

Subsection 97(2) of the Act provides rules that allow a person to transfer certain types of property on a tax-deferred “rollover” basis to a partnership.

Subsection 97(2) is amended so that it does not apply to a transfer of property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition “specified participating interest” in subsection 248(1), see the commentary on that definition.

This amendment applies to dispositions that occur in taxation years that begin after 2006.

Clause 22

Disposition of Partnership Property

ITA
98

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

ITA
98(7)

New subsection 98(7) of the Act applies if at a particular time a partnership ceases to exist. In this case, the partnership is, at a time (the ”disposition time”) that is three instants before the particular time, deemed

- to have disposed of each of its properties that is at the disposition time a specified participating interest for proceeds of disposition equal to the property’s fair market value at the disposition time; and
- to have acquired the property immediately after the disposition time at a cost equal to that fair market value.

This amendment applies to fiscal periods that begin after 2006.

Clause 23

Trusts and their Beneficiaries

ITA
104

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

ITA
104(4)(*a*), (*a*.5) and (*c*)

Subsection 104(4) of the Act sets out what is generally referred to as the “21-year deemed realization rule” for trusts. The purpose of subsection 104(4) is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital property. Subsection 104(4) generally treats capital property of a trust (other than certain trusts for the benefit of a spouse or common-law partner) as having been disposed of and reacquired by the trust every 21 years at the property’s fair market value.

Subparagraph 104(4)(*a*)(i.1) is amended to apply to a trust to which property is transferred in circumstances to which paragraph 70(5.2)(*c*) applied. It is also amended to ensure that it continues to apply to a trust to which property was transferred in circumstances to which paragraph 70(5.2)(*b*) or (*d*) applied as those paragraphs read in their application to taxation years that began before 2007.

Paragraph 104(4)(*a*.5) is introduced to provide for a deemed disposition day for a trust that is deemed by subsection 94(3) to be resident in Canada for a taxation year for the purpose of computing the trust's income for the year. The deemed disposition day is the day (in that taxation year) on which, because a "contributor" (as defined in subsection 94(1) of the Act) to the trust either ceases to be resident in Canada or ceases to be a contributor to the trust because of the application at any time of paragraph 94(2)(*t*), there is no resident contributor to the trust (or the only resident contributors to the trust are entities each of which is an entity the maximum amount recoverable from which under the provisions referred to in paragraph 94(3)(*d*) is limited to the entities' recovery limits determined under subsection 94(8)). However, no deemed disposition will occur under paragraph 104(4)(*a*.5) if subsection 94(5) applies in respect of the contributor ceasing on that day to be a resident contributor of the trust. For more information on section 94, see the commentary on that section.

Paragraph 104(4)(*c*) is amended so that there is not a deemed disposition day for a trust 21 years after any day determined under new paragraph 104(4)(*a*.5). In effect, the time from which 21 years is counted under paragraph 104(4)(*c*) is determined without regard to days determined without regard to days determined under any of paragraphs 104 (4)(*a*) to (*a*.5)

These amendments apply to trust taxation years that begin after 2006. They also apply to trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming into-force provision for new section 94 of the Act.

ITA
104(4.1)

New subsection 104(4.1) of the Act provides that, for the purposes of the deemed disposition rule in subsection 104(4), a property's status as capital property is determined without reference to new subparagraph 39(1)(*a*)(ii.3). As a result, if subsection 94.2(3) applies for a taxation year to a taxpayer that is a trust in respect of a participating interest of the trust and the trust is deemed to have disposed of the interest because of the application of subsection 104(4), there is a recognition of the "deferral amount" in applying subsection 94.2(4).

This amendment applies to trust taxation years that begin after 2006.

ITA
104(6)

Subsection 104(6) of the Act generally permits a trust to deduct, in computing income for a taxation year, any income payable to a beneficiary under the trust.

Subsection 104(6) is amended so that it is expressly subject to subsections 104(7) to 104(7.1).

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA
104(7.01)

Subsection 104(6) generally permits a trust to deduct, in computing income for a taxation year, an amount not exceeding the portion of its income for the year that becomes payable in the year to a beneficiary under the trust. Because of subsection 104(24), trust income is deemed not to have become payable in the year to a beneficiary unless it is paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

New subsection 104(7.01) of the Act restricts the amount that a trust, that is deemed by subsection 94(3) to be resident in Canada (referred to in this commentary as a "subsection 94(3) trust"), can deduct under subsection 104(6) in computing its income in the event that the trust has Canadian-source income and makes distributions to beneficiaries not resident in Canada.

In effect, subsection 104(7.01) acts as a proxy for taxes under Parts XII.2 and XIII of the Act in connection with Canadian-source income earned by a subsection 94(3) trust that has become payable by the trust to its non-resident beneficiaries.

New subsection 94(3) deems a trust to which it applies to be resident in Canada for certain purposes, not including Part XII.2. Accordingly, a trust that is resident in Canada solely because of the deeming provision in subsection 94(3) would generally be non-resident for purposes of Part XII.2. Because of an existing exemption for non-resident trusts in Part XII.2, a tax under that Part does not apply to such a trust.

A subsection 94(3) trust is also exempt from Part XIII withholding obligations on Canadian-source income earned by it that becomes payable by it in the year to non-resident persons.

However, to ensure that subsection 94(3) trusts are not inappropriately used to distribute Canadian-source income free of tax to non-resident beneficiaries, subsection 104(7.01) limits the amount of any trust deduction under subsection 104(6) for such distributions, thereby ensuring the income is subject to Part I tax in the trust.

(It should also be noted that persons that pay or credit an amount to a subsection 94(3) trust are still liable for a withholding obligation under section 215 of the Act notwithstanding that the trust itself is exempt from Part XIII tax. This is because new paragraph 94(4)(*c*) provides that the deemed Canadian residence under subsection 94(3) does not apply for the purposes of determining withholding obligations under section 215. The Canada Revenue Agency will hold the withholding taxes paid and apply them on account of the trust's Part I tax liability, but only to the extent the amount on which Part XIII tax is paid is an amount included in the trust's income. The existing provisions of the Act do not expressly give a Part XIII exemption in this regard to trusts that are subject to existing subsection 94(1). Instead, existing subparagraph 94(1)(*c*)(ii) allows a tax credit to be claimed by those trusts under section 126 in connection with Part XIII tax on payments made to those trusts.)

As mentioned above, subsection 104(7.01) reduces the maximum deduction under subsection 104(6). More specifically, the amount by which the maximum deduction under subsection 104(6) for a taxation year is reduced under subsection 104(7.01) is equal to the total of:

- the portion of the trust's "designated income" for the year (as defined in Part XII.2) that became payable in the year to a non-resident beneficiary under the trust in respect of an interest of the non-resident as a beneficiary under the trust, and
- all amounts each of which is the product obtained by multiplying a specified factor by each particular amount that is paid or credited in the year to the trust that would, disregarding express provisions to the contrary in the Act, be subject to Part XIII tax and that is payable in the year to a non-resident beneficiary under the trust in respect of an interest of the non-resident as a beneficiary under the trust.

The specified factor in respect of each particular amount described in the second paragraph above is 0.35, if the trust can establish to the satisfaction of the Minister of National Revenue that the non-resident beneficiary to whom the particular amount is payable is resident in a country with which Canada has a tax treaty under which the income tax that Canada may impose on the beneficiary in respect of the amount is limited. In any other case, the specified factor is 0.6.

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin after 2000, after 2001, after 2002 after 2003 after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

The example below illustrates the operation of new subsection 104(7.01).

Example

1. *Trust X is an offshore trust established by Stefan, a long-term resident of Canada. The primary beneficiaries under the trust are Linda (a resident of Canada), Tim (a resident of non-Treatyland) and Bart (a resident of the United States).*
2. *Trust X receives $1,600 of income in its 2007 taxation year. This income consists of $400 of taxable dividends received from a taxable Canadian corporation. The remaining $1,200 of income is from other sources, none of which is "designated income" (as defined in Part XII.2) of the trust.*
3. *$1,050 of Trust X's income for 2007 is made payable in the year to Bart. Of this amount, $100 represents the taxable dividends. Trust X makes payable $200 of its income to Tim. Of this amount, $200 represents the taxable dividends. The remaining $350 of the trust's income is made payable in the year to Linda. Of this amount, $100 represents the taxable dividends.*
4. *Trust X is assumed to have designated the $400 of taxable dividends under subsection 104(19). (Where a designation under subsection 104(19) is available and the designation is made, the designated portion of the dividend income of the trust will, for the purposes of the Act (other than Part XIII), maintain its character, as dividend income, in the hands of the beneficiary.)*

Results

1. *Because Trust X has a resident contributor at the end of its 2007 taxation year, the trust is deemed by new subsection 94(3) to be resident in Canada for the purposes of computing its income.*
2. *Before taking into account any deduction under subsection 104(6), Trust X's income is $1,600. Note that the $400 in dividends is included in computing the trust's income.*
3. *Before taking into account new subsection 104(7.01), the maximum deduction under subsection 104(6) is also $1,600.*
4. *Because of subsection 104(7.01), the maximum deduction under subsection 104(6) is reduced to $1,445 (i.e., $1,600 minus the total of: nil + ((.60 x $200) and (0.35 x $100))).*
5. *Assuming that the trust claims a deduction of $1,445 under subsection 104(6), the trust would consequently have income of $155. If a tax rate of 42.92% were assumed (i.e., combined federal rates of 29% (because of subsections 122(1) and 117(2) and 13.92% (because of subsection 120(1)), the trust would be liable for Canadian income tax of approximately $67. Note that the trust is exempt from having to collect a Part XIII tax in respect of the amounts made payable to Bart and Tim that are referred to in paragraph 104(7.01)(b) in respect of the trust for the particular taxation year, because these are exempt amounts for the purposes of subparagraph 94(3)(a)(ix). Disregarding this exemption, the Part XIII tax that would have had to have been collected by the trust in respect of the amounts made payable to Bart and Tim would have been $65 (i.e., 25% of $200 and 15% of $100).*

ITA
104(21.3)

Subsection 104(21.3) of the Act defines the expression “net taxable capital gains”. The expression is used in subsections 104(21) and (21.2), which permit a trust to flow through its taxable capital gains realized in a year to a beneficiary to whom an amount of the trust’s income for the year has been made payable. The trust can flow through its taxable capital gains to beneficiaries only to the extent of its net taxable capital gains for the year.

Under subsection 104(21.3), the amount of a trust’s net taxable capital gains for a taxation year equals the amount, if any, by which its total taxable capital gains for the year exceeds the total of two amounts:

- its total allowable capital losses for the year, and
- the amount deducted by it under paragraph 111(1)(*b*) in computing its taxable income for the year (i.e., deduction of carried-over net capital losses for preceding years and for the three following years).

Subsection 104(21.3) is amended so that allowable business investment losses (ABILs) are disregarded for the purpose of the first of the two amounts. Accordingly, ABILs will not result in a reduction of taxable capital gains that may be flowed through to beneficiaries under trusts and against which allowable capital losses can be claimed.

This amendment applies to trust taxation years that begin after 2000.

ITA
104(24)

The determination of when an amount becomes payable in a taxation year is relevant for a number of purposes, including the determination of the amount deductible under subsection 104(6) of the Act. Under subsection 104(24), an amount is deemed not to have become payable in the year to a beneficiary unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

Subsection 104(24) is amended so that it also applies for the purposes of paragraph (*c*) of the definition “specified charity” in subsection 94(1), subsection 94(8) and subsection 104(7.01). For more information, see the commentary on those provisions.

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin after 2000, after 2001, after 2002 after 2003 after 2004 or after 2005, if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 24

Cost of Capital Interest

ITA
107(1.1)

Subsection 107(1.1) of the Act provides rules for computing the cost to a taxpayer of a capital interest in a personal trust or a prescribed trust. Paragraph 107(1.1)(*b*) provides that the cost is nil, except where certain conditions apply.

Paragraph 107(1.1)(*b*) is amended so that if a capital interest in a personal trust or prescribed trust is a participating interest in a foreign investment entity, the cost of the capital interest will not be deemed by that paragraph to be nil. For more details, see the commentary on new sections 94.1 to 94.4.

This amendment applies to taxation years that begin after 2006.

ITA
107(4.01)

New subsection 107(4.01) of the Act provides that subsection 107(2.1) applies (and subsection 107(2) does not apply) to a distribution to a beneficiary by a trust of a property that is a specified participating interest. The concept of a specified participating interest is generally relevant in the context of the foreign investment entity rules in sections 94.1 to 94.4. For more information on the definition "specified participating interest" in subsection 248(1), see the commentary on that definition.

This amendment applies to distributions that occur in taxation years that begin after 2006.

Clause 25

Qualifying Disposition

ITA
107.4(1)(*k*)

Subsection 107.4(1) of the Act defines a qualifying disposition of property to a trust to be a disposition of property to the trust that does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that subsection. Under subsection 107.4(3), a qualifying disposition generally qualifies for a tax-deferred "rollover" of the property to the trust.

New paragraph 107.4(1)(*k*) provides that a disposition of property to a trust does not include a disposition of property that is, immediately before the disposition, a specified participating interest.

This amendment applies to dispositions that occur in taxation years that begin after 2006.

Clause 26

Trusts

ITA
108

Section 108 of the Act sets out certain definitions and rules that apply for the purposes of subdivision k, which deals with the taxation of trusts and their beneficiaries.

Definitions

ITA
108(1)

"cost amount"

The definition "cost amount" in subsection 108(1) of the Act applies, for the purposes of sections 104 to 108 (except section 107.4), in determining the cost amount to a taxpayer of the taxpayer's capital interest (and any Part of it relevant in the circumstances) in a trust. However, where the trust is a foreign affiliate of the taxpayer this definition of "cost amount" does not apply. (A trust may be a foreign affiliate of a taxpayer because of the operation of paragraph 94(1)(*d*) of the Act, which can deem a trust to be in certain circumstances a non-resident corporation in which the taxpayer own shares.)

The definition "cost amount" in subsection 108(1) of the Act is amended to reflect the repeal of paragraph 94(1)(*d*).

Note that, while the cost amount to a taxpayer of its capital interest in a trust may be relevant in applying sections 94.1 to 94.4 to the taxpayer where the trust is a "foreign investment entity" (as defined in new subsection 94.1(1)) in which the taxpayer's capital interest is a "participating interest" (as defined in new subsection 94.1(1)), the definition cost amount in subsection 108(1) does not apply for these purposes.

This amendment applies to taxation years that begin after 2006.

“income interest”

Subsection 108(1) of the Act contains the definition “income interest”. It is defined as a right of a taxpayer as a beneficiary under a personal trust to, or to receive, all or any part of the income of the trust and after 1999 includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of a right that is an income interest.

Under subsection 108(3), “income” for this purpose is determined without reference to the provisions of the Act.

The definition “income interest” is amended to provide that it does not include, at any time, a participating interest in respect of which subsection 94.1(3) or 94.2(9) applies for the year that includes that time. For more details on foreign investment entities, see the commentary on sections 94.1 to 94.4.

This amendment applies to trust taxation years that begin after 2006.

“trust”

Subsection 108(1) of the Act defines “trust”, for the purposes of the 21-year deemed disposition rule and other specified measures, to exclude certain listed trusts.

Paragraph (*a*.1) of that definition is amended to clarify that its intended application should be limited to health and welfare trusts.

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin after 2000, after 2001, after 2002 after 2003 after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Income of a Trust in Certain Provisions

ITA
108(3)

Subsection 108(3) of the Act provides that, for the purposes of the definition “income interest” in subsection 108(1), the income of a trust is its income computed without reference to the provisions of the Act.

Subsection 108(3) is amended so that the rule described above also applies for the purposes of the definitions “life-time benefit trust” in subsection 60.011(1) and “exempt foreign trust” in new subsection 94(1).

This amendment applies to trust taxation years that begin after 2000.

Interests Acquired for Consideration

ITA
108(7)

Subsection 108(7) of the Act contains a rule that, in general terms, provides that a person (or two or more related persons) can make a contribution to a trust and retain an interest under the trust without the interest being considered to have been acquired for consideration. This rule applies for the purposes of paragraph 53(2)(*h*), subsection 107(1), paragraph (*j*) of the definition “excluded right or interest” in subsection 128.1(10) and the definition “personal trust” in subsection 248(1).

Subsection 108(7) is amended so that it also applies for the purpose of paragraph (*b*) of the definition “exempt amount” in subsection 94(1). For more detail on that definition, see the commentary above.

This amendment applies in determining after 2006 whether an interest in a trust has been acquired for consideration.

Clause 27

Deduction in Respect of Dividend Received from Foreign Affiliate

ITA
113

Subsection 113(1) of the Act permits a resident corporation to deduct specified amounts in respect of dividends received from a foreign affiliate out of the exempt, taxable and pre-acquisition surplus of the foreign affiliate. The amounts so deductible are determined largely with reference to Part LIX of the *Income Tax Regulations*. The deductions under paragraphs 113(1)(*b*) and (*c*) with regard to dividends out of taxable surplus are also determined with reference to the resident corporation's "relevant tax factor".

Subsection 113(1) is amended to explicitly link the "relevant tax factor" to the resident corporation receiving the dividends and the taxation year in which the dividends are received.

This amendment applies after 2000.

Clause 28

Part-year Residents

ITA
114

Section 114 of the Act provides rules for computing the taxable income of an individual who is resident in Canada for a period or periods in a taxation year, and is non-resident for the rest of the year.

Section 114 is amended so that it is subject to paragraph 94.2(5)(*c*), a rule that applies in connection with a participating interest, in a foreign investment entity, in respect of which the mark-to-market regime under section 94.2 applies to a taxpayer. Paragraph 94.2(5)(*c*) is, however, only relevant to an individual who ceases to be, and later becomes, resident in Canada in the same taxation year. For further information, see the commentary on new subsection 94.2(5).

This amendment applies to taxation years that begin after 2006.

Clause 29

Taxable Income Earned in Canada

ITA
115(1)

Section 115 of the Act determines the amount of a non-resident person's income that is subject to tax under Part I of the Act. This amount is referred to as the non-resident's "taxable income earned in Canada". Subsection 115(1) provides general rules to be applied in calculating a non-resident's "taxable income earned in Canada". Paragraphs 115(1)(*a*) to (*c*) set out special assumptions that are applied in computing the taxable income earned in Canada of a non-resident taxpayer. Subparagraph 115(1)(*a*)(vii) includes in the taxable income earned in Canada of an authorized foreign bank the amount claimed by the bank to the extent that the inclusion increases the bank's usable foreign tax credit under subsection 126(1) but does not increase any amount deductible by the bank under section 127.

Subparagraph 115(1)(*a*)(vii) of the Act is amended so that, in computing the taxable income earned in Canada of an authorized foreign bank, there must also be included amounts (not otherwise included in computing its taxable income earned in Canada) that are required by paragraph 12(1)(*k*) to be included in computing the bank's income, but only to the extent that the income is earned in its Canadian banking business.

This amendment is made in conjunction with paragraph 94.1(2)(*t*), which ensures that an authorized foreign bank is subject to the FIE rules in respect of participating interests held by it in a FIE.

This amendment applies to taxation years that begin after July 18, 2005.

Clause 30

Tax Payable by *Inter Vivos* Trust

ITA
122(2)(*d*.1)

Subsection 122(1) of the Act provides that, instead of graduated income tax rates, *inter vivos* trusts are generally subject to top marginal rates of income tax on their undistributed income. Subsection 122(2), which does not apply to mutual fund trusts, permits graduated income tax rates for certain *inter vivos* trusts established before June 18, 1971. One of the conditions for an *inter vivos* trust continuing to qualify for graduated income tax rates is that it not receive any gifts after June 18, 1971.

The opening words of subsection 122(2) are amended to modernize the language and to clarify its intended scope.

Paragraph 122(2)(*d*.1) is introduced so that the graduated income tax rates cease to apply to a trust in the event that, after June 22, 2000, a "contribution" is made to the trust. For this purpose, the expression "contribution" is defined in new section 94.

This amendment applies to trust taxation years that begin after 2002.

Clause 31

Foreign Tax Credit

ITA
126

Section 126 of the Act provides rules under which taxpayers may deduct, from tax otherwise payable, amounts they have paid in respect of foreign taxes.

ITA
126(1)(*a*) and (1.2)

Subsection 126(1) of the Act provides a tax credit to a taxpayer in respect of foreign non-business income tax – that is, foreign taxes levied on investment and other non-business income of the taxpayer. However, paragraph 126(1)(*a*) provides an exception to the effect that no tax credit is available if the taxpayer is a corporation and the foreign taxes paid by the taxpayer are in respect of income from a share of the capital stock of a foreign affiliate of the taxpayer.

Paragraph 126(1)(*a*) is amended to remove the reference to the exception for taxes paid in respect of income from a share of a foreign affiliate. This exception is now found in subsection 126(1.2).

New subsection 126(1.2) describes circumstances in which subsection 126(1) does not apply. More specifically, it provides that subsection 126(1):

- does not apply to non-business income tax paid by a taxpayer in respect of a particular amount that is included in computing, in respect of the taxpayer, the amount determined under subparagraph 94.4(2)(*a*)(i) in respect of a participating interest of the taxpayer, if the taxpayer made a deduction under subsection 94.4(3) in respect of the particular amount – in this regard, see the commentary on the related rule found in new subsection 94.3(3), and
- does not apply to non-business income tax paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation.

These amendments apply to taxation years that begin after 2006.

Clause 32

Changes in Residence

ITA
128.1

Section 128.1 sets out the income tax effects of becoming or ceasing to be resident in Canada.

ITA
128.1(1.1)

Subsection 128.1(1) sets out rules that apply where a taxpayer becomes resident in Canada.
Paragraph 128.1(1)(*b*) treats a taxpayer who becomes resident in Canada as having disposed of the taxpayer's property, with certain exceptions, for proceeds equal to the property's fair market value.

New subsection 128.1(1.1) identifies a set of circumstances in which paragraph 128.1(1)(*b*) does not apply to a taxpayer that is a trust.

Under subsection 128.1(1.1), paragraph 128.1(1)(*b*) will not apply, at a time in a particular taxation year of a trust, to the trust if the trust is resident in Canada because of new paragraph 94(3)(*a*) for the particular taxation year for the purpose of computing its income.

This rule applies to ensure that a deemed disposition does not occur solely because the basis for a trust's residency in Canada changes from paragraph 94(3)(*a*) to some other basis.

For more detail on subsections 94(3) and (4), see the commentary on those provisions.

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 33

Exempt Corporations

ITA
149(10)(*c*)

Subsection 149(10) of the Act applies where, at a particular time, a corporation becomes or ceases to be exempt from tax under Part I on its taxable income (otherwise than by reason of the exemption for certain insurers in paragraph 149(1)(*t*)). A new taxation year is considered to start at the particular time and the corporation's properties are deemed to have been disposed of at fair market value and reacquired at the particular time for the same amount.

Paragraph 149(10)(*c*) provides that the corporation is, for specified purposes in the Act, treated as a new corporation. One of the specified purposes is with regard to the investment tax credit regime set out in subsections 127(5) to (26).

Paragraph 149(10)(*c*) is amended so that it is also relevant in applying

- additional rules for the investment tax credit that are set out in subsections 127(27) to (35) (this amendment is consequential on the earlier enactment of those subsections), and
- sections 94.1 to 94.4. (For example, a corporation's "deferral amount" (as defined in subsection 94.2(1)) in respect of any interest it holds in a foreign investment entity is determined without reference to taxation years that occurred before the corporation's change of status. This will typically result in a nil deferral amount for the corporation.)

These amendments apply to corporations that, after 2006, become or cease to be exempt from tax on their taxable income under Part I of the Act.

Clause 34

Assessment and Reassessment

ITA
152(4)(*b*)(vi)

In general terms, subsection 152(4) of the Act provides that the Minister of National Revenue may not reassess tax payable by a taxpayer for a taxation year after the normal reassessment period for the taxpayer in respect of the year unless certain conditions described in paragraph 152(4)(*a*) or (*b*) have been met. Subparagraph 152(4)(*b*)(vi) allows the Minister to reassess a taxpayer within 3 years after the end of the normal reassessment period for the taxpayer in respect of the year where the reassessment is made in order to give effect to the application of subsection 118.1(15) or (16) of the Act.

Subparagraph 152(4)(*b*)(vi) is amended to also allow the Minister to reassess a taxpayer within three years after the end of the normal reassessment period where the reassessment is made in order to give effect to the application of subsection 94(9) or (10). For more information on subsections 94(9) and (10), see the commentary on those subsections.

This amendment applies after 2006.

Clause 35

Tax Liability – Non-arm's Length Transfers of Property

ITA
160

Section 160 contains rules regarding the joint and several liability of a taxpayer for the income tax liability of another person who, when not dealing at arm's length with the taxpayer, transferred property to the taxpayer for consideration less than its fair market value.

Assessment

ITA
160(2.1)

New subsection 160(2.1) of the Act allows the Minister of National Revenue to assess a taxpayer at any time in respect of any amount payable because of paragraph 94(3)(*d*) or (*e*). Such an assessment has the same effect as if it had been made under section 152 of the Act and is subject to interest. For more information on paragraphs 94(3)(*d*) and (*e*), see the commentary on those provisions.

This amendment applies to assessments made after 2006.

Discharge of Liability

ITA
160(3)

Subsection 160(3) of the Act provides that, where a taxpayer becomes jointly and severally liable with another taxpayer under subsection 160(1) or (1.1) with respect to a tax liability of the other person, a payment by the particular taxpayer on account of the particular taxpayer's tax liability will discharge the joint liability to the extent of the payment.

Subsection 160(3) is amended so that it also applies where the particular taxpayer has become jointly and severally, or solidarily, liable with another taxpayer under because of paragraph 94(3)(*d*) or (*e*) in respect of Part or all of a liability under this Act of the other taxpayer. (The expression "solidarily " is added to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.) For more information on paragraphs 94(3)(*d*) and (*e*), see the commentary on those provisions.

This amendment applies to assessments made after 2006.

Clauses 36 and 37

Penalties

ITA
162 and 163

Subsections 162 and 163 of the Act impose penalties for infractions such as failing to provide certain information on a return, failing to file a return for a taxation year, and making false statements on a return.

ITA
162(10.1) and (10.11)

Subsection 162(10.1) of the Act imposes a penalty on any person or partnership that is more than 24 months late in filing an information return that the person or partnership was required to file under any of sections 233.1 to 233.4. (This penalty applies in addition to the penalties imposed under subsections 162(7) and (10).)

The penalty imposed under subsection 162(10.1) with respect to a particular information return is equal to a specified amount less the amount of the penalties imposed under subsections 162(7) and (10) with respect to the return. The specified amount with respect to an information return for a trust required to be filed by a person or partnership under section 233.2 is equal to 5% of the total fair market value of any property transferred or loaned to the trust that, if no other loan or transfer were taken into account, would have imposed an obligation on the person or partnership to file the return.

Subsection 162(10.1) is amended, as a consequence of amendments made to section 233.2, by changing the manner in which the specified amount is determined. The specified amount is now to be determined with reference to the fair market value of “contributions” made by the person or partnership to the trust.

New subsection 162(10.11) provides that, for the purpose of the calculation in subsection 162(10.1), the definitions and rules in subsections 94(1), (2) and (9) generally apply. Subsection 162(10.11) is similar to amended subsection 233.2(2), described in greater detail in the commentary below.

These amendments apply to returns in respect of taxation years that begin after 2006. They also apply to returns in respect of taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA
162(10.3), 162(10.4), 163(2.6) and 163(2.91)

Existing paragraph 94(1)(*d*) of the Act provides for non-resident trusts to be treated as foreign affiliates. It is being repealed as a consequence of the introduction of new rules for non-resident trusts in section 94. Subsections 162(10.3) and (10.4) are rules that affect the calculation of penalty tax in respect of a person’s or partnership’s failure to file a return in respect of a foreign affiliate.

Subsections 163(2.6) and (2.91) are similar provisions that affect the calculation of penalty tax in respect of false statements and omissions in such a return.

Subsections 162(10.3) and 163(2.6) are amended to reflect the changes to section 94 under which non-resident trusts are no longer treated as foreign affiliates. Subsections 162(10.4) and 163(2.91) are repealed for the same reason.

These amendments apply to returns in respect of taxation years that begin after 2006. They also apply to returns in respect of taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA
163(2.4)(*b*) and (2.41)

Subsection 163(2.4) of the Act imposes a penalty on any person or partnership that, knowingly or under circumstances amounting to gross negligence, has made or has participated in, assented to, or acquiesced in, the making of a false statement or omission in a return required to be filed under any of sections 233.1 to 233.6. The penalty under paragraph 163(2.4)(*b*) relates to a return required to be filed under section 233.2. The existing penalty is the greater of $24,000 and 5% of the total fair market value of the property that the person or partnership loaned or transferred to the trust that gave rise to the obligation to file.

Paragraph 163(2.4)(*b*) is amended as a consequence of changes made to the non-resident trust rules in section 94 and the annual reporting requirement in respect of non-resident trusts under section 233.2. Under amended section 233.2, a person is subject to the annual reporting requirement where the person makes a "contribution" to the trust.

Accordingly, amended paragraph 163(2.4)(*b*) provides for a penalty for a person equal the greater of $24,000 and a specified amount in respect of the return. The specified amount for a person is essentially equal to 5% of the fair market value of "contributions" made by the person. The specified amount is calculated in the same way as the specified amount under amended subsection 162(10.1) in respect of late-filed returns. Under new subsection 163(2.41), the definitions and rules in subsections 94(1), (2) and (9) generally apply. Subsection 163(2.41) is similar to amended subsection 233.2(2), described in greater detail in the commentary below.

These amendments apply to returns in respect of taxation years that begin after 2006. They also apply to returns in respect of taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 38

Withholding and Remittance of Tax

ITA
215

Section 215 sets out rules governing when a person paying or crediting an amount to a non-resident must withhold a portion of the amount paid or credited.

ITA
215(1)

Subsection 215(1) provides that, where a resident of Canada pays or is deemed to pay an amount to a non-resident person in respect of which the non-resident person is liable for withholding tax under Part XIII, the payer is required to withhold the tax from the amount and remit it to the Receiver General on behalf of the non-resident.

Subsection 215(1) is amended to ensure that, where an amount is paid or credited (or deemed to be paid or credited) to a trust that is deemed, by paragraph 94(3)(*a*), to be resident in Canada for the purpose of determining the trust's liability for tax under Part XIII, the payer is required to withhold the tax that would otherwise be payable by the trust and to remit it to the Receiver General.

For more detail on the application of Part XIII to trusts deemed, under paragraph 94(3)(*a*), to be resident in Canada, and to payers of amounts to such trusts, see the commentary on subsection 94(3) and (4) and subsections 216(4.1).

This amendment applies to trust taxation years that begin after 2006. It also applies to trust taxation years that begin

- after 2000 if the trust makes a valid election under the coming-into-force provision of new section 94,
- after 2001 if the trust makes a valid election under the coming-into-force provision of new section 94,
- after 2002 if the trust makes a valid election under the coming-into-force provision of new section 94,
- after 2003 if the trust makes a valid election under the coming-into-force provision of new section 94,
- after 2004 if the trust makes a valid election under the coming-into-force provision of new section 94, and
- after 2005 if the trust makes a valid election under the coming-into-force provision of new section 94.

Clause 39

Deduction and Payment of Tax

ITA
216

Section 216 of the Act provides certain rules relating to non-residents who elect to be taxed under Part I in respect of certain rental and timber royalty income rather than under Part XIII, which would normally apply in such circumstances.

Rents and Timber Royalties –Optional Method of Payment

ITA
216(4.1)

In general, Part XIII of the Act imposes a withholding tax of 25% on rental payments made by Canadians to non-resident owners of Canadian real property. An exception to this general rule exists where a non-resident chooses, under subsection 216(4) of the Act, to file a Canadian income tax return in respect of the rental income and timber royalty income and pay tax on the net amount of such income. Where the conditions of subsection 216(4) are satisfied, the rule requiring a Canadian payer (or agent of the payee pursuant to s. 215(3)) to remit 25% of the gross payment to the Canada Revenue Agency does not apply; instead, only 25% of the net amount of income received by the non-resident's agent need be remitted.

Although an otherwise non-resident trust to which paragraph 94(3)(*a*) of the Act applies is deemed resident in Canada for the purposes of determining the trust's liability under Part XIII on amounts paid or credited to the trust, for the purpose of determining the liability of a Canadian payer on amounts paid or credited to the trust, the trust is effectively treated as resident in Canada (see paragraph 94(4)(*c*) and section 215).

Subsection 216(4.1) is introduced to provide a measure of relief in these circumstances. Under that subsection, if a trust is deemed by subsection 94(3) to be resident in Canada for a taxation year for the purpose of computing the trust's income for the year, a person who is otherwise required by subsection 215(3) to remit in the year, in respect of the trust, an amount to the Receiver General in payment of tax on rent on real property or on a timber royalty may elect in prescribed form filed with the Minister under this subsection not to remit under subsection 215(3) in respect of amounts received after the election is made. Under paragraphs 216(4.1)(*a*) and (*b*), if that election is made, the elector shall,

- when any amount is available out of the rent or royalty received for remittance to the trust, deduct 25% of the amount available and remit the amount deducted to the Receiver General on behalf of the trust on account of the trust's tax under Part I; and

- if the trust does not file a return for the year as required by section 150, or does not pay the tax that the trust is liable to pay under Part I for the year within the time required by that Part, on the expiration of the later of the time for filing or payment, as the case may be, pay to the Receiver General, on account of the trust's tax under Part I, the amount by which the full amount that the elector would otherwise have been required to remit in the year in respect of the rent or royalty exceeds the amounts that the elector has remitted in the year under paragraph 216(4.1)(*a*) in respect of the rent or royalty.

This amendment applies to trust taxation years that begin after 2006.

Clause 40

Foreign Reporting Requirements

ITA
233.2

Existing section 233.2 of the Act requires certain persons who have made transfers or loans to a "specified foreign trust", or to a non-resident corporation that is a controlled foreign affiliate of such a trust, to file annual information returns with respect to the trust. A "specified foreign trust", as defined in subsection 233.2, includes a trust with a "specified beneficiary" resident in Canada. As defined in subsection 233.2(1), a "specified beneficiary" is generally any beneficiary under the trust with the exception of persons listed in subparagraphs (*a*)(i) to (x) of the definition. For a return to be required to be filed as a consequence of a transfer or loan, it is necessary to have a "non-arm's length indicator", as set out in subsection 233.2(2), apply in respect of the transfer or loan. One of the cases where a "non-arm's length indicator" applies in respect of a transfer to a trust is where the transferor is a "specified beneficiary" under the trust. Subsection 233.2(3) provides a look-through rule so that, where a partnership transfers property, it is considered to have been transferred by members of the partnership.

New section 94 sets out new rules governing the taxation of non-resident trusts. In order to be consistent with the new rules:

- the definitions "specified beneficiary" and "specified foreign trust" in section 233.2 are repealed,
- there is no longer a requirement for a "non-arm's length indicator", so the existing rule in subsection 233.2(2) is repealed,
- except as described below, the definitions and rules of application in subsections 94(1), (2) and (10) to (13) apply because of amended subsection 233.2(2), and
- there is no longer a requirement for an explicit look-through rule for partnerships in section 233.2, given that the rule in paragraph 94(2)(*o*) applies because of amended subsection 233.2(2). Consequently, subsection 233.2(3) is repealed.

Under amended subsection 233.2(4), reporting will generally be required for a taxation year of a person if the person is a "contributor", "connected contributor" or "resident contributor" to a trust that is non-resident at a "specified time" in the taxation year, of the trust, that ends in that taxation year of the taxpayer. Because of amended subsection 233.2(2), the expressions "contributor", "contribution", "connected contributor", "resident contributor" and "specified time" generally carry the same meaning as in new section 94 (including by reference to deeming rules such as, for example, 94(12) and (13)), with most of the same exceptions for "arm's length transfers" contained in the definition of that expression in subsection 94(1). However, the exception in that definition against transfers of "restricted property" (as defined in subsection 94(1)) is extended to apply to most transfers described in paragraph 94(2)(*g*) (unless the transfer involves, generally, an issuance of a unit or share from a mutual fund trust, a mutual fund corporation or a corporation other than a closely-held corporation, as the case may be), with the result that such transfers do not give rise to an exception to the obligations for reporting under subsection 233.2(4). It should be noted that amended subsection 233.2(2) also applies for the purpose of new paragraph 233.5(*c*.1).

New subparagraph 233.2(4)(*c*)(ii) sets out a list of persons for whom reporting obligations are not imposed. This list is consistent with the list of beneficiaries who are not treated as “specified beneficiaries” under the existing rules in section 233.2.

Amended subsection 233.2(4) of the Act also exempts contributors from filing information returns under section 233.2 with regard to trusts described in paragraphs (*c*) to (*h*) of the new definition “exempt foreign trust” in subsection 94(1). For more information in this regard, see the commentary on that definition.

These amendments generally apply to returns in respect of trust taxation years that begin after 2006. They also apply to returns in respect of trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

ITA
233.2(4.1)

New subsection 94(3) of the Act provides that, where a non-resident trust has a resident contributor or resident beneficiary at the end of the trust’s taxation year, the trust is generally taxed on its income in Canada for the year as if the trust were resident in Canada. However, the deeming provisions in subsection 94(3) apply only to arrangements that are considered to be trusts for Canadian income tax purposes. In some cases, there may be doubt as to whether a given arrangement is a trust for Canadian income tax purposes.

New subsection 233.2(4.1), in combination with subsection 233.2(4), imposes a filing obligation on contributors to certain entities or arrangements in respect of which reporting is not otherwise required. One of the key objectives of subsection 233.2(4.1) is to ensure that claims that section 94 does not apply can be reviewed by the Canada Revenue Agency.

More specifically, new subsection 233.2(4.1) applies where property has, directly or indirectly, been transferred or loaned by a person to be held

- under an arrangement governed by laws that are not laws of Canada or a province, or
- by a non-resident entity (as defined in subsection 94.1(1)).

The person must, where certain additional conditions are satisfied, file the information return referred to in amended subsection 233.2(4).

New subsection 233.2(4.1) provides that, except as the Minister of National Revenue otherwise permits in writing, the person has obligations under amended subsection 233.2(4) if all of the following conditions are satisfied:

- the transfer or loan is not an arm’s length transfer (within the meaning that would be assigned by the definition “arm’s length transfer” in subsection 94(1) as amended by subsection 233.2(2));
- the transfer or loan is not solely in exchange for property that would be described in paragraphs (*a*) to (*i*) of the definition “specified foreign property” in subsection 233.3(1) if that definition were read without reference to paragraphs (*j*) to (*q*) of that definition;
- the entity or arrangement is not a trust in respect of which the person would, without reference to subsection 233.2(4.1) and the explicit exemptions for filing returns contained in subsection 233.2(4), be required to file an information return for a taxation year that includes that time; and
- the entity or arrangement is, for a taxation year or fiscal period that includes that time, not

    (i) an exempt foreign trust (as defined in subsection 94(1)),

    (ii) foreign affiliate in respect of which the person is a reporting entity (as defined in subsection 233.4(1)), or

    (iii) an exempt trust (as defined in subsection 233.2(1)).

Where the above conditions are satisfied, the person's obligations under subsection 233.2(4) and related provisions are determined as if:

- the transfer were a contribution to which paragraph 233.2(4)(*a*) applied;
- the entity or arrangement were a trust not resident in Canada throughout the calendar year that includes the time of the transfer or loan; and
- the taxation year of the entity or arrangement were that calendar year.

These amendments apply to returns in respect of taxation years that begin after 2006. They also apply to returns in respect of taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 41

Returns in Respect of Foreign Property

ITA
233.3

Section 233.3 of the Act provides reporting requirements in respect of foreign property. In general terms, it provides that certain taxpayers resident in Canada and certain partnerships must file an information return with respect to their "specified foreign property" if the total cost amount of such property exceeds $100,000. For this purpose, "specified foreign property" (as defined in subsection 233.3(1)) includes an interest in a non-resident trust or a trust that would be non-resident were it not for section 94. It does not include an interest in a non-resident trust that was not acquired for consideration by the person or partnership or a related person or partnership.

Paragraph (*d*) of the definition "specified foreign property" is amended by eliminating the reference to section 94. Under new subparagraph 94(3)(*a*)(vi), a trust is deemed to be resident in Canada only for the purpose of determining its obligation to file a return under section 233.3. As a result, such a deemed resident trust will be treated as resident in Canada in determining whether it is a specified Canadian entity and a reporting entity for purposes of section 233.3. In respect of the obligations of a person or partnership that has an interest in the trust, new paragraph 94(3)(*a*) does not apply to deem the trust to be resident in Canada. As a result, an interest in a trust, otherwise deemed to be resident in Canada, will be considered a specified foreign property unless otherwise expressly excluded.

Paragraph (*d*.1) of the definition is introduced so that specified foreign property includes an interest in an insurance policy issued by a non-resident insurer, if the mark-to-market regime in section 94.2 applies in respect of the interest. New paragraph (*d*.1) of the definition applies to returns for taxation years that begin after 2006. For further information in this regard, see the commentary on new subsection 94.2(11).

Paragraph (*l*) of the definition is repealed to eliminate a reference to trusts that are treated as foreign affiliates. This reference is no longer necessary in light of new section 94, under which non-resident trusts are no longer treated as foreign affiliates.

Except as indicated above, these amendments generally apply to returns in respect of trust taxation years that begin after 2006. In addition, amended paragraphs (*d*) of the definition "specified foreign property" and the repeal of paragraph (*l*) of that definition apply to returns in respect of trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 42

Returns Respecting Foreign Affiliates

ITA
233.4(1) and (2)

Section 233.4 of the Act provides reporting requirements in respect of foreign affiliates. In general terms, it provides that taxpayers resident in Canada (or certain partnerships) of which a non-resident corporation or non-resident trust is a foreign affiliate must file an information return in respect of the affiliate.

Subsections 233.4(1) and (2) are amended to eliminate references to foreign affiliates that are non-resident trusts. These references are no longer necessary in light of new subsection 94(1), under which non-resident trusts are no longer treated as foreign affiliates.

These amendments apply to taxation years and fiscal periods that begin after 2006. They apply to taxation years and fiscal periods that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94 of the Act.

Clause 43

Due Diligence Exception

ITA
233.5

Section 233.5 of the Act provides that, where specified conditions set out in paragraphs 233.5(*a*) to (*d*) are met, information required in a return filed under section 233.2 or 233.4 does not include information that is not available to the person or partnership required to file the return. In the case of a return required to be filed by a person or partnership under section 233.2, paragraph 233.5(*c*) provides that it must be reasonable for the person or partnership to expect, at the time of each transaction entered into by the person or partnership after March 5, 1996 that either gives rise to the requirement to file the return or that affects the information to be reported in the return, that sufficient information would be available to the person or partnership to comply with section 233.2.

Paragraph 233.5(*c*) is amended so that it applies only in connection with transactions entered into before June 23, 2000 that gave rise to the requirement to file a return for a taxation year of the trust that began before 2003. In connection with trust returns required to be filed for trust taxation years that began before 2003, it must be reasonable for the person or partnership to expect that sufficient information would have been available to the person or partnership to comply with section 233.2 if the proposed amendments to section 94 were not taken into account.

Paragraph 223.5(*c*) is also amended so that it does not apply to returns required to be filed under section 233.4. It is replaced in this respect by new paragraph 233.5(*c*.2), without any change in the specified conditions for such returns.

Paragraph 233.5(*c*.1) is introduced in connection with returns required to be filed under section 233.2 by a person or partnership for a taxation year of the trust that begins after 2006. Where "contributions" (determined with reference to subsection 233.2(2), referred to in the commentary above) are made after June 22, 2000, relief under section 233.5 is available only if it was reasonable for the person or partnership to expect, at the time of each such contribution that either gives rise to the requirement to file the return or that affects the information to be reported in the return, that sufficient information would be available to the person or partnership to comply with section 233.2.

This amendment applies to returns in respect of taxation years that begin after 2006. It also applies to returns in respect of taxation years that begin

- in 2001, 2002, 2003, 2004, 2005 or 2006, if the trust makes a valid election under the coming-into-force provision for new section 94 of the Act, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*),
- in 2002, 2003, 2004, 2005 or 2006, if the trust makes a valid election under the coming-into-force provision of new section 94 Act, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*)
- in 2003, 2004, 2005 or 2006, if the trust makes a valid election under the coming-into-force provision of new section 94, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*),
- in 2004, 2005 or 2006, if the trust makes a valid election under the coming-into-force provision of new section 94, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*),
- in 2005 or 2006, if the trust makes a valid election under the coming-into-force provision of new section 94, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*), and
- in 2006, if the trust makes a valid election under the coming-into-force provision of new section 94, in which case section 233.5 of the Act shall be read, in respect of the trust, without reference to paragraph 233.5(*c*).

Clause 44

Interpretation and Certain Arrangements under Civil Law

ITA
248(1)

Section 248 of the Act defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

"amount"

The expression "amount" is defined in subsection 248(1) of the Act to mean money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing. A number of special definitions, that apply in limited circumstances, of "amount" are set out in paragraphs (*a*) to (*c*) of the definition.

The definition "amount" is amended to add new paragraph (*b*.1). New paragraph (*b*.1) of that definition provides that in the case of a stock dividend paid by a non-resident corporation, the amount of any stock dividend is, except where subsection 95(7) applies to the dividend, the greater of two amounts. The first is the amount by which the paid-up capital of the corporation that paid the dividend is increased by reason of the payment of the dividend. The second is the fair market value of the share or shares paid as a stock dividend at the time of payment.

This amendment applies to dividends declared on or after July 18, 2005.

"controlled foreign affiliate"

The expression "controlled foreign affiliate" is defined to have the meaning assigned by subsection 95(1).

This definition is amended so that it applies except as expressly otherwise provided in the Act. See, for example, the definition "controlled foreign affiliate" in subsection 17(15).

This amendment applies to taxation years that begin after 2006.

“cost amount”

This definition is used throughout the Act, particularly in provisions relating to the transfer of properties to and from corporations, trusts and partnerships.

New paragraph (*c*.2) of the definition provides that, where a cost of property to a taxpayer is determined as of any time under new subsection 94.2(13), that cost is also the “cost amount”, under subsection 248(1), of the property to the taxpayer at that time.

This amendment applies to taxation years that begin after 2006.

“disposition”

The expression “disposition” is used throughout the Act, particularly in provisions relating to transactions involving property.

The definition “disposition” is amended to add new paragraph (*b*.1). New paragraph (*b.1*) of the definition ensures that, where a property is an interest in a life insurance policy, what would constitute a disposition for the purposes of section 148 will also constitute a disposition for the entire Act.

“inventory”

A taxpayer’s “inventory” is generally described in subsection 248(1) of the Act as a description of property the cost or value of which is relevant in computing a taxpayer’s income from a business for a taxation year. Rules for “inventory” in section 10 and elsewhere in the Act affect the calculation of a taxpayer’s income from business.

The definition “inventory” is amended to exclude property of a taxpayer that is subject to the application of subsection 94.1(4) or 94.2(3) of the Act in respect of the taxpayer.

This amendment applies to fiscal periods that begin after 2006.

“share”

The definition “share” is amended so that it applies except as the context otherwise requires. For example, if the context requires that the expression “share” refer to a portion of an amount or thing, then it would not carry the meaning otherwise assigned by subsection 248(1).

This amendment applies to taxation years that begin after 2006.

“foreign accrual property income”

The definition “foreign accrual property income” is included in subsection 248(1) so that the definition of this expression in section 95 of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2006.

“foreign investment entity”

The definition “foreign investment entity” is included in subsection 248(1) so that the definition of this expression in subsection 94.1(1) of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2006.

“participating interest”

The definition “participating interest” is included in subsection 248(1) so that the definition of this expression in subsection 94.1(1) of the Act applies for the purposes of the Act.

This amendment applies to taxation years that begin after 2006.

"specified participating interest"

This definition is used throughout the Act, particularly in provisions relating to the transfer of properties to and from corporations, trusts, partnerships, spouses or common-law partners. In general, a transfer of property that is a specified participating interest will not qualify for special rules in the Act that would otherwise allow the transferor of the property to defer recognition, for income tax purposes, of any accrued gains or losses in respect of the property.

A specified participating interest at any time means a property of a taxpayer that at that time is a "participating interest" (e.g., a share of a non-resident corporation, or a beneficial interest in a non-resident trust) of the taxpayer in a "foreign investment entity" (as those expressions are defined in subsection 94.1(1)). However, if the interest is at that time an "exempt interest" (as defined in subsection 94.1(1)) of the taxpayer in the foreign investment entity, it will not be at that time a specified participating interest.

A specified participating interest at any time also means a property of a taxpayer that at that time is a participating interest of the taxpayer in a "tracking entity" (as defined in subsection 94.2(1)). However, if the interest is at that time an exempt interest of the taxpayer in the tracking entity, it will not be at that time a specified participating interest, unless the tracking entity is a controlled foreign affiliate of the taxpayer or is a qualifying entity that is a foreign affiliate of the taxpayer in respect of which the taxpayer has a qualifying interest (within the meaning assigned by paragraph 95(2)(*m*) of the Act). In addition, if the interest is at that time an interest, of the taxpayer in the tracking entity, that is a participating interest in respect of which subsection 94.2(9) does not apply to the taxpayer solely because of paragraph 94.2(9)(*e*), it will not be at that time a specified participating interest.

For more detail on the definitions "participating interest", "tracking entity", "exempt interest", and "foreign investment entity", see the commentary on those definitions.

This amendment applies to taxation years that begin after 2006.

Civil Law

ITA
248(3)

Subsection 248(3) provides a number of rules that apply for the purposes of applying the Act in relation to the Province of Quebec. Paragraphs 248(3)(*a*) to (*d*) deem certain institutions or arrangements created under the laws of the Province of Quebec to be trusts for those purposes. Paragraph 248(3)(*e*) clarifies that a person is deemed to be beneficially interested in a trust if the person has any right to receive the income or the capital in respect of property that is deemed, under any of paragraphs 248(3)(*a*) to (*d*), to be held in trust. Paragraph 248(3)(*f*) provides that a person beneficially owns property, even if there is a servitude in respect of the property, in relation to which the person has rights described in any of subparagraphs 248(3)(*f*)(i) to (iii).

A number of changes are being made to subsection 248(3), effective for taxation years beginning after October 30, 2003. These changes are as follows.

The preamble to subsection 248(3) is amended to indicate that the provisions of the subsection apply generally for the purposes of the Act.

New paragraph 248(3)(a)

The rules found in existing paragraphs 248(3)(*a*) to (*c*) are now found in new paragraph 248(3)(*a*), which sets out the treatment as a trust of certain civil law institutions.

New paragraphs 248(3)(b) and (c)

New paragraphs 248(3)(*b*) and (*c*) are a continuation of existing paragraph 248(3)(*d*), with some modifications.

Existing paragraph 248(3)(*d*) provides that an arrangement established by or under a written contract governed by the laws of Quebec (and that is not otherwise a trust) is deemed to be a trust, and its property is deemed to be held in trust, if: (i) the rights and obligations created under that arrangement are similar to those under a

trust; and (ii) the contract specifically provides that, for the purposes of the *Income Tax Act*, the arrangement shall be considered to be a trust. The purpose of this provision was to allow certain commercial arrangements that were created for investment purposes -- but which could not be considered to be trusts under the *Civil Code of Lower Canada* (CCLC), since they were not constituted by gift or bequest -- to be characterized as trusts for the purposes of applying the *Income Tax Act* in the Province of Quebec.

With the replacement of the CCLC by the *Civil Code of Quebec* (CCQ) in 1994, it became possible for arrangements that were intended to be accommodated by existing paragraph 248(3)(*d*) to be established as valid trusts in Quebec. As a result, arrangements established after the introduction of the CCQ did not have to rely on the deeming rules in existing paragraph 248(3)(*d*) to be characterized as trusts for purposes of the *Income Tax Act*.

Since the status of arrangements established before the introduction of the CCQ were not altered with the introduction of the CCQ, they continued to rely on the deeming provisions in existing paragraph 248(3)(*d*) for their trust status under the *Income Tax Act*. These arrangements continue to be accommodated under new paragraphs 248(3)(*b*) and (*c*), with paragraph (*c*) applying specifically in the context of registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs).

New paragraph 248(3)(*b*) also accommodates non-trust arrangements that, although not specifically intended to be accommodated under existing paragraph 248(3)(*d*), nevertheless fall within the ambit of that paragraph. This is the case, however, only for arrangements established before October 31, 2003. Finally, new paragraph 248(3)(*b*) clarifies that it does not apply to partnerships or to arrangements that are otherwise trusts.

New paragraph 248(3)(*c*) applies to arrangements marketed as trusteed RRSPs or RRIFs, but that do not qualify as valid trusts under Quebec law. This would include, for example, arrangements established before the introduction of the CCQ (as noted above) and any arrangements whose status under the *Income Tax Act* may be affected by the judgment of the Supreme Court of Canada in the *Bank of Nova Scotia* v. *Thibault*, [2004] 1 S.C.R. 785. In that judgment, which involved the seizability of an arrangement that had been marketed as a self-directed trusteed RRSP, the Court concluded that a trust had not been created under the CCQ.

The conditions for new paragraph 248(3)(*c*) to apply are modified from those set out in existing paragraph 248(3)(*d*). This is in recognition of the fact that there are elements of the *Thibault* decision that give rise to concerns that the particular arrangement considered by the Court (and other similar arrangements seeking RRSP or RRIF status) might not be able to satisfy the conditions for existing paragraph 248(3)(*d*) to apply. (These modified conditions are also incorporated, as required, into existing paragraph 248(3)(*d*).)

Specifically, under new paragraph 248(3)(*c*), there is no requirement that the arrangement create rights and obligations similar to those under a trust. Instead, the following conditions must be satisfied:

- The arrangement must be entered into between an individual and a corporation authorized to offer to the public its services as trustee.
- The arrangement must be established under or pursuant to a specimen plan or fund that is approved by the Canada Revenue Agency (CRA) for the application of the rules governing RRSPs or RRIFs. (Such specimens are used by the CRA to streamline the registration process. For more information, see Information Circular 72-22R9 “Registered Retirement Savings Plans” and Information Circular 78-18R6 “Registered Retirement Income Funds”.)

Also, new paragraph 248(3)(*c*) provides that, where the specimen does not specify that the arrangement shall be considered to be a trust for purposes of the *Income Tax Act*, it will suffice for the specimen to be presented as a declaration of trust.

The provisions of new paragraph 248(3)(*c*) apply only to arrangements established before 2010. This means that any arrangements sold in Quebec after 2009, and seeking to qualify as trusteed RRSPs or RRIF under the *Income Tax Act*, will have to meet the civil law requirements for trusts. This deadline gives trust companies that market individual retirement products in the province of Quebec time to assess whether the status of those products under the *Income Tax Act* may be affected by the *Thibault* decision and, if so, to adjust accordingly.

New paragraphs 248(3)(d) and (e)

The provisions of existing paragraphs 248(3)(*e*) and (*f*) are found in new paragraphs 248(3)(*d*) and (*e*), respectively. In the latter, the obsolete terms “lessee under an emphyteutic lease” / droit de preneur dans un bail emphytéotique are replaced with “lessee under an emphyteusis” / droit d’emphytéote, the new terminology used in the Civil Code of Québec.

Technical Amendments to the Income Tax Amendments Act, 2000

Clause 45

***Inter Vivos* Transfer of Property by an Individual**

***S.C. 2001*, C.17**
53(2)(*a*)

Income Tax Act
73(1)

Subsection 73(1) of the *Income Tax Act* generally provides for a tax-free disposition of capital property if it is transferred by an individual to the individual's spouse, common-law partner or a trust for the exclusive benefit of the spouse or common-law partner during the lifetime of the spouse or common-law partner. For subsection 73(1) to apply, the transferor and transferee must both be resident in Canada at the time of the transfer. Where the transferee is a trust, in respect of transfers that occur in 2000 or 2001, the residency requirement is determined without reference to subsection 94(1) as it read before 2002.

This amendment to the *Income Tax Amendments Act, 2000*, ensures that, in applying subsection 73(1) in respect of transfers that occur after 1999 and before 2007, the residence of a transferee will be determined without reference to section 94 of the Act, as it reads in its application to taxation years that began before 2007.

This amendment is deemed to come into force on June 14, 2001.

Clause 46

Disposition by Taxpayer of Capital Interest

***S.C. 2001*, C.17**
80(19)

Income Tax Act
107(1)

Paragraph 107(1)(*a*) of the *Income Tax Act* applies for the purpose of computing a taxpayer's taxable capital gain from the disposition of a capital interest in a personal trust (or a prescribed trust described in section 4800.1 of the *Income Tax Regulations*), except where the interest was an interest in a non-resident *inter vivos* trust purchased by the taxpayer and the disposition was not by way of a distribution to which subsection 107(2) applies. For this purpose the residency of the trust is to be determined without reference to section 94 as it read before 2002.

This amendment to the *Income Tax Amendments Act, 2000*, ensures that, in applying subsection 107(1) in respect of transfers that occur after 1999 and before 2007, the residence of a transferee trust will be determined without reference to section 94 of the Act, as it reads in its application to taxation years that began before 2007.

This amendment is deemed to come into force on June 14, 2001.

Part 2

General Amendments

Clause 47

Income or Loss from a Source or from Sources in a Place – Deductions Applicable

ITA
4(3)(*a*)

Subsection 4(2) of the *Income Tax Act* provides that, in determining the income or loss from a source, no deductions are permitted under sections 60 to 64 of the Act. Subsection 4(3) provides that this rule does not apply, with the exception of certain deductions, in determining the foreign source income designated by a trust to a beneficiary under subsections 104(22) and 104(22.1), in determining a taxpayer's taxable income earned in Canada under section 115 and in determining a taxpayer's foreign tax credit under section 126 of the Act. The exceptions are for deductions permitted by paragraphs 60(*b*) to (*o*), (*p*), (*r*) and (*v*) to (*w*).

Paragraph 4(3)(*a*) is amended to expand the list of exceptions to include deductions permitted by paragraph 60(*x*) (e.g., repayment of Canada Education Savings Grants).

This amendment applies to the 2002 and subsequent taxation years.

Clause 48

Employment Income

ITA
6

Section 6 of the Act deals with employment income. This section provides for the inclusion in an employee's income of most employment-related benefits other than those specifically excluded.

Amounts Receivable for Covenant

ITA
6(3.1)

New subsection 6(3.1) of the Act provides that an employee is – if certain circumstances exist – required to include in the employee's income from employment for a taxation year an amount that is receivable at the end of a taxation year in respect of a covenant as to what the employee is, or is not, to do. Subsection 6(3.1) is added consequential to new section 56.4 of the Act which concerns the tax treatment of amounts received or receivable in respect of a restrictive covenant (additional commentary is provided in the explanatory notes accompanying new section 56.4). In contrast, amounts related to covenants made in the context of an office or employment are generally included in income on a "received" basis.

New subsection 6(3.1) applies to a receivable of an employee in respect of a covenant if

- the amount is not receivable under a salary deferral arrangement to which paragraph 6(1)(*a*) applies because of subsection 6(11) (in such cases, the amount is currently taxable as employment income even though it is receivable),
- the employee agreed to the covenant more than 36 months before the end of the taxation year, and
- the amount would be included in the taxpayer's income, as income from an office or employment, if it were received by the taxpayer in the year.

If applicable, subsection 6(3.1) provides that the amount receivable is deemed to be received by the taxpayer at the end of the taxation year for services rendered as an officer or during the period of employment, and that the amount is deemed not to be received at any other time (thereby precluding an inclusion because of the receipt).

In cases where subsection 6(3.1) deems an amount that is receivable to be received, new paragraph 60(*f*) provides a deduction in a subsequent taxation year if the amount becomes a bad debt.

Subsection 6(3.1) applies to amounts receivable in respect of a covenant agreed to after October 7, 2003.

Forgiven Amount

ITA
6(15.1)

Subsection 6(15) of the Act provides that, for the purpose of paragraph 6(1)(*a*), the value of the benefit derived from the forgiveness of a debt is the forgiven amount in respect of the obligation. Subsection 6(15.1) of the Act provides that, for the purpose of subsection 6(15), the expression "forgiven amount" in respect of an obligation has the meaning that would be assigned by subsection 80(1) of the Act if certain assumptions were made.

Subsection 6(15.1) of the French version of the Act refers to conditions that must be met in order for the provision to apply. This statement could be interpreted as requiring that the obligation referred to in the preamble of subsection 6(15.1) be a commercial obligation. In order to avoid this interpretation, the French version of subsection 6(15.1) is amended to clarify that the statements made in paragraphs (*a*) to (*d*) are assumptions and not conditions.

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

Clause 49

Employee Security Options – Definitions

ITA
7(7)

Section 7 of the Act deals with agreements (generally referred to as stock options) under which employees of a corporation or mutual fund trust acquire rights to acquire securities of the employer (or a person with whom the employer does not deal at arm's length).

Subsection 7(7) of the Act defines the expressions "qualifying person" and "security" for the purposes of section 7 and certain other provisions of the Act relating to those agreements. "Qualifying person" is defined as a corporation or a mutual fund trust. "Security" is defined as a share issued by a corporation or a unit of a mutual fund trust.

Subsection 7(7) is amended to have these definitions also apply for the purposes of new subsections 110(1.7) and (1.8) of the Act. New subsection 110(1.7) ensures that a reduction in the exercise price under an employee security option will not disqualify the employee from claiming the security option deduction under paragraph 110(1)(*d*), provided certain conditions are met. New subsection 110(1.8) sets out the conditions that must be met in order for new subsection 110(1.7) to apply.

This amendment, which applies after 1998, is consequential to the enactment of new subsections 110(1.7) and (1.8). For additional information, see the commentary to those subsections.

Clause 50

Income from Office or Employment – Deductions

ITA
8

Section 8 of the Act provides for the deduction of various amounts in computing income from an office or employment.

Legal Expenses of Employee

ITA
8(1)(*b*)

Paragraph 8(1)(*b*) of the Act allows the deduction of amounts paid by the taxpayer to collect or establish a right to salary or wages owed to the taxpayer by the taxpayer's employer or former employer.

Concern has been expressed that where an amount is not owed to the employee directly by the employer, any legal expenses incurred by the taxpayer would not be deductible under paragraph 8(1)(*b*), even though the amount, when received, would be taxable as employment income. This would be the case, for example, with respect to legal fees incurred by a taxpayer to collect insurance benefits under a sickness or accident insurance policy provided through an employer.

Paragraph 8(1)(*b*) is amended, effective for amounts paid after 2000, to allow a deduction for legal expenses incurred by a taxpayer to collect, or establish a right to collect, an amount that, if received, would be included in computing the taxpayer's employment income.

Dues and Other Expenses of Performing Duties

ITA
8(1)(*i*)

Paragraph 8(1)(*i*) of the Act permits an employee to deduct certain dues and other employment expenses that are paid by the employee. Paragraph 8(1)(*i*) is amended, applicable on Royal Assent, to clarify that an expense described in that paragraph that is paid on an employee's behalf is deductible by the employee if the amount paid is required to be included in computing the employee's income.

Quebec Parental Insurance Plan Premium

ITA
8(1)(*l*.2)

New paragraph 8(1)(*l*.2) of the Act permits a taxpayer to deduct, in computing income for a taxation year, an amount paid by the taxpayer in the year as an employer's premium under the new Quebec Parental Insurance Plan in respect of salary, wages or other remuneration, including gratuities, paid to an individual employed by the taxpayer as an assistant or substitute to perform the duties of the taxpayer's office or employement if an amount is deductible by the taxpayer for the year under subparagraph 8(1)(*i*)(ii) in respect of that individual.

This amendment applies to the 2006 and subsequent taxation years and is consequential to the introduction of the new Quebec Parental Insurance Plan on January 1, 2006.

Clause 51

Income Inclusions

ITA
12

Section 12 of the Act provides for the inclusion of various amounts in computing the income of a taxpayer from a business or property.

Inducements, Reimbursements, etc.

ITA
12(1)(*x*)(v.1)

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 must be included in income "to the extent that" the particular amounts have not otherwise been included in income or reduced the cost of a property or the amount of an outlay or expense. Paragraph 12(1)(*x*) is amended consequential to the restrictive covenant rules in new section 56.4 of the Act (additional commentary is provided in the explanatory notes accompanying new section 56.4).

New subparagraph 12(*x*)(v.1) provides that the income inclusion referred to in paragraph (*x*) does not apply to the extent the amount in respect of a restrictive covenant (as defined by new subsection 56.4(1)) was included under subsection 56.4(2) in computing the income of a person related to the taxpayer. In other words, to the extent that a taxpayer receives an amount for a restrictive covenant that a person related to the taxpayer is required under subsection 56.4(2) to include in computing income, paragraph 12(1)(*x*) will not apply to require the taxpayer to include the amount in computing the taxpayer's income.

New subparagraph 12(1)(*x*)(v.1) applies after October 7, 2003.

No Deferral of Section 9 Under Paragraph (1)(*g*)

ITA
12(2.01)

New subsection 12(2.01) of the Act, which comes into force on Royal Assent, provides that paragraph 12(1)(*g*) of the Act does not defer the inclusion in a taxpayer's income of an amount that would otherwise be so included at an earlier time in accordance with section 9 of the Act. Accordingly, where an amount based on production or use would be included in computing a taxpayer's income from a business or property (if section 12 were read without reference to paragraph 12(1)(*g*)) at a time when the amount is accrued but not yet received, subsection 12(2.01) clarifies that paragraph 12(1)(*g*) does not apply to defer the inclusion of the amount in income until the time of receipt.

Clause 52

Depreciable Property

ITA
13

Section 13 of the Act provides a number of special rules related to the treatment of depreciable property. Generally, these rules apply for the purposes of sections 13 and 20 of the Act and the capital cost allowance regulations.

Recaptured Depreciation

ITA
13(1)

Subsection 13(1) of the Act provides for the inclusion in a taxpayer's income of recaptured capital cost allowance when the taxpayer's proceeds of disposition of depreciable property of a prescribed class exceeds the undepreciated capital cost (UCC) of the property.

Subsection 13(1) is amended to add a reference to the new descriptions of D.1 and K of the definition "undepreciated capital cost" in subsection 13(21). Those descriptions provide for an addition to the UCC of a class of certain countervailing duties paid in respect of property of the class ("D.1") and a corresponding reduction for any refunds of those amounts ("K").

This amendment applies to taxation years that end after February 23, 1998, and corrects a technical deficiency.

Exchanges of Property

ITA
13(4)(*c*)(ii)

Subsection 13(4) of the Act allows a taxpayer, who is required under subsection 13(1) to include in income recaptured depreciation resulting from the disposition of certain depreciable property, to elect to defer tax on the recapture to the extent that the taxpayer reinvests the proceeds of disposition in a replacement property within a certain period of time, namely

- in the case of certain involuntary dispositions, e.g., theft or expropriation, before the end of the taxpayer's second taxation year that begins after the property was disposed of, or
- in other situations, before the end of the taxpayer's first taxation year that begins after the property was disposed of.

Subparagraph 13(4)(*c*)(ii) is amended to accommodate taxation years that are shorter than 12 months, by providing that the periods for acquiring replacement property end at the later of the times mentioned above and

- in the case of involuntary dispositions, within 24 months after the end of the taxation year in which the property was disposed of, or
- in other situations, within 12 months after the end of the taxation year in which the property was disposed of.

These amendments apply, in the case of involuntary dispositions, in respect of dispositions that occur in taxation years that end on or after December 20, 2000, and in any other case, in respect of dispositions that occur in taxation years that end on or after December 20, 2001.

Election – Limited Period Franchise, Concession or License

ITA
13(4.2) and (4.3)

Subsection 14(6) of the Act permits a taxpayer to defer tax otherwise arising on the disposition of an eligible capital property, to the extent that the taxpayer reinvests the proceeds of disposition in a replacement property within a certain period of time. A franchise, concession or license with an indefinite term may be such an eligible capital property. However, such a property with a defined term will generally be a depreciable property included in Class 14 of Schedule II of the *Income Tax Regulations* ("the Regulations") and will not be eligible for similar replacement treatment under subsection 13(4) of the Act because such a property is not a "former business property" as defined in subsection 248(1) of the Act. Further, the replacement property provisions for depreciable property generally apply only to immoveable property.

New subsections 13(4.2) and (4.3) of the Act are added, concurrent with the amendment of the definition "former business property", to allow a taxpayer (the "transferor") to use the replacement property rules under subsection 13(4) in respect of the disposition or termination of a property that is the subject of a joint election with the purchaser (the "transferee") of the property.

New subsection 13(4.2) describes the circumstances under which the transferor and the transferee may make a joint election. Property eligible for the election is a "former property" described in subsection 13(4) that is a franchise, concession or license for a limited period that is wholly attributable to the carrying on of a business at a fixed place. The election may be made where the property is disposed of directly by the transferor to the transferee or where the property of the transferor is terminated and the transferee acquires a similar property in respect of the same fixed place from another person. Both parties must elect in their returns of income for their respective taxation years that include the year of the disposition or termination.

New subsection 13(4.3) provides rules that apply when an election has been made under subsection 13(4.2). If the transferee acquires the property disposed of by the transferor (the "former property"), the transferee is deemed to own that property until such time as the transferee owns neither the former property nor a similar property in respect of the same fixed place to which the former property related. If the transferee instead acquires a similar property in respect of the same fixed place (i.e., the life of the former property was terminated), the transferee is deemed to have also acquired the former property and to continue to own it until the transferee no longer owns the similar property.

In either case, for the purpose of claiming a deduction by the transferee under paragraph 20(1)(*a*) of the Act, the life of the former property in the hands of the transferee is deemed to be the term remaining at the time the transferor originally acquired the property. For instance, a license with a 20-year life when it was originally acquired by the transferor, but with 5 years remaining at the time of the transfer, would be considered to have a 20-year life in the hands of the transferee for the purposes of claiming a deduction under paragraph 20(1)(*a*).

There may be circumstances where, but for an election under subsection 13(4.2), a portion of the consideration given by a transferee upon the sale of a limited period franchise, license or concession might reasonably be considered to be an eligible capital amount to the transferor and an eligible capital expenditure to the transferee. For instance, a portion of the consideration may reasonably relate to the preferred status that the transferee may receive in obtaining a new property at the end of the term. Where an election under subsection 13(4.2) is made, subsection 13(4.3) provides that such an amount will be neither an eligible capital amount to the transferor, nor an eligible capital expenditure to the transferee, but will instead be included in the cost to the transferee and proceeds of disposition of the transferor of the former property.

In this regard, it is also proposed that section 1101 of the Regulations be amended, applicable after December 20, 2002, by adding the following after subsection (1*af*):

> (1*ag*) If more than one property of a taxpayer is described in the same class in Schedule II, and one or more of the properties is a property in respect of which the taxpayer is a transferee that has elected under subsection 13(4.2) of the Act, a separate class is prescribed for each such property of the taxpayer that would otherwise be included in the same class.

If, subsequent to the acquisition of the former property by the transferee, the life of the former property expires and a similar property in respect of the same fixed place is not acquired by the transferee, the transferee may, under subsection 20(16) of the Act, be entitled to a terminal loss in respect of the former property. Refer to the commentary to new paragraph 20(16.1)(*b*) of the Act regarding limitations in respect of the deduction of such a terminal loss.

New subsections 13(4.2) and (4.3) apply in respect of dispositions and terminations that occur after December 20, 2002.

Example 1

Ms. Mubarak is a franchisee with 5 years remaining of a 20-year agreement. The original cost was $60,000, and the undepreciated capital cost ("UCC") is $15,000. The agreement is transferable, so she agrees to sell the franchise to Mr. Grando at its fair market value of $85,000. Ms. Mubarak will, in the same taxation year, purchase from Ms. Vincent a replacement franchise that has 15 years remaining of a 20-year term, for $100,000.

But for the making of an election under subsection 13(4.2), Ms. Mubarak would have a capital gain of $25,000 (i.e., $85,000 - $60,000) and a UCC balance of $55,000 (i.e., $15,000 + $100,000 - $60,000) before deducting any capital cost allowance for the year. The adjusted cost base ("ACB") of her replacement franchise would be $100,000. Mr. Grando would have acquired a Class 14 property with an ACB and capital cost of $85,000, depreciable over 5 years.

If Ms. Mubarak and Mr. Grando jointly elect under subsection 13(4.2), Ms. Mubarak may elect under subsections 13(4) and 44(1) to defer the capital gain, such that the ACB and capital cost of the replacement franchise will be deemed to be $75,000 (i.e., $100,000 less the $25,000 deferred capital gain). Furthermore, Ms. Mubarak's UCC balance for Class 14 will be $30,000 (i.e., an increase equivalent to the $100,000 cost of the replacement franchise less the $85,000 proceeds from the former property), to be amortized over the remaining 15-year term. In this regard, note that the term for amortizing Ms. Mubarak's replacement franchise is unaffected by her and Mr. Grando's joint election in respect of the former property. Mr. Grando, on the other hand, will be required to amortize his $85,000 cost of the former property over 20 years, which was the term of the former property when it was first acquired by Ms. Mubarak.

If Mr. Grando does not enter into a new agreement with the franchisor after the 5-year period, he will be eligible for a terminal loss (even if there are other Class 14 assets, because the $85,000 property will be in a "separate class"). However, a terminal loss will not be available if a person dealing non-arm's length with Mr. Grando, at any time before the time that is 24 months after the expiry of the old agreement, enters into a new franchise agreement in respect of the same fixed place.

Example 2

Consider the same example, except that the original franchise agreement of Ms. Mubarak (the former property) is not transferable, but instead must be terminated and renewed with the franchisor. Suppose that it is renewed by Mr. Grando for a period of 12 years, with an additional amount of $120,000 paid by Mr. Grando to the franchisor for the new agreement.

In this case it is arguable that, for Mr. Grando, the $85,000 payment to Ms. Mubarak is, absent an election under subsection 13(4.2), an eligible capital expenditure by Mr. Grando. That is, Mr. Grando will pay a separate amount of $120,000 to the franchisor for a Class 14 asset, but the $85,000 payment to Ms. Mubarak is, in effect, incurred to acquire the right to renew the franchise, not to acquire a Class 14 property. Ms. Mubarak has likewise received proceeds of disposition of an eligible capital property (i.e., an "eligible capital amount", 3/4 of which would reduce her Cumulative Eligible Capital balance), not proceeds of disposition of a Class 14 property. Absent an election under subsection 13(4.2), Ms. Mubarak would not be entitled to acquire a replacement eligible capital property, but could be entitled to claim a terminal loss on the termination of the original franchise agreement (if she had no other Class 14 assets on hand at the end of the taxation year of disposition). Subsection 14(1) would apply to the eligible capital amount received by Ms. Mubarak.

The $120,000 cost of the new agreement to Mr. Grando, paid to the franchisor, could be written off by Mr. Grando over its 12-year term.

If Ms. Mubarak and Mr. Grando jointly elect under subsection 13(4.2), no part of the proceeds of disposition for the former property will be an eligible capital amount or an eligible capital expenditure. The results are the same as in Example 1, except that Mr. Grando will now have two Class 14 properties:

- *the new franchise agreement, the $120,000 cost of which may be written off by him over its 12-year term; and*
- *the former property, deemed to have been acquired by him and included in a separate class, the $85,000 cost of which may be written off by him over its deemed 20-year term.*

Example 3

Consider again Example 1, but suppose that the replacement franchise, purchased by Ms. Mubarak from Ms. Vincent, is itself the subject of a joint election by them under subsection 13(4.2). Ms. Mubarak is required to amortize her $30,000 UCC (see Example 1) over the original 20-year term of Ms. Vincent, not over its remaining 15 years.

Clause 53

Eligible Capital Property

ITA
14

Section 14 of the Act provides rules concerning the tax treatment of expenditures and receipts of a taxpayer in respect of eligible capital properties and operates on a pooling basis. Annual deductions, which are calculated as a percentage of this pool, may be claimed under paragraph 20(1)(*b*) of the Act. "Eligible capital property" includes goodwill, customer lists, farm quotas and licenses of unlimited duration.

Acquisition of Eligible Capital Property

ITA
14(3)

Subsection 14(3) of the Act provides rules regarding non-arm's length transfers of eligible capital property. The provision prevents the deduction, under paragraph 20(1)(*b*) of the Act, of the portion of the purchaser's cost that is reflected in a capital gains exemption claimed by the vendor under section 110.6 of the Act. Absent any claim by the vendor of a capital gains exemption under subsection 110.6, the eligible capital expenditure to the purchaser generally equals the proceeds of disposition of the vendor. That is, the eligible capital expenditure of the purchaser equals 4/3 of the amount determined in respect of the vendor under the description of E in the formula in the definition "cumulative eligible capital" in subsection 14(5) of the Act.

Paragraph 14(3)(*a*) is amended, for taxation years that end after February 27, 2000, to ensure that, if the eligible capital property is the subject of an election by the vendor under subsection 14(1.01) or (1.02) of the Act, the eligible capital expenditure of the purchaser will, subject to the adjustments in subsection 14(3) for deductions under section 110.6, equal the actual proceeds of disposition to the vendor.

Definition of Cumulative Eligible Capital

ITA
14(5)

The definition "cumulative eligible capital" in subsection 14(5) of the Act provides for the calculation of a taxpayer's cumulative eligible capital property pool for the purpose of determining the taxpayer's allowable deduction in respect of eligible capital property (ECP) for the year.

Variable A in the definition "cumulative eligible capital" represents 3/4 of the eligible capital expenditures of a taxpayer as the result of the acquisition of an eligible capital property after the taxpayer's "adjustment time" (generally since 1987). Variable A is amended to ensure that the taxpayer's pool includes only the taxable portion of the gain realized by the non-arm's length transferor on the disposition after December 20, 2002 of eligible capital property.

Variable A is generally reduced by 1/2 of the gain of the transferor in respect of the property under paragraph 14(1)(*b*) or 38(*a*) of the Act. (Where the transferor has claimed a capital gains exemption in respect of the transfer under subsection 110.6 of the Act, subsection 14(3) of the Act reduces the taxpayer's eligible capital expenditure accordingly. The reduction in Variable A will therefore not include 1/2 of the amount of that claim.) Where the transferor has realized such a gain in a taxation year in respect of more than one property, the amount of the gain of the transferor for the purposes of this calculation is that proportion of the gain that the proceeds of disposition of the eligible capital property acquired by the taxpayer is of the total proceeds of disposition of all such property disposed of in the transferor's taxation year.

The reduction to Variable A does not apply where the eligible capital property has previously been disposed of by the taxpayer or was acquired on or before December 20, 2002.

Example 1

Mr. X purchased a farm production quota several years ago for $300,000 and claimed no cumulative eligible capital amounts, such that his cumulative eligible capital at the end of his previous taxation year was $225,000. This year he sold the production quota to his sister, Mrs. Y, for its fair market value of $1,200,000. Mr. X reported income of $450,000 under paragraph 14(1)(b) of the Act, and did not claim a capital gains exemption under section 110.6 of the Act. (Alternatively, Mr. X could have made an election under subsection 14(1.01) of the Act to report a taxable capital gain under paragraph 38(a) of the Act.)

Because Mrs. Y purchased the production quota in a non-arm's length transaction, the amount included in Variable A of her cumulative eligible capital balance at the end of the year of acquisition would be $675,000 (i.e. 3/4 of $1,200,000, less 1/2 of the taxable gain of Mr. X of $450,000). This result may also be illustrated as the total of the taxable gain of Mr. X of $450,000 and 3/4 of his eligible capital expenditure of $300,000.

Example 2

Assume the same facts as Example 1, except that Mr. X claimed a capital gains exemption of $250,000 in respect of his $450,000 taxable gain under paragraph 14(1)(b) of the Act.

Mrs. Y's eligible capital expenditure under subsection 14(3) of the Act is deemed to be $700,000, calculated as 4/3 of the excess of

- *3/4 of the actual proceeds of disposition of $1,200,000 (i.e. $900,000)*

over

- *3/2 of the $250,000 capital gains exemption claimed by Mr. X (i.e. $375,000)*

The amount included in Variable A of Mrs. Y's cumulative eligible capital balance is calculated as follows:

• *3/4 of her deemed eligible capital expenditure of $700,000*		*$525,000*
less 1/2 of the amount by which		
• *the taxable gain of Mr. X*	*$450,000*	
exceeds		
• *the capital gains exemption claimed by Mr. X*	*250,000*	
	200,000	
	x 1/2	
		100,000
Amount included in Variable A		*$425,000*

The calculation of "cumulative eligible capital" is designed so that the pool cannot be negative immediately after the end of the year. In this regard, variable F in the calculation generally reduces the pool by the total amount of ECP deductions claimed in prior years (generally, variable P), net of amounts included in income in prior years (variable R) under subsection 14(1) of the Act as recapture of ECP deductions or as deemed capital gains.

Variable R in the definition "cumulative eligible capital" is amended to ensure that amounts included in the income of a corporation under former paragraph 14(1)(*b*) of the Act (as it applied to taxation years that ended before February 28, 2000) continue to be included in the calculation of variable F.

The amendments generally apply to taxation years that end after February 27, 2000.

Restrictive Covenant Amount

ITA
14(5.1)

New subsection 14(5.1) of the Act provides that the description E of the definition "cumulative eligible capital" in subsection 14(5) does not apply to an amount if the amount is required to be included in the taxpayer's income because of subsection 56.4(2). However, subsection 56.4(2) does not apply to an amount if paragraph 56.4(3)(*b*) applies to the amount, in which case the amount may be a cumulative eligible capital receipt for the purposes of applying section 14. As well, if new subparagraph 56.4(7)(*d*)(i) or (ii) applies, consideration that could reasonably be regarded as being for the restrictive covenant granted by a taxpayer for nil proceeds may be – depending on the circumstances – a goodwill amount (as defined by new subsection 56.4(1)) that is to be included in computing the cumulative eligible capital of the taxpayer, or the taxpayer's eligible corporation (as defined by new subsection 56.4(1)). New section 56.4 is more fully described below in the notes accompanying that provision.

New subsection 14(5.1) is consequential to the rules for restrictive covenant amounts as set out in new section 56.4, and applies after October 7, 2003.

Exchange of Property

ITA
14(6)

Where a taxpayer has disposed of an eligible capital property in a taxation year and has acquired a replacement eligible capital property before the end of the subsequent taxation year, subsection 14(6) of the Act allows the taxpayer to elect to defer the inclusion of an amount in income under subsection 14(1) of the Act that would normally result from a negative balance in the taxpayer's cumulative eligible capital account at the end of the year of disposition.

Subsection 14(6) is amended to accommodate taxation years that are shorter than 12 months, by providing that the period for acquiring a replacement property ends at the later of the end of the subsequent taxation year and the time that is 12 months after the end of the taxation year in which the property was disposed of. This amendment applies in respect of dispositions of eligible capital property that occur in taxation years that end on or after December 20, 2001.

Clause 54

Shareholder Benefits

ITA
15

Section 15 of the Act requires the inclusion in income of certain benefits received or enjoyed by shareholder of a corporation.

Forgiven Amount

ITA
15(1.21)

Subsection 15(1.2) of the Act provides that, for the purpose of subsection 15(1), the value of the benefit where an obligation issued by a debtor is settled or extinguished is deemed to be the forgiven amount in respect of the obligation. Subsection 15(1.21) of the Act provides that, for the purpose of subsection 15(1.2), the expression "forgiven amount" in respect of an obligation has the meaning that would be assigned by subsection 80(1) of the Act if certain assumptions were made.

Subsection 15(1.21) of the French version of the Act refers to conditions that must be met in order for the provision to apply. This statement could be interpreted as requiring that the obligation referred to in the preamble of subsection 15(1.21) be a commercial obligation. In order to avoid this interpretation, the French version of subsection 15(1.21) is amended to clarify that the statements made in paragraphs 15(1.21)(*a*) to (*d*) are assumptions and not conditions.

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

Shareholder Debt

ITA
15(2)

Subsection 15(2) of the Act requires that certain shareholder indebtedness be included in computing the income of the debtor. Included in such indebtedness are loans from a corporation to its shareholders, loans to persons connected with the shareholders, as well as loans from a partnership to a shareholder of one of its corporate members.

Subsection 15(2) was amended in 1998 by S.C. 1998, c.19, s.75(1) [formerly Bill C-28], generally applicable to loans and indebtedness arising in the 1990 and subsequent taxation years. Prior to that amendment, the English and French versions of subsection 15(2) referred to the expression “has become indebted” (devient la débitrice). However, the 1998 amendments incorrectly introduced into the French version of the subsection the expression « contracter une dette » (to incur a debt). This unintended inconsistency in terminology is corrected in the French version by replacing the expression « contracter une dette » (to incur a debt) with the expression « devient la débitrice » (has become indebted).

This amendment applies to loans made and indebtedness arising in the 1990 and subsequent taxation years.

Clause 55

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.

Securities Lending Arrangement Compensation Payments

ITA
18(1)(*w*)

Section 260 of the Act provides special rules relating to securities lending arrangements. Former subsection 260(6) prohibited a borrower, other than in certain circumstances, from deducting in computing its income an amount paid as a compensation payment pursuant to a securities lending arrangement.

As part of the restructuring of section 260, particularly subsection 260(6), new paragraph 18(1)(*w*) is enacted to prohibit a borrower from deducting a compensation payment, except where expressly permitted by the Act. This new paragraph, therefore, continues the function of the former subsection 260(6).

This amendment applies after 2001.

Losses – Adventurers in Trade

ITA
18(14)

Subsection 18(14) of the Act describes the circumstances in which the loss-deferral rule in subsection 18(15) applies to dispositions of property that is described in an inventory of a business that is an adventure or concern in the nature of trade. Paragraph 18(14)(*c*) excludes from the application of the rule dispositions under specified provisions of the Act. As a consequence of the restructuring of section 132.2 of the Act, the reference in paragraph 18(14)(*c*) to paragraph 132.2(1)(*f*) is replaced by references to paragraphs 132.2(3)(*a*) and (*c*).

This amendment applies to dispositions that occur after 1998.

Clause 56

Non-application of Section 18.1

ITA
18.1(15), (16) and (17)

Section 18.1 of the Act provides rules that restrict the deductibility of a taxpayer's cost of a "right to receive production", by prorating the deductibility of the amount of the investment over the economic life of the right. In the transactions that are subject to these rules, investors undertake to pay expenditures that would otherwise be expenses payable by the "vendor" (e.g., payroll, selling commissions) in exchange for a right to receive future income (a "right to receive production"), usually from the vendor's business operations. Such an expenditure by the taxpayer, referred to as a "matchable expenditure", is defined in subsection 18.1(1) of the Act.

Subsection 18.1(15) of the Act provides two general exceptions to the application of the matchable expenditure rules. One such exception, in paragraph 18.1(15)(*b*), generally applies where the matchable expenditure relates to the issuance of an insurance policy for which all or a portion of a risk has been ceded to the taxpayer. This exception remains unchanged other than changes in numbering.

Paragraph 18.1(15)(*a*) provides the other exception to the matchable expenditure rules, applicable only if no part of the expenditure of the taxpayer can reasonably considered to have been paid to another person to acquire the right to receive production from that person. If this condition is met, the expenditures must meet one of two further criteria. Subparagraph 18.1(15)(*a*)(i) allows the exception if the taxpayer's expenditure cannot reasonably be considered to relate to a tax shelter investment and none of the main purposes of making the expenditure is to obtain a tax benefit. Alternatively, subparagraph 18.1(15)(*a*)(ii) allows the exception if, in the same year as the matchable expenditure is made, the total revenues of the taxpayer from the right to receive production exceed 80% of the expenditure. If this 80% revenue threshold is met, the portion of the expenditure that is deductible is limited only by general rules that apply to all business expenditures.

Subparagraph 18.1(15)(*a*)(i) is renumbered as new subsection 18.1(16) and remains unchanged. The alternative exception in subparagraph 18.1(15)(*a*)(ii) (the 80% revenue threshold) is renumbered as new subsection 18.1(17) and no longer provides a general exception to the application of the matchable expenditure rules. This amended rule provides that if any portion of the matchable expenditure can reasonably be considered to relate to a tax shelter or a tax shelter investment, subsection 18.1(4), which requires the amortization of the expenditure (subject to an income limit), will apply without reference to paragraph 18.1(4)(*a*). The result is that the cumulative amount deducted in respect of a matchable expenditure may not exceed the taxpayer's cumulative revenue from the associated right to receive production.

The amendments to section 18.1 generally apply in respect of expenditures made by a taxpayer on or after September 18, 2001.

Clause 57

Deductions

ITA
20

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

Reserve Not Available

ITA
20(8)

Paragraph 20(1)(*n*) of the Act allows a taxpayer to claim a reserve in respect of the taxpayer's profit from the sale of certain property, where all or part of the proceeds of the sale are not due until at least two years after the time of sale. However, subsection 20(8) of the Act provides that this reserve is limited to taxation years that end less than 36 months after the time of the sale. For example, where the taxation year is 12 months, the reserve is available in the taxation year in which the sale occurred and the two subsequent taxation years.

New paragraphs 20(8)(*c*) and (*d*) generally apply, in respect of dispositions of property that occur after December 20, 2002, to provide that the reserve under paragraph 20(1)(*n*) is not available to a taxpayer where the purchaser of the property is a corporation controlled by the taxpayer or is a partnership of which the taxpayer is a majority interest partner.

Deduction for Foreign Tax

ITA
20(12)

Subsection 20(12) of the Act allows a taxpayer to deduct, in computing income for a taxation year from a business or property, non-business income taxes paid to a foreign government in respect of the income. The subsection is amended to make explicit the requirement that the taxpayer claiming the deduction be resident in Canada during all or part of the year for which the claim is made. This amendment is clarifying only, and applicable after December 20, 2002. (Accordingly, the amendment is effective for any application of the Act after that date.)

Terminal Loss

ITA
20(16)

Subsection 20(16) of the Act permits a taxpayer to deduct, in computing the taxpayer's income for a year, the terminal loss of the taxpayer in respect of a class of depreciable property at the end of the year. That subsection is amended to add a reference to the new descriptions of D.1 and K of the definition "undepreciated capital cost" in subsection 13(21) of the Act. For information about those new descriptions, see the commentary to subsection 13(1).

This amendment applies to taxation years that end after February 23, 1998, and corrects a technical deficiency.

Non-Application of Subsection (16)

ITA
20(16.1)

Subsection 20(16.1) of the Act provides that a terminal loss under subsection 20(16) in respect of a depreciable property that is a "passenger vehicle" costing more than a prescribed amount (currently set at $30,000) is not deductible in computing income. That rule is renumbered as paragraph 20(16.1)(*a*) and new paragraph 20(16.1)(*b*) is added, applicable to taxation years that end after December 20, 2002. These amendments are made concurrently with the addition of subsections 13(4.2) and (4.3) of the Act and with the amendment of the definition "former business property" in subsection 248(1) of the Act.

New paragraph 20(16.1)(*b*) provides that a terminal loss is not available in respect of another person's former business property that was deemed under paragraph 13(4.3)(*a*) or (*b*) (as the result of a joint election under subsection 13(4.2) by the taxpayer and the other person) to be owned by the taxpayer. For further information, refer to the commentary to subsections 13(4.2) and (4.3).

Clause 58

Scientific Research and Experimental Development

ITA
37

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

ITA
37(8)(*a*)(ii)(B)(V)

Paragraph 37(8)(*a*) of the Act provides rules for interpreting the expression "expenditures on or in respect of scientific research and experimental development" which is used in subsections 37(1), (2) and (5).

Clause 37(8)(*a*)(ii)(B) provides for the alternative "proxy" method for determining SR&ED expenditures. Subclause 37(8)(*a*)(ii)(B)(V) provides that, in the context of the proxy method for determining SR&ED expenditures, the references to expenditures on or in respect of SR&ED (other than in subsection 37(2)) include only, among things listed in clause 37(8)(*a*)(ii)(B), the cost of "materials consumed" in the prosecution of SR&ED in Canada.

Subclause 37(8)(*a*)(ii)(B)(V) is amended for costs incurred after February 23, 1998 in two respects. First, the phrase "materials consumed" is changed to "materials consumed or transformed". Second, the reference in the French version of the subclause to "matières" is changed to "matériaux".

Clause 59

Allocation of Gain on Gifts to Qualified Donees

ITA
38.1

Paragraphs 38(*a*.1) and (*a*.2) of the Act provide a special inclusion rate for capital gains arising as a result of a gift to qualified donees of certain securities or of environmentally sensitive land. This inclusion rate is one-half of the normal inclusion rate.

Section 38.1 of the Act is added consequential to the addition of new subsections 248(31) to (33) of the Act, for gifts made after December 20, 2002. New section 38.1 provides that, where a taxpayer is entitled to an advantage or benefit in respect of a gift, only part of the taxpayer's capital gain will be entitled to the special inclusion rate. The Part entitled to the special inclusion rate is that proportion of the gain that the eligible amount of the gift is of the taxpayer's total proceeds of disposition in respect of the property.

For additional details, see the commentary to new subsections 248(31) and (32) regarding the eligible amount of a gift and the amount of the advantage in respect of a gift.

Clause 60

Gains and Losses – General Rules

ITA
40

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

Gift of Non-qualifying Security

ITA
40(1.01)(*c*)

Subsection 40(1.01) of the Act allows a taxpayer to claim a reserve in respect of any gain realized from the making of a gift of a "non-qualifying security", as defined for the purposes of sections 110.1 and 118.1 of the Act. The gift is not recognized as a gift for the purposes of those sections until a subsequent time when the security ceases to be a non-qualifying security or it is disposed of by the donee. The reserve available in subsection 40(1.01) allows the resulting inclusion in income to be deferred until the year that includes the subsequent time, unless the taxpayer first becomes non-resident or tax-exempt.

Paragraph 40(1.01)(*c*) is amended consequential to the addition of new subsections 248(30) to (33) of the Act, for gifts made after December 20, 2002, to provide that the reserve claimed by the taxpayer may not exceed the eligible amount of the gift. For additional details, see the commentary to subsection 248(31) of the Act regarding the eligible amount of a gift.

Reserve on Property Sold to a Controlled Partnership

ITA
40(2)(*a*)

Paragraph 40(2)(*a*) of the Act generally restricts a taxpayer's ability to claim a capital gains reserve in respect of properties disposed of to a non-resident or to a corporation that controlled the taxpayer or was controlled by the taxpayer. Paragraph 40(2)(*a*) is amended in respect of dispositions of property that occur after December 20, 2002, to provide that a capital gains reserve will also not be allowed to a taxpayer where the purchaser of the property is a partnership of which the taxpayer is a majority interest partner.

Limited Partner

ITA
40(3.14)(*a*)

Subsection 40(3.1) of the Act provides that a member of a partnership is considered to realize a capital gain from the disposition, at the end of a fiscal period of the partnership, of the member's interest in the partnership where, at the end of the fiscal period, the member is a limited partner or was, since becoming a partner, a "specified member" of the partnership and the member's adjusted cost base of the interest is negative at that time.

Subsection 40(3.14) of the Act provides an extended definition of "limited partner" for the purpose of determining whether a member's interest in a partnership is subject to the negative adjusted cost base rule in subsection 40(3.1).

Paragraph 40(3.14)(*a*) provides that a member of a partnership is a "limited partner" if, by operation of law governing the partnership agreement, the liability of the member as a member is limited. However, paragraph 40(3.14)(*a*) does not apply in cases where a member's liability is limited by operation of a statutory provision of Canada (or of a province) that limits the member's liability only for the debts, obligations and liabilities of a limited liability partnership (or of any member of the partnership) arising from negligent acts or omissions of another member of the partnership (or of an employee, agent or representative of the partnership) in the course of the partnership business and while the partnership is a limited liability partnership.

The Province of Quebec has amended its legislation concerning partnerships to allow partners to carry on their activities within a limited liability partnership. That legislation refers to the civil law concept of "fault/fautes". Paragraph 40(3.14)(*a*) of the English version does not currently refer to the civil law concept of "fault" and is amended to do so, effective after June 20, 2001.

Deemed Identical Property

ITA
40(3.5)

Subsections 40(3.3) and (3.4) of the Act set out rules under which losses on certain dispositions of non-depreciable capital property are deferred. In some cases, the application of these rules is contingent upon whether one property is identical to the disposed of non-depreciable capital property.

Current paragraph 40(3.5)(*b*) treats a share that is acquired in exchange for another share under any of a number of sections as being identical to that other share. One of the effects of this deeming rule is to ensure that a deferred loss is not inappropriately realized through a transaction under one of those sections.

For example, assume that a taxpayer, who on Day 1 disposed of a share for proceeds that were less than the taxpayer's adjusted cost base of the share, reacquired an identical share on Day 15. Under the loss-deferral rules, the taxpayer's loss on the disposition will be deferred until, generally, neither the taxpayer nor an affiliated person owns such a share. If the taxpayer then exchanged that share for another, under for example an exchange under section 86 of the Act, it would be appropriate to continue to defer recognition of the deferred loss until that substituted share is disposed of. This is accomplished by treating the share acquired on the exchange as identical to the share given up.

However, paragraph 40(3.5)(*b*) can have an inappropriate effect where a taxpayer uses the share-for-share exchange rule in section 85.1 of the Act. Provided certain criteria are satisfied, that section permits a share-for-share exchange to take place on a tax-deferred basis, but it also allows the exchanging shareholder to realize a loss. A shareholder who chooses to do so may find that paragraph 40(3.5)(*b*) forces a deferral of that loss – even though the loss arises from the section 85.1 exchange itself, not from a previous disposition as in the above example.

Paragraph 40(3.5)(*b*) is amended to deem a share that is acquired in exchange for another share under section 85.1 to be identical to that other share only if the loss in respect of the exchanged share is suspended at the time of the exchange by virtue of subsections 40(3.3) and (3.4).

This amendment to paragraph 40(3.5)(*b*) applies to dispositions of property that occur after April 26, 1995, subject to the coming-into-force provisions that originally enacted subsection 40(3.5).

Clause 61

Part Dispositions

ITA
43

Section 43 of the Act provides rules governing the disposition of part of a property. For the purpose of computing a taxpayer's gain or loss from the disposition of a part of a property, a portion of the adjusted cost base must be allocated to the Part on a reasonable basis.

Ecological Gifts

ITA
43(2)

Section 43(2) of the Act applies where the part of a property donated as an ecological gift is a covenant, easement or servitude established under common law, the civil law of the province of Quebec, or the law of other provinces allowing for their establishment. Subsection 43(2) ensures that a portion of the adjusted cost base ("ACB") of the land to which the covenant, easement or servitude relates is allocated to the donated covenant, easement or servitude. For this purpose, the allocation of the ACB of the land to the gift is calculated in proportion to the percentage decrease in the value of the land as a result of the donation.

Subsection 43(2) is amended to clarify its application to "real servitudes" under the *Civil Code of Quebec*. This amendment applies to gifts made after December 20, 2002.

Clause 62

Life Estates in Real Property

ITA
43.1(1)

Section 43.1 of the Act deals with the disposition of a remainder interest in real property by a taxpayer who retains the life estate or estate *pur autre vie* in the property. Subsection 43.1(1) provides that in such a case the taxpayer will be considered to have disposed of the life estate, that has been retained, for proceeds equal to its fair market value at the time the remainder interest is disposed of, and to have reacquired the life estate immediately after that time at the same fair market value.

However, subsection 43.1(1) does not apply in cases where the remainder interest is a gift to a donee described in the definition "total charitable gifts" or "total Crown gifts" in subsection 118.1(1) of the Act. Subsection 43.1(1) is amended to also preclude its application to gifts made to donees described in the definition "total ecological gifts" in subsection 118.1(1). This amendment applies to dispositions of life interests that occur after February 27, 1995, when ecological gifts were first defined for the purposes of section 118.1.

Clause 63

Exchanges of Property

ITA
44(1)(*c*) and (*d*)

Subsection 44(1) of the Act allows a taxpayer who incurs a capital gain on the disposition of certain capital property to elect to defer tax on the gain to the extent that the taxpayer reinvests the proceeds in a replacement property within a certain period of time, namely

- in the case of certain involuntary dispositions, e.g., theft or expropriation, before the end of the second taxation year of the taxpayer that begins after the property was disposed of, or
- in other situations, before the end of the first taxation year of the taxpayer that begins after the property was disposed of.

Paragraphs 44(1)(*c*) and (*d*) are amended to accommodate taxation years that are shorter than 12 months, by providing that the periods for acquiring replacement property end at the later of the times mentioned above and

- in the case of involuntary dispositions, within 24 months after the end of the taxation year in which the property was disposed of, or
- in other situations, within 12 months after the end of the taxation year in which the property was disposed of.

These amendments apply, in the case of involuntary dispositions, in respect of dispositions that occur in taxation years that end on or after December 20, 2000 and, in any other case, in respect of dispositions that occur in taxation years that end on or after December 20, 2001.

Where Subparagraph 44(1)(*e*)(iii) Does Not Apply

ITA
44(7)

Subsection 44(7) of the Act restricts a taxpayer from claiming a capital gains reserve under subparagraph 44(1)(*e*)(iii) where the former property of the taxpayer was disposed of to a non-resident or a corporation that, immediately after the disposition, controlled the taxpayer or was controlled by the taxpayer or by a person or group of persons who controlled the taxpayer. Subsection 44(7) is amended, generally in respect of dispositions of property that occur after December 20, 2002, to provide that the capital gains reserve is also not allowed to a taxpayer where the purchaser of the property is a partnership of which the taxpayer is a majority interest partner.

Clause 64

Capital Gains Deferral – Eligible Small Business Investments

ITA
44.1

Section 44.1 of the Act permits an individual to defer, in certain circumstances, the recognition for income tax purposes of all or a portion of a capital gain arising on a disposition of an eligible small business investment.

Special Rule - Eligible Small Business Corporation Share Exchanges

ITA
44.1(6)

Subsection 44.1(6) of the Act provides rules that apply where an individual exchanges an eligible small business corporation share for new eligible small business corporation share. Subsection 44.1(6) is amended to substitute the reference to subsection 85.1(3) with a reference to subsection 85.1(1) and to add a reference to sections 51 and 86. These changes apply to dispositions of shares made after February 27, 2000.

Special Rule - Active Business Corporation Share Exchanges

ITA
44.1(7)

Subsection 44.1(7) of the Act provides rules that apply where an individual, in the course of a qualifying disposition, disposes of common shares of an active business corporation for consideration consisting only of new common shares of another active business corporation issued to the individual. Subsection 44.1(7) is amended to substitute the reference to subsection 85.1(3) with a reference to subsection 85.1(1) and to add a reference to sections 51 and 86.

These changes apply to dispositions of shares made after February 27, 2000.

Anti-avoidance Rule

ITA
44.1(12)

Subsection 44.1(12) of the Act is an anti-avoidance rule. It applies where an individual or persons related to the individual dispose of shares of a particular corporation (which would normally result in the use of the corporate reorganization rules or a return of paid-up capital of shares of the corporation) and acquire new shares of the particular corporation or a corporation that does not deal at arm's length with the particular corporation principally for the purpose of increasing the total amount of permitted deferrals with respect to qualifying dispositions of the individual and the related persons. Where the rule applies, the permitted deferral with respect to qualifying dispositions of the new shares is deemed to be nil.

Subsection 44.1(12) is amended to apply to the following circumstances:

- when the new shares are issued by a corporation that, at or immediately after the time of issue of the new shares, was a corporation that was not dealing at arm's length with the individual; and
- when the new shares are issued, by a corporation that acquired the old shares (or by another corporation related to that corporation), as part of the transaction or event or series of transactions or events that included that acquisition of the old shares.

This amendment applies to dispositions that occur after February 27, 2004.

Order of Disposition of Shares

ITA
44.1(13)

New subsection 44.1(13) of the Act is a provision that applies when an individual disposes of a share that is identical to other shares owned by the individual. The provision deems, for the purposes of section 44.1, the shares to have been disposed of in the same order in which the individual acquired them.

New subsection 44.1(13) applies to dispositions that occur after December 20, 2002 or, if the individual so elects in writing and files the election with the Minister of National Revenue, to dispositions made after February 27, 2000.

Clause 65

Cost of Certain Property

ITA
52

Section 52 of the Act sets out rules for determining the cost of certain property for the purposes of measuring any gain or loss on its disposition.

Cost of Stock Dividend

ITA
52(3)(*a*)

Subsection 52(3) of the Act establishes the cost of a share received as a stock dividend by a shareholder of a corporation.

If the stock dividend is a dividend under the Act, paragraph 52(3)(*a*) provides that the cost of a stock dividend received by a shareholder is the amount of the dividend. Paragraph 52(3)(*a*) is amended to provide that the cost of a stock dividend to a shareholder that is a corporation does not include the amount, if any, of a dividend that the corporation may deduct under subsection 112(1) of the Act in computing the corporation's taxable income. Essentially, this change is meant to ensure that the cost of a stock dividend does not include an amount that is not taxable income to the recipient corporation.

For related amendments, see the commentary accompanying amended paragraph 53(1)(*b*) and amended definition "capital dividend account" in subsection 89(1) of the Act.

This amendment is consequential to amendments made to the expenditure limitation proposals in new section 143.3, which were first released for consultation on November 17, 2005 (Department of Finance release 2005-080). For further commentary, see the notes to amended paragraph 53(1)(*b*) and the amended definition "capital dividend account" in subsection 89(1).

This amendment applies in respect of amounts received on or after Announcement Date.

Clause 66

Adjustments to Cost Base

ITA
53

Section 53 of the Act sets out rules for determining the adjusted cost base (ACB) of property. Certain adjustments are made under this section. Subsection 53(1) provides for additions in computing the ACB of a property, and subsection 53(2) provides for deductions in computing the ACB of a property.

Adjustments to Cost Base - Deemed Dividend

ITA
53(1)(*b*)

Paragraph 53(1)(*b*) of the Act provides an addition to cost base – where the taxpayer's property is a share of the capital stock of a corporation resident in Canada – equal to the amount of any dividend on the share deemed by the anti-avoidance rule in subsection 84(1) of the Act to have been received by the taxpayer before that time.

Paragraph 53(1)(*b*) is amended to exclude from this addition certain amounts received by a recipient shareholder that is a corporation. The amount excluded from the cost base addition is the portion, if any, of the dividend that the corporate shareholder is permitted to deduct under subsection 112(1) of the Act in computing the corporation's taxable income, and that arose directly or indirectly as a result of a conversion by the corporation that issued the share of its contributed surplus into paid-up capital.

In general, a deemed dividend arises in respect of a corporate conversion of contributed surplus into paid-up capital under subsection 84(1) in cases where the corporation's surplus arose on the issuance by it of shares in consideration for acquiring property that was transferred to it on tax-deferred basis by the transferor (e.g., under section 85). In such cases, the Act provides specific rules that determine the cost of the issued share to the shareholder as well as the paid-up capital of the issuing corporation.

This amendment to paragraph 53(1)(*b*), as well as to paragraph 52(3)(*a*) and to paragraph (*a*) of the definition "capital dividend account" in subsection 89(1) of the Act, addresses circumstances in which increases in a corporation's paid-up capital result in dividends that may be deducted under subsection 112(1) by a recipient corporate shareholder in computing its taxable income.

This amendment also relates to changes made to the expenditure limitation proposals in new section 143.3 of the Act, which were originally released for consultations on November 17, 2005 (Department of Finance release 2005-080). Under the original proposal, the amount by which the fair market value of shares issued by a corporation exceeded the increase in the issuing corporation's paid-up capital could not be treated as an expenditure. One outcome of this approach would have been to preclude certain increases in the adjusted cost base of shares in the issuing corporation where the issuing corporation subsequently increased its paid-up capital by all or a portion of the excess. That proposal has been amended to remove the reference to paid-up capital.

This amendment applies in respect of dividends received on or after Announcement Date.

Adjustments to Cost Base – Partnership Interest

ITA
53(1)(*e*)(iv.1)

Paragraph 53(1)(*e*) of the Act provides for additions to the adjusted cost base of a taxpayer's partnership interest. This paragraph is being amended, by adding new subparagraph (iv.1), effective for payments made in taxation years that end after 2002. New subparagraph 53(1)(*e*)(iv.1) provides for an addition to the taxpayer's adjusted cost base in circumstances where the taxpayer makes a payment to a partnership that is described in subsection 80.2(1). The addition to the adjusted cost base is equal to the amount of the payment that is not deductible in computing the income of the taxpayer.

Adjustments to Cost Base – Interest in a Partnership

ITA
53(2)(*c*)(iii)

Paragraph 53(2)(*c*) of the Act provides deductions from a taxpayer's adjusted cost base ("ACB") of a partnership interest for the purpose of determining its adjusted cost base. Subparagraph 53(2)(*c*)(iii) provides for the deduction from the ACB of a partnership interest of an amount deemed by subsection 110.1(4), 118.1(8) or 127(4.2) of the Act to have been a charitable donation or a political party contribution because of the taxpayer's membership in the partnership.

Subparagraph 53(2)(*c*)(iii) is amended, consequential to the amendment of subsections 110.1(4), 118.1(8) and 127(4.2) and the addition of new subsection 248(31) of the Act, for gifts made after December 20, 2002. Amended subparagraph 53(2)(*c*)(iii) refers to the "eligible amount" of a gift or contribution made because of the taxpayer's membership in the partnership. For additional information about eligible amounts, see the commentary to new subsections 248(31) and (32).

Recomputation of Adjusted Cost Base on Transfers and Deemed Dispositions

ITA
53(4)

Subsection 53(4) of the Act provides rules that affect the computation of the adjusted cost base (ACB) to a taxpayer of any "specified property". As defined in section 54, "specified property" is capital property that is a share, a capital interest in a trust, a partnership interest or an option to acquire any such property. The rules in subsection 53(4) apply where the proceeds of disposition of a specified property are determined under any one of a number of specified provisions in the Act set out in the subsection.

Subsection 53(4) is amended to reflect amendments to a number of those specified provisions; namely, subsections 107(2.1), (4) and (5) of the Act. The references in subsection 53(4) to subsections 107(4) and (5) are removed because those provisions no longer provide for a deemed disposition of trust property. Instead, where subsection 107(4) or (5) applies, a disposition of property will result under paragraph 107(2.1)(*a*). Therefore, the reference to paragraph 107(2.1)(*a*) in subsection 53(4) is sufficient.

This amendment applies after February 27, 2004.

Clause 67

Definitions – Capital Gains and Losses

ITA
54

“superficial loss”

Section 54 of the Act defines various terms for the purposes of the rules relating to taxable capital gains and allowable capital losses. The definition “superficial loss” in section 54 excludes losses on dispositions listed in paragraphs (*c*) to (*h*) of the definition from being superficial losses. As a consequence of the restructuring of section 132.2 of the Act, the reference in paragraph (*c*) of the definition to paragraph 132.2(1)(*f*) is replaced by references to paragraphs 132.2(3)(*a*) and (*c*).

This amendment applies to dispositions that occur after 1998.

Clause 68

Exception to Principal Residence Rules

ITA
54.1(1)

Section 54.1 of the Act sets out an exception to the principal residence rules. Under the rules in section 54 of the Act, if a housing unit is not ordinarily inhabited in a year and is rented out, it can continue to qualify as a principal residence for up to 4 years if the taxpayer so elects under subsection 45(2) of the Act. However, under section 54.1 it can continue to so qualify indefinitely provided that, as a consequence of a relocation of employment of the taxpayer or the taxpayer’s spouse or common-law partner, the property is not ordinarily inhabited by the taxpayer. The recent amendments to add references in the Act to a common-law partner was not made to the English version of section 54.1. The current amendment adds the required reference and corrects that oversight and generally applies to the 2001 and subsequent taxation years. However, it may apply as early as 1998 where common-law partners have jointly elected to be treated as such under the Act, starting in that year.

Clause 69

Tax Avoidance – Dividends

ITA
55

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

Definitions

ITA
55(1)

Subsection 55(1) of the Act sets out a number of definitions for the purpose of section 55.

“qualified person”

The definition “qualified person” is added to subsection 55(1), in conjunction with amendments to clause 55(3.1)(*b*)(i)(B) and paragraph 55(3.2)(*h*) of the Act. As a result of these amendments, a person or partnership may exchange shares of a distributing corporation (“old shares”) for new shares of the distributing corporation and, where the conditions set out in the definition are satisfied, the ownership of the old shares will not affect the tax treatment of dividends received in the course of a reorganization to which paragraph 55(3)(*b*) applies. In general terms, a qualified person is a person or partnership that exchanges all of the old shares that caused that person or partnership to be a specified shareholder of the distributing corporation for consideration consisting solely of shares of a specified class. The definition also provides that the old shares must not be shares of a specified class solely because they were convertible into a class of shares that was not a specified class and that every holder of old shares must participate in the exchange. In addition, a person or partnership will not be a qualified person unless the old shares and the new shares are non-voting in respect of the election of the board of directors (or have voting rights only in the event of failure or default under the terms of the shares).

The addition of the definition “qualified person”, applicable in respect of dividends received after 1999, is made concurrently with the addition of new subsection 55(3.4) of the Act. New subsection 55(3.4) provides that shares of a specified class are not taken into consideration in determining if a person is a specified shareholder for the purpose of subparagraph 55(3.1)(*b*)(i) and for the purpose of paragraph 55(3.2)(*h*), as that paragraph applies for the purpose of subparagraph 55(3.1)(*b*)(iii).

“specified class”

The definition “specified class” is relevant in determining whether an exchange of shares of the capital stock of a distributing corporation for shares of the capital stock of another corporation constitutes a permitted exchange, which, in turn, is relevant for the purpose of paragraph 55(3.1)(*b*) of the Act. The definition “specified class” is also relevant in determining if a redemption of shares by the distributing corporation prior to a distribution is a permitted redemption.

The rules applicable to shares of a specified class are based on the premise that such shares are equivalent to debt. Thus, to ensure that these shares more closely resemble debt, the definition is amended, for shares issued after December 20, 2002, to include a requirement that they be non-voting with respect to the election of the directors of the corporation (or have voting rights only in the event of failure or default under the terms of the shares).

Exempt Dividends

ITA
55(3)(*a*)

Paragraph 55(3)(*a*) provides an exemption from the application of subsection 55(2) of the Act for dividends received in the course of certain related-party transactions. More specifically, paragraph 55(3)(*a*) exempts a dividend received by a corporation if, as part of a transaction or event or a series of transactions or events that includes the receipt of the dividend, there was not, at any particular time, a disposition of property or a significant increase in the total direct interest in a corporation in the circumstances described in subparagraphs 55(3)(*a*)(i) to (v).

ITA
55(3)(*a*)(iii)(B)

Clause 55(3)(*a*)(iii)(B) of the Act describes a disposition, to a person or partnership that was unrelated to the dividend recipient, of property more than 10% of the fair market value of which was derived from shares of the capital stock of the dividend payer. Clause 55(3)(*a*)(iii)(B) is amended, for dividends received after February 21, 1994, to exclude a disposition of property that is a share of the capital stock of the dividend recipient. This amendment ensures that subsection 55(2) of the Act does not apply to the dividend received in the circumstances described in the following example involving the disposition of the shares of the dividend recipient:

> *A corporation (BuyerCo) owns all the shares of another corporation (SubCo). BuyerCo acquires all the shares of a third corporation (Target) in an arm's length transaction for fair market value. Target owns all the shares of two corporations – T1Subco and T2Subco. Target transfers, on a tax-deferred basis under section 85, all the shares of T2SubCo to SubCo in consideration for High/Low Shares of SubCo. SubCo subsequently redeems the High/Low Shares with the result that Target receives a deemed dividend.*

Interpretation for Paragraph 55(3)(*a*)

ITA
55(3.01)(*d*)

Paragraphs 55(3.01)(*a*) to (*e*) of the Act contain various interpretive rules for the purpose of paragraph 55(3)(*a*) of the Act. Paragraph 55(3.01)(*d*) provides that proceeds of disposition are to be determined without reference to the application of paragraph 55(2)(*a*) of the Act. This rule is intended to ensure that proceeds of disposition do not include a dividend or deemed dividend that is subject to subsection 55(2).

Section 93 of the Act permits a corporation resident in Canada to elect to treat the proceeds of disposition of a share of a foreign affiliate as a dividend in certain circumstances. Where such an election is made, the proceeds of disposition of the share are reduced accordingly. The reduction in the proceeds of disposition under section 93 is not intended to affect the application of paragraph 55(3)(*a*). Thus, paragraph 55(3.01)(*d*) is amended, for dividends received after February 21, 1994, to ensure that, for the purpose of paragraph 55(3)(*a*), proceeds of disposition are determined without reference to section 93.

Where Paragraph (3)(*b*) not Applicable

ITA
55(3.1)(*b*)(i)(B)

Paragraph 55(3.1)(*b*) of the Act provides that a dividend received in the course of a reorganization to which paragraph 55(3)(*b*) applies is not excluded from the application of subsection 55(2) of the Act if one of the transactions or events described in paragraph 55(3.1)(*b*) occurs as part of the series of transactions or events that includes the receipt of the dividend. Subparagraph 55(3.1)(*b*)(i) deals with a disposition of property in circumstances described in clauses 55(3.1)(*b*)(i)(A) to (C). Clause 55(3.1)(*b*)(i)(A) describes the type of property (i.e., shares of the distributing or transferee corporation or property whose value is derived from such shares), clause 55(3.1)(*b*)(i)(B) describes the type of vendor (i.e., a specified shareholder of the distributing or transferee corporation) and clause 55(3.1)(*b*)(i)(C) describes the type of acquirer (i.e., a person unrelated to the vendor or a partnership).

Clause 55(3.1)(*b*)(i)(B) is amended, for dividends received after 1999, to exclude a vendor that is a qualified person in relation to the distribution. "Qualified person" is a new expression defined in subsection 55(1) of the Act. For additional information, see the commentary to "qualified person" under subsection 55(1).

Interpretation

ITA
55(3.2)(*h*)

Subsection 55(3.2) of the Act sets out a number of interpretative rules for the purpose of paragraph 55(3.1)(*b*). Paragraph 55(3.2)(*h*) provides that each corporation that is a shareholder and specified shareholder of the distributing corporation at any time during the course of the series of transactions or events that includes a distribution is deemed to be a transferee corporation in relation to the distributing corporation. Paragraph 55(3.2)(*h*) is amended, for dividends received after 1999, to ensure that a "qualified person" as defined in subsection 55(1) is not deemed by this provision to be a transferee corporation in relation to the distributing corporation. For additional information, see the comments in the explanatory note to "qualified person" under subsection 55(1).

Specified Shareholder

ITA
55(3.4)

New subsection 55(3.4) of the Act is added to provide that shares of a specified class are not to be considered in determining whether a person is a specified shareholder for the purposes of subparagraph 55(3.1)(*b*)(i) and paragraph 55(3.2)(*h*) (as it applies for the purpose of subparagraph 55(3.1)(*b*)(iii)) and for the purpose of the definition "qualified person" in subsection 55(1) of the Act. New subsection 55(3.4), which applies to dividends received after 1999, ensures that a person or partnership that would not, but for the ownership of shares of a specified class, be a specified shareholder, will not be subject to the restrictions on the disposition of property described in subparagraph 55(3.1)(*b*)(i) and will not be deemed to be a transferee corporation for the purpose of subparagraph 55(3.1)(*b*)(iii).

Amalgamations – Related Corporations

ITA
55(3.5)

Subsection 55(3.5) of the Act is a new provision that applies for the purposes of paragraphs 55(3.1)(*c*) and (*d*) of the Act. Paragraphs 55(3.1)(*c*) and (*d*) provide that a dividend arising in the course of a reorganization to which paragraph 55(3)(*b*) applies is not exempt from the application of subsection 55(2) of the Act where, as Part of the series of transactions or events that includes the receipt of the dividend, property described therein is acquired by a particular person or partnership. In the case of paragraph 55(3.1)(*c*), the particular person is a person who is not related to the transferee corporation (or ceases to be related to the transferee corporation). In the case of paragraph 55(3.1)(*d*), the particular person is a person who is not related to the distributing corporation (or ceases to be related to the distributing corporation). Property described in paragraph 55(3.1)(*c*) does not include a share of the capital stock of the transferee corporation. Similarly, property described in paragraph 55(3.1)(*d*) does not include a share of the capital stock of the distributing corporation.

New subsection 55(3.5), which applies to dividends received after April 26, 1995, deems an amalgamated corporation to be the same corporation as, and a continuation of, each of its predecessor corporations provided each of the predecessor corporations was related to each other immediately before the amalgamation. As a result, the references in paragraphs 55(3.1)(*c*) and (*d*) to a share of the capital stock of the transferee or distributing corporation include a share of the capital stock of a new corporation formed on an amalgamation where the new corporation is deemed by new subsection 55(3.5) to be the same corporation as, and a continuation of, the transferee or distributing corporation, as the case may be.

Unlisted Shares of Public Corporation Deemed to be Listed

ITA
55(6)

New subsection 55(6) of the Act, which applies to shares issued after April 26, 1995, treats a taxpayer's unlisted shares of a public corporation ("reorganization shares") – that were issued to the taxpayer and redeemed in the course of a tax-deferred reorganization spin-off by the public corporation – to be listed on a prescribed stock exchange. This subsection ensures that the shares are listed on a prescribed stock exchange for the purposes of the clearance certificate rule in subsection 116(1) and the definition "taxable Canadian property" in subsection 248(1) of the Act. However, for this treatment to apply, the following conditions must be met:

- a dividend must be received in the course of the reorganization to which the anti-avoidance rule in subsection 55(2) does not apply because of the exception for certain spin-off butterfly transactions in paragraph 55(3)(*b*);
- in contemplation of the reorganization
  - the reorganization share must be issued to a taxpayer by a public corporation in an exchange for another share of that corporation (the old share) owned by the taxpayer, and
  - the reorganization share must be exchanged by the taxpayer for a new share of another public corporation in an exchange that would be within the meaning of the definition "permitted exchange" in subsection 55(1) if that definition were read without reference to paragraph (*a*) and subparagraph (*b*)(ii) of that definition. In other words, the exchange occurs in contemplation of a public corporation transacting a spin-off reorganization;
- immediately before the exchange, the old share
  - must be listed on a prescribed stock exchange, and
  - must not be taxable Canadian property of the taxpayer; and
- the new share must be listed on a prescribed stock exchange.

Clause 70

Other Sources of Income

ITA
56 to 59.1

Sections 56 to 59.1 of the Act list some of the types of "other income" that are required by paragraph 3(*a*) of the Act to be included in computing the income of a taxpayer for a taxation year from sources of income (these sources are sources other than the taxpayer's income for the year from each office, employment, business and property).

Pension Benefits, Unemployment Insurance Benefits

ITA
56(1)(*a*)

Paragraph 56(1)(*a*) includes in the income of a taxpayer certain amounts received in a taxation year. This paragraph is amended by adding new subparagraph (vii) to include in the income of a taxpayer the amount of a benefit received under the new Quebec Parental Insurance Plan.

This amendment applies to the 2006 and subsequent taxation years and is consequential to the introduction of the new Quebec Parental Insurance Plan on January 1, 2006.

Restrictive Covenant - Bad Debt Recovered

ITA
56(1)(*m*)

New paragraph 56(1)(*m*) of the Act is added to provide that a taxpayer is required to include in income any amount received in a taxation year on account of a debt in respect of which a bad debt deduction was made under new paragraph 60(*f*) of the Act in computing the taxpayer's income for a preceding taxation year. In other words, if a taxpayer makes a bad debt deduction for an amount receivable in respect of a restrictive covenant that was previously included in computing the taxpayer's income because of new section 56.4 (or new subsection 6(3.1)) of the Act, and the taxpayer (or a person not dealing at arm's length with the taxpayer) subsequently receives the amount, the amount so received is to be included in computing the taxpayer's income.

Government Assistance

ITA
56(1)(*r*)

Paragraph 56(1)(*r*) requires that certain amounts received as earnings supplements under government sponsored projects or as financial assistance under programs established by the Canada Employment Insurance Commission or under similar programs established by other government entities or organizations pursuant to agreements with the Commission are to be included in computing the recipient's income.

In recent years, there have been a number of income replacement benefits paid under government programs, usually in response to an unforeseen event, or as bridging benefits payable until another program is implemented. These income replacement benefits are generally paid to individuals who are not eligible for employment insurance (EI) benefits either because they have not worked enough weeks or because they have otherwise exhausted their benefits. However, the benefits paid are generally calculated by reference to the amounts that the individual would receive under the *Employment Insurance Act* if they were eligible for benefits under that Act.

Paragraph 56(1)(*r*) is amended, for the 2003 and subsequent taxation years, to clarify that income replacement benefits received under government assistance programs that are similar to income replacement payments provided under the *Employment Insurance Act* are to be included in computing the recipient's income.

Foreign Retirement Arrangement

ITA
56(12)

Clause 56(1)(*a*)(i)(C.1) of the Act generally requires that payments received by a taxpayer from a foreign retirement arrangement (FRA) be included in computing the taxpayer's income as a superannuation or pension benefit. An FRA is defined in subsection 248(1) of the Act as a prescribed plan or arrangement. Presently, the only arrangements prescribed to be an FRA under Regulation 6803 are individual retirement accounts and annuities (IRAs) established pursuant to section 408(a), (b) or (h) of the United States' *Internal Revenue Code of 1986* (referred to as the "Code").

New subsection 56(12) is introduced to require Canadian residents who hold IRAs to include in income any amount treated under the Code as a distribution from an IRA, to the extent that the amount is required to be included in income for U.S. tax purposes. New subsection 56(12), among other things, gives effect to a proposal that was announced in Finance Canada News Release 1998-129, dated December 18, 1998.

In certain circumstances, the Code provides that an amount is to be treated as a distribution from an IRA even though no distribution has in fact been made. For example, if an individual converts an IRA into a Roth IRA (which is an individual retirement plan established pursuant to section 408A(b) of the Code) simply by amending the plan terms, section 408A(d)(3)(C) of the Code treats the converted amount as a distribution from the regular IRA and, thus, includible in income for U.S. tax purposes. For Canadian tax purposes, however,

the converted amount might not be considered to have been received by the individual and, thus, could escape taxation in Canada. Other circumstances in which the Code treats a distribution to have occurred include borrowing money from an IRA and using an IRA as security for a loan. New subsection 56(12) clarifies that such "deemed" distributions under the Code are to be treated as distributions for Canadian income tax purposes.

More specifically, subsection 56(12) provides that, for the purpose of paragraph 56(1)(*a*), an individual is deemed to have received an amount as a payment from an FRA where, as a result of a transaction, event or circumstance, the income tax laws of the foreign country in which the FRA is established treats the amount as having been distributed from the FRA to the individual. The taxation year in which the individual is deemed to have received the amount is the taxation year that includes the time of the transaction, event or circumstance.

Subsection 56(12) applies to the 1998 and subsequent taxation years except that, in its application to the 1998 to 2001 taxation years, two modifications are made. First, its application is limited to circumstances involving the conversion of an IRA into a Roth IRA. Second, for conversions of IRAs into Roth IRAs that occurred in 1998, the amount and timing of the income inclusion in Canada will match the amount and timing in the U.S. Under the Code, individuals who converted an IRA into a Roth IRA in 1998 were entitled to spread the income inclusion over a four-year period. Subsection 56(12) provides for the same treatment. However, if an individual became resident in Canada after having converted an IRA into a Roth IRA in 1998, the individual will not be subject to taxation in Canada on any amounts relating to the conversion that remain taxable for U.S. tax purposes.

Clause 71

Restrictive Covenants

ITA
56.4

New section 56.4 of the Act sets out rules with respect to amounts that are received or receivable in respect of a restrictive covenant. New section 56.4 reflects changes to the income tax law proposed by the Minister of Finance on October 7, 2003 (release 2003-049) and on July 18, 2005 (Department of Finance release 2005-049). Subject to certain exceptions, new section 56.4 applies to amounts received or receivable by a taxpayer after October 7, 2003, other than to amounts received by the taxpayer before 2005 under a grant of a restrictive covenant made in writing on or before October 7, 2003 between the taxpayer and a person with whom the taxpayer deals at arm's length.

In addition to new section 56.4, there are consequential changes to other provisions of the Act, including section 6 (employment income), subsection 14(5.1) (restrictive covenant amount), section 56 (amounts to be included in income), section 60 (other deductions), section 68 (allocation of consideration) and section 212 (Part XIII tax, non-resident withholding tax) of the Act. The notes accompanying those consequential changes contain additional details about each change.

Definitions

ITA
56.4(1)

New subsection 56.4(1) defines an "eligible corporation", an "eligible interest", a "restrictive covenant", a "goodwill amount", "a permanent establishment" and a "taxpayer" - these definitions are relevant for the purpose of computing the amount, if any, that a taxpayer is required to include in income, or in proceeds of disposition in respect of certain capital property, in respect of amounts received or receivable for a restrictive covenant.

“eligible corporation”

“Eligible corporation” of a taxpayer means a taxable Canadian corporation of which,

- the taxpayer holds, directly or indirectly, shares of the capital stock; and
- taxpayers with whom the taxpayer does not deal at arm’s length (determiend without reference to paragraph 251(5)(*b*)) hold in aggregate, directly or indirectly, less than 10% of the issued share capital (votes and value).

This definition is relevant for the purpose of determining whether new subsections 56.4(5) and (7) apply to provide an exception (for goodwill amounts) from the rule in section 68 that may deem a person who grants a restrictive covenant to receive an amount for the restrictive covenant.

“eligible interest”

“Eligible interest”, of a taxpayer, means capital property of the taxpayer that is

- a partnership interest in a partnership that carries on a business,
- a share of the capital stock of a corporation that carries on a business, or
- a share of the capital stock of a corporation 90% or more of the fair market value of which is attributable to eligible interest in one other corporation.

“goodwill amount”

“Goodwill amount”, of a taxpayer, is an amount that is received or receivable by the taxpayer as consideration for the disposition by the taxpayer of goodwill, and that is required by the description of E in the definition “cumulative eligible capital” in subsection 14(5) to be included in computing the cumulative eligible capital of a business carried on through a permanent establishment located in Canada. This definition is relevant for the purpose of determining whether new subsections 56.4(5) and (7) apply to provide an exception from the rule in section 68 that may deem a person who grants a restrictive covenant to receive an amount for the restrictive covenant.

“permanent establishment”

”Permanent establishment” means a permanent establishment as defined for the purpose of subsetcion 16.1(1) of the Act – see Income Tax Regulation 8201.

“restrictive covenant”

“Restrictive covenant”, of a taxpayer, means an arrangement entered into, an undertaking made, or a waiver of an advantage or right by a taxpayer (other than an arrangement or undertaking for the disposition of the taxpayer’s property or – except where the obligation being satisfied is in respect of a right to property or services that the taxpayer acquired for less than its fair market value – for the satisfaction of an obligation described in section 49.1 that is not a disposition), that affects, in any way whatever, the acquisition or provision of property or services by a taxpayer or by another taxpayer that does not deal at arm’s length with the taxpayer.

“taxpayer”

“Taxpayer” includes a partnership.

Income - Restrictive Covenants

ITA
56.4(2)

New subsection 56.4(2) of the Act provides that there is to be included in computing a taxpayer's income for a taxation year amounts in respect of a restrictive covenant that are received or receivable in the taxation year by the taxpayer (or by another taxpayer with whom the taxpayer does not deal at arm's length). If an amount that is receivable is included because of subsection 56.4(2) in computing a taxpayer's income, or the taxpayer's eligible corporation's income, in a taxation year, the amount will not be included in computing the taxpayer's income in a subsequent year. Subsection 56.4(2) does not apply in certain circumstances described in subsection (3). Also, subsection 56.4(12) provides a clarfying rule in respect of amounts included in income under subsection 56.4(2).

Non-application of Subsection (2)

ITA
56.4(3)

There are three exceptions to the income inclusion rule in subsection 56.4(2) of the Act for amounts received or receivable in respect of a restrictive covenant granted by a taxpayer to a person with whom the taxpayer deals at arm's length (the "purchaser").

First, subsection 56.4(2) does not apply to an amount if section 5 or 6 of the Act applies to include the amount in computing the taxpayer's income for the year or would have so applied if the amount had been received in the taxation year.

Second, subsection 56.4(2) does not apply to an amount that would, if the Act were read without reference to section 56.4, be required by the description of E in the definition "cumulative eligible capital" in subsection 14(5) of the Act to be included in computing the taxpayer's cumulative eligible capital in respect of the business to which the restrictive covenant relates. The taxpayer (and the purchaser if the purchaser carries on business in Canada) is required to elect jointly in prescribed form to apply this exception. The note accompanying new subsection 56.4(14) provides further details with respect to filing an election.

Third, subsection 56.4(2) does not apply to an amount to the extent that the amount is additional "proceeds of disposition" from the disposition of an eligible interest (see the definition "eligible interest" in subsection 56.4(1)) of the taxpayer if certain conditions are met. all of the following conditions must be met:

- The amount must directly relate to the taxpayer's disposition of an eligible interest in the partnership or corporation that carries on the business to which the restrictive covenant relates, or that is an eligible interest by virtue of paragraph (c) of the definition "eligible interest" where the other corporation refered to in that paragraph carries on the business to which the restrictive covenant relates.
- The disposition of the eligible interest must be to the purchaser of the restrictive covenant (or to a person related to that purchaser).
- The amount received or receivable must be consideration for an undertaking by the taxpayer not to provide property or services in competition with the property or services provided by the purchaser (or by a person related to the purchaser).
- The restrictive covenant must be reasonably considered to have been granted to maintain or preserve the value of the eligible interest disposed of to the purchaser.
- In order to be able to add the restrictive covenant amount to the proceeds of disposition of an eligible interest that is a share, there cannot be a redemption, acquisition or cancellation of the share to which subsection 84(3) applies. This requirement applies to a restrictive covenant granted on or after July 18, 2005.

- The disposition of the eligible interest cannot be the subject matter of a rollover under section 85 or subsection 97(2). This requirement applies to restrictive covenants granted on or after Announcement Date.
- The amount is added in the taxpayer's proceeds of disposition of the eligible interest.
- The taxpayer and the purchaser of the restrictive covenant jointly elect in prescribed form to apply this exception. The note accompanying new subsection 56.4(14) provides further details with respect to filing an election.

New paragraph 56.4(3)(*c*) is, however, subject to new susbection 56.4(10) – discussed below in the accompanying note – which provides an anti-avoidance rule that, if applicable, results in the non application of paragraph 56.3(*c*).

Treatment of Purchaser

ITA
56.4(4)

New subsection 56.4(4) of the Act provides rules that apply to an amount paid or payable by a purchaser of a restrictive covenant in certain circumstances.

If the amount paid or payable by a purchaser of a restrictive covenant is employment income of an employee of the purchaser, the amount is considered to be wages paid or payable by the purchaser to the employee.

If an election has been made under paragraph 56.4(3)(*b*) in respect of the amount, the amount is to be considered to be an outlay incurred by the purchaser on account of capital for the purpose of applying the definition "eligible capital expenditure" in subsection 14(5) and not to be an amount paid or payable for all other purposes of the Act.

If an election has been made under paragraph 56.4(3)(*c*) in respect of the amount and the amount relates to the purchaser's acquisition of property that is immediately after the acquisition an eligible interest of the purchaser, the amount is to be included in computing the cost to the purchaser of that interest and is considered not to be an amount paid or payable for all other purposes of the Act.

Non-application of Section 68

ITA
56.4(5)

New subsection 56.4(5) of the Act provides that, in respect of a restrictive covenant granted by a taxpayer, section 68 does not apply to deem consideration to be received or receivable by the taxpayer for the restrictive covenant. There are three cases in which subsection 56.4(5) may apply, which are more fully described below in the notes accompanying new subsections 56.4(6) and (8).

Application of Subsection (5) – If Employee Provides Covenant

ITA
56.4(6)

New subsection 56.4(6) of the Act provides a set of conditions that, if met, result in subsection 56.4(5) applying with respect to a restrictive covenant granted by an individual – with the result that section 68 does not apply to deem consideration to be received or receivable by the individual for granting the restrictive covenant. This is the case if all of the following conditions exist:

- The individual grants a restrictive covenant to another taxpayer with whom the individual deals at arm's length (referred to as the "purchaser").
- The restricted covenant directly relates to the acquisition from one or more other persons (referred to as the "vendors") by the purchaser of an eligible interest in the individual's employer, in a corporation related to that employer or in the business carried on by that employer.

- The individual deals at arm’s length with the employer and with the vendors.
- The restrictive covenant is an undertaking of the individual not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser (or by a person related to the purchaser) in the course of carrying on the business to which the restrictive covenant relates.
- No proceeds are received or receivable by the individual for granting the restrictive covenant.
- The amount that can reasonably be regarded to be consideration for the restrictive covenant is received or receivable only by the vendors.

Application of Subsection (5) – Goodwill Amount

ITA
56.4(7)

New subsection 56.4(7) of the Act provides a set of conditions that, if met, result in subsection 56.4(5) applying with respect to a restrictive covenant granted by a taxpayer – with the result that section 68 does not apply to deem consideration to be received or receivable by a taxpayer for granting the restrictive covenant. This is the case if all of the following conditions exist:

- The restrictive covenant is granted by a taxpayer (in this subsection referred to as the “vendor”) to another taxpayer with whom the vendor deals with at arm’s length (referred to as the “purchaser”).
- The restrictive covenant is an undertaking of the vendor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser (or by a persons related to the purchaser) in the course of carrying on the business to which the restrictive covenant relates.
- No proceeds are received or receivable by the vendor for granting the restrictive covenant.
- The amount that could otherwise be reasonably be regarded as being consideration for the restrictive covenant is
    - included by the vendor in computing a goodwill amount of the vendor, or
    - received or receivable by a corporation that was an eligible corporation of the vendor when the restrictive covenant was granted and is included by that corporation in computing a goodwill amount in respect of the business to which the restrictive covenant relates.
- The restrictive covenant may reasonably be considered to have been granted to maintain or preserve the value of the goodwill acquired by the purchaser.
- The disposition of the goodwill amount cannot be the subject matter of a rollover under section 85 or subsection 97(2).
- No portion of the consideration for the restrictive covenant can be received or receivable by an indiviual with whom the taxpayer does not deal at arm’s length (the non arm’s length individual), or by another taxpayer in which the non arm’s length individual holds, directly or indirectly, an interest. If this condition is not satisfied, the taxpayer may be eligible to elect capital gain treatment under new subsection 56.4(9) in respect of the consideration received by the non arm’s length individual or by the other taxpayer.
- The vendor and the purchaser, or the vendor, the eligible corporation and the purchaser, as the case may be, jointly elect in prescribed form to apply subsection (5) to the restrictive covenant. The note accompanying new subsection 56.4(14) provides further details with respect to filing an election.

In general, if subsection (7) applies to a vendor who grants a restrictive covenant that directly relates to a transfer of goodwill by the vendor, no amount need be allocated to the restrictive covenant under section 68 provided the amount is included in the vendor's goodwill amount. Similarly, this exception may also apply to a vendor's grant of a restrictive covenant if it is the vendor's eligible corporation that transfers goodwill to which the restrictive covenant directly relates, provided the amount is included in computing the vendor corporation's goodwill amount.

Subsection 56.3(7) is, however, subject to new susbection 56.4(11) – discussed below in the accompanying note – which provides an anti-avoidance rule that, if applicable, results in the non application of susbection 56.4(7).

Application of Subsection (5) – Disposition of Property

ITA
56.4(8)

New subsection 56.4(8) of the Act provides a set of conditions that, if met, result in subsection 56.4(5) applying with respect to a restrictive covenant granted by a taxpayer – with the result that section 68 does not apply to deem consideration to be received or receivable by a taxpayer for granting the restrictive covenant. This is the case if all of the following conditions exist:

- The restrictive covenant is granted by a taxpayer (in this subsection referred to as the "vendor") to another taxpayer with whom the vendor deals with at arm's length (referred to as the "purchaser").
- The restrictive covenant is an undertaking of the vendor not to provide, directly or indirectly, property or services in competition with the property or services provided or to be provided by the purchaser (or by a persons related to the purchaser) in the course of carrying on the business to which the restrictive covenant relates.
- It is reasonable to conclude that the restrictive covenant is integral to an agreement in writing
    - Under which the vendor disposes of property (other than shares of a target corporation, which are referred to below), to the purcahser for considertaion that is received or receivable by the vendor. If this is the case, the consideration that can reasonably be regarded as being for the restrictive covenant must be received or receivable by the vendor as consideration for the disposition of the property.
    - Under which shares of a corpoartion (referred to as the "target corporation") are disposed of to the purchaser. If this is the case, while the consideration that can reasonably be regarded as being for the restrictive covenant is not received or receivable by the vendor, no portion of that consideration may be received or receivable by an individual with whom the vendor does not deal at arm's length (the "non arm's length indivdiual") or by another taxpayer in which the non arm's length individual holds, directly or indirectly, an interest. If this condition is not satisfied, the vendor may be eligible to elect capital gain treatment under new subsection 56.4(9) in respect of the consideration received by the non arm's length individual or by the other taxpayer.
- In order to be able to add the restrictive covenant amount to the proceeds of disposition of property, the disposition cannot be a redemption, acquisition or cancellation of the share to which subsection 84(3) applies.
- The disposition of the property cannot be the subject matter of a rollover under section 85 or subsection 97(2).
- The restrictive covenant must be granted to maintain or preserve the fair market value of the vendor's property disposed of to the purchaser, or of the shares of the target corporation disposed of to the purchaser.

New subsetcion 56.4(8) is, however, subject to new susbection 56.4(11) – discussed below in the accompanying note – which provides an anti-avoidance rule that, if applicable, results in the non application of new subsection 56.4(8).

To extent section 68 Applies – Capital Gain Election

ITA
56.4(9)

New subsection 56.4(9) of the Act provides four rules that apply if section 68 applies to a taxpayer's grant of a restrictive covenant solely because all or a portion of the consideration in respect of the restrictive covenant is received or receivable by a non arm's length individual, or by another taxpayer in which the non arm's length indivdiual holds, directly or indirectly, an interest.

First, paragraph 56.4(9)(*a*) provides that section 68 applies solely to the consideration allocatable to the non arm's length individuals and any other taxpayer in which those indiviuals hold, directly or indirectly, an interest.

Second, paragraph 56.4(9)(*b*) provides for a joint election in respect of the allocatable portion. Under the election the allocatable portion is deemed to be received by the taxpayer granting the restrictive covenant as a goodwill amount or as proceeds from the disposition of capital property, based on which provision has not been satisfied so as to render section 68 applicable.

Third, paragraph 56.4(9)(*c*) provides that the consideration deemed under paragraph 56.4(9)(*b*) to be received by the grantor of the restrcitive covenant is considered not to be received by the non arm's length individuals or other taxpayers who make the joint election with the grantor.

Fourth, paragraph 56.4(9)(*d*) clarifies that the purchaser's outlay for the property acquired does not differ from what it would be if subsections 56.4(7) or (8) had applied to all of the consideration paid or payable for the property by the purcahser to the non arm's length indivdials or other taxpayers referred to in paragaraph 56.4(9)(b).

New subsection 56.4(9) is, however, subject to new susbection 56.4(11) – discussed below in the accompanying note – which provides an anti-avoidance rule that, if applicable, results in the non application of new susbection 56.4(9).

Anti-avoidance – Non application of Paragraph 56.4(3)(*c*)

ITA
56.4(10)

New subsection 56.4(10) of the Act provides an anti-avoidance rule that, if applcable, denies an election under paragraph 56.4(3)(*c*) that would have allowed a taxpayer to add to their proceeds of disposition in respect of an eligible interest consideration that can reasonbaly be regarded as being for granting a restrictive covenant. Subsection 56.4(10) applies – and paragraph 56.4(3)(*c*) does not apply – to an amount received by a taxpayer for granting a restrictive covenant if the amount would, if the Act were read without reference to section 56.4 (other than the definitions in subsection 56.4(1)), be included in computing a taxpayer's income from a source that is an office or employment or a business or property.

New subsection 56.4(10) is meant to preclude elections under subsection 56.4(3)(*c*) from applying to consideration in respect of a restrictive covenant that is taxable as ordinary income. For example, paragraph 56.4(3)(*c*) does not apply to consideration receivable by an employee/shareholder that can reasonbaly be regarded under section 68 to be receivable for a covenant to which subsetcion 6(3) applies.

Anti-avoidance – Non Application of Subsections (7) to (9)

ITA
56.4(11)

New subsection 56.4(11) provides an anti-avoidance rule that overrides the exceptions to the applictaion of section 68 that are found in subsections 56.4(7) to (9). Subsection 56.4(11) applies, and as a result section 68 applies, to consideration that can reasonably be regarded as being for a restrictive covenant if one of the results of not applying section 68 to the consideration would be that the consideration would not be included in computing a taxpayer’s income from a source that is an office or employment or a business or property.

New subsection 56.4(11) is meant to preclude subsections (7) to (9) from applying to consideration in respect of a restrictive covenant that is taxable as ordinary income. For example, if a taxpayer were to grant a restrictive covenant to a purcahser in circumstances where another taxpayer disposes of shares to the purcahser, section 68 would apply to the consideration that can reasonably be regarded as being for the restrictive covenant if that consideration would be ordinary income to the other taxpayer – which would be the case, for example, if those shares were held by the other taxpayer on income account. As a result, the taxpayer granting the restrictive covenant would be required to apply susbection 56.4(2) to the consideration deemed by section 68 to have been received by the taxapyer for the covenant when computing income.

Clarification if Subsection (2) Applies – Where Another Person Receives the Amount

ITA
56.4(12)

New subsection 56.4(12) provides that, for greater certainty, if susbection (2) applies to include in computing a taxpayer’s income an amount received or receivable by another taxpayer, that amount is not to be included in computing the income of that other taxpayer.

Clarification if Subsection (5) Applies

ITA
56.4(13)

New subsection 56.4(13) of the Act provides that, if subsection 56.4(5) applies in respect of restrictive covenant granted by a taxpayer (that is, section 68 does not apply to allocate consideration to the taxpayer’s grant of a restrictive covenant), for greater certainty

- The amount referred to in paragraph 56.4(6)(f) – that is, the amount received by the vendors other than the taxpayer – is to be added in computing the amount received or receivable by those vendors as consideration for the disposition of the interest referred to in paragraph 56.4(6)(b).
- The amount referred to in paragraph 56.4(7)(d) – that is, the amount that could reasonably be regarded as consideration for the restrictive covenant that was included in the taxpayer’s income as a goodwill amount, or in the taxpayer’s eligible corporation as a goodwill amount – is to be added in computing the taxpayer’s or the eligible corporation’s cumulative eligible capital, as the case may be.
- The amount referred to in subparagraph (8)(c)(i) and (ii) – in general, the amount that could reasonably be regarded as consideration for the restrictive covenant that was received or receivable as proceeds for the disposed of property – is to be added in computing the consideration receivable for disposing of the property.

Filing of Prescribed Form

ITA
56.4(14)

New subsection 56.4(14) of the Act provides that a joint election in prescribed form filed under paragraph 56.4(3)(*b*) and (*c*) or under paragraphs 56.4(7)(*h*) and (9)(*b*) is to include a copy of the restrictive covenant, and be filed

- if the person who agreed to the restrictive covenant is a person resident in Canada when the restrictive covenant was granted, by that person with the Minister on or before that person's filing due-date for the taxation year that includes the day on which the restrictive covenant was granted, and
- in any other case, with the Minister on or before the day that is six months after the day on which the restrictive covenant was granted.

However, such an election is deemed to be filed on a timely basis if it is filed on or before the day that is 180 days after the day this provision is assented to.

Non-application of Section 42

ITA
56.4(15)

New subsection 56.4(15) of the Act provides that section 42 of the Act does not apply to an amount received or receivable as consideration for a restrictive covenant.

Clause 72

Deductions in Computing Income

ITA
60

Section 60 of the Act provides for various deductions in computing income.

Restrictive Covenant - Bad Debt

ITA
60(*f*)

New paragraph 60(*f*) provides a taxpayer with a deduction for a bad debt in respect of an amount that was receivable on a restrictive covenant and previously included in computing the taxpayer's income because of new section 56.4 (or new subsection 6(3.1)) of the Act. This amendment applies after October 7, 2003.

Quebec Parental Insurance Plan – Self-Employed Premiums

ITA
60(*g*)

New paragraph 60(*g*) provides for a deduction in computing the income of a taxpayer for a taxation year equal to the amount by which the amounts payable by the taxpayer in respect of self-employed earnings for the taxation year as a premium under the new Quebec Parental Insurance Plan exceeds the amounts that would be payable by the taxpayer as an employee's premium under that Plan for the taxation year if those earnings were employment income of the taxpayer.

The other portion of the premiums paid may be claimed as a credit under section 118.7 at the lowest marginal rate.

This amendment applies to the 2006 and subsequent taxation years and is consequential to the introduction of the new Quebec Parental Insurance Plan on January 1, 2006.

Transfers of Refund of Premiums under RRSP

ITA
60(*l*)

In circumstances where an individual has received (or is deemed to have received) certain taxable lump sum amounts from a registered retirement savings plan, a registered retirement income fund or a registered pension plan, paragraph 60(*l*) of the Act allows the individual to claim an offsetting deduction for qualifying payments (not exceeding the amounts so received) made by or on behalf of the individual.

If the individual is a minor and the taxable amount is received as a consequence of the death of a parent or grandparent on whom the minor was financially dependent, a payment made to acquire an immediate annuity payable for a fixed term not exceeding 18 years minus the age of the minor at the time of acquisition is a qualifying payment for the purpose of paragraph 60(*l*). Clause 60(*l*)(ii)(B) requires that the annuitant under the annuity be either the minor or a trust under which the minor is the sole person beneficially interested in amounts payable under the annuity.

Clause 60(*l*)(ii)(B) is amended to require that the minor be the annuitant under the annuity. This is consequential to the introduction of new section 60.011 of the Act which, among other things, allows this requirement in paragraph 60(*l*) to be disregarded, if the annuitant under the term annuity is a trust under which the minor is the sole person beneficially interested in amounts payable under the annuity. Section 60.011 also provides that, in determining if the minor is the sole person beneficially interested in amounts payable under the annuity, any right of a person to receive an amount from the trust only on or after the death of the minor is to be disregarded. Section 60.011 also introduces a requirement, applicable with respect to annuities acquired after 2005, that the annuity provide for commutation on the death of the minor. (Refer to the explanatory notes to new section 60.011 for further details.)

This amendment applies after 1988, which reflects the effective date of the amendment to paragraph 60(*l*) allowing a trust to be named as the annuitant.

Repayment of Pension or Benefits

ITA
60(*n*)

Paragraph 60(*n*) of the Act provides a deduction for repayments of certain benefits included in income. This paragraph is amended, consequential to the introduction of the new Quebec Parental Insurance Plan on January 1, 2006, to provide for a deduction for repayments made under that Plan. This amendment applies to the 2006 and subsequent taxation years.

Clause 73

Application of Paragraph 60(*l*) to Annuity with Trust as Annuitant

ITA
60.011

New section 60.011 of the Act contains special rules relating to the application of paragraph 60(*l*) of the Act.

In circumstances where a taxpayer has received (or is deemed to have received), as a consequence of the death of a spouse or common-law partner or of a parent or a grandparent on whom the taxpayer was financially dependent, certain taxable lump sum amounts from a registered retirement savings plan (RRSP), registered retirement income fund (RRIF) or registered pension plan (RPP), paragraph 60(*l*) allows the taxpayer to claim an offsetting deduction for, among other things, a payment made by or on behalf of the taxpayer to acquire an immediate annuity that satisfies the requirements set out in that paragraph.

A taxpayer is deemed to have received an amount from an RRSP, RRIF or RPP when the amount is paid to the deceased individual's estate and an election in respect of the amount is made jointly by the taxpayer and the deceased individual's legal representative. These deeming provisions are found in subsections 104(27), 146(8.1) and 146.3(6.1) for RPPs, RRSPs and RRIFs respectively.

There are two types of annuity for which an offsetting deduction may be provided under paragraph 60(*l*).

- One type (referred to in these notes as a "life annuity") is an annuity that is payable for the life of the taxpayer (with or without a guaranteed period), or for a fixed term equal to 90 years minus the age of the taxpayer when the annuity is acquired, and under which the taxpayer is the annuitant. Where the taxpayer is a child or grandchild of the deceased individual, this type of annuity is available only if the taxpayer was dependent on the deceased individual by reason of physical or mental infirmity.
- The other type (referred to in these notes as a "minor term annuity") is an annuity payable for a fixed term not exceeding 18 years minus the age of the taxpayer when the annuity is acquired. For this type of annuity, the annuitant may be the taxpayer or a trust under which the taxpayer is the sole person beneficially interested in amounts payable under the annuity.

(Refer to subparagraph 60(*l*)(ii) of the Act for a complete description of the conditions applicable to these annuities.)

New section 60.011 contains provisions dealing with the application of paragraph 60(*l*) to a taxpayer in circumstances where a trust (under which the taxpayer is a beneficiary) is named as the annuitant under an annuity acquired with funds paid out of an RRSP, RRIF or RPP as a consequence of the death of a spouse, common-law partner, parent or grandparent of the taxpayer and included in the taxpayer's income. Section 60.011 incorporates the existing provision of paragraph 60(*l*) that allows a trust to be named the annuitant under a minor term annuity, and it allows a trust to be named the annuitant under a life annuity, if certain conditions are met. It ensures that the taxpayer is not denied the deduction under paragraph 60(*l*) by reason only of the fact that the taxpayer is not the annuitant under the annuity, or the fact that the annuity is acquired by the trust or the estate of the deceased individual rather than "by or on behalf of the taxpayer". The provisions of section 60.011 are explained in greater detail below.

Consequential changes to reflect the introduction of section 60.011 are also made. Specifically, new section 75.2 attributes to the taxpayer amounts payable under such an annuity, with corresponding changes to section 160.2 making the annuitant and the policyholder jointly and severally, or solidarily, liable with the taxpayer for any tax payable in connection with amounts attributed to the taxpayer. Paragraph 148(1)(*e*) is amended to ensure that such annuities are considered to be prescribed annuity contracts and treated in the same manner as other prescribed annuity contracts, the purchase price of which is deductible under paragraph 60(*l*). Lastly, subsection 146(8.1) is amended to ensure that the election provided for thereunder can be made if the taxpayer is "beneficially interested" in the deceased individual's estate (as defined in subsection 248(25) of the Act), but not a beneficiary under the estate (as is currently required under subsection 146(8.1)). See the explanatory notes to these provisions for further details.

New section 60.011 applies after 1988, which reflects the effective date of the amendment to paragraph 60(*l*) allowing a trust to be named as the annuitant under a minor term annuity.

Meaning of "lifetime benefit trust"

ITA
60.011(1)

New subsection 60.011(1) of the Act defines "lifetime benefit trust" with respect to a taxpayer and the estate of a deceased individual for the purposes of new subsection 60.011(2). Subsection 60.011(2) defines "qualifying trust annuity" with respect to a taxpayer and includes, under paragraph 60.011(2)(*a*), a life annuity acquired after 2005 under which the annuitant is, at the time the annuity is acquired, a lifetime benefit trust with respect to the taxpayer and the estate of a deceased individual. Subsection 60.011(2) is relevant for new

subsection 60.011(3), the provisions of which ensure that the eligibility requirements for a taxpayer to deduct the purchase price of an annuity under paragraph 60(*l*) can be met where the annuity is a qualifying trust annuity with respect to the taxpayer.

Subsection 60.011(1) defines a trust to be, at a particular time, a lifetime benefit trust with respect to a taxpayer and the estate of a deceased individual, if two conditions are satisfied. First, the taxpayer must be, immediately before the death of the deceased individual, a mentally infirm spouse or common-law partner of the deceased individual, or a mentally infirm child or grandchild of the deceased individual who was dependent on the deceased individual by reason of that infirmity. Second, the trust must be, at the particular time, a personal trust under which

- no person other than the taxpayer may, during the taxpayer's lifetime, receive or otherwise obtain the use of any of the income of the trust (determined, as required under subsection 108(3) of the Act, without reference to the provisions of the Act) or the capital of the trust,
- the trustees are empowered to pay amounts from the trust to the taxpayer, and
- the trustees are required to consider the needs of the taxpayer (including the comfort, care and maintenance of the taxpayer) in determining whether to pay, or not to pay, an amount to the taxpayer.

Meaning of "qualifying trust annuity"

ITA
60.011(2)

New subsection 60.011(2) of the Act defines "qualifying trust annuity" with respect to a taxpayer. Subsection 60.011(2) is relevant for new subsection 60.011(3), the provisions of which ensure that the eligibility requirements for a taxpayer to deduct the purchase price of an annuity under paragraph 60(*l*) can be met where the annuity is a qualifying trust annuity with respect to the taxpayer. It is also relevant for the purposes of new section 75.2, amended section 160.2 and amended paragraph 148(1)(*e*). Also, subsection 248(1) of the Act is amended to define the expression "qualifying trust annuity" as having the meaning assigned by subsection 60.011(2), thus ensuring that the definition in subsection 60.011(2) applies whenever the expression is used in the Act.

Subsection 60.011(2) defines three types of qualifying trust annuities with respect to a taxpayer, all of which have, as the annuitant thereunder, a trust under which the taxpayer is a beneficiary.

- Paragraph 60.011(2)(*a*) describes a life annuity that is acquired after 2005 and the annuitant under which is a trust that is, at the time of acquisition, a "lifetime benefit trust" with respect to the taxpayer and the estate of a deceased individual. ("Lifetime benefit trust" is defined in new subsection 60.011(1).) If the annuity has a guaranteed period or is for a fixed term, it must provide for commutation in the event of the death of the taxpayer during the guaranteed period or fixed term.
- Paragraph 60.011(2)(*b*) describes a minor term annuity that is acquired after 1988 and the annuitant under which is a trust under which the taxpayer is the sole person beneficially interested in amounts payable under the annuity (determined without regard to any right of a person to receive amounts from the trust only on or after the death of the taxpayer). If the annuity is acquired after 2005, it must provide for commutation in the event of the death of the taxpayer during the fixed term.
- Paragraph 60.011(2)(*c*) describes a life annuity that is acquired after 2000 and the annuitant under which is a trust under which the taxpayer is the sole person beneficially interested in amounts payable under the annuity (determined without regard to any right of a person to receive amounts from the trust only on or after the death of the taxpayer). The taxpayer must be infirm at the time of acquisition, and the annuity must be acquired before 2005 in the case of a physically infirm taxpayer, and before 2006 in the case of a mentally infirm taxpayer.

Application of Paragraph 60(*l*) to "Qualifying Trust Annuity"

ITA
60.011(3)

New subsection 60.011(3) of the Act contains provisions which ensure that the eligibility requirements for a taxpayer to deduct the purchase price of an annuity under paragraph 60(*l*) can be met where the annuity is a "qualifying trust annuity" with respect to the taxpayer (as defined in new subsection 60.011(2)). A distinguishing feature of a qualifying trust annuity with respect to a taxpayer is that the annuitant thereunder is a trust under which the taxpayer is a beneficiary.

Paragraph 60(*l*) requires that the taxpayer claiming a deduction for the purchase price of an annuity be the annuitant under the annuity. New paragraph 60.011(3)(*a*) provides for this requirement to be disregarded in the case of a qualifying trust annuity.

Paragraph 60(*l*) allows a taxpayer to deduct the purchase price of an annuity only if the amount paid to acquire the annuity was paid "by or on behalf of" the taxpayer. If a qualifying trust annuity with respect to a taxpayer is acquired either by the trust that is the annuitant, or by the estate of a deceased individual who was a spouse or common-law partner of the taxpayer or a parent or grandparent of the taxpayer on whom the taxpayer was dependent for support, and the purchase price would not otherwise be considered to have been paid "by or on behalf of the taxpayer", paragraph 60.011(3)(*b*) deems the amount to have been paid on behalf of the taxpayer. For this deeming rule to apply, the taxpayer must so elect in the taxpayer's return of income for the year in which the amount would have been deductible under paragraph 60(*l*) had the purchase price been paid by the taxpayer. (A taxpayer is deemed to have made the election required under paragraph 60.011(3)(*b*) with respect to any amount claimed by the taxpayer as a deduction under paragraph 60(*l*) in computing income for a taxation year ending before 2005.)

Clause 74

Child Care Expenses

ITA
63(2)(*b*)

Section 63 of the Act provides rules concerning the deductibility of child care expenses in computing an individual's income. When more than one taxpayer contributes to the support of an eligible child, the child care expense deduction must generally be claimed by the taxpayer with the lower income for the year. One of the exceptions to this rule is where a medical doctor certifies that the lower-income supporting individual is incapable of caring for children because of that individual's mental or physical infirmity. This amendment clarifies that such a certification has to be in writing.

This amendment applies to certifications made after December 20, 2002.

Clause 75

Exploration and Development Expenses

ITA
66

Section 66 of the Act provides rules in respect of Canadian and foreign exploration and development expenses.

Canadian Exploration Expenses to Flow-Through Shareholder

ITA
66(12.6)

Subsection 66(12.6) of the Act permits a principal-business corporation to renounce Canadian exploration expenses ("CEE") to its flow-through shareholders. To be eligible for flow-through treatment, CEE must be incurred in the 24-month period that begins on the day on which the relevant flow-through share agreement is entered into and must be incurred, or deemed to be incurred, on or before the effective date of the renunciation.

Subsection 66.1(9) of the Act provides for the reclassification of certain Canadian development expenses as CEE ("reclassified CDE"). The reclassified CDE is deemed, for the purposes of the Act, to be incurred by the taxpayer at the time of the reclassification and not at the time the reclassified CDE was actually incurred. To ensure that expenses actually incurred before a flow-through share agreement is entered into cannot be renounced under a flow-through share agreement, subsection 66(12.6) is amended, applicable to renunciations made after December 20, 2002, to exclude reclassified CDE from CEE that may be renounced by a corporation to its flow-through shareholders.

Effect of Renunciation

ITA
66(12.63)

Subsection 66(12.63) of the Act provides that Canadian development expenses renounced under subsection 66(12.62) of the Act by a corporation to a person are considered to have been incurred by that person on the effective date of the renunciation and not to have been incurred by the corporation.

Subsection 66(12.63) currently provides that it is subject to subsections 66(12.691) to (12.702) of the Act. Subsection 66(12.63) is amended, applicable to renunciations made after December 20, 2002, to provide that it is subject to subsections 66(12.69) to (12.702).

Expenses in the First 60 Days of the Year

ITA
66(12.66)

Subsection 66(12.66) of the Act permits a corporation to renounce Canadian exploration expenses ("CEE") and Canadian development expenses ("CDE") to a flow-through shareholder within defined limits. Where the conditions described in subsection 66(12.66) are met, the corporation may renounce in January, February or March of a particular calendar year, effective as of the end of the preceding calendar year, the expenses described in subsection 66(12.66) that the corporation has incurred, or plans to incur, in the particular year. In other words, subsection 66(12.66) provides a "look-back" period of one year.

The French version of subsection 66(12.66) is amended to insert paragraph (*a*.1), which was inadvertently omitted when the subsection was amended by subsection 104(5) of S.C. 1998, c. 19 (formerly Bill C-28), and to correct certain grammatical errors.

The closing words of subsection 66(12.66) currently refer to "the last day of the year". The closing words are amended, effective upon Royal Assent, to clarify that the reference to "the year" means the preceding year referred to in paragraphs 66(12.66)(*a*.1), (*c*) and (*e*).

Definitions

ITA
66(15)

Subsection 66(15) of the Act contains various definitions for the purposes of section 66.

“Canadian resource property”

A “Canadian resource property” is defined to include various interests in oil and gas and mineral resources located in Canada. The cost of a Canadian resource property is either a Canadian oil and gas property expense or a Canadian development expense.

Paragraphs (*d*) and (*e*) of the definition “Canadian resource property” are amended, effective for property acquired after December 20, 2002, to ensure that a rental or royalty described therein will not qualify as a Canadian resource property unless the person paying the rental or royalty has an interest in the property to which the rental or royalty relates and 90% or more of the rental or royalty is payable out of the production from the property.

“flow-through share”

A flow-through share is a share of the capital stock of a principal-business corporation, or a right to such a share, that is issued to a person pursuant to an agreement in writing under which the corporation agrees to incur resource expenses and renounce those expenses to that person.

The definition is amended to exclude a prescribed right from the class of rights that qualifies as flow-through shares. A “prescribed right” is proposed to be defined in new subsections 6202.1(1.1) and (2.1) of the Regulations. This amendment ensures that restrictions on the type of shares that may qualify as flow-through shares, currently found in subsections 6202.1(1) and (2) of the Regulations, also apply to rights to acquire shares.

The amended definition “flow-through share”, which applies to agreements made after December 20, 2002, no longer includes the phrase, “any interest acquired in such a share by a person pursuant to such an agreement”. This phrase is being deleted because the amended definition is sufficiently comprehensive to include any interest in property that qualifies as a flow-through share.

Clause 76

Exploration and Development Expenses – Successor Rules

ITA
66.7

Section 66.7 of the Act provides rules (commonly known as the “successor rules”) in respect of Canadian exploration and development expenses, foreign exploration and development expenses, foreign resource expenses, Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses, respectively. The successor rules establish the parameters within which unused resource expenses of an “original owner” may be deducted by a corporation (“successor corporation”) following an acquisition of resource properties by the successor corporation in circumstances described in section 66.7 of the Act.

Amalgamation – Partnership Property

ITA
66.7(10.1)

Subsection 66.7(10) of the Act treats a corporation as a successor corporation for the purposes of the successor rules in section 66.7 following an acquisition of control (or a change in the tax-exempt status) of the corporation. A rule in paragraph 66.7(10)(*j*) deems the corporation to own its percentage share of the properties owned by a partnership of which it was a member at the time of the acquisition of control. This “look-through rule” permits the deduction of resource expenses against income from, and proceeds of disposition of, the properties owned by the partnership at the time of the acquisition of control. No similar rule currently exists which would allow a new corporation formed on an amalgamation (other than an amalgamation to which subsection 87(2.1) applies) to deduct resource expenses against income from properties owned by a partnership in which a predecessor corporation was a member at the time of the amalgamation.

New subsection 66.7(10.1) of the Act applies to an amalgamation to which subsection 87(1.2) does not apply and provides a look-through rule similar to the rule in paragraph 66.7(10)(*j*) of the Act. It does so by deeming the predecessor corporation to have owned a portion of the properties owned by a partnership immediately before the amalgamation and to have disposed of them to the new corporation formed on the amalgamation. Thus, subsection 66.7(10.1) allows a new corporation, to the extent permitted under subsections 66.7(1) to (5), to deduct from the resource pools of the predecessor corporation, amounts relating to the new corporation's share of the income from properties owned by a partnership in which a predecessor corporation was a member at the time of the amalgamation. New subsection 66.7(10.1) applies to amalgamations that occur after 1996.

Clause 77

Allocation of Amounts in Consideration for Property, Services or Restrictive Covenants

ITA
68

Section 68 of the Act applies where an amount received or receivable can reasonably be regarded as being in Part consideration for the disposition of a particular property of a taxpayer or as being in Part consideration for the provision of particular services. If the amount is in Part consideration for the disposition of property, that Part of the consideration that can reasonably be regarded as being for the disposition of property is deemed to be the proceeds of disposition of that property and, reciprocally, the cost of the property for the acquirer. If the amount is in Part consideration for the provision of particular services, that part of the consideration that can reasonably be regarded as being for the provision of particular services is deemed to be an amount received or receivable by the taxpayer in respect of those services and, reciprocally, an amount paid or payable by the person to whom the services are rendered.

Section 68 is amended to apply in circumstances where consideration received or receivable from a person is in Part for a restrictive covenant (as defined by new subsection 56.4(1) of the Act) granted by a taxpayer. However, exceptions to the application of section 68 to a restrictive covenant are provided in new subsections 56.4(5) to (8). If section 68 applies, the part of the consideration that can reasonably be regarded as being for the restrictive covenant is considered to be an amount that is received or receivable by the taxpayer in respect of the restrictive covenant, and that Part is also considered to be paid or payable to the taxpayer by the person to whom the restrictive covenant was granted.

This change applies on and after February 27, 2004, other than to a taxpayer's grant of a restrictive covenant made in writing before February 27, 2004 between the taxpayer and a person with whom the taxpayer deals at arm's length.

Clause 78

Inadequate Consideration

ITA
69

Section 69 of the Act provides a series of rules dealing primarily with transactions between non-arm's length persons or between persons on non-arm's length terms.

ITA
69(1)(*b*)(iii)

Subsection 69(1) of the Act provides rules that deal with gifts and non-arm's length dispositions of property, except where such transactions are expressly covered by other provisions in the Act that apply to the gift or other disposition. The English version of subparagraph 69(1)(*b*)(iii) is amended to correct an editorial error, by deleting the word "and" at the end of the subparagraph.

This amendment applies to dispositions that occur after December 23, 1998.

Clause 79

Death of a Taxpayer

ITA
70

Section 70 of the Act deals in particular with the transfer or distribution of property at the time of the death of a taxpayer. The French version of subsections 70(3), (6), (6.1), (7), (9), (9.1), (9.2) and (9.3) is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the taxpayer's beneficiaries and not simply set aside for them. Stylistic changes have also been made to these subsections. The amendments will come into force on Royal Assent.

Clause 80

Election by Legal Representative and Transferee re Reserves

ITA
72(2)

Subsection 72(2) of the Act sets out the rules that apply in instances where the property of a deceased taxpayer that has a right to receive any amount is transferred or distributed to the taxpayer's spouse or common-law partner or to a trust. The French version of this subsection is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. Stylistic changes have also been made to the French version of this subsection. The amendments will come into force on Royal Assent.

Clause 81

***Inter Vivos* Transfers by Individuals**

ITA
73

Section 73 of the Act provides rules for the tax treatment of certain *inter vivos* transfers of property.

Capital Cost and Amount Deemed Allowed

ITA
73(2)

Subsection 73(2) of the Act applies where a person ("transferor") transfers depreciable capital property ("DCP") of a prescribed class to a taxpayer ("transferee") in circumstances in which subsection 73(1) applies. If the capital cost to the transferor of the DCP is greater than the amount at which the transferee is deemed under subsection 73(1) to have acquired the DCP, subsection 73(2) ensures that the proper amount of capital cost allowance allowed to the transferor is available for recapture on a subsequent disposition of the DCP by the transferee.

Subsection 73(2) of the Act is amended to replace the reference to paragraph 73(1)(*e*) with a reference to paragraph 73(1)(*b*). Paragraph 73(1)(*b*) now provides for the amount at which the transferee is deemed to acquire property on a transfer to which subsection 73(1) applies.

This amendment applies to transfers that occur after 1999.

Clause 82

Rules Applicable With Respect to "qualifying trust annuity"

ITA
75.2

New section 75.2 of the Act provides attribution rules in respect of a "qualifying trust annuity" with respect to a taxpayer (as defined in new subsection 60.011(2) of the Act), the purchase price of which is deductible by the taxpayer under paragraph 60(*l*). A distinguishing feature of such an annuity is that the annuitant thereunder is a qualifying trust under which the taxpayer is a beneficiary.

Paragraph 75.2(*a*) deems any amount paid out of or under such an annuity at any time after 2005 and before the taxpayer's death to have been received at that time by the taxpayer. The taxpayer is required, by paragraph 56(1)(*d.2*) of the Act, to include this amount in computing the taxpayer's income for the year in which they are deemed to have received the amount, as would be the case if the taxpayer were the annuitant under the annuity. Paragraph 75.2(*a*) also deems the amount not to have been received by any other taxpayer, thus ensuring that the amount, although payable to the trust that is the annuitant under the annuity, is disregarded in determining the trust's income for tax purposes.

Paragraph 75.2(*b*) contains special provisions that apply where a taxpayer who was entitled to a deduction under paragraph 60(*l*) for the purchase price of a qualifying trust annuity with respect to the taxpayer dies after 2005. Subparagraph 75.2(*b*)(i) deems the taxpayer to have received, immediately before death, an amount out of or under the annuity equal to the fair market value of the annuity at that time. This amount is included, also under paragraph 56(1)(*d.2*), in computing the taxpayer's income for the taxation year that includes that time.

Subparagraph 75.2(*b*)(ii) provides for the annuity to be disregarded in determining, for the purpose of subsection 70(5) of the Act, the fair market value of the taxpayer's interest in the trust that is the annuitant under the annuity. Subsection 70(5) deems a deceased taxpayer to have disposed of each capital property owned by the taxpayer immediately before death for proceeds equal to the fair market value of the property at that time. To the extent that subsection 70(5) deems a taxpayer who dies after 2005 to have disposed of an interest in a trust that is the annuitant under a qualifying trust annuity with respect to the taxpayer, subparagraph 75.2(*b*)(ii) ensures – by disregarding the annuity in determining the fair market value of the taxpayer's interest in the trust – that the taxpayer is not subject to double taxation with respect to the annuity.

Clause 83

Reimbursement of Crown Charges

ITA
80.2

Section 80.2 of the Act is a special rule that applies where a taxpayer pays an amount to another person as a reimbursement, contribution or allowance (collectively referred to herein as a "reimbursement") in respect of a Crown charge described in paragraph 12(1)(*o*) or 18(1)(*m*) of the Act. If applicable, section 80.2 deems the taxpayer to have paid an amount described in paragraph 18(1)(*m*) and deems the other person (the "recipient") neither to have received nor to have become entitled to receive the reimbursement. In effect, section 80.2 provides for the transfer of non-deductible Crown charges from the recipient to the taxpayer. Normally, the taxpayer is entitled to a share of the production or the income from production from the property that is subject to the Crown charge. Therefore, although section 80.2 treats the taxpayer as having incurred a non-deductible Crown charge, the taxpayer would be entitled to a deduction under paragraph 20(1)(*v*.1) of the Act (resource allowance) calculated by reference to the taxpayer's income from the property.

Section 80.2 operates to deem the taxpayer making the reimbursement to have paid an amount described in paragraph 18(1)(*m*) only to the extent that the reimbursed Crown charge was either included in the recipient's income or was denied as a deduction in computing the recipient's income. With the phasing out of the income

inclusion in paragraph 12(1)(*o*) and the prohibition against the deduction of Crown charges in paragraph 18(1)(*m*), section 80.2 may no longer apply to the entire amount of a reimbursement. In addition, section 80.2 does not explicitly preclude the recipient from taking a deduction (or reducing an income inclusion) in respect of a reimbursed Crown charge. As well, since section 80.2 does not deem the taxpayer to have made the reimbursement at the time the obligation to pay the Crown charge arose, a taxpayer may seek to increase the percentage of the reimbursement that is not subject to paragraph 18(1)(*m*) by delaying the reimbursement. For these reasons, the total amount deductible in computing the income of the taxpayer and the recipient may, in certain circumstances, exceed the amount that was intended to be deductible.

Accordingly, section 80.2 of the Act is amended:

(*a*) to eliminate any excess deductions that may be available as a result of a reimbursement of a Crown charge;

(*b*) to preclude a taxpayer who makes a reimbursement of a Crown charge from increasing the amount deductible by delaying the time of the reimbursement; and

(*c*) to ensure that a taxpayer who makes a reimbursement of a Crown charge is deemed to have paid an amount described in paragraph 18(1)(*m*) only to the extent that the reimbursed Crown charge can reasonably be considered to relate to the taxpayer’s share of the production, or the income from production, from the property to which the Crown charge relates.

New section 80.2 of the Act applies to reimbursements made after 2001, except that, the rule described in paragraph (*c*) above, applies only to reimbursements made on or after September 17, 2004.

The ability to claim excess deductions in respect of reimbursed Crown charges is eliminated by treating the eligible portion of the reimbursement (in most cases, the full amount of the reimbursement) as a payment described in paragraph 18(1)(*m*) (subsection 80.2(2)) and by reversing the benefit of any deduction in respect of a reimbursed Crown charge claimed by the recipient (subsection 80.2(6)). The eligible portion of the reimbursement is referred to in new section 80.2 as the “eligible portion of the specified amount” (see discussion below under subsections 80.2(11) and (12)). The amount of a reimbursement that exceeds the eligible portion of the specified amount is included in the income of the recipient (subsection 80.2(8)) and, subject to paragraphs 18(1)(*a*) and (*b*), is deductible in computing the income of the taxpayer (subsection 80.2(9)). In addition, new subsection 80.2(3) of the Act precludes a taxpayer from increasing the deductible portion of a reimbursement by delaying the time of the reimbursement. It does this by ensuring that the amount deductible is determined by reference to the time that the reimbursed Crown charge was imposed (*i.e.*, became payable to, or receivable by, the Crown or an emanation of the Crown). It should be noted that new subsection 80.2(3) does not apply to a reimbursement paid to a partnership if the reimbursement meets the conditions described in new subsection 80.2(4) of the Act. These conditions, which are set out in paragraphs 80.2(4)(*a*) to (*d*), are discussed in the commentary to new subsection 80.2(4).

Application

ITA
80.2(1)

New subsection 80.2(1) of the Act provides that subsections 80.2(2) to (13) apply if a taxpayer (either resident in Canada or carrying on business in Canada) pays an amount, under the terms of a contract, that may reasonably be considered to have been received by the recipient as a reimbursement in respect of a Crown charge described by paragraph 12(1)(*o*) or 18(1)(*m*) of the Act. The Crown charge is referred to in new section 80.2 as the “original amount.” By referring to an original amount “described” by paragraphs 12(1)(*o*) or 18(1)(*m*) (and not the amount either included in income or denied as a deduction under these provisions), subsection 80.2(1) ensures that section 80.2 applies to the full amount of the reimbursement. The full amount of the reimbursement is referred to in new section 80.2 as the “specified amount.”

New paragraph 80.2(1)(*b*) of the Act provides that the reimbursed Crown charge must be paid or payable by the recipient or receivable by a person described in paragraph 12(1)(*o*) in a taxation year or fiscal period of the recipient that begins before 2007. As a result, section 80.2 will only apply to a reimbursement if the recipient is subject to restrictions on the deductibility of the reimbursed Crown charge (*i.e.*, the Crown charge is described in paragraph 18(1)(*m*)) or is required to include some portion of the Crown charge in income (*i.e.*, the Crown charge is described in paragraph 12(1)(*o*)).

Rules Relating to Time of Payment

ITA
80.2(2)

New subsection 80.2(2) of the Act provides that if the specified amount is paid in a taxation year of the taxpayer that begins before 2008, the eligible portion of the specified amount is deemed to be an amount described by paragraph 18(1)(*m*). It also provides that, if the specified amount is paid in a taxation year of the taxpayer that begins after 2007, the specified amount is deemed, for the purpose of applying section 80.2 to the taxpayer, to be nil.

For payments made before September 17, 2004, the eligible portion of the specified amount is equal to the specified amount. For reimbursements made on or after September 17, 2004, the eligible portion of the specified amount may be less than the specified amount. The rules for determining the eligible portion of the specified amount are described in the commentary to subsections 80.2(11) and (12).

To accommodate the payment of a reimbursement in a taxation year of the taxpayer that begins after 2006 and before 2008 (the eligible portion of which is deemed to be described by paragraph 18(1)(*m*)), paragraph 18(1)(*m*), which was originally repealed effective for taxation years that begin after 2006, will be repealed for taxation years that begin after 2007. If, however, a reimbursement described in subsection 80.2(1) is delayed to a taxation year of the taxpayer that begins after 2007, the specified amount is deemed, for the purpose of applying section 80.2 to the taxpayer, to be nil and no deduction will be available to the taxpayer in respect of the reimbursement.

Applying Paragraph 18(1)(*m*)

ITA
80.2(3)

To ensure that the taxpayer does not benefit (*i.e.*, increase the percentage of the reimbursement that is deductible in computing income) by delaying the reimbursement of a Crown charge, new subsection 80.2(3) of the Act provides that paragraph 18(1)(*m*) applies as if the reimbursement were made at the time the Crown charge was imposed (*i.e.*, became payable or receivable). If the taxpayer did not exist at the time the Crown charge was imposed (*e.g.*, a new corporation created on an amalgamation), the percentage of the reimbursement that is subject to paragraph 18(1)(*m*) is computed as if the taxpayer were in existence at that time and had a calendar year-end. In either case, the percentage of the reimbursement that is subject to paragraph 18(1)(*m*) and, accordingly, the amount that is not deductible in the taxation year in which the reimbursement is paid, is determined by reference to the percentages described in the transitional rules to the repeal of paragraph 18(1)(*m*), as if the taxpayer paid the reimbursement at the time the reimbursed Crown charge was imposed.

Exception for Certain Partnership Reimbursements

ITA
80.2(4)

New subsection 80.2(4) of the Act provides that subsection 80.2(3) does not apply to certain partnership reimbursements if the conditions, set out in new paragraphs 80.2(4)(*a*) to (*d*), are met. Those conditions require the taxpayer to be a member of the partnership at the end of the particular fiscal period in which the Crown

charge became payable or receivable and require the reimbursement to be paid before the end of the taxation year of the taxpayer in which the particular fiscal period of the partnership ends. The purpose of new subsection 80.2(4) is to permit a member of a partnership to determine the amount deductible in respect of a reimbursed Crown charge by reference to the same taxation year as the profit from the partnership's production (on which the reimbursed Crown charge was imposed) is allocated to the member.

Specified Amount Deemed to be Paid at End of Taxation Year

ITA
80.2(5)

New subsection 80.2(5) of the Act is a special rule that applies to a taxpayer that made a reimbursement payment to a partnership before September 17, 2004 ("initial reimbursement"). If the conditions set out in new subsection 80.2(5) are met, the taxpayer may make a supplemental reimbursement ("top-up reimbursement") that is deemed to have been paid at the end of the taxation year in which the initial reimbursement was made. New subsection 80.2(5) only applies if the taxpayer's share of the original amount in respect of the initial reimbursement is greater than the initial reimbursement (*i.e.*, the taxpayer reimbursed the partnership for less than the taxpayer's share of the Crown charges). In addition, the top-up reimbursement must be paid before 2006 and cannot exceed the difference between the taxpayer's share of the original amount in respect of the initial reimbursement and the initial reimbursement. The rules for determining a taxpayer's share of the original amount in respect of the initial reimbursement are set out in new subsection 80.2(12).

The purpose of new subsection 80.2(5) is to permit a taxpayer to make a retroactive top-up reimbursement if the initial reimbursement was less than the taxpayer's share of the Crown charges. This provision recognizes that: 1) a taxpayer may have made a partial reimbursement prior to September 17, 2004 (the date of the press release announcing the amendments to section 80.2) in the expectation of obtaining a deduction in respect of reimbursed Crown charges that was proportionate to the reduction in the taxpayer's resource allowance; and 2) the deduction anticipated by the taxpayer may have been diminished by new section 80.2. Thus, new subsection 80.2(5) affords the taxpayer the opportunity to correct for unanticipated tax consequences relating to the application of new section 80.2 to the initial reimbursement.

Inclusion in Recipient's Income

ITA
80.2(6)

New subsection 80.2(6) of the Act requires the recipient to include in income, for the taxation year or fiscal period in which the original amount was paid or became payable or receivable, the amount by which the eligible portion of the specified amount exceeds the portion of the original amount that was included in the income of the recipient (if the reimbursement relates to a paragraph 12(1)(*o*) amount) or was not allowed as a deduction (if the reimbursement relates to a paragraph 18(1)(*m*) amount). The purpose of this provision is to offset any reduction in income available to the recipient in respect of a reimbursed Crown charge.

Interpretation – Portion of the Original Amount

ITA
80.2(7)

New subsection 80.2(7) of the Act provides that, in determining the amount included in the income of the recipient under subsection 80.2(6), the portion of the original amount that was included in computing the income of the recipient or that was not deductible in computing the income of the recipient is determined as if the original amount were equal to the eligible portion of the specified amount. For example, assume that, in its taxation year ending on December 31, 2003, a recipient was entitled to a deduction of $500 in respect of $5,000 of Crown charges described in paragraph 18(1)(*m*) (10% of $5,000) and that one-half of the Crown charges ($2,500) were reimbursed in that year. In this case, the recipient would be required to include $250 in its income (10% of $2,500 – the amount deductible by the recipient if the original amount were equal to the

eligible portion of the specified amount). As a further example, assume that the recipient receives a reimbursement of $3,000 after September 17, 2004 in respect of $5,000 of Crown charges incurred in its taxation year ending December 31, 2004. It is further determined that the eligible portion of the specified amount is $2,000. In this case, the recipient would be required to include $500 in its income under this provision (25% of $2,000 – the amount deductible by the recipient if the original amount were equal to the eligible portion of the specified amount). The portion of the reimbursement that exceeds the eligible portion of the specified amount ($1,000) would be included in the recipient's 2004 income under new subsection 80.2(8).

Inclusion in Recipient's Income

ITA
80.2(8)

New subsection 80.2(8) of the Act requires the recipient to include, in computing the recipient's income for its taxation year or fiscal period in which the original amount was paid or became payable or receivable, the amount, if any, by which the specified amount exceeds the eligible portion of the specified amount. The amount included in the income of the recipient under this subsection is equal to the amount that may be deductible by the taxpayer under subsection 80.2(9).

Deduction by Taxpayer

ITA
80.2(9)

New subsection 80.2(9) of the Act provides that the taxpayer may deduct, subject to paragraphs 18(1)(*a*) and (*b*), in computing the taxpayer's income for the taxpayer's taxation year in which the specified amount was paid, the amount, if any, by which the specified amount exceeds the eligible portion of the specified amount. The amount described in this subsection is that portion of a reimbursement that is not treated as a payment described by paragraph 18(1)(*m*).

Specified Amount Deemed Not to be Payable or Receivable

ITA
80.2(10)

New paragraphs 80.2(10)(*a*) and (*b*) of the Act, provide that, except for the purposes of section 80.2 and subparagraph 53(1)(*e*)(iv.1), the taxpayer is deemed not to have paid and not to have been obligated to pay, the specified amount and the recipient is deemed not to have received and not to have been entitled to receive, the specified amount. This subsection ensures that the tax implications of payments described in subsection 80.2(1) are dealt with entirely within section 80.2.

Eligible Portion of a Specified Amount

ITA
80.2(11)

The amount of a reimbursement that is deemed by new subsection 80.2(2) of the Act to be a payment described by paragraph 18(1)(*m*) is the "eligible portion of the specified amount." The eligible portion of the specified amount is defined in paragraph 80.2(11)(*b*), subject to certain exceptions enumerated in paragraph 80.2(11)(*a*), as the taxpayer's share of the original amount. The taxpayer's share of the original amount is described in new subsection 80.2(12).

Paragraph 80.2(11)(*a*) provides that the eligible portion of the specified amount is equal to the specified amount if

(*a*) the specified amount was paid before September 17, 2004;

(*b*) the original amount is a tax imposed under a law of a province on freehold minerals; or

(*c*) the specified amount does not exceed the taxpayer's share the original amount.

The specified amount of a reimbursement, in future, may also be prescribed by regulation, to be equal to the eligible portion of the specified amount.

Taxpayer's Share of Original Amount

ITA
80.2(12)

New subsection 80.2(12) of the Act provides that the taxpayer's share of the original amount is the amount that may reasonably be considered to be the taxpayer's share of the Crown charges in respect of a particular property. More specifically, this subsection provides that the taxpayer's share of the Crown charges may not exceed the total of the amounts described in paragraphs 80.2(12)(*a*) and (*b*) of the Act.

New paragraph 80.2(12)(*a*) of the Act provides that the taxpayer's share of the Crown charges in respect of a property upon which the taxpayer has an overriding royalty (a royalty calculated without reference to the cost of exploration or production) is the proportion of those Crown charges that is equal to the taxpayer's proportionate share of the production from the property.

New paragraph 80.2(12)(*b*) of the Act provides that the taxpayer's share of the Crown charges in respect of a property (excluding any Crown charges that were reimbursed under the terms of an overriding royalty) is equal to the taxpayer's share of the income from the property.

The requirement that the taxpayer be entitled to a share of the production, or the income, from the property to which the reimbursed Crown charge relates is intended to ensure that a reimbursement paid by a taxpayer will be deemed to be an amount described by paragraph 18(1)(*m*) only to the extent that the taxpayer is entitled to an appropriate share of the production, or the income, from the property. This, in turn, is intended to ensure that section 80.2 is not used to separate the Crown charges (through a reimbursement) from the resource profits generated by a particular property for the purpose of increasing the deduction that may be available in respect of the Crown charges.

Reduction in Original Amount for Part XII of the *Income Tax Regulations*

ITA
80.2(13)

New subsection 80.2(13) of the Act clarifies that, in computing the resource profits under Part XII of the Regulations, the Crown charges that were paid or became payable by the recipient, or that were receivable in respect of the recipient, are reduced by the eligible portion of the specified amount. For example, if a recipient had an amount described in paragraph 12(1)(*o*) equal to $1,000 and $700 of this amount was reimbursed (and the $700 did not exceed the eligible portion of the specified amount) in circumstances described in subsection 80.2(1), the recipient would be treated, for the purpose of computing the recipient's resource profits, as having a paragraph 12(1)(*o*) amount equal to $300.

Payment of Tax

In circumstances where a taxpayer or recipient is required to pay any income tax that the taxpayer or recipient would not be so liable but for the amendments to section 80.2, such taxes will be deemed to have been paid on the balance-due day for the relevant year if the balance due date was before September 17, 2004 and the tax is paid to the Receiver General for Canada before March 2005.

Examples

Assume that each of the recipient and the taxpayer is a resident taxable Canadian corporation and that each has a calendar taxation year. The recipient acquires a lease on Crown lands, which gives it the right to explore for and produce oil and natural gas from a particular property. Under the terms of the lease, the recipient is subject to a provincial Crown royalty based on the production from the property. The recipient enters into a contract with the taxpayer under which it sells a royalty interest on the property to the taxpayer equal to 50% of the production from the property free of all costs of development and operation. During each of 2003, 2004 and 2005, the production from the property is $2.4 million, the royalty payable to the taxpayer is $1.2 million and the Crown royalty on the production from the property is $600,000.

Example 1

Assume that the Crown royalty is described in paragraph 18(1)(m) and that, under the terms of the contract, the taxpayer agreed to reimburse the recipient for the portion of the Crown royalty relating to its share of production ($300,000). During 2003, the taxpayer reimburses the recipient on a monthly basis at the same time that the Crown royalty became payable to the provincial government. Although the recipient receives the reimbursement, it claims a deduction in respect of the reimbursed Crown royalty equal to $30,000. In this case, new section 80.2 would apply as follows:

	Recipient (2003)	***Taxpayer (2003)***
80.2(2)		*($30,000)**
80.2(6)	*$30,000*	
Penalty/Interest	*Nil***	*Nil***

**Note that if the taxpayer had claimed a deduction that exceeded $30,000, the "excess" deduction would be disallowed.*
***Assuming that any tax resulting from the application of proposed section 80.2 is paid before March 2005.*

The taxpayer is deemed by subsection 80.2(2) to have paid an amount under paragraph 18(1)(m) equal to the specified amount (the amount of the reimbursement), 90% of which is denied as a deduction in computing the taxpayer's income by paragraph 18(1)(m). In addition, the deduction taken by the recipient in respect of the reimbursed Crown royalty is reversed by subsection 80.2(6). Pursuant to subsection 80.2(13), the recipient would not include in computing its resource profits under Part XII of the Regulations any portion of the Crown royalty that was reimbursed by the taxpayer. Accordingly, for the purpose of computing its resource profits, the recipient would be treated as having a Crown royalty equal to $300,000.

Example 2

Assume that the Crown royalty is described by paragraph 12(1)(o) and that, under the terms of the contract, the taxpayer reimburses the recipient on January 1, 2004 for its share of the Crown royalty that became receivable in 2003. Although the recipient is entitled to the reimbursement, it includes, under paragraph 12(1)(o), only $270,000 in its income in respect of the reimbursed Crown royalties (90% of $300,000). In this case, new section 80.2 would apply as follows:

	Recipient (2003)	***Taxpayer (2004)***
80.2(2)/(3)		*($30,000)**
80.2(6)	*$30,000*	
Penalty/Interest	*Nil***	

**(10% of $300,000). Note that if the taxpayer had claimed a total deduction that exceeded $30,000, the "excess" deduction would be disallowed.*
***Assuming that any tax resulting from the application of proposed section 80.2 is paid before March 2005.*

As in Example 1, the recipient has a $30,000 income inclusion under new subsection 80.2(6). The result is that the total amount included in the income of the recipient in 2003 under paragraph 12(1)(o) and subsection 80.2(6) in respect of the reimbursed Crown royalty is equal to $300,000. In addition, new subsections 80.2(2) and (3) ensure that the entire amount of the reimbursement is an amount described in paragraph 18(1)(m) and that the percentage of the reimbursement that is not deductible by the taxpayer is determined as if the reimbursement were paid at the time the Crown royalty became receivable (i.e., 2003 percentages apply). Pursuant to subsection 80.2(13), the recipient would not include in computing its resource profits under Part XII of the Regulations any portion of the Crown royalty that was reimbursed by the taxpayer. Accordingly, for the purpose of computing its resource profits, the recipient would be treated as having a Crown royalty equal to $300,000.

Example 3

Assume that, under the terms of the contract, the taxpayer reimburses the recipient $400,000 on January 31, 2005 in respect of Crown royalties described in paragraph 12(1)(o), all of which became receivable by the province during 2004. In this situation, the reimbursement exceeds the eligible portion of the specified amount by $100,000. In computing its income for 2004, the recipient includes $300,000 (75% of $400,000) in respect of the reimbursed Crown royalty. Assuming that a deduction by the taxpayer for any portion of the reimbursement would not be denied by either paragraph 18(1)(a) or (b), new section 80.2 would apply as follows:

	Recipient (2004)	***Taxpayer (2005)***
80.2(2)/(3)		*($75,000)**
80.2(6)	*$75,000***	
80.2(8)	*$100,000****	
80.2(9)		*($100,000)*

**The deduction for the eligible portion of the specified amount is based on the percentage that applies in the taxpayer's 2004 taxation year (25% of $300,000).*
***Subsection 80.2(6) requires the recipient to include in its income, the amount by which the eligible portion of the specified amount ($300,000) exceeds the portion of the original amount that was included in the recipient's income ($225,000 or 75% of $300,000).*
****Subsection 80.2(8) requires the recipient to include in income, in the taxation year in which the Crown royalty became receivable, an amount equal to the difference between the specified amount ($400,000) and the eligible portion of the specified amount ($300,000).*

Clause 84

Compensation Payments Deductible by Individuals

ITA
82(1)(*a*)(ii)(B)

Clause 82(1)(*a*)(ii)(B) of the Act allows an individual who has entered into a securities lending arrangement to deduct, to the extent of the individual's dividend income, the dividend compensation payment paid by the individual.

Due to the amendments made to the securities lending arrangement rules in section 260 of the Act, clause 82(1)(*a*)(ii)(B) is amended in two ways. First, it is amended to apply in respect of an individual's specified proportion of a dividend compensation payment made by a partnership of which the individual is a member. Secondly, since new subsection 260(5.1) of the Act now sets out the treatment of dividend compensation payments, the clause is amended to replace the reference to "subsection 260(5)" with a reference to "subsection 260(5.1)".

Whether this amendment applies in respect of a particular securities lending arrangement depends on when the arrangement is made and, in the case of an arrangement made after November 2, 1998 and before December 21, 2002, whether the parties to the arrangement have elected to have the amended definition of "dividend rental arrangement" in subsection 248(1) of the Act apply. The following table shows these alternative results.

	Date Arrangement Was Made			
	Before November 3, 1998	*After November 2, 1998 and before 2002*	*After 2001 and before December 21, 2002*	*After December 20, 2002*
Election made	Election not available. Amendment does not apply	Amendment applies, but read reference to 260(5.1) as a reference to 260(5)	Amendment applies	Election not available. Amendment applies
Election not made	Election not available. Amendment does not apply	Amendment does not apply	Amendment applies, but ignore reference to 260(12)(*b*)	Election not available. Amendment applies

Clause 85

Deemed Dividend

ITA
84(4.1)

Subsection 84(4.1) of the Act treats a payment on a reduction of paid-up capital by a public corporation as a dividend, except where the payment is made by way of a redemption, acquisition or cancellation of a share or in the course of a transaction described in subsection 84(2) or section 86 of the Act.

Subsection 84(4.1) is amended to introduce a new exception. Generally, this exception will apply where the amount paid on a reduction of paid-up capital may reasonably be considered to be a distribution of proceeds of disposition realized from a transaction that did not occur in the ordinary course of the corporation's business and those proceeds were derived from a transaction that occurred no more than 24 months before the return of the paid-up capital.

In the case of a transaction that funds the payment, generally relief from the deemed dividend rule in subsection 84(4.1) will apply if the paid-up capital distribution can be traced to proceeds of disposition realized in connection with a transaction that may reasonably be considered to be derived from a transaction that occurs outside of the ordinary course of the corporation's business. For example, a paid-up capital distribution paid out of proceeds realized on the sale of a business unit of a corporation, where the proceeds were not required for reinvestment, would generally not be considered to be a distribution from amounts realized in the ordinary course of the corporation's business. In general terms, this aspect of the amendment to subsection 84(4.1) is intended to ensure that only a return of corporate capital, as opposed to a distribution of earnings, is subject to the new exception to subsection 84(4.1).

In order to ensure that the proceeds from an extraordinary transaction are not used to fund a stream of regular or periodic distributions, only one return of paid-up capital will be permitted in respect of any particular extraordinary transaction and that return must occur within 24 months of the proceeds being realized. However, this one-time return rule and 24-month limitation will not apply to distributions of paid-up capital made after 1996 and before February 27, 2004.

Clause 86

Transfer of Property to Corporation by Shareholders

ITA
85

Section 85 of the Act provides rules for tax-deferred transfers of certain types of properties by a taxpayer to a taxable Canadian corporation in exchange for shares.

Transfer of Property to a Corporation By Shareholders

ITA
85(1)(*d*.1), (*d*.11) and (*d*.12)

Subsection 85(1) of the Act provides a tax deferral for the transfer of various types of property by a taxpayer to a taxable Canadian corporation for consideration that includes shares of the corporation's capital stock. In general, tax deferral may be achieved if the taxpayer and the corporation jointly elect that the proceeds of disposition of the taxpayer and the eligible capital expenditure of, or cost to, the corporation are deemed to be less than the fair market value of the property transferred.

Paragraph 85(1)(*d*.1) generally reduces, for the corporation that has acquired an eligible capital property (ECP), the gain that would be included in income under paragraph 14(1)(*b*) of the Act on a subsequent disposition of the property. Paragraph 85(1)(*d*.1) adjusts the gain, in order to take into account the 1988 change of the rate of income inclusion and expenditure deductibility from 1/2 to 3/4, by adjusting the calculation of variable Q in the definition "cumulative eligible capital" in subsection 14(5) of the Act. Variable Q generally represents, for the period prior to the taxpayer's "adjustment time", the difference between ECP deductions claimed under paragraph 20(1)(*b*) of the Act and the total of recapture and gains from prior dispositions of eligible capital property by the taxpayer. Paragraph 85(1)(*d*.1) adjusts variable Q only for the purposes of calculating the amount to be included in a corporation's income under paragraph 14(1)(*b*), but not for the purpose of calculating the corporation's cumulative eligible capital balance for other purposes, such as the claiming of ECP deductions. Specifically, the adjustment of variable Q adjusts the value of variables A, B and C in the formula in paragraph 14(1)(*b*). Variables A and B are affected indirectly, since variable Q affects variable F in the calculation of the cumulative eligible capital balance.

Paragraph 85(1)(*d*.1) is amended concurrently with the addition of new paragraph 85(1)(*d*.11) of the Act. New paragraph 85(1)(*d*.11) generally applies to ensure that an amount that would have been recaptured ECP deductions to the taxpayer under subsection 14(1), if the taxpayer had disposed of the eligible capital property for an amount greater than the taxpayer's cumulative eligible capital at the time of the disposition, is subject to recapture in the hands of the corporation upon a subsequent sale of the property. This result is achieved by adding an allocation of the potential recapture to the taxpayer (i.e., variable F of the taxpayer) simultaneously to the corporation's eligible capital expenditures and aggregate ECP deductions (i.e., variables A and F respectively in the definition "cumulative eligible capital" of the corporation). This adjustment applies only for the purpose of calculating the amount to be included in income of the corporation under subsection 14(1) upon the subsequent disposition of eligible capital property. In this regard, variable F of the taxpayer is determined at the beginning of the taxpayer's following taxation year if the taxpayer's taxation year that included the transfer had ended immediately after the disposition time, determined without reference to new paragraph (*d*.12). Variable F of the taxpayer is apportioned to the corporation, by means of the quotient B/C in paragraph 85(1)(*d*.11), in the same proportion as the fair market value of the property transferred is to the fair market values of all such property transferred before that transfer and the fair market value of the total eligible capital property of the taxpayer immediately before the transfer.

Because new paragraph 85(1)(*d*.11) now accommodates variable F of the corporation, paragraph 85(1)(*d*.1) is amended to add 1/2 of the taxpayer's variable Q amount directly to the corporation's variable C amount in paragraph 14(1)(*b*), rather than adjusting variable Q of the corporation (and thus variable F as well). The quotient B/C in paragraph 85(1)(*d*.1) provides that this adjustment to the corporation is in the same proportion as the fair market value of the property transferred at a particular time is to the total of the fair market values of all such property transferred before that transfer and the fair market value of the total eligible capital property of the taxpayer immediately before the transfer.

New variables F and G of paragraph 85(1)(*d*.1) provide that the adjustments under this paragraph, and similar earlier adjustments to the taxpayer under paragraph 88(1)(*c*.1) of the Act, are not lost on a subsequent rollover.

New paragraph 85(1)(*d*.12) of the Act is added, concurrently with new paragraph 85(1)(*d*.11), to ensure that a subsequent disposition of other ECP by the taxpayer does not result in recapture of depreciation under paragraph 14(1)(*a*) when the resulting gain from that disposition should have been taxed at a lower rate under paragraph 14(1)(*b*). This could happen, for instance, if the taxpayer were to defer all of the recapture to the corporation, such that the taxpayer's cumulative eligible capital balance at the end of the taxation year that includes the rollover is nil. In this case, if in the next taxation year the taxpayer were to make another disposition of ECP, paragraph 85(1)(*d*.12) would reduce to nil the amounts that would be determined for the taxpayer by subparagraph 14(1)(*a*) and variable B of paragraph 14(1)(*b*).

These amendments generally apply in respect of dispositions by a corporation that occur after December 20, 2002.

Example of 85(1)(d.1) and (d.11)

Mr. X purchased an eligible capital property in 1984 (when the income inclusion rate for eligible capital property was one half) at a cost of $300,000. This was the first and only eligible capital property held in respect of his business. Mr. X claimed deductions of $40,650 under paragraph 20(1)(b) of the Act before his "adjustment time" (in the case of Mr. X, January 1, 1988), and of $11,482 subsequent to that time. Mr. X now transfers the property to a corporation in circumstances to which subsection 85(1) applies. Immediately before the time of the transfer, the fair market value of the property is $500,000. Mr. X and the corporation agree that the proceeds of disposition to Mr. X will be $203,391, which is 4/3 of the cumulative eligible capital balance of $152,543. The balance is calculated as follows:

Eligible capital expenditure	*$300,000*
Rate applicable in 1984	*50%*
	150,000
Depreciation before 1988	*<40,650>*
Cumulative eligible capital at adjustment time	*109,350*
"C" amount: 3/2 of 109,350	*164,025*
"D" amount: depreciation before 1988	*40,650*
"P" amount: depreciation after 1987	*<11,482>*
"Q" amount: depreciation before 1988	*<40,650>*
Cumulative eligible capital of Mr. X	*$152,543*

Upon the subsequent sale of the property by the corporation for actual proceeds of disposition of $500,000, the amount included in the corporation's income under subsection 14(1) is calculated as follows:

Agreed amount of eligible capital expenditure (4/3 of $152,543)	*$203,391*
Eligible capital expenditure rate	*75%*
"A" amount in cumulative eligible capital balance of corporation	*152,543*

14(1)(a) calculation for corporation:

Proceeds	*$500,000*		
Rate applicable	*75%*		
"E" amount in cumulative eligible capital balance of corporation		*375,000*	
Excess		*222,457*	
"F" for corporation: bumped by 85(1)(d.11) ($40,650 + $11,482)		*52,132*	
14(1)(a) income: lesser of "F" and excess			*$52,132*

14(1)(b) calculation for corporation:

Excess (as above)	*$222,457*	
Less: "B" amount: amount "F", as bumped by 85(1)(d.11)	*<52,132>*	
"C" amount: ½ of "Q" (above), as bumped by 85(1)(d.1)	*<20,325>*	
Net	*150,000*	
Multiply by 2/3	*2/3*	
14(1)(b) income		*$100,000*
Total 14(1) income inclusion to corporation		*$152,132*

Clause 87

Eligible Distribution Not Included in Income

ITA
86.1(2)

Subsection 86.1(2) of the Act defines an "eligible distribution" for the purposes of the tax-deferral that applies with respect to distributions to Canadian resident shareholders of spin-off shares by a foreign corporation. Subsection 86.1(2) is amended in three respects.

First, subparagraph 86.1(2)(*c*)(ii) requires that a taxpayer's original shares be included in a class that is widely held and actively traded on a prescribed stock exchange in the United States at the time of the distribution (section 3201 of the Regulations prescribes certain U.S. stock exchanges). The condition that the share be actively traded on a U.S. stock exchange is amended effective after 1999 to require that the taxpayer's original shares of the foreign corporation be, at the time of the distribution, widely held and

- actively traded on a prescribed stock exchange in the United States, or
- required, under the *Securities Exchange Act of 1934* of the United States, to be registered with the Securities and Exchange Commission (and are so registered).

In general, a class of shares of a U.S. corporation must be registered under the *Securities Exchange Act of 1934* with the Securities and Exchange Commission ("SEC") if more than 500 shareholders own shares of the class, the corporation has more than $10 million in assets and shares of the class will be traded on a national securities exchange. Thus this SEC registration requirement applies if it is expected that the shares will trade on a national securities exchange, with the SEC filing and public disclosure requirements thereafter applying to the corporation regardless of whether any of its issued shares trade in the future on the exchange.

Second, the references in subparagraphs 86.1(2)(*c*)(iii) and 86.1(2)(*e*)(vi) to the *United States Internal Revenue Code* are replaced by "the *Internal Revenue Code of 1986* of the United States, as amended from time to time".

Third, subparagraph 86.1(2)(*e*)(i) is amended consequential to the amendment to subparagraph 86.1(2)(*c*)(ii) described above.

Clause 88

Amalgamations

ITA
87

Section 87 of the Act provides rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation.

Patronage Dividends

ITA
87(2)(*g*.5)

New paragraph 87(2)(*g*.5) of the Act deems a new corporation formed on an amalgamation to be the same corporation as and a continuation of each of the predecessor corporations for the purpose of section 135 of the Act. This paragraph, which applies to amalgamations that occur after 1997, ensures that the rules in section 135 concerning the deduction for and inclusion in income of patronage dividends continue to apply where a cooperative corporation or a customer of a cooperative corporation amalgamates with one or more other corporations between the time a cooperative corporation makes an allocation in proportion to patronage and the time that the patronage dividend is paid. This amendment ensures that payments made under subsection 135(1) by the new corporation in satisfaction of allocations made by a predecessor corporation will be deductible by the new corporation. In addition, new paragraph 87(2)(*g*.5) ensures that the deductibility of an amount paid to a new corporation formed on the amalgamation of the cooperative corporation's customer and another corporation will not be affected by the amalgamation.

Part I.3 and Part VI Tax

ITA
87(2)(*j*.91)

Subsection 88(1) of the Act sets out 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. 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).

Paragraph 87(2)(*j*.91) allows a new corporation, or, in the case of a winding-up under subsection 88(1), a parent corporation, to be considered as a continuation of its predecessors or subsidiary, as the case may be, for the purposes of determining an amount deductible under subsection 181.1(4) or 190.1(3) of the Act. Those provisions relate, respectively, to the deduction from a corporation's tax otherwise payable under Part I.3 of the Act of an amount in respect of its Canadian surtax, and the deduction from a financial institution's tax otherwise payable under Part VI of the Act of an amount in respect of its tax under Part I of the Act.

Paragraph 87(2)(*j*.91) is amended to clarify that it does not affect the fiscal period of, or tax payable by, any corporation for any taxation year that ends prior to an amalgamation, or, by virtue paragraph 88(1)(*e*.2), the commencement of a winding-up under subsection 88(1).

This amendment to paragraph 87(2)(*j*.91) applies to amalgamations that occur, and windings-up that begin, after December 20, 2002.

Subsection 13(4.2) Election

ITA
87(2)(*l*.4)

New paragraph 87(2)(*l*.4) of the Act is added to provide that, for the purposes of the rules in new subsection 13(4.3) and paragraph 20(16.1)(*b*) of the Act in respect of which an election is made under new subsection 13(4.2), the new corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation. This new provision also applies in respect of the winding up of a corporation to which section 88 of the Act applies, as a result of the application of paragraph 88(1)(*e*.2). New paragraph 87(2)(*l*.4) applies to amalgamations that occur, and windings up that begin, after December 20, 2002.

Gift of Predecessor's Property

ITA
87(2)(*m*.2)

New subsection 248(35) of the Act contains rules regarding the value, for tax purposes, of a gift of property acquired within a certain period. New paragraph 87(2)(*m*.2) of the Act provides that the period that would have applied to a predecessor corporation, if the predecessor had made the gift, will continue to apply after it has been wound up into the parent corporation. New paragraph 87(2)(*m*.2) applies in respect of gifts made after December 3, 2003.

Employees Profit Sharing Plan

ITA
87(2)(*r*)

New paragraph 87(2)(*r*) of the Act preserves an election under subsection 144(10) in connection with an employees profit sharing plan that was made by a predecessor corporation before an amalgamation. Paragraph 88(1)(*e*.2) of the Act provides that this rule also applies, with appropriate modifications, for the purposes of the rules relating to the winding-up of a subsidiary corporation into its parent corporation.

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

UI Premium Tax Credit

ITA
87(2)(*mm*)

Paragraph 87(2)(*mm*) of the Act ensures that an amalgamated corporation will be treated as a continuation of, and the same corporation as, each of its predecessor corporations for the purposes of the provisions relating to UI premium tax credit. That paragraph is repealed as a consequence of the repeal of the provisions relating to the UI premium tax credit. For additional information, see the commentary to section 126.1.

This change applies in respect of amalgamations that occur, and to windings-up that begin, after March 20, 2003.

Quebec Credit Unions

ITA
87(2.3)

New subsection 87(2.3) of the Act provides a special rule that applies to an "investment deposit" of a Quebec credit union in another Quebec credit union (the "predecessor corporation"). This rule applies where the credit union's investment deposit in the predecessor corporation is disposed of because of an amalgamation of credit unions that includes the predecessor corporation with that amalgamation being governed by section 689 of the *Act Respecting Financial Services Cooperatives,* R.S.Q., 2001, c. C-67.3. The credit union's investment deposit will, if certain conditions are met, be deemed to be a share of the capital stock of the predecessor corporation having an adjusted cost base and paid up capital equal to the adjusted cost base of the investment deposit to the credit union. The conditions that must be met are that

- immediately before the amalgamation the investment deposit must be an investment deposit (to which section 425 of the *Savings and Credit Unions Act,* R.S.Q., 2001, c. C-4.1 applies) in an investment fund of the predecessor corporation; and
- on the amalgamation the credit union disposes of the investment deposit for consideration that consists solely of shares of the capital stock of the new corporation.

This amendment applies to amalgamations that occur after June 2001.

Flow-Through Shares

ITA
87(4.4)

Subsection 87(4.4) of the Act applies where there is an amalgamation of two or more corporations and a predecessor corporation of the new corporation formed on the amalgamation had entered into a flow-through share agreement. The rules in subsection 87(4.4) generally enable the new corporation to renounce certain resource-related expenses incurred after the amalgamation to a flow-through shareholder.

Paragraph 87(4.4)(*c*) sets out certain conditions that must be satisfied for a new corporation to renounce expenses to a flow-through shareholder of a predecessor corporation. This paragraph is amended, effective for amalgamations that occur after 1997, to delete the unnecessary reference to the definition "flow-through share" in subsection 66(15) of the Act and to ensure that this paragraph is consistent with the amended definition "flow-through share" in subsection 66(15).

Paragraph 87(4.4)(*d*) sets out certain conditions that must be satisfied to qualify for the relief provided in subsection 87(4.4). Subparagraph 87(4.4)(*d*)(i) requires the new corporation to issue a new share to the flow-through share subscriber in consideration for the flow-through share. Current subparagraph 87(4.4)(*d*)(i) does not, however, contemplate the transfer of a flow-through share by the flow-through share subscriber ("original flow-through shareholder") prior to an amalgamation. Consequently, subsection 87(4.4) does not accommodate a renunciation by the new corporation to an original flow-through shareholder of expenses incurred by the new corporation if the original flow-through shareholder transferred those shares to another person. Subparagraph 87(4.4)(*d*)(i) is amended, effective for amalgamations that occur after 1997, to accommodate the issuance of a new share to a person other than the original flow-through shareholder. This amendment ensures that the new corporation may renounce resource expenses incurred after an amalgamation to an original flow-through shareholder on the same basis as if that person had owned the flow-through share at the time of the amalgamation.

Rules Applicable in Respect of Certain Mergers – “Triangular Amalgamations”

ITA
87(9)

Subsection 87(9) of the Act contains rules that apply on a “triangular amalgamation” – an amalgamation in which shares of the parent corporation are issued in exchange for shares of the amalgamating corporations.

New paragraph 87(9)(*a*.21), which is effective for amalgamations that occur after 1997, provides that a share of the parent issued to a shareholder on a triangular amalgamation is considered, for the purpose of paragraph 87(4.4)(*d*), to be a share issued by the new corporation and that a right to acquire a share of the parent issued to a person on a triangular amalgamation is deemed to be in consideration for a right to acquire a share of the new corporation. New paragraph 87(9)(*a*.21) therefore ensures that the requirements in subparagraphs 87(4.4)(*d*)(i) and (ii), that the new corporation issue a share or right to a person, are satisfied. As a result, a new corporation may renounce expenditures to a flow-through shareholder of a predecessor corporation in accordance with a flow-through share agreement concluded before the triangular amalgamation.

Clause 89

Winding-up of a Corporation

ITA
88(1)

Section 88 of the Act deals with the tax consequences arising from the winding-up of a corporation. Subsection 88(1) provides rules that apply where a subsidiary has been wound up into its parent corporation in circumstances where both the parent and the subsidiary are taxable Canadian corporations and the parent owns at least 90% of the issued shares of each class of the capital stock of the subsidiary.

ITA
88(1)(*c*.1)

Subparagraph 88(1)(*a*)(iii) of the Act generally provides that property of a subsidiary corporation is deemed to have been disposed of on its winding-up for proceeds of disposition equal to its cost amount to the subsidiary immediately before the winding-up. Under subparagraph 88(1)(*c*)(ii) of the Act, the cost of such property to the parent corporation is equal to such proceeds of disposition. Paragraph 88(1)(*c*.1) applies similarly in the case of a winding-up as paragraph 85(1)(*d*.1) applies to a rollover of eligible capital property from a shareholder to a corporation. That is, it generally reduces, for the parent that has acquired an eligible capital property, the gain that would be included in income under paragraph 14(1)(*b*) of the Act on a subsequent disposition of the property. This adjustment takes into account the 1988 change of the rate of income inclusion and expenditure deductibility from 1/2 to 3/4, by adjusting the calculation of variable Q in the definition “cumulative eligible capital” in subsection 14(5) of the Act.

Paragraph 88(1)(*c*.1) is renumbered as subparagraph 88(1)(*c*.1)(ii), and is further amended to ensure that the adjustment, or an earlier adjustment to the subsidiary under paragraph 85(1)(*d*.1), is not lost on a subsequent disposition by way of winding-up.

Paragraph 88(1)(*c*.1) is further amended by the addition of new subparagraph (i), which applies similarly to the application of paragraph 85(1)(*d*.11) of the Act to a shareholder in respect of a disposition of an eligible capital property to a corporation. That is, new subparagraph 88(1)(*c*.1)(i) ensures that an amount that would have been recaptured depreciation to the subsidiary under subsection 14(1) of the Act, if the subsidiary had instead disposed of the eligible capital property for fair market value proceeds, is subject to possible recapture in the hands of the parent upon a subsequent sale of the property. Amounts claimed under paragraph 20(1)(*b*) of the Act by the subsidiary after its “adjustment time” (as defined in subsection 14(5) of the Act, i.e., generally the

beginning of the first taxation year of the subsidiary that starts after June 30, 1988) are included in the amount subject to potential recapture, by means of an adjustment to variables A and F in the definition "cumulative eligible capital" in subsection 14(5), as it applies to the subsidiary for the purposes only of calculating any income or gain under subsection 14(1).

New subparagraph 88(1)(*c*.1)(i) also applies to ensure that the adjustment, or an earlier adjustment to the subsidiary under paragraph 85(1)(*d*.11), is not lost on a subsequent disposition by way of winding-up.

For additional information, refer to the commentary to paragraphs 85(1)(*d*.1) and (*d*.11) of the Act.

Amended paragraph 88(1)(*c*.1) generally applies in respect of dispositions by a parent corporation that occur after December 20, 2002.

ITA
88(1)(*c*.3)(vi) and (vii)

Paragraph 88(1)(*c*) of the Act generally provides that the cost to the parent of each property distributed to it on the winding-up of a subsidiary is equal to the subsidiary's proceeds of disposition plus, where the property is a capital property and is not an ineligible property, an amount determined under paragraph 88(1)(*d*) in respect of the property. "Ineligible property" is described in subparagraphs 88(1)(*c*)(iii) to (vi). Pursuant to subparagraph 88(1)(*c*)(vi), ineligible property includes any property distributed to the parent on the winding-up if, as part of the series of transactions or events that includes the winding-up, the parent acquired control of the subsidiary and the property or property acquired in substitution for such property was acquired by a person or persons described in clause 88(1)(*c*)(vi)(B). Property acquired in substitution for property distributed on the winding-up ("substituted property") has its ordinary meaning and an extended meaning found in paragraph 88(1)(*c*.3) of the Act.

Paragraph 88(1)(*c*.3) of the Act provides that substituted property includes property described in subparagraphs 88(1)(*c*.3)(i) and (ii) but excludes property described in subparagraphs 88(1)(*c*.3)(iii) to (v). Subparagraph 88(1)(*c*.3)(i) provides that, for the purpose of clause 88(1)(*c*)(vi)(B), substituted property includes property (other than a "specified property") owned by a person after the acquisition of control of the subsidiary where the fair market value of the property is wholly or partly attributable to property distributed to the parent on the winding-up. Subparagraph 88(1)(*c*.3)(iv) ensures that property that would be substituted property under the ordinary meaning of the term will not be substituted property if it is not owned by the person after the acquisition of control.

Example 1 of the explanatory notes to the introduction of paragraph 88(1)(*c*.3) [see the explanatory notes to S.C. 1998, c.19 (formerly Bill C-28)] describes a scenario under the heading *Safe Income Crystallization* that illustrates the application of subparagraph 88(1)(*c*.3)(iv) to a situation involving a safe income crystallization prior to a takeover. In that example, Sco, a taxable Canadian corporation, owns 15% of Tco, a publicly traded taxable Canadian corporation. Another corporation ("Pco") makes a takeover offer for all the shares of Tco. In anticipation of the sale of the Tco shares, Sco incorporates Newco and transfers, on a tax-deferred basis under section 85 of the Act, all of its Tco shares to Newco in exchange for Newco shares. The adjusted cost base and the paid-up capital of the Newco shares are then increased by the amount equal to the so-called "safe income" attributable to the Tco shares. Immediately thereafter, Sco sells the Newco shares to Pco for cash and Newco is wound up into Pco.

In the example, subparagraph 88(1)(*c*.3)(iv) ensures that the Newco shares are not substituted property since Sco did not own the Newco shares after the acquisition of control of Newco by Pco. However, assuming that Tco is subsequently wound up into Pco, the non-depreciable capital property ("bump property") owned by Tco at the time of the acquisition of control of Tco would be ineligible property since, as part of the series of transactions or events that includes the winding up of Tco, property substituted for the bump property (i.e., the 15% of the Tco shares) would have been acquired by a specified shareholder of Tco (i.e., Newco) and would have been owned by Newco after the acquisition of control of Tco.

New subparagraphs 88(1)(*c*.3)(vi) and (vii) of the Act, which apply to windings-up that begin after 1997, are enacted to ensure that certain shares or debt will not be substituted property even if they are owned by a specified shareholder after the acquisition of control of the subsidiary. Subparagraph 88(1)(*c*.3)(vi) provides that shares or debt of the subsidiary will not be substituted property if such shares or debt are owned by the parent immediately before the winding-up of the subsidiary. Thus, in the example discussed above, the Tco shares, which are owned by Pco immediately before the winding-up of Tco, would not be substituted property.

Subparagraph 88(1)(*c*.3)(vii) provides that a share or debt of a corporation will not be substituted property if the fair market value of the share or debt is not attributable, at any time after the winding-up process begins, to property acquired by the parent on the winding-up. This exemption would apply, for example, if an individual ("Mr. S"), who is a specified shareholder of Tco, incorporates Newco in contemplation of the takeover of Tco and transfers the Tco shares to Newco. Mr. S then transfers the Newco shares to Sco. Immediately after the increase in the adjusted cost base of the shares of Newco (i.e., following the safe income crystallization) Sco sells the Newco shares to Pco. In this scenario, the Sco shares owned by Mr. S after the sale would not be substituted property by reason of new subparagraph 88(1)(*c*.3)(vii).

ITA
88(1)(*c*.4)(i)

Paragraph 88(1)(*c*.4) of the Act defines "specified property" for the purposes of subparagraphs 88(1)(*c*.3)(i) and (v) of the Act. Specified property is excluded from the extended meaning of a substituted property found in subparagraph 88(1)(*c*.3)(i). Subparagraph 88(1)(*c*.4)(i) is amended to include, within the definition "specified property", shares of the parent issued for consideration that consists solely of money. This amendment, which applies to windings-up that begin after 1997, ensures that a specified shareholder that participates in a takeover by acquiring shares of the parent for cash consideration will not be considered to have acquired substituted property within the meaning assigned by subparagraph 88(1)(*c*.3)(i).

ITA
88(1)(*e*.6)

Paragraph 88(1)(*e*.6) of the Act permits a parent corporation to deduct the amount of a subsidiary's charitable gifts, gifts to Her Majesty, gifts to certain cultural institutions and ecological gifts, to the extent that they were not deducted by the subsidiary prior to the time of its winding-up. Paragraph 88(1)(*e*.6) is amended, consequential to the addition of new subsection 248(31) of the Act, to allow the parent to deduct the eligible amount of a gift made after December 20, 2002 that was not deducted by the subsidiary. For additional details, see the commentary to new subsection 248(31).

Winding-up of a Corporation

ITA
88(1.1)(*e*)

Subsection 88(1.1) of the Act allows a parent corporation under certain circumstances to use losses of a subsidiary corporation that has been wound up. Paragraph 88(1.1)(*e*) limits the use that can be made of the former subsidiary's non-capital losses and farm losses where either the parent or the subsidiary has undergone an acquisition of control. In its current form, the paragraph applies these limits regardless of when the acquisition of control took place. This can produce results that are unnecessarily restrictive. If, for example, a newly-acquired corporation is made the parent of an existing subsidiary that has losses, but the subsidiary itself has not undergone an acquisition of control since it incurred those losses, there is no reason for paragraph 88(1.1)(*e*) to limit the use that the parent corporation can make of the subsidiary's losses after the winding-up.

To ensure that it applies more appropriately, paragraph 88(1.1)(*e*) is amended to distinguish between acquisitions of control of the parent corporation and acquisitions of control of the subsidiary. In respect of the parent, the limits imposed by the provision will apply only where a person or group of persons has acquired control after the commencement of the winding-up. In respect of the subsidiary, those limits will continue to apply if control has been acquired at any time.

Amended paragraph 88(1.1)(*e*) applies to windings-up that begin after May 1996.

Clause 90

Taxable Canadian Corporation

ITA
89

Section 89 of the Act defines certain terms that apply to corporations and their shareholders.

Definitions

ITA
89(1)

"capital dividend account"

Clauses (*a*)(i)(A) and (*a*)(ii)(A) of the definition "capital dividend account" are amended to provide that a corporation's capital gain or loss from the disposition of a property is computed for capital dividend account purposes without reference to subparagraph 52(3)(*a)*(ii) and 53(1)(*b*)(ii). In general, this amendment means that no capital dividend election may be made in respect of a corporation's capital gain from disposing of shares to the extent that gain arises because the cost of the shares does not include amounts described in those amended subparagraphs, which are more fully discussed in the commentary accompanying those amendments. Essentially, this amendment ensures that those subparagraphs cannot be used in conjunction with a capital dividend election to convert corporate surplus into capital gains upon which a capital dividend election could be made.

This amendment applies in respect of dispositions that occur on or after Announcement Date.

The French versions of paragraphs (*f*) and (*g*) of the definition "capital dividend account" in subsection 89(1) of the Act are amended to clarify that the amounts described in those paragraphs relate to distributions from a trust. This technical change does not represent a change in policy.

These amendments apply to elections in respect of capital dividends that became payable after 1997.

"taxable Canadian corporation"

Paragraph (*b*) of the definition "taxable Canadian corporation" in subsection 89(1) of the Act is amended to clarify that a farming or fishing insurer to which paragraph 149(1)(*t*) of the Act applies is a taxable Canadian corporation. This amendment applies in respect of taxation years that end after 1999.

Clause 91

Partnerships and their Members

ITA
96

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

Income Allocation to Former Member

ITA
96(1.01)

New subsection 96(1.01) of the Act generally applies to the 1995 and subsequent taxation years. Paragraph 96(1.01)(*a*) deems a taxpayer who is a former member of a partnership to be a member at the end of the fiscal period in which the taxpayer ceased to be a member, for the purpose of allocating partnership income or loss for that period. This new provision clarifies that, although a taxpayer may have ceased to be a member of a partnership before the end of the partnership's fiscal period, an amount of the income or loss of the partnership is allocable to the taxpayer under subsection 96(1) of the Act. The amount so allocated is relevant to certain calculations relating to partnership income or loss, including the calculation of the adjusted cost base of the former member of the partnership immediately before the taxpayer ceased to be member.

New subsection 96(1.01) applies notwithstanding the rule in paragraph 98.1(1)(*d*) of the Act that would otherwise deem a former partnership member with a residual interest not to be a member of the partnership for the purposes of certain provisions of the Act.

New paragraph 96(1.01)(*a*) does not require that partnership income or loss be calculated immediately after a member leaves the partnership. The income or loss allocation, including that of the former member, continues to be calculated after the end of the partnership's fiscal period. In some circumstances the fiscal period of a partnership may end in a taxation year of the former member that is after the taxation year in which the partnership interest was disposed of. It is, therefore, possible that a member will not be required to report a partnership income allocation until the taxation year following that in which a capital gain or loss on the disposition of the partnership interest is required to be reported.

New paragraph 96(1.01)(*b*) clarifies that an income or loss allocation for the "stub period" during which a taxpayer was a member is included in the calculation of the adjusted cost base of the partnership interest at the time the former member disposes of the interest or a residual interest. The income or loss allocation will affect the calculation of a capital loss under paragraph 98.1(1)(*c*) or subsection 100(2) of the Act. Subsection 96(1.01) may ameliorate certain situations where, under the existing provisions of the Act, a former member may have been required to report a capital gain in the year that the person left the partnership, only to be offset by a capital loss in a subsequent year.

Example

Ms. Brown was a partner in XYZ Partnership until June 30. The fiscal period of the partnership ends December 31. The adjusted cost base of her partnership interest on January 1 was Nil. From January to June 30 she withdrew $16,000 in capital.

Just before the end of the partnership's fiscal period, all the partners agree that Ms. Brown's share of income for the period was $20,000. On December 30 she was paid $4,000 in satisfaction of her residual interest.

A summary of Ms. Brown's adjusted cost base is as follows:

	Adjusted Cost Base	
January 1, Year 1:		*Nil*
January 31, Drawings	*$ <16,000>*	*<16,000>*
Retirement of Ms. Brown, June 30		
December 30		
- Share of income for 6 months	*20,000*	*4,000*
- Payout of rights to equity	*4,000*	*Nil*
December 31 - Fiscal period ends		

In the result, Ms. Brown is allocated $20,000 income under subsection 96(1.01). The adjusted cost base of her interest immediately before she retired on June 30 was $4,000 (i.e., $20,000 less $16,000). She is deemed by paragraph 98.1(1)(b) to have disposed of her residual interest on December 31 for proceeds of disposition of $4,000, such that she has no capital gain or loss on the disposition.

Subparagraph 53(1)(*e*)(v) of the Act requires that "rights or things" (referred to in subsection 70(2) of the Act) in respect of the partnership interest of a deceased partner be included in the adjusted cost base of the partnership interest of the deceased. This provision is no longer relevant to income of the partnership to which a partner is entitled at the time of death, since new subsection 96(1.01) applies to the allocation of partnership income for the fiscal period in which the taxpayer dies. However, subparagraph 53(1)(*e*)(v) continues to apply in respect of other rights or things, if any, to which the deceased taxpayer is entitled through the partnership that are required to be included in the income of the deceased taxpayer under subsection 70(2).

Limited Partner

ITA
96(2.4)(*a*)

Subsection 96(2.4) of the Act provides an extended definition of "limited partner" for the purpose of applying the limited partnership at-risk rules in subsection 96(2.2).

Paragraph 96(2.4)(*a*) provides that a member of a partnership is a "limited partner" if, by operation of law governing the partnership agreement, the liability of the member as a member is limited. However, paragraph 96(2.4)(*a*) does not apply in cases where a member's liability is limited by operation of a statutory provision of Canada or of a province that limits the member's liability only for the debts, obligations and liabilities of a limited liability partnership (or of any member of the partnership) arising from negligent acts or omissions of another member of the partnership (or of an employee, agent or representative of the partnership) in the course of the partnership business and while the partnership is a limited liability partnership.

The Province of Quebec has amended its legislation concerning partnerships to allow partners to carry on their activities within a limited liability partnership. That legislation refers to the civil law concept of "fault/fautes". The English version of paragraph 96(2.4)(*a*) does not refer to the civil law concept of "fault" and is amended to do so, effective after June 20, 2001.

Election by Partnership Member for 2000 Taxation Year

ITA
96

The calculation of the capital gains inclusion rate of a taxpayer for the 2000 taxation year takes into account the net capital gains or losses of the taxpayer for the year 2000 other than those allocated by a partnership. It is the inclusion rate of the taxpayer, determined without reference to the allocated partnership gains, that is applied to the taxpayer's share of the partnership gains in determining the taxable capital gains of the taxpayer derived from the partnership capital gains. As a result, taxpayers with different inclusion rates report different amounts of taxable capital gains in respect of capital gains allocated to the taxpayer by a partnership.

Subclause 91(5) of the *Income Tax Amendment Act, 2006* introduces a special transitional rule under which members of a partnership may elect to treat capital gains and losses allocated to them by a partnership as their own capital gains and losses for the purpose of calculating the taxpayer's capital gains inclusion rate for the year 2000. The gains and losses will be considered to have been realized by the taxpayer on the day on which the fiscal period of the partnership ends.

If a taxpayer so elects, subsection 96(1.7) of the Act will not apply. The taxpayer will be deemed to have realized (on the day on which the fiscal period of the partnership ends in the taxpayer's 2000 taxation year) a capital gain, a capital loss or a business investment loss in respect of the partnership equal to the amount of the taxable capital gain, the allowable capital loss or the allowable business investment loss, as the case may be, of the partnership allocated to the taxpayer, multiplied by the reciprocal of the fraction in paragraph 38(*a*) of the Act that applied to the partnership for the particular fiscal period. Where the inclusion rate for the partnership cannot be determined, the rules in subsection 96(1.7) apply to determine the inclusion rate of the partnership. This capital gain, capital loss or business investment loss is deemed to be a capital gain, capital loss or business investment loss, as the case may be, of the taxpayer from a disposition of a capital property on the day that the particular fiscal period ends.

Clause 92

Fiscal Period of Terminated Partnership

ITA
99(1)

Subsection 99(1) of the Act provides that, generally, a fiscal period of a partnership is considered to end immediately before the particular time that the partnership ceases to exist. In order to accommodate the calculation of adjusted cost base immediately before the particular time, under section 53 of the Act, subsection 99(1) is amended to provide that fiscal period of a partnership is considered to end immediately before the time that is immediately before the particular time. This amendment applies on Royal Assent.

Clause 93

Replacement of Partnership Capital

ITA
100(5)

Section 100 of the Act contains rules relevant to the calculation of capital gains and losses in respect of an interest in a partnership. There may be circumstances under which a former member of a partnership or an heir of a deceased member is required to pay an amount to the partnership to cover a deficit in the former member's equity account. Such a situation could arise, for instance, where the partnership has a net loss for the partnership's fiscal period in which the taxpayer ceased to be a member. The former member may have been deemed to have realized a capital gain under subsection 100(2) of the Act upon disposition of the partnership interest, if the former member had at that time a "negative" adjusted cost base under section 54 of the Act (if such a negative balance were allowed under that section).

New subsection 100(5) of the Act, which generally applies to the 1995 and subsequent taxation years, deems a taxpayer to have a capital loss from the payment by the taxpayer of an amount after the time of disposition of the partnership interest, if that amount would have been a capital contribution to the partnership if the taxpayer had still been a member at the time of the payment. The loss is available to the former member or to an heir who has been deemed by subsection 100(3) of the Act to have acquired a right to acquire partnership property.

Example

Mr. Green was a partner in XYZ Partnership until June 30. The fiscal period end of the partnership was December 31. The adjusted cost base of his partnership interest on January 1 was Nil. From January to June 30 he withdrew $16,000 in capital.

Shortly after the fiscal period end, all the partners agree that Mr. Green's share of the partnership loss for the period was $20,000. During the following year he paid $36,000 owing by him to the partnership in satisfaction of his obligation.

A summary of Mr. Green's adjusted cost base is as follows:

	Adjusted Cost Base	
January 1, Year 1:		*Nil*
January 31, Drawings	*$ <16,000>*	*<16,000>*
Retirement of Mr. Green, June 30		
December 31, Year 1,		
Share of loss for 6 months	*<20,000>*	*<36,000>*
March 31 - Repayment of		
partnership capital	*36,000*	*Nil*

Mr. Green is entitled to claim a partnership loss of $20,000 for the taxation year in which he retired ("Year 1"). He had a $36,000 "negative" adjusted cost base for his partnership interest as at the time that he left the partnership, giving rise to a deemed capital gain under subsection 100(2) of the Act for Year 1. However, he will be allowed a $36,000 capital loss under subsection 100(5) for the taxation year in which he repaid the deficit.

Clause 94

Trusts and their Beneficiaries

ITA
104

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

Restricted Meaning of "beneficiary"

ITA
104(1.1)

Subsection 104(1.1) of the Act applies for the purpose of identifying beneficiaries under a trust for the purposes of subsection 104(1), subparagraph 73(1.02)(*b*)(ii) and paragraphs 104(4)(*a*.4) and 107.4(1)(*e*) of the Act.

Subsection 104(1.1) is amended to clarify that it applies notwithstanding subsection 248(25) of the Act. Subsection 248(25) of the Act describes, for other purposes of the Act, the circumstances in which a person or partnership is considered to be "beneficially interested" in a trust.

This amendment applies to the 1998 and subsequent taxation years.

Deemed Disposition and Election

ITA
104(4) and (5.3)

Paragraphs 104(4)(*a*.2) and (5.3)(*b*.1) of the Act deal with cases where a trust distributes property to a beneficiary. The French version of these paragraphs is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

Designation in Respect of Taxable Dividends

ITA
104(19)

Subsection 104(19) of the Act permits a trust to designate a taxable dividend received by it in a taxation year on the share of a taxable Canadian corporation. Where the designation is made in respect of a beneficiary under the trust, the dividend is treated, for the purposes of the Act (other than Part XIII), as a taxable dividend received by the beneficiary from the corporation, and is treated, for the purposes of the dividend gross-up in paragraph 82(1)(*b*) and stop-loss rules in paragraphs 107(1)(*c*) and (*d*) and section 112, as not having been received by the trust.

Subsection 104(19) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of a taxable dividend received by the trust in a particular taxation year of the trust, on a share of the capital stock of a taxable Canadian corporation, the portion of the dividend in respect of which the designation is made is

- for the purposes of paragraphs 82(1)(*b*) and 107(1)(*c*) and (*d*) and section 112, deemed not to have been received by the trust, and
- for the purposes of the Act other than Part XIII, deemed to be a taxable dividend on the share received by the taxpayer in the taxpayer's taxation year in which the particular taxation year of the trust ends.

These deeming rules do not apply, however, unless a number of conditions are met. One of these conditions – that a designated amount not be made in respect of more than one beneficiary under the trust – is replaced with a new requirement that the total of all amounts designated by the trust under subsection 104(19) for the particular taxation year of the trust not exceed the total of all amounts each of which is the amount of a taxable dividend received by the trust in the particular taxation year on a share of the capital stock of a taxable Canadian corporation.

The deeming rules under subsection 104(19) apply, in respect of a beneficiary under the trust, only to the portion of the amount, designated under that subsection, that may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or (14) or section 105, as the case may be, was included in computing the income for a particular taxation year of a beneficiary under the trust. This condition is also amended and now provides that the portion of a taxable dividend designated by a trust is deemed to be a taxable dividend of a taxpayer who is a beneficiary of the trust (and not to be a dividend received by the trust) only if an amount equal to the amount of the designated portion may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust) to be part of the amount that, because of paragraph 104(13)(*a*) or subsection 104(14) or section 105, was included in computing the income of that taxpayer (*i.e.*, the taxpayer in respect of whom the amount is designated).

The amended reference in the above rule to paragraph 104(13)(*a*), instead of subsection 104(13), applies to taxation years that end after JULY 18, 2005. This change clarifies that the deeming rules do not apply to taxable dividends received by a trust governed by an employee benefit plan and paid to an employer under the plan. This is intended to ensure the appropriate characterization of such amounts for purposes of the rules relating to employee benefit plans. For taxation years that end after February 27, 2004 and on or before JULY 18, 2005, the referenced provision is subsection 104(13).

Except as noted above, these amendments apply to taxation years that end after February 27, 2004.

Designation in Respect of Taxable Capital Gains

ITA
104(21)

Subsection 104(21) of the Act permits a trust to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains. Where the designation is made, the amount designated is deemed, for the purposes of sections 3 and 111 (except as they apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under section 110.6 and subject to paragraph 132(5.1)(*b*)), to be a taxable capital gain for the year of the beneficiary from the disposition of capital property.

Subsection 104(21) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of its net taxable capital gains for a particular taxation year of the trust, the designated amount is deemed to be a taxable capital gain, for the taxation year of the taxpayer in which the particular taxation year ends, from the disposition by the taxpayer of capital property.

The deeming rule does not apply, however, unless a number of conditions are met. One of these conditions – that a designated amount not be made in respect of more than one beneficiary under the trust – is replaced with a new requirement that the total amounts designated under subsection 104(21) by the trust for a particular taxation year of the trust not exceed the trust's net taxable capital gains for the particular taxation year.

The deeming rule under subsection 104(21) applies, in respect of a beneficiary under a trust, only to the portion of the net taxable gains of the trust that may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or 104(14) or section 105, as the case may be, was included in computing the income of a beneficiary under the trust. This condition is also amended and now provides that an amount, in respect of the trust's net taxable capital gains, is deemed to be a taxable capital gain from the disposition by a taxpayer of capital property only if the amount may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust) to be part of the amount that, because of paragraph 104(13)(*a*) or subsection 104(14) or section 105, was included in computing the income of that taxpayer (*i.e.*, the taxpayer in respect of whom the amount is designated).

The amended reference in the above rule to paragraph 104(13)(*a*), instead of subsection 104(13), applies to taxation years that end after JULY 18, 2005. This change clarifies that the deeming rule does not apply to employee benefit plan trusts and ensures consistency with amended subsection 104(19). For taxation years that end after February 27, 2004 and on or before JULY 18, 2005, the referenced provision is subsection 104(13).

Subsection 104(21) is also amended to clarify that the deeming rule does not apply to a designation made by a trust, for a particular taxation year of the trust, in respect of a non-resident beneficiary, unless the trust is a mutual fund trust throughout the particular taxation year.

Except as provided above, these amendments apply to taxation years that end after February 27, 2004.

Deemed Gains - Subsection (21.4) Applies

ITA
104(21.6)

Subsection 104(21.6) of the Act provides rules for the determination of the inclusion rate to be used by a taxpayer for capital gains realized by a trust in 2000. This subsection applies to a taxpayer who has a taxation year that begins after October 17, 2000 and who is deemed by subsection 104(21.4) to have capital gains from the disposition of capital property in the year in respect of dispositions of property by a trust of which the taxpayer is a beneficiary.

This subsection ensures that the inclusion rate for capital gains realized on property disposed of by a trust prior to February 27, 2000 is 3/4, and is 2/3 in respect of property disposed of by a trust after February 27, 2000 and before October 18, 2000.

Subsection 104(21.6) is amended by adding new paragraph (*f*.1) to ensure that where the deemed gains are in respect of capital gains from dispositions of property by the trust that occurred after February 27, 2000 and before October 17, 2000 in circumstances where the taxation year of the taxpayer began after February 27, 2000 and ended after October 17, 2000, the gains are deemed to be a capital gain of the taxpayer from the disposition by the taxpayer of capital property in the taxpayer's taxation year and in the period that began after February 27, 2000 and ended before October 18, 2000. This amendment applies to taxation years that end after February 27, 2000.

Paragraph 104(21.6)(*g*) is amended to correct a technical deficiency in a reference to a date. The reference to "October 17, 2000" is changed to "October 18, 2000" which reflects the date on which the reduction of the capital gain inclusion rate from 2/3 to 1/2 was announced. This amendment applies to trust taxation years that end after December 20, 2002.

Designation in Respect of Foreign Income

ITA
104(22)

Subsection 104(22) of the Act permits a trust to designate, in respect of a beneficiary under the trust, an amount of its foreign income. Such a designation is made by the trust on a source-by-source basis. Where the designation is made, the amount designated is deemed, for the purpose of subsections 104(22) and (22.1) and section 126, to be the beneficiary's income for the year from that source.

Subsection 104(22) is amended to clarify that where an amount is designated, in respect of a taxpayer, by a trust in respect of the trust's income for a particular taxation year of the trust from a source in a country other than Canada, the designated amount is deemed to be income of the taxpayer, for the taxation year of the taxpayer in which the particular taxation year of the trust ends, from that source.

The deeming rule does not apply, however, unless a number of conditions are met. One of these conditions - that a designated amount not be made in respect of more than one beneficiary under the trust - is replaced with a new requirement that the total amounts designated, in respect of the trust's income from a particular foreign source, under subsection 104(22) by the trust for a particular taxation year of the trust not exceed the trust's income for the particular taxation year from that source.

The deeming rule under subsection 104(22) applies, in respect of a beneficiary under a trust, only to the portion of the trust's income, from a source in a country other than Canada, that may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or 104(14) or section 105, as the case may be, was included in computing the income of a beneficiary under the trust. This condition is also amended and now provides that an amount, in respect of the trust's income from a source in a country other than Canada, is deemed to be income, from that source, only if the amount may reasonably be considered (having regard to all the circumstances

including the terms and conditions of the trust) to be part of the amount that, because of paragraph 104(13)(*a*) or subsection 104(14) or section 105, was included in computing the income of that taxpayer (*i.e.*, the taxpayer in respect of whom the amount is designated).

The amended reference in the above rule to paragraph 104(13)(*a*), instead of subsection 104(13), applies to taxation years that end after JULY 18, 2005. This change clarifies that the deeming rule does not apply to employee benefit plan trusts and ensures consistency with amended subsection 104(19). For taxation years that end after February 27, 2004 and on or before JULY 18, 2005, the referenced provision is subsection 104(13).

Except as provided above, these amendments apply to taxation years that end after February 27, 2004.

Testamentary Trusts

ITA
104(23)(*a*) and (*b*)

Subsection 104(23) of the Act provides special rules that apply to testamentary trusts. Paragraph 104(23)(*a*) defines the taxation year of a testamentary trust to be the period for which the accounts of the trust are made up for purposes of assessment under the Act. For this purpose, that paragraph also provides that no such period may exceed 12 months and no change in the time when such a period ends may be made for the purposes of the Act without the concurrence of the Minister of National Revenue. Paragraph 104(23)(*b*) provides that, in the case of a testamentary trust when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year.

Paragraphs 104(23)(*a*) and (*b*) are repealed.

This amendment applies after December 20, 2002. For a related set of amendments, see the commentary on section 249 and the definition “testamentary trust” in subsection 108(1).

Clause 95

Proceeds of Disposition of Income Interest

ITA
106(3)

Subsection 106(3) of the Act stipulates that a trust that distributes any property to a taxpayer who is a beneficiary under the trust in satisfaction of the taxpayer’s interest in the income of the trust is deemed to have disposed of the property for proceeds of disposition equal to the fair market value of the property. The French version of this subsection is amended to correct a terminology error. In effect, the concept of “attribution” is replaced by “distribution” so that it is clear that the property is actually remitted to the trust’s beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 96

Interests in Trusts

ITA
107

Section 107 of the Act provides certain rules relating to the acquisition and disposition of a capital interest in a trust.

Cost Reduction Rule

ITA
107(1)(*e*)

Subsection 107(1) of the Act contains special rules applicable to the disposition of an interest in a trust. A trust can distribute non-taxable amounts, such as returns of capital and the non-taxable portion of a capital gain, to the holders of interests in the trust. Currently, the Act requires a return of capital to be accounted for by reducing the recipient's adjusted cost base of the interest in the trust. While the effect of this general rule is clear where the interest is held as capital property, it is not as clear where the property is held as inventory.

New paragraph 107(1)(*e*) applies when a taxpayer disposes of an interest in a trust that is not held as capital property. The paragraph deems the taxpayer's cost amount of that interest to be the cost amount used for inventory valuation purposes less the total of all returns of capital and non-taxable capital gains payable to the taxpayer, in respect of the interest, prior to the disposition. This is to recognize that all receipts for a property held on income account should be treated as either income or a reduction in the cost of the property to the holder.

The new paragraph applies to dispositions after 2001 if the trust interest is a qualified security, as defined in subsection 260(1) of the Act, and an SLA compensation payment or a dealer compensation payment, as defined in subsection 260(1) of the Act has been paid in respect of the trust unit after 2001 and before February 27, 2004. Otherwise, the new rule applies to dispositions after February 27, 2004, except that it will not apply to a disposition that took place after February 27, 2004 and before 2005, if the taxpayer had on or before February 27, 2004 entered into an agreement in writing for the disposition of the interest.

There is a further exception to the application of the new paragraph. Distributions of the non-taxable portion of capital gains will reduce the cost amount of an interest in a trust only if those distributions took place after the new paragraph came into effect – that is, in the case of a trust interest that was the subject of a security lending arrangement (SLA) that was made between January 1, 2002 and February 27, 2004, after 2001, and, in all other cases, after February 27, 2004.

Inventory Valuation – Deemed Fair Market Value

ITA
107(1.2)

Where an interest in a trust is held as an inventory, the fair market value of the interest at valuation for the purpose of section 10 of the Act can be affected by non-taxable distributions from the trust, potentially producing a tax loss to the holder of the interest even though the holder had suffered no economic loss (thanks to the non-taxable distribution the holder has already received).

New subsection 107(1.2) requires that at any particular valuation time the fair market value of an interest in a trust be deemed to be the total of the fair market value otherwise determined and the sum of any returns of capital and non-taxable capital gains payable before that time.

The new subsection applies to valuations of trust interest that take place after February 27, 2004, and to valuations after 2001 if the trust interest in question is a qualified security, as defined in subsection 260(1) of the Act, and an SLA compensation payment or a dealer compensation payment, as defined in subsection 260(1) of the Act, has been paid in respect of the trust unit after 2001 and before February 27, 2004.

There is an exception to the application of the new subsection. Distributions of the non-taxable portion of capital gains will be added to the fair market value of an interest in a trust only if those distributions took place after the new subsection came into effect – that is, in the case of a trust interest that was the subject of a security lending arrangement (SLA) that was made between January 1, 2002 and February 27, 2004, after 2001, and, in all other cases, after February 27, 2004.

Distribution by Personal Trust

ITA
107(2)

Subsection 107(2) of the Act applies where a personal trust or a prescribed trust described in section 4800.1 of the Regulations distributes property to a beneficiary and there is a resulting disposition of Part or all of the beneficiary's capital interest in the trust. Under paragraph 107(2)(*a*), the trust is deemed to have disposed of the property for proceeds of disposition equal to the property's cost amount. Under paragraph 107(2)(*b*), the property is deemed to have been acquired by the beneficiary for an amount equal to the total of the amount described in paragraph 107(2)(*a*) and a "bump" equal to the specified percentage of any excess of the adjusted cost base to the beneficiary of the capital interest over its cost amount (as defined by subsection 108(1) of the Act) to the beneficiary of the interest. Under subparagraph 107(2)(*b*.1)(iii), the specified percentage for property (other than non-depreciable capital property and eligible capital property) is 75%. Where subsection 107(2) applies, paragraph 107(2)(*c*) provides that the beneficiary is deemed to have disposed of all or part, as the case may be, of the capital interest for proceeds equal to the amount determined under that paragraph.

Subparagraph 107(2)(*b*.1)(iii) is amended to replace the reference to 75% with a reference to 50%, consistent with the current capital gains inclusion rate.

This amendment applies to distributions, from a trust, made after December 20, 2002.

Paragraph 107(2)(*c*) is amended to clarify that it applies to determine a taxpayer's proceeds of disposition of the capital interest in a trust (or of the part of it) disposed of by the taxpayer on a distribution, to which subsection 107(2) applies, of property by the trust.

This amendment applies to distributions, from a trust, made after 1999.

Paragraph 107(2)(*d*.1) determines the tax consequences of the disposition of taxable Canadian property by a trust to a non-resident beneficiary before October 2, 1996. In the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, paragraph 107(2)(*d*.1) ensures that it continues to be taxable Canadian property of the beneficiary.

Paragraph 107(2)(*d*.1) is amended by adding to the list of specified provisions, that explicitly deem property to be taxable Canadian property, a reference to subsection 85.1(5) of the Act.

This amendment applies in determining after October 1, 1996 whether property is taxable Canadian property.

Distribution of Property Received on Qualifying Disposition

ITA
107(4.2)

New subsection 107(4.2) of the Act prevents a tax-deferred distribution of property after December 20, 2002 from a personal trust or a trust prescribed for the purpose of subsection 107(2) of the Act to a beneficiary of the trust if specified conditions are met. The specified conditions are that:

- at a particular time before December 21, 2002 there was a qualifying disposition (within the meaning assigned by subsection 107.4(1) of the Act) of the property, or of other property for which the property is substituted, by a particular partnership or a particular corporation, as the case may be, to any trust; and
- the beneficiary is neither the particular partnership nor the particular corporation.

Where the specified conditions are met, subsection 107(2.1) will apply so that the trust is deemed to have disposed of the property for proceeds equal to the property's fair market value at the time of distribution.

This amendment applies to distributions, from a trust, that are made after December 20, 2002.

Distribution of Property to a Non-Resident Beneficiary

ITA
107(5)

Subsection 107(5) of the Act applies to the distribution of property (other than shares in non-resident-owned investment corporations or property described in any of subparagraphs 128.1(4)(*b*)(i) to (iii)) of the Act) by a trust resident in Canada to a non-resident beneficiary (note that new paragraph 94(3)(*a*) of the Act does not apply in determining the residency of the beneficiary where it is a trust). In these circumstances, the rollover under subsection 107(2) is not available and instead subsection 107(2.1) of the Act will apply to determine the Canadian income tax consequences of the distribution to the trust and the beneficiary.

Subsection 107(5) is amended so that it applies whether the trust making the distribution is resident in Canada or not.

This amendment applies to distributions made after February 27, 2004.

Amendments to French Version of Section 107

ITA
107

Subsections 107(2), (2.001), (2.002), (2.01), (2.1), (2.11), (2.2), (4), (4.1), (5) and (5.1) of the Act deal with distributions by trusts. The French version of these subsections is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. Stylistic changes have also been made to the French versions of these subsections. The amendments will come into force on Royal Assent.

Clause 97

Distribution by Employee Trust, Employee Benefit Plan or Similar Trust

ITA
107.1

Section 107.1 of the Act prescribes the rules that apply where an employee trust, a trust governed by an employee benefit plan or trust described in paragraph (*a*.1) of the definition "trust" in subsection 108(1) distributes any property to its beneficiary in satisfaction of any part of the beneficiary's interest in the trust. The French version of this section is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. The amendments will come into force on Royal Assent.

Clause 98

Distribution by a Retirement Compensation Arrangement

ITA
107.2

Section 107.2 of the Act prescribes the rules that apply where a trust governed by a retirement compensation arrangement distributes any property to its beneficiary in satisfaction of any part of the taxpayer's interest in the trust. The French version of this section is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. Stylistic changes have also been made to the French version of this section. The amendments will come into force on Royal Assent.

Clause 99

Qualifying Disposition

ITA
107.4(1)

Subsection 107.4(3) of the Act generally provides for a rollover of property to a trust where the property is transferred to the trust by way of a qualifying disposition. For this purpose, subsection 107.4(1) defines "qualifying disposition" to be a disposition of property to a trust that does not result in any change in the beneficial ownership of the property and that otherwise meets the conditions set out in that subsection. A partnership, corporation or individual (including a trust) are all qualified transferors for the purpose of applying the definition "qualifying disposition" in subsection 107.4(1). Where the transferee trust is a non-resident trust, a qualifying disposition will occur only where the conditions in paragraph 107.4(1)(*c*) are satisfied. Another condition that must be met for there to be a qualifying disposition is found in paragraph 107.4(1)(*d*), which requires that the disposition not be by a partnership, if the disposition is part of a series of transactions or events that begins after December 17, 1999 and includes the cessation of the partnership's existence and a subsequent distribution from a personal trust to a former member of the partnership in circumstances to which subsection 107(2) of the Act applies.

Subsection 107.4(1) is amended so that after December 20, 2002 only an individual (including a trust) may make a qualifying disposition to a trust. As a result, paragraph 107.4(1)(*d*) is repealed.

These amendments are deemed to come into force on December 20, 2002. For a related amendment, see the commentary to new subsection 107(4.2) of the Act.

In addition, paragraph 107.4(1)(*c*) is amended so that a qualifying disposition can only be made where the transferee trust is resident in Canada at the time of the transfer. This amendment applies to dispositions that occur after February 27, 2004. For this purpose, the residency of a trust is determined without regard to new paragraph 94(3)(*a*). For more detail, see the commentary to new paragraph 94(4)(*b*) of the Act.

ITA
107.4(1)(*g*)

The French version of paragraph 107.4(1)(*g*) of the Act has been amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

ITA
107.4(3)

Subsection 107.4(3) of the Act provides a number of income tax consequences that apply in respect of a "qualifying disposition" (as defined in subsection 107.4(1) of the Act) of property to a trust. Paragraph 107.4(3)(*f*) ensures that, in the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, the property continues to be taxable Canadian property of the trust.

Paragraph 107.4(3)(*f*) is amended by adding to the list of specified provisions, that explicitly deem property to be taxable Canadian property, a reference to paragraph 44.1(2)(*c*) and to subsection 85.1(5) of the Act.

This amendment applies to dispositions that occur after December 23, 1998, and also applies in respect of the 1996 and subsequent taxation years, to transfers of capital property that occurred before December 24, 1998.

Clause 100

Taxation of Trusts and their Beneficiaries

ITA
108

Section 108 of the Act sets out certain definitions and rules that apply for the purposes of subdivision k of the Act, which deals with the taxation of trusts and their beneficiaries.

Definitions

ITA
108(1)

“testamentary trust”

Subsection 108(1) of the Act defines “testamentary trust” generally as a trust or estate that arose on and in consequence of the death of an individual, and provides some exceptions to that definition.

Subsection 104(1) of the Act provides that references to a “trust” in subdivision k of the Act (i.e., sections 104 to 108) of Division B of Part I of the Act include a trust or estate. The definition “testamentary trust” in subsection 108(1) is therefore amended to remove the reference to “estate” because the references in that definition to a “trust” include an estate.

New paragraph (*d*) of the definition “testamentary trust” is an anti-avoidance rule. That new paragraph provides that a testamentary trust in a taxation year does not include a trust (in the commentary on this amendment, references to “trust” include an estate) that incurs, after December 20, 2002 and before the end of the taxation year, a debt or any other obligation to pay an amount to, or guaranteed by, a beneficiary or any other person or partnership (referred to in this commentary as the “specified party”) with whom any beneficiary of the trust does not deal at arm’s length. However, such a debt will not affect the status of the trust as a testamentary trust if it is a debt or other obligation owed to the specified party and

- it is incurred by the trust in satisfaction of the specified party’s right as a beneficiary under the trust to enforce payment of an amount of income or capital gains payable by the trust to the specified party or to otherwise receive any part of the capital of the trust,
- it arose because of a service (for greater certainty, not including any transfer or loan of property) rendered by the specified party to, for or on behalf of the trust; for example, this would include debts or other obligations arising in respect of services rendered in a person’s capacity as an executor or administrator of an estate, as a liquidator of succession or as a trustee of a trust, or
- it arose because of a payment made by the specified party for or on behalf of (but not to) the trust; for example, a payment of funeral expenses on behalf of the deceased’s estate. However, to qualify under this provision, additional conditions must be satisfied. In very general terms, these conditions are that the trust fully reimburse the specified party within a year of the specified party making the payment. More precisely, in exchange for the payment the trust must transfer property (the fair market value of which is not less than the principal amount of that debt or other obligation that arose because of the payment) to the specified party within 12 months after the specified party made the payment (or, where written application has been made to the Minister by the trust within that 12 months, within any longer period that the Minister considers reasonable in the circumstances). A transfer of property, within the required period by the trust to the specified party, which does not result in the settlement or cancellation of that debt or obligation would not satisfy this requirement. It must also be reasonable to conclude that the specified party would have been

willing to make the payment if the specified party dealt at arm's length with the trust. This third requirement is suspended, however, where the trust is an individual's estate and the payment giving rise to the debt or obligation was made within the first 12 months after the individual's death (or, where written application has been made to the Minister of National Revenue by the estate within that 12 months, within any longer period that the Minister considers reasonable in the circumstances).

These amendments apply to trust taxation years that end after December 20, 2002. However, a transfer that is required, by clause (*d*)(iii)(B) of the definition "testamentary trust" in subsection 108(1) to be made within 12 months after a payment was made, is deemed to have been made in a timely manner if it is made no later than 12 months after this amended definition receives Royal Assent. In effect, the deadline imposed by that clause for the full reimbursement of the specified party by the trust or estate is extended, without need for written application, provided that the full reimbursement is made within 12 months after Royal Assent.

In addition, for taxation years that end before Royal Assent, the exception from the arm's length condition for obligations owed by an estate (which condition and exception are set out in clause (*d*)(iii)(C) of the definition) will apply so that a payment that is made by a specified party for or on behalf of the estate and that is described in clause (*d*)(iii)(A) will not be subject to the arm's length requirement where the payment is made at any time after the individual's death and not later than 12 months after Royal Assent. For these taxation years, if such a qualifying payment is not made within 12 months after Royal Assent, then the Minister may grant a further extension of the period, beyond 12 months after Royal Assent, if written application is made to the Minister by the estate within 12 months after Royal Assent.

"trust"

For the purposes of the 21-year deemed disposition rule and other specified measures, subsection 108(1) of the Act defines "trust" to exclude certain listed trusts.

For these purposes, paragraph (*f*) of the definition excludes unit trusts (as defined in subsection 108(2) of the Act) and paragraph (*g*) excludes, except as specified, trusts all interests in which have vested indefeasibly.

This definition is amended so that section 106 of the Act is not a provision for the purposes of which paragraphs (*f*) and (*g*) of the definition apply. Section 106 provides rules in respect of an "income interest" (as defined in subsection 108(1) of the Act) in a "personal trust" (as defined in subsection 248(1) of the Act). As a result of this amendment, for the purpose of section 106, references to a trust will include a trust described in paragraph (*g*) of the definition "trust" in subsection 108(1). (As the definition "personal trust" expressly excludes a unit trust, paragraph (*f*) of the definition "trust" in subsection 108(1) is not relevant for this purpose.)

This amendment applies to the 1998 and subsequent taxation years.

French Version of the Definitions "cost amount", "trust" and "eligible offset"

ITA
108(1)

The French version of the definitions of "cost amount", "trust" and "eligible offset" in subsection 108(1) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

Clause 101

Taxable Income – Deductions

ITA
110

Section 110 of the Act provides various deductions that may be claimed in computing a taxpayer's taxable income.

Part VI.1 Tax

ITA
110(1)(*k*)

Paragraph 110(1)(*k*) of the Act provides a deduction in computing a corporation's taxable income equal to a multiple of the amount of any tax payable by it for the year under Part VI.1 of the Act on dividends it paid on taxable preferred shares. The deduction approximates the income that would have generated an amount of income tax equal to the Part VI.1 tax. The multiple used to produce this result is currently 9/4, which implies a total federal and provincial income tax rate of 44.44%.

As part of a series of amendments reflecting recent and planned reductions in income tax rates, the multiple in paragraph 110(1)(*k*) is increased to 3. This amendment, which applies for the 2003 and subsequent taxation years, implies a total tax rate of 33.3%.

Taxable Income – Employee Security Options Deduction

ITA
110(1.7) and (1.8)

Subsection 110(1.7) of the Act provides that the definitions in subsection 7(7) of the Act relating to employee security options also apply for the purposes of subsections 110(1.5) and 110(1.6) of the Act. Since subsection 7(7) also provides for the definitions to so apply, existing subsection 110(1.7) is unnecessary and is repealed.

A new subsection 110(1.7) is added that applies in circumstances where there is a reduction in the amount (referred to in these notes as the "exercise price") payable by an employee to acquire securities under an employee security option and the conditions in new subsection 110(1.8) of the Act are satisfied.

This new subsection ensures that a reduction in the exercise price under an employee security option does not disqualify the employee from claiming the security option deduction under paragraph 110(1)(*d*) of the Act, if the reduction could have been effected by way of an exchange of options without jeopardizing the employee's eligibility for the deduction.

Paragraph 110(1)(*d*) of the Act provides a deduction in computing taxable income in circumstances where subsection 7(1) of the Act deems an employee to have received a benefit from employment in connection with the exercise or disposition of rights under an employee option agreement. The deduction is currently equal to one-half of the amount of the employment benefit, and the effect of the deduction is to tax the benefit at a rate equivalent to the capital gains inclusion rate.

Paragraph 110(1)(*d*) sets out certain conditions that must be satisfied in order to qualify for the security option deduction. These conditions include a minimum exercise price requirement under the option giving rise to the benefit under subsection 7(1) and, if that option was acquired as a consequence of one or more qualifying exchanges of options, under each of the previous options. Thus, if a reduction in the exercise price under an employee security option causes the exercise price to fall below the minimum threshold established under paragraph 110(1)(*d*) for that option, the employee will not be entitled to claim the security option deduction.

However, there are situations in which an otherwise disqualifying reduction in an option exercise price could be effected by way of an exchange of options without jeopardizing the employee's eligibility for the deduction. This would be the case, for example, if the exercise price had originally been set at the fair market value (FMV) of the underlying securities at the time of grant, there is a subsequent decline in the FMV of the securities and the exercise price is adjusted to that lower FMV. The combined effect of subsections 110(1.7) and (1.8) is to deem such a reduction to have been effected by way of an exchange, thus ensuring that the employee remains eligible for the security option deduction.

In particular, new subsection 110(1.7) provides that, where there is a reduction in the exercise price under an employee security option and the conditions in subsection 110(1.8) are satisfied, the employee is deemed to have disposed of the rights under the option immediately before the reduction and to have acquired the amended rights immediately thereafter as consideration for the disposition.

New subsection 110(1.8) sets out two conditions that must be satisfied in order for new subsection 110(1.7) to apply.

- First, the employee would not qualify for the security option deduction if the option were exercised immediately after the exercise price reduction (and subsection 110(1.7) were disregarded).
- Second, the employee would have been eligible for the deduction had there, in fact, been an exchange of options and the employee exercised the option immediately after the exchange.

These conditions ensure that the provisions of subsection 110(1.7) apply only where an otherwise disqualifying reduction in the exercise price under an employee security option could have been effected by way of an exchange of options without so disqualifying the employee.

Example:

Pierre is granted an option to acquire ten shares of Company A at an exercise price of $100 a share, which is the FMV of such a share at that time. After a downturn of the business, the Company amends the option to reduce the exercise price to $30 a share, which is the new FMV of such a share.

Results:

Without the benefit of subsection 110(1.7), paragraph 110(1)(d) would require that the exercise price under the option at the time of exercise be no less than the FMV of the underlying share at the time the option was granted. Since the exercise price of $30 would be less than the FMV of $100 at the time the option was issued, this condition would not be met and Pierre would not be eligible for the security option deduction.

If the reduction had been effected by way of an exchange of options, there would have been no increase in the net benefit associated with the option (i.e., the difference between the FMV of the shares under the "new option" and the "new exercise price" ($300 - $300 = $0) would have been no greater than the difference between the FMV of the shares under the "old option" and the "old exercise price" ($300 - $1,000 = $0)). Thus, the exchange would have been an exchange to which subsection 7(1.4) applied.

If Pierre had exercised the new option immediately after the exchange, paragraph 110(1)(d) would have required that the following exercise price tests be met:

- *The exercise price under the old option at the time it was disposed of would have to be not less than the FMV of the underlying shares when the option was granted. Since the exercise price of $100 was equal to the FMV at the date of grant, this condition would have been met.*
- *The exercise price under the new option at the time of exercise would have to be not less than the exercise price set when the new option was acquired. Since Pierre would have paid $30 a share on exercise, which was the exercise price established when the new option was acquired, this condition would have been met.*

Thus, if the reduction had been effected by way of an exchange and Pierre had exercised the option immediately after the exchange, he would have been eligible for the security option deduction.

Since the requirements of subsection 110(1.8) are satisfied, subsection 110(1.7) applies to deem the reduction to have been effected by way of an exchange. Consequently, the reduction will not disqualify Pierre from claiming the stock option deduction.

New subsections 110(1.7) and (1.8) apply to exercise price reductions that occur after 1998.

Extended Deadline for Deferral Election

Where certain conditions are satisfied, subsection 7(8) of the Act allows an employee to defer taxation of a security option benefit to the year in which the employee disposes of the security. One condition is that the employee be eligible to claim the deduction under paragraph 110(1)(*d*) in respect of the benefit. Another condition is that the employee files an election to defer before January 16th of the year following the year in which the option is exercised (or before August 14, 2001 for securities acquired in 2000).

The coming-into-force provisions for subsections 110(1.7) and (1.8) extend the deferral election deadline for securities which are acquired before this legislation receives Royal Assent, and which become qualified for the deduction under paragraph 110(1)(*d*) only by reason of amended subsection 110(1.7), to the later of

- the election deadline that would otherwise apply, and
- the day that is 60 days after Royal Assent.

Clause 102

Charitable Donations Deduction

ITA
110.1

Section 110.1 of the Act provides a deduction in computing taxable income in respect of gifts made by corporations to registered charities and to certain other entities. Section 110.1 is amended to expand the entities referred to in this section to include municipal or public bodies performing a function of government in Canada. This amendment is in response to the Quebec Court of Appeal decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, 2001 D.T.C. 5144. For additional information, see the commentary to paragraph 149(1)(*d*.5).

Section 110.1 is also amended as a consequence of the addition of new subsections 248(30) to (38) of the Act. Generally, those subsections clarify the circumstances under which a transfer of property will be considered a gift notwithstanding that the transferor may be entitled to receive an advantage or benefit in respect of the property. New subsection 248(31) generally provides that the "eligible amount" of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. For additional information, see the commentary to new subsections 248(30) to (39).

Deduction for Gifts

ITA
110.1(1)

Paragraphs 110.1(1)(*a*) to (*d*) of the Act provide, respectively, for the deduction by a corporation of amounts in respect of "charitable gifts", "gifts to Her Majesty", "gifts to institutions" and "ecological gifts". The amount deductible by the corporation is generally the fair market value of the gift. These paragraphs are amended, consequential to the addition of new subsection 248(31) of the Act, to provide that the amount deductible by the corporation is generally the "eligible amount" of a gift.

In addition, paragraphs 110.1(1)(*a*) and 110.1(1)(*d*) are expanded to provide that a deduction is available in respect of gifts made by corporations to municipal or public bodies performing a function of government in Canada.

Paragraph 110.1(1)(*d*) is also amended to clarify its application to "real servitudes" under the *Civil Code of Quebec*.

The amendments to subsection 110.1(1) apply in respect of gifts made after December 20, 2002, except that the amendments to subparagraphs 110.1(1)(*a*)(iv.1) and 110.1(1)(*d*)(iii) apply in respect of gifts made after May 8, 2000.

Proof of Gift

ITA
110.1(2)

Subsection 110.1(2) of the Act provides that a corporation may not deduct an amount in respect of a gift unless the gift is evidenced by a receipt containing prescribed information. The subsection is amended, concurrently with subsection 110.1(1) of the Act, to refer to the "eligible amount" of a gift.

It is proposed that subsections 3501(1), (1.1) and (6) of the Regulations be amended to provide that every official receipt issued by a registered organization in respect of a gift contain, in addition to the information already prescribed, the amount of the advantage, if any, and the eligible amount of the gift.

For additional details, see the commentary to new subsections 248(31) and (32) of the Act regarding the eligible amount and the amount of the advantage in respect of a gift.

These amendments to subsection 110.1(2) of the Act and subsections 3501(1), (1.1) and (6) of the Regulations are to be effective in respect of gifts made after December 20, 2002.

Gifts of Capital Property

ITA
110.1(2.1) and (3)

Subsection 110.1(3) of the Act provides that, if a corporation donates capital property to a charity, it may designate 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 the purpose of calculating its capital gain and the amount of the gift for the purpose of the deduction allowed for charitable donations under subsection 110.1(1) of the Act.

Subsection 110.1(3) is restructured as new subsection 110.1(2.1) and revised subsection 110.1(3). New subsection 110.1(2.1) describes the circumstances under which amended subsection 110.1(3), which remains generally unchanged, will apply. However, where the property is depreciable property, subsection 110.1(2.1) includes those situations where the actual value of the gifted property is between the undepreciated capital cost of that class at the end of the taxation year of the corporation and the fair market value of the donated property.

Amended subsection 110.1(3) provides for the amount that may be designated by the corporation. As with the former provision, the amount designated is considered to be the corporation's proceeds of disposition of the gift. The subsection also continues to provide that the amount designated is treated as the fair market value of the property transferred by way of gift. However, under the amended version, this is for the purpose of new subsection 248(31) of the Act instead of for subsection 110.1(1). New subsection 248(31) generally provides that the "eligible amount" of a gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. The "eligible amount" is relevant to the determination of the amount deductible under subsection 110.1(1) by the corporation.

Finally, amended subsection 110.1(3) allows a corporation to reduce the amount of recaptured depreciation that might otherwise be calculated in respect of a gift of depreciable property, with a corresponding reduction to the eligible amount deductible under subsection 110.1(1) in respect of the gift. However, the designated amount may not be lower than the amount of any actual proceeds of disposition in respect of the property (or, more specifically, the amount of the advantage in respect of the gift, as defined in new subsection 248(32) of the Act).

In particular, the amount designated by the corporation in respect of the property transferred may not exceed the fair market value of the property otherwise determined, and may not be less than the greater of

- the amount of the advantage, if any, in respect of the gift, and
- the adjusted cost base of the property or, if the property is depreciable property of the corporation, the undepreciated capital cost of the class of the property at the end of the corporation's taxation year (determined without reference to the proceeds of disposition designated in respect of the property).

See also the example in the commentary to subsections 118.1(5.4) and (6) of the Act, which apply similarly to individuals as do subsections 110.1(2.1) and (3) to corporations.

Subsections 110.1(2.1) and (3) of the Act (as amended) generally apply in respect of gifts made after 1999. For additional details regarding the eligible amount and the amount of the advantage in respect of a gift, see the commentary to new subsections 248(31) and (32) of the Act.

Gifts Made by a Partnership

ITA
110.1(4)

Subsection 110.1(4) of the Act allows the attribution of gifts made by a partnership to its corporate members, according to each member's share in the partnership. Subsection 110.1(4) is amended, consequential to the addition of new subsection 248(31) of the Act, in respect of gifts made by a partnership after December 20, 2002, to refer to the "eligible amount" of a gift made because of a corporation's membership in a partnership.

Ecological Gifts

ITA
110.1(5)(*b*)

Subsection 110.1(5) of the Act provides that the fair market value of a gift of ecologically sensitive land (or a covenant, easement or servitude in respect of ecologically sensitive land) is deemed to be the amount determined by the Minister of the Environment. Paragraph 110.1(5)(*b*) provides that the amount so determined in respect of a covenant, easement or servitude will not be considered to be less than the decrease in value of the subject land that resulted from the making of the gift.

Paragraph 110.1(5)(*b*) is amended to clarify its application to "real servitudes" under the *Civil Code of Quebec*.

This amendment applies to gifts made after December 20, 2002.

Clause 103

Lifetime Capital Gains Exemption

ITA
110.6

Section 110.6 of the Act sets out the rules that apply in calculating an individual's entitlement to the lifetime capital gains exemption.

Deduction Not Permitted

ITA
110.6(7)

The French version of paragraph 110.6(7)(*b*) is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Related Persons, etc.

ITA
110.6(14)

Subsection 110.6(14) of the Act provides certain rules that apply for the purposes of the definition "qualified small business corporation share" in subsection 110.6(1) and the capital gains exemption in respect of such shares. This subsection is amended to add new paragraph 110.6(14)(*d*.1).

New paragraph 110.6(14)(*d*.1) deems a person who is a member of a partnership that is a member of another partnership (a lower-tiered partnership) to be a member of the lower-tiered partnership. This amendment will permit such a taxpayer to have access to the deduction for taxable capital gains arising on the disposition of a qualified small business corporation share by the lower-tiered partnership.

This amendment applies to dispositions that occur after December 20, 2002 and, if a taxpayer so elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year in which this amendment is assented to, to dispositions made by the taxpayer after 1999.

Clause 104

Loss Carryovers

ITA
111

Section 111 of the Act establishes the extent to which a taxpayer is permitted to deduct, in computing taxable income for a taxation year, losses of other years.

Net Capital Losses

ITA
111(1.1)

Subsection 111(1.1) of the Act determines the amount that a taxpayer may deduct in respect of a net capital loss claimed under paragraph 111(1)(*b*). The 2000 Budget and the 2000 Economic Statement provided for the reduction of the capital gains inclusion rate from 3/4 to 2/3 and then to 1/2, respectively. This reduction in the inclusion rate gave rise to changes to the adjusting factors in subsection 111(1.1). An additional amendment is made to subsection 111(1.1) to permit the Minister of National Revenue to determine a reasonable amount of deduction in respect of net capital loss carryovers where the other rules in that subsection produce inappropriate results.

The amendment to subsection 111(1.1) applies to the 2000 and subsequent taxation years.

Definitions

ITA
111(8)

Subsection 111(8) of the Act contains definitions that apply for the purposes of section 111.

"pre-1986 capital loss balance"

An individual's "pre-1986 capital loss balance" for a taxation year is relevant for the purpose of paragraph 111(1.1)(*b*) and represents the individual's unused pre-1986 capital losses that the individual can deduct, to a maximum of $2,000 per year, from income other than capital gains of the individual. The reference in the description of C in the definition to "taxation years that end before 1988 or after October 17, 2000" is corrected to refer to "taxation years that end before 1988 or begin after October 17, 2000". The amended definition is applicable to the 2000 and subsequent taxation years.

Clause 105

Certificates for Dispositions

ITA
116(5.2)

Section 116 of the Act sets out rules that apply when a non-resident person disposes of any of certain types of property. Subsection 116(5.2) allows a non-resident vendor to obtain what is commonly known as a "clearance certificate" in respect of the disposition or proposed disposition of, among other things, depreciable property that is a taxable Canadian property. Subsection 116(5.2) is amended to include among the types of property to which it applies eligible capital property that is a taxable Canadian property. This amendment applies after December 23, 1998, which is when the definition "taxable Canadian property" in subsection 248(1) of the Act first included eligible capital property used in carrying on a business in Canada.

Excluded Property – Authorized Foreign Banks

ITA
116(6)(*f*)

Subsection 116(6) of the Act defines "excluded property" for the purposes of section 116 of the Act. Paragraph 116(6)(*f*) defines the "excluded property" of an authorized foreign bank.

Paragraph 116(6)(*f*) currently treats as an excluded property any property of an authorized foreign bank that is used or held in the bank's "Canadian banking business" (defined in subsection 248(1) of the Act). The paragraph is amended to treat as excluded property all of the property of an authorized foreign bank that carries on a Canadian banking business. As a result, the treatment of authorized foreign banks will in this respect be comparable to the treatment of non-resident insurers.

This amendment applies to dispositions that occur after June 27, 1999.

Clause 106

Personal Tax Credits

Married Status

ITA
118(1)(*a*)

Paragraph 118(1)(*a*) of the Act deals with the tax credit to persons who are married or in a common-law partnership. In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of paragraph 118(1)(*a*), were overlooked. This paragraph is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

Pension Credit

ITA
118(7)

"pension income"

Section 118 of the Act provides for a number of credits that are deductible in computing the tax payable by an individual, including the pension credit in subsection 118(3). The pension credit available to a taxpayer who is 65 years of age or older is based on the taxpayer's "pension income", as defined in subsection 118(7). Pension income includes lifetime annuity payments under a pension plan and payments under a registered retirement income fund (RRIF).

The definition “pension income” is amended to add periodic payments under a money purchase provision of a registered pension plan (RPP), to the extent that such payments are not already included. This amendment is consequential on amendments to section 8506 of the Regulations, the purpose of which is to allow money purchase RPPs to provide members with retirement benefits that are payable in the same manner as is permitted under a RRIF. Since these benefits would not be considered to be lifetime annuity payments, it is necessary to ensure that they qualify for the purpose of the pension credit.

This amendment applies to the 2004 and subsequent taxation years.

Clause 107

Charitable Donations Tax Credit

ITA
118.1

Section 118.1 of the Act provides for a charitable donations tax credit to individuals in respect of gifts made to registered charities and to certain other entities. Section 118.1 is amended to expand the entities referred to in this section to include municipal or public bodies performing a function of government in Canada. This amendment is in response to the Quebec Court of Appeal decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, 2001 D.T.C. 5144. For additional information, see the commentary to paragraph 149(1)(*d*.5).

The amendments to section 118.1, described below, are made consequential to the addition of new subsections 248(30) to (39) of the Act. Generally, those subsections clarify the circumstances under which a transfer of property will be considered a gift notwithstanding that the donor may be entitled to receive an advantage or benefit in respect of the property. New subsection 248(31) generally provides that the “eligible amount” of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. For additional information, see the commentary to new subsections 248(30) to (39).

Definitions

ITA
118.1(1)

Subsection 118.1(1) of the Act provides definitions of the terms “total charitable gifts”, “total Crown gifts”, “total cultural gifts” and “total ecological gifts”. These definitions apply for the purpose of the tax credit available under subsection 118.1(3) of the Act to individuals who make such gifts. The amount of a gift that is eligible for a tax credit is, generally, the fair market value of the property disposed of by the individual in the making of the gift.

The definitions “total charitable gifts”, “total Crown gifts”, “total cultural gifts” and “total ecological gifts” in subsection 118.1(1) are amended, as a consequence of the addition of new subsection 248(31) of the Act, to provide that the amount that qualifies for the credit under subsection 118.1(3) is the “eligible amount” of a gift.

In addition, the definition of “total charitable gifts” and the definition of “total ecological gifts” in subsection 118.1(1) are expanded to include a gift to a municipal or public body performing a function of government in Canada.

The definition “total ecological gifts” is also amended to clarify its application to “real servitudes” under the *Civil Code of Quebec*.

Variable B in the formula in the definition of “total gifts” in subsection 118.1(1) generally provides that 100% of a taxable capital gain that results from a gift is included in the annual income limit that applies to gifts. This is an enhancement of the 75% income limit that generally applies to other types of income. Variable B is amended as a consequence of the addition of new subsection 248(31) of the Act, to ensure that the enhanced income limit only applies to the portion of a taxable capital gain that relates to the eligible amount of a gift.

The amendments to subsection 118.1(1) apply in respect of gifts made after December 20, 2002, except that the amendments to paragraph (*d*.1) of the definition of “total charitable gifts” and paragraph (*c*) of the definition of “total ecological gifts” apply in respect of gifts made after May 8, 2000.

Proof of Gift

ITA
118.1(2)

Subsection 118.1(2) of the Act provides that an amount in respect of a gift by an individual may not be included in the amount eligible for a tax credit under subsection 118.1(3) unless the gift is evidenced by a receipt containing prescribed information. Subsection 118.1(2) is amended concurrently with subsection 118.1(1), to refer to the “eligible amount” of a gift.

It is proposed that subsections 3501(1), (1.1) and (6) of the Regulations be amended to provide that every official receipt issued by a registered organization in respect of a gift contain, in addition to the information already prescribed, the amount of the advantage, if any, and the eligible amount of the gift.

For additional details, see the commentary to new subsections 248(31) and (32) of the Act regarding the eligible amount and the amount of the advantage in respect of a gift.

The amendments to subsection 118.1(2) of the Act and subsections 3501(1), (1.1) and (6) of the Regulations are to be effective in respect of gifts made after December 20, 2002.

Gift of Capital Property

ITA
118.1(5.4) and (6)

Subsection 118.1(6) of the Act provides that, if an individual donates capital property to a charity, the individual may designate 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 the purpose of calculating the individual’s capital gain and the amount of the gift for the purpose of calculating the tax credit allowed for charitable donations under subsection 118.1(3) of the Act.

Subsection 118.1(6) is restructured as new subsection 118.1(5.4) and revised subsection 118.1(6). New subsection 118.1(5.4) describes the circumstances under which amended subsection 118.1(6), which remain generally unchanged, will apply. However, where the property is depreciable property, subsection 118.1(5.4) includes those situations where the actual value of the gifted property is between the undepreciated capital cost of that class at the end of the taxation year of the individual and the fair market value of the gifted property.

Amended subsection 118.1(6) provides for the amount that may be designated by the individual. As with the former provision, the amount designated is deemed to be the individual’s proceeds of disposition of the gift. The provision also continues to provide that the amount designated is treated as the fair market value of the property transferred by way of gift. However, under the amended version, this is for the purpose of new subsection 248(31) of the Act (changed from subsection 118.1(1) of the Act). New subsection 248(31) generally provides that the “eligible amount” of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. The “eligible amount” is relevant to the determination of the tax credit deductible by the individual under subsection 118.1(3).

Finally, amended subsection 118.1(6) effectively allows an individual to reduce the amount of recaptured depreciation that might otherwise be calculated in respect of a gift of depreciable property, with a corresponding reduction to the eligible amount deductible in respect of the gift under subsection 118.1(6). However, the designated amount may not be lower than the amount of any actual proceeds of disposition in respect of the property (or, more specifically, the amount of the advantage in respect of the gift, as defined under new subsection 248(32) of the Act).

In particular, the amount designated by the individual in respect of the property transferred may not exceed the fair market value of the property otherwise determined, and may not be less than the greater of

- the amount of the advantage, if any, in respect of the gift, and
- the adjusted cost base of the property or, if the property is depreciable property of the individual, the undepreciated capital cost of the class of the property at the end of the individual's taxation year (determined without reference to the proceeds of disposition designated in respect of the property).

Subsections 118.1(5.4) and (6) (as amended) generally apply in respect of gifts made after 1999. For additional details regarding the eligible amount and the amount of the advantage in respect of a gift, see the commentary to new subsections 248(31) and (32).

Example

Mr. Adams transfers a rental property with a fair market value of $200,000 to a registered charity, in exchange for proceeds of disposition of $95,000. The original cost to Mr. Adams when he purchased the property in 1985 was $65,000. The rental property is the only depreciable property in its class, with an undepreciated capital cost balance before the transfer of $45,000.

Assuming that the transfer qualifies as a gift (see the commentary to subsections 248(30) to (32)), Mr. Adams may designate any amount between $95,000 and $200,000 as the proceeds of disposition for the gift. Mr. Adams could have designated an amount as low $45,000, if he had received a lesser amount in actual proceeds from the charity.

Mr. Adams decides to designate $150,000 as its proceeds of disposition. The taxable gain to Mr. Adams on the transfer can therefore be allocated as follows:

Designated proceeds		*$150,000*
Adjusted cost base (original cost)	*65,000*	*65,000*
Capital Gain		*85,000*
Taxable Capital Gain		*42,500*
Undepreciated Capital Cost	*45,000*	
Recaptured depreciation		*20,000*
Total Income Inclusion		*$ 62,500*

The eligible amount of the gift is calculated as follows:

Designated proceeds	*$150,000*
Amount of advantage (consideration)	*95,000*
Eligible amount of the gift	55,000

Gifts of Art

ITA
118.1(7)(*d*) and 118.1(7.1)(*d*)

Subsection 118.1(7) of the Act provides that, if an artist donates artwork created by the artist and held in the artist's inventory, the artist may designate a value between the cost amount and the fair market value of the artwork to be treated both as the proceeds of disposition for the purpose of calculating the artist's income and the amount of the gift for the purpose of calculating the tax credit allowed for charitable donations under subsection 118.1(3) of the Act.

If the artwork is certified as a cultural gift, as described in subsection 118.1(1) of the Act, subsection 118.1(7.1) of the Act applies instead of subsection 118.1(7). Under subsection 118.1(7.1), the artist is treated as having received proceeds of disposition equal to the cost amount to the artist of the work of art for the purpose of calculating the artist's income, but the fair market value of the artwork is not affected. This means that the artist is entitled to a credit based on the value of the donation, but that the artist recognizes neither a profit nor a loss on the disposition of the work of art in computing income from a business for income tax purposes.

Paragraphs 118.1(7)(*d*) and (7.1)(*d*) are amended consequential to the addition of subsections 248(31) and (32) of the Act. Amended paragraph 118.1(7.1)(*d*) generally provides that the artist's proceeds of disposition from a gift of cultural property that was created by the artist and held as inventory may not be lower than the amount of any actual proceeds of disposition in respect of the property (or, more specifically, the amount of the advantage in respect of the gift, as defined under new subsection 248(32)). In particular, the amount that may be designated by the artist must be the greater of the cost amount of the work of art and the amount of the advantage in respect of the gift. As a result, the artist will have business income from the disposition if the amount of the advantage in respect of the gift exceeds the cost amount to the artist of the work of art.

For gifts from an artist's inventory that are not certified cultural property, amended paragraph 118.1(7)(*d*) provides that the amount designated in the artist's return of income is deemed to be the artist's proceeds of disposition. The provision also continues to provide that the amount designated is treated as the fair market value of the property transferred by way of gift. However, under the amended version, this is for the purpose of new subsection 248(31) (changed from subsection 118.1(1)). New subsection 248(31) generally provides that the "eligible amount" of the gift is the excess of the fair market value of a property transferred by way of gift over the value of the advantage or benefit, if any, to which the transferor is entitled. The "eligible amount" is relevant to the determination of the tax credit deductible by the individual under subsection 118.1(3).

The amount designated in the artist's return of income in respect of the property transferred may not exceed the fair market value of the property otherwise determined, and may not be less than the greater of

- the amount of the advantage, if any, in respect of the gift, and
- the cost amount to the artist of the work of art.

As a result, the artist will have business income from the disposition to the extent that the amount of the advantage in respect of the gift (or some other amount designated in the artist's return of income, if greater) exceeds the cost amount to the artist of the work of art.

For additional details regarding the eligible amount and the amount of the advantage in respect of a gift, see the commentary to new subsections 248(31) and (32) of the Act.

The amendments to paragraphs 118.1(7)(*d*) and (7.1)(*d*) apply in respect of gifts made after December 20, 2002.

Gifts Made by Partnership

ITA
118.1(8)

Subsection 118.1(8) of the Act allows the attribution of gifts made by a partnership to its individual members, according to each member's share in the partnership. Subsection 118.1(8) is amended consequential to the addition of new subsection 248(31) of the Act, to refer to the "eligible amount" of a gift made because of an individual's membership in a partnership.

The amendment applies in respect of gifts made by a partnership after December 20, 2002.

Non-qualifying Securities

ITA
118.1(13)(*b*) and (*c*)

Subsection 118.1(13) of the Act provides that, if an individual makes a gift of a "non-qualifying security" (defined in subsection 118.1(18) of the Act), that gift will be ignored for the purpose of the charitable donations tax credit.

Paragraphs 118.1(13)(*b*) and (*c*) concern the amount to be included in a taxpayer's "total charitable gifts" or "total Crown gifts" (defined in subsection 118.1(1) of the Act) for the taxation year in which a security ceases to be a "non-qualifying security" or the donee disposes of a non-qualifying security. If either of these events occurs within five years of the actual donation of the non-qualifying security by a taxpayer, the taxpayer will be treated as having made a gift at that later time. The fair market value of this deemed gift is considered to be the lesser of two amounts. The first amount is the fair market value of the security at the time that it was actually donated. (Note that this amount may have been designated by the taxpayer as a lower amount than the actual fair market value if an election were made under subsection 118.1(6) of the Act for the taxation year of the actual donation.) The second amount is

- if the security ceased at the later time to be a non-qualifying security, the fair market value of the security at that later time, or
- if the security was disposed of by the donee at that later time, the fair market value of the consideration received by the donee.

Amendments to paragraphs 118.1(13)(*b*) and (*c*) are to provide language complementary to the amendment of the definitions "total charitable gifts" and "total Crown gifts" in subsection 118.1(1). The amendments apply to gifts actually made after December 20, 2002.

Clause 108

Medical Expense Tax Credit

ITA
118.2

Section 118.2 of the Act provides rules for determining the amount that may be claimed, as a tax credit, in respect of an individual's medical expenses.

ITA
118.2(2)(*c*), (*d*), (*e*), (*g*), and (*h*)

The eligibility of certain expenses to the medical expense tax credit is conditional on a medical practitioner's certification. Paragraphs 118.2(2)(*c*), (*d*), (*e*), (*g*), and (*h*) are amended to clarify that such a certification has to be in writing. These amendments apply after December 20, 2002.

ITA
118.2(2)(*l*.1)

Paragraph 118.2(2)(*l*.1) of the Act allows for the deduction, as medical expenses, of certain expenses related to a bone marrow or organ transplant. The French version of the paragraph refers to “moelle épinière” rather than “moelle osseuse”. The amendment corrects this error and will come into force on Royal Assent.

Clause 109

Tax Credit for Mental or Physical Impairment

ITA
118.3(2)(*a*)

Paragraph 118.3(2)(*a*) of the French version of the Act is amended to include a phrase that was inadvertently deleted from the provision when it was last amended. This amendment applies to the 2001 and subsequent taxation years.

Clause 110

Tuition Credit

ITA
118.5(1)(*a*)(iii)

Subsection 118.5(1) of the Act provides a tax credit in respect of tuition fees paid to certain educational institutions. Subparagraph 118.5(1)(*a*)(iii) provides that an amount paid on behalf of an individual by the individual’s employer is not eligible for the credit unless the amount is required to be included in computing the individual’s income. Subparagraph 118.5(1)(*a*)(iii) is amended, applicable on Royal Assent, to clarify that an amount paid by the individual, for which the individual is reimbursed by the individual’s employer, is also not eligible for the credit unless the reimbursement is required to be included in computing the individual’s income.

Clause 111

Education Tax Credit

ITA
118.6

Section 118.6 of the Act contains rules governing the education tax credit.

Definitions

ITA
118.6(1)

Subsection 118.6(1) of the Act defines the expression “designated educational institution”, which is relevant for the purposes of the child care expense and attendant care expense deductions and the tuition fee and education tax credits. Generally speaking, a designated educational institution is an institution that provides post-secondary education, an institution certified by the Minister of Human Resources Development that furnishes or improves skills in an occupation, or a foreign university. This amendment to subparagraph (*a*)(i) of that definition, applicable to the 1998 and subsequent taxation years, is consequential on the change in the name of the Quebec statute under which financial assistance is provided to students as well as the change in the name of the responsible Quebec ministry.

Clause 112

Credit for EI and QPIP Premiums and CPP Contributions

ITA
118.7

Section 118.7 of the Act provides the formula for calculating an individual's tax credit in respect of CPP/QPP contributions and employment insurance premiums. Section 118.7 is amended, consequential to the introduction of the new Quebec Parental Insurance Plan(QPIP) on January 1, 2006, to provide for a tax credit in respect of premiums paid under that Plan. The marginal note is also amended to add a refence to the QPIP. This amendment applies to the 2006 and subsequent taxation years.

Clause 113

Minimum Tax Carry-over

ITA
120.2(3)(*b*)

Section 120.2 of the Act allows an individual to apply additional taxes, imposed for a given year under the minimum tax in section 127.5 of the Act, against the individual's ordinary Part I tax liability for following years. Paragraph 120.2(3)(*b*) is amended to remove the reference in that paragraph to subsection 120.4(2). This mendment ensures that an individual's additional tax in respect of the minimum tax does not include the special 29% tax imposed under section 120.4 on certain passive income of minors.

This amendment applies to the 2000 and subsequent taxation years.

Clause 114

Lump-sum Payments

ITA
120.31(3)(*b*)

Section 120.31 of the Act provides for the calculation of the tax payable on certain lump-sum payments. The amount of the tax is equal to the total of the additional taxes that would be payable for each relevant taxation year if the portion of the lump-sum payment that relates to that preceding year were added to the individual's taxable income for that year.

A notional amount of interest (using the rate of interest on tax refunds applicable to the relevant period) is added to the additional tax to take into account the fact that the calculation of the tax on the lump-sum payment should reflect not only the additional tax that would have been payable had the payment been received on an on-going basis, but also the fact that this additional tax was not paid during those preceding years.

The amendment to paragraph 120.31(3)(*b*) clarifies that the notional amount of interest is calculated on the amount of the additional tax for each relevant previous year and not on the whole tax payable for that year. This amendment applies to the 1995 and subsequent taxation years.

Clause 115

Tax on Split Income

ITA
120.4

Section 120.4 of the Act provides a special 29% tax applicable to certain passive income of individuals under the age of 18. These tax on split income rules were first proposed in the 1999 Budget Plan. At the time, the Government indicated that it "would monitor the effectiveness of this targeted measure, and may take appropriate action if new income-splitting techniques develop".

Definitions

ITA
120.4(1)

"split income"

The expression "split income" describes the type of income to which this measure applies.

Among other things, split income of an individual includes all amounts (other than excluded amounts) required to be included in the individual's income in respect of partnership or trust income if the source of the income is the provision of goods or services by the partnership or trust to, or in support of, a business carried on by

- a person who is related to the individual,
- a corporation of which a person who is related to the individual is a specified shareholder, or
- a professional corporation of which a person related to the individual is a shareholder.

The phrase "goods or services" in the English version of subparagraph (*b*)(ii) and clause (*c*)(ii)(C) in the definition "split income" is replaced by the phrase "property or services". This ensures that the split income rules will apply to income from property, such as rental income. This change applies in computing the split income of a specified individual for taxation years that begin after December 20, 2002, other than in computing an amount included in that income that is from a trust or partnership for a fiscal period or taxation year of the trust or partnership that began before December 21, 2002. Also see the commentary to subsection 160(1.2) of the Act, which is amended consequential to this amendment.

Clause 116

Overseas Employment Tax Credit

ITA
122.3

Section 122.3 of the Act provides an "overseas employment tax credit" to individuals resident in Canada who are employed for at least six consecutive months in a foreign country by a specified employer in respect of certain enumerated activities.

Subsection 122.3(1.1), which at present limits access to the tax credit in one set of circumstances, is amended so that the credit is also unavailable in another situation. New paragraph 122.3(1.1)(*b*) denies an individual the benefit of the credit if, at any time in the qualifying period, the services of the individual are provided to a firm with which the employer does not deal at arm's length, and less than 10% of the fair market value of all the interests in the firm are held directly or indirectly by persons resident in Canada.

> ***Example:***
>
> ***Situation:***
>
> *An individual is employed by a corporation that is a specified employer. The employer supplies the individual's services to a non-resident corporation, the shares of which are held as follows: 60% are held by a non-resident corporation that also controls the individual's corporate specified employer; 20% are held by a non-resident trust, all of the units of which are held by non-residents; and 20% are held by a second non-resident trust, half of the units of which are held by residents of Canada.*
>
> ***Result:***
>
> *Since they are related, the specified employer does not deal at arm's length with the recipient of the services in this example. However, new paragraph 122.3(1.1)(b) would not apply in this instance because residents of Canada hold, indirectly through the second trust, 10% of the interests in the recipient corporation.*

The set of circumstances currently described in paragraphs 122.3(1.1)(*a*), (*b*) and (*c*) is contained in amended paragraph 122.3(1.1)(*a*), and subsection 122.3(1) is amended to ensure that the term "qualifying period" applies to subsection 122.3(1.1), as well as to subsection 122.3(1).

These amendments to subsections 122.3(1) and (1.1) apply to taxation years that begin after this Act is assented to.

Clause 117

Small Business Deduction

ITA
125

Section 125 of the Act provides for a corporate tax reduction (called the "small business deduction") in respect of income of a Canadian-controlled private corporation (CCPC) from an active business carried on by it in Canada.

ITA
125(1)

Under subsection 125(1) of the Act, a CCPC's small business deduction for a taxation year is calculated as 16% of the least of three amounts. One of these, set out in paragraph 125(1)(*b*), is the amount by which the corporation's taxable income for the year exceeds income that has supported a foreign tax credit (FTC) or that is statutorily exempt from tax. The amount of income that has supported an FTC is determined by multiplying the corporation's FTCs for the year (subject to certain adjustments) by a factor that reflects an assumed rate of tax. For FTCs in respect of foreign non-business income, the factor is currently 10/3, reflecting an assumed tax rate of 30%. For business-income FTCs, the factor is currently 10/4, which reflects an assumed tax rate of 40%.

Subparagraph 125(1)(*b*)(ii) is amended to adjust the factor for foreign business income, as part of a series of amendments reflecting recent and planned reductions in income tax rates. The factor for business-income FTCs will become 3. This implies an assumed tax rate of 33.3%. This amendment applies to the 2003 and subsequent taxation years.

ITA
125(5.1)

A corporation's entitlement to the small business deduction for a particular taxation year is determined by reference to, among other things, the "business limit" of the corporation for the particular year. In broad terms, subsection 125(5.1) of the Act reduces the business limit of a corporation if tax under Part I.3 of the Act was payable by the corporation for its preceding taxation year. If the corporation is associated with one or more other corporations in the particular year, the provision takes into account the Part I.3 tax payable by it and those other corporations, in each case for their last taxation years that ended in the preceding calendar year.

Subsection 125(5.1) is amended to respond better to cases in which a corporation is associated with more, fewer or different corporations in one taxation year than in the past. Specifically, the description of B in the formula in the subsection – a description that in effect refers to an amount of tax under Part I.3 – will take one of three forms, depending on the corporation's associations in the current and, in some cases, the preceding taxation year:

- if the corporation is not associated with any other corporation in the current year, and was not associated with any other corporation in the preceding taxation year, the description of B is based on the corporation's Part I.3 tax for the preceding taxation year;
- if the corporation is not associated with any other corporation in the current year, but was so associated in the preceding taxation year, the description of B is based on the corporation's Part I.3 tax for the current year; and
- if the corporation is associated with one or more corporations in the current year, the description of B is the product of a formula that looks to the total taxable capital employed in Canada of the corporation itself and all the corporations with which it is associated in the current year, in each case for its last taxation year that ended in the preceding calendar year.

This amendment applies to taxation years that begin after December 20, 2002.

Clause 118

Manufacturing and Processing Profits Deduction

ITA
125.1

Section 125.1 of the Act provides a reduced rate of corporate tax on Canadian manufacturing and processing profits.

Manufacturing and Processing Profits Deduction

ITA
125.1(1)(*b*)(ii)

Subsection 125.1(1) of the Act provides the basic rules for the calculation of a corporation's manufacturing and processing profits deduction. The deduction for a given taxation year is the lesser of two amounts, one of which is the corporation's taxable income less certain other amounts. One of these other amounts, described in subparagraph 125.1(1)(*b*)(ii), is the grossed up amount of the corporation's foreign tax credits (FTCs) for the year in respect of foreign businesses. Currently, the corporation's FTCs are grossed up by a factor of 10/4, which assumes this income was subject to tax at a rate of 40%.

Subparagraph 125.1(1)(*b*)(ii) is amended to adjust this factor to reflect recent reductions to income tax rates. The new factor will be 3, which implies an assumed tax rate of 33.3% on foreign source business income.

This amendment applies to the 2003 and subsequent taxation years.

Definitions

ITA
125.1(3)

Subsection 125.1(3) of the Act defines the expression “manufacturing or processing” for the purpose of section 125.1. Paragraph 125.1(3)(*l*) of this definition excludes any manufacturing or processing of goods for sale or lease.

The French version of subparagraphs (*l*)(i) and (ii) of the definition are amended to replace the word “*articles*” by the word “*marchandises*” in order to be consistent with the terminology used in the opening words of paragraph (*l*) of the definition. A similar amendment is made to the French version of the definition “Canadian manufacturing and processing profits” in subsection 125.1(3).

These amendments apply on Royal Assent.

Clause 119

Resource Income

“taxable resource income”

ITA
125.11

Section 125.11 of the Act has the effect of reducing the federal corporate income tax rate for income earned from resource activities from 28% to 21% by 2007. This is accomplished for the years 2003-2006 by providing a deduction against the 28% rate for income that falls within the definition of “taxable resource income”. After 2006 resource income will be included in full rate taxable income and be subject to the general rate reduction rules.

Currently, a taxpayer’s “taxable resource income” is the lesser of the taxpayer’s taxable income for the taxation year and the amount calculated by the following formula: 3(A/B) + C- D. A represents the deduction taken as a resource allowance under paragraph 20(1)(*v*.1). B is a reduction of the resource allowance, which is being phased out between 2003 and 2006, prorated for non-calendar year-ends. C represents additions to the taxpayer’s income resulting from negative resource pools. Lastly, D is any amounts deducted from income on account of resource pools.

The definition “taxable resource income” is being amended to ensure that resource income that was earned by a Canadian-controlled private corporation (CCPC) and received a small business deduction under section 125(1) of the Act is not also eligible for this rate reduction. The result is that a taxpayer’s “taxable resource income” will now be the lesser of two amounts. The first amount is the taxpayer’s taxable income for the year less 100/16 of the amount the taxpayer deducted from tax payable pursuant to section 125(1) of the Act. The second amount is calculated by the formula 3(A/B) + C - D - E. Elements A to D are unchanged from the previous formula contained in this definition, and remain as described above. New element E is 100/16 of the amount deducted from tax otherwise payable pursuant to subsection 125(1) of the Act. This amendment ensures that resource income earned by a CCPC can only benefit from one rate reduction.

This amendment applies to taxation years that begin after February 27, 2004.

Clause 120

Canadian Film or Video Production Tax Credit

ITA
125.4

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 ("CFVPTC"). Generally, this tax credit is available at a rate of 25% of qualified labour expenditures incurred by a qualified corporation for a production certified by the Minister of Canadian Heritage to be a Canadian film or video production.

Except as noted below, the amendments to subsection 125.4 generally apply in respect of productions for which development commences on or after November 14, 2003 or the first labour expenditures (as determined under subsections 125.4(1) and (2) as they applied before that date – the "old rules") of the production corporation are incurred after 2003. As well, if development commenced before November 14, 2003 and the first labour expenditures (as defined under the old rules) were incurred by the corporation in its taxation year that includes November 14, 2003, the corporation may elect to have the new rules apply. Subject to this election, corporations must continue to claim the CFVPTC under the old rules for productions that qualified under those rules. Where, in the case of a co-production, more than one qualified corporation is eligible to claim a CFVPTC in respect of the production, the election to have the new rules apply must be made jointly. A production cannot qualify under both schemes.

Definitions

ITA
125.4(1)

"assistance"

In computing the CFVPTC, qualified labour expenditures in respect of a film or video production are limited to 48% of the amount by which the cost of the production exceeds any "assistance" in respect of that cost that has not been repaid.

The definition "assistance" is amended to provide that the equity share of a production of a government or other public authority is treated in the same manner as government assistance. This could include, for example, a loan from a government agency where repayment of the loan is dependent on profit from the production.

"Canadian film or video production certificate"

A qualified corporation 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. A "Canadian film or video production certificate", as defined in subsection 125.4(1) of the Act, is issued by the Minister of Canadian Heritage. The definition is amended to provide that that Minister will also certify that the public funding of the production would not be contrary to public policy and that, generally, a qualified corporation or a related taxable Canadian corporation will retain an acceptable share of revenues from the exploitation of the production in non-Canadian markets. The Minister of Canadian Heritage will issue guidelines as to how these criteria can be met.

This amendment generally applies in respect of Canadian film or video productions for which certificates are issued by the Minister of Canadian Heritage after December 20, 2002.

The definition is also amended to remove the requirement for the Minister of Canadian Heritage to provide estimates relevant to the calculation of the CFVPTC, in respect of certificates issued after 2003.

“investor”

The definition “investor” describes a 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 in Canada. A CFVPTC may not be claimed in respect of 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.

The definition of investor is repealed, applicable to taxation years that end after November 14, 2003, as well as to productions in respect of which a qualifying production corporation has, in a return of income filed before November 14, 2003, claimed an amount under subsection 125.4(3) of the Act in respect of a labour expenditure incurred after 1997 in respect of the production.

“labour expenditure”

The definition “labour expenditure” describes the underlying expenditures of a qualified corporation in respect of a film or video production that will be eligible for the CFVPTC. The definition is amended concurrently with the repeal of the definition “investor” in subsection 125.4(1) and the amendment of subsections 125.4(2) and (4) of the Act, to include those production expenditures incurred by the qualified corporation for or on behalf of another person. That is, labour expenditures are no longer limited to those included in the cost to the qualified corporation of the production. The definition is also amended concurrently with the introduction of the definition “production commencement time”, which represents the time after which an eligible expenditure will qualify for the CFVPTC.

Where a particular corporation is a co-producer with another qualified corporation, and that other corporation has incurred expenditures for or on behalf of the taxpayer, new paragraph 125.4(2)(*d*) of the Act prevents the particular corporation from claiming a CFVPTC in respect of those expenditures.

For more information on subsections 125.4(2) and (4) and the definitions “investor” and “production commencement time”, refer to the commentary for those provisions.

“production commencement time”

For the purpose of the definition “labour expenditure” in subsection 125.4(1) of the Act, in order to be eligible for the CFVPTC, expenditures in respect of a film or video production must be incurred by a qualified corporation from the time that is the “final script stage” of the production. The definition “labour expenditure” is amended to instead refer to expenditures incurred after the production commencement time. The new definition “production commencement time” describes the time that is the latest of the following:

1. The time at which a qualified corporation or its parent company first incurs development labour costs for the development of property of the corporation that is script material on which a Canadian film or video production is based.
2. The first time at which the qualified corporation or its parent company acquires a right in respect of the story that is the basis of the final script. Such rights might include a published literary work, play or screenplay.
3. Two years before the date on which principal photography of the production begins.

It is intended that the in-house development labour costs of an initial draft of a script, as well as the cost of modifications, should fall within the period of production for which labour expenditures qualify for the CFVPTC. These in-house costs could include the cost to hire an independent writer to create a script on the basis of some other story or literary work for which the rights have been acquired by the corporation.

Existing conditions on eligible labour expenditures also apply to scriptwriting labour. (See, for example, amounts excluded from the definition “salary and wages” in subsection 125.4(1) of the Act, such as amounts determined by reference to profits or revenues). As well, the cost to acquire an initial script or any other right referred to above will, like other rights, not qualify. Such an expenditure represents the cost of a property, not a labour expenditure.

The new definition "script material" in subsection 125.4(1) is defined for the purpose of the definition "production commencement time".

"qualified labour expenditure"

The definition "qualified labour expenditure" describes 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. Under a formula in the definition, qualified labour expenditures in respect of a production are limited to 48% of the amount by which the cost of the production to the qualified corporation exceeds any "assistance" in respect of that cost that has not been repaid.

Variable A in the formula is amended to increase the maximum amount of labour expenditure that qualify for the CFVPTC from 48% to 60% of the cost of the production. The definition is also amended concurrently with the repeal of the definition "investor" in subsection 125.4(1) and the amendment of subsections 125.4(2) and (4) of the Act, to include in the production cost those production expenditures incurred by the qualified corporation for or on behalf of another person. That is, production expenditures are no longer limited to those included in the cost to the qualified corporation of the production.

Where the taxpayer corporation is a co-producer with another qualified corporation, and that other corporation has incurred expenditures for or on behalf of the taxpayer, those expenditures are excluded from the formula by new paragraph 125.4(2)(*b*) of the Act.

For more information on subsections 125.4(2) and (4) and the definition "investor", refer to the commentary for those provisions.

"salary or wages"

For the purposes of the Canadian film and video production tax credit, the definition "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.

The definition "salary or wages" is amended to provide that it also does not include an amount paid to a person in respect of services rendered by the person at a time when the person was non-resident, unless the person was at that time a Canadian citizen.

"script material"

The new definition "script material" applies for the purpose of determining the "production commencement time" of a production. Script material is written material describing the story on which the production is based and, for greater certainty, includes a draft script, original story, screen story, narration, television production concept, outline or scene-by-scene schematic, synopsis or treatment. These descriptions are terms commonly used in the film production industry.

Rules Governing Labour Expenditure of a Corporation

ITA
125.4(2)

Subsection 125.4(2) of the Act provides 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.

Subsection 125.4(2) is amended to provide that it also applies to the definition "qualified labour expenditure" in subsection 125.4(1). In addition, paragraph 125.4(2)(*a*) is amended to provide that remuneration also does not included remuneration in respect of services rendered by a person at a time when the person was non-resident, unless the person was at that time a Canadian citizen.

A film or video production may be produced jointly by two or more qualified corporations. New paragraph 125.4(2)(*d*) of the Act is added to ensure that only one qualified corporation may claim a CFVPTC in respect of any particular expenditure. Where another qualified corporation supplies goods to or renders services for or on behalf of the taxpayer corporation, new paragraph 125.4(2)(*d*) provides that the related expenditure by the taxpayer is not a labour expenditure, a cost or capital cost of the production to the taxpayer. This provision does not affect the calculation of the cost of the production for other purposes of the Act.

Exception

ITA
125.4(4)

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. An investor is defined in subsection 125.4(1) to include, generally, any person, other than a prescribed person, that does not carry on a film or video production basis in Canada on a substantial basis.

Subsection 125.4(4) is amended concurrently with the repeal of the definition "investor", to deny the CFVPTC only in circumstances where the production or a person or partnership holding an interest in the production is a tax shelter investment for the purpose of section 143.2 of the Act.

However, section 1106 of the *Income Tax Regulations* includes a requirement that, for a film or video production to qualify as a Canadian film or video production eligible for the CFVPTC, a prescribed taxable Canadian corporation must retain worldwide ownership of copyright.

This amendment applies to taxation years that end after November 14, 2003, or if a qualifying production corporation has, in a return of income filed before November 14, 2003, claimed an amount under subsection 125.4(3) in respect of a labour expenditure incurred after 1997 in respect of the production.

Revocation of a Certificate

ITA
125.4(6)

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. The 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.

Subsection 125.4(6) is amended, applicable after November 14, 2003, to clarify that a Canadian film or video production certificate may be revoked in respect of one episode of a television series without affecting the eligibility of other episodes in the series and that, in such a case, the expenditures attributable to that episode do not qualify for the CFVPTC.

Guidelines

ITA
125.4(7)

New subsection 125.4(7) of the Act, which applies in respect of Canadian film or video productions for which certificates are issued by the Minister of Canadian Heritage after December 20, 2002, requires the Minister of Canadian Heritage to issue guidelines respecting the circumstances under which new conditions in the definition "Canadian film or video production certificate" in subsection 125.4(1) are met. For further details, see the commentary for that definition.

Clause 121

Foreign Tax Credit

ITA
126(2.22)

The French version of subsection 126(2.22) of the Act is amended to correct a terminology error. In effect, the concept of “attribution” is replaced by “distribution” so that it is clear that the property is actually remitted to the trust’s beneficiary and not simply set aside for him or her. These amendments will come into force on Royal Assent.

Foreign Tax Credit – Dispositions Ignored

ITA
126(4.4)

Subsection 126(4.4) of the Act directs that certain dispositions and acquisitions of property be ignored for the purposes of the foreign tax credit limitations in subsections 126(4.1) and (4.2) and the definition of ”economic profit” in subsection 126(7). As a consequence of the restructuring of section 132.2 of the Act, the reference in paragraph 126(4.4)(*a*) to paragraph 132.2(1)(*f*) is replaced by a reference to section 132.2.

This amendment applies to dispositions and acquisitions that occur after 1998 except that, in applying paragraph 126(4.4)(*a*) of the Act to dispositions and acquisitions that occur before June 28, 1999, that paragraph is to be read without reference to subsections 10(12), 10(13), 14(14) and 14(15) of the Act.

Rules of Construction

ITA
126(6)(*d*)

Section 126 of the Act permits a taxpayer to claim a foreign tax credit. Subsection 126(1) sets out the rules for claiming the credit in respect of foreign non-business-income tax – that is, the foreign taxes imposed on investment income and other categories of foreign source non-business income. A credit in respect of foreign taxes on business income is provided under subsection 126(2).

Subsection 126(1) has been interpreted to allow a non-business foreign tax credit for non-business foreign tax paid on interest income earned abroad by a Canadian business that does not carry on business in the foreign jurisdiction, and therefore is not eligible for a business foreign tax credit. In order to ensure that the credit continues to be available in these situations, subsection 126(6), which contains interpretation rules that apply to the section, is amended to add new paragraph 126(6)(*d*). New paragraph 126(6)(*d*) deems foreign interest income earned from a business carried on in Canada, and for which the business has paid a non-business foreign tax to a country other than Canada, to be from a source in that other country. Therefore, if a taxpayer includes in its Canadian business income for the year foreign interest income, and has paid foreign tax with respect to this amount, the taxpayer will be eligible to claim a non-business foreign tax credit subject to the limits set out in section 126.

New paragraph 126(6)(*d*) applies to amounts received after February 27, 2004.

Clause 122

UI Premium Tax Credit

ITA
126.1

Section 126.1 of the Act provides certain employers with a refundable tax credit to offset the increase in the employer’s portion of 1993 unemployment insurance premiums.

This section has lapsed, and is repealed in respect of forms filed after March 20, 2003.

Clause 123

Deductions in Computing Tax

ITA
127

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

Logging Tax Deduction

ITA
127(2)

The amendments to the French version of subsection 172(2) of the Act correct a grammatical error. In this subsection, the expression "revenu tiré pour l'année des opérations forestières dans la province" has the meaning set out in the Regulations. However, the expression that appears in the Regulations is "revenu tiré pour l'année d'opérations forestières dans la province", which is grammatically correct. The Act is therefore amended accordingly on Royal Assent.

Contributions to Registered Parties and Candidates

ITA
127(3)

Subsection 127(3) of the Act provides a tax credit to a taxpayer in respect of amounts contributed to a registered party or to a candidate. Subsection 127(3) is amended consequential to the addition of new subsections 248(31) and (32) of the Act, to provide that the amount of a contribution that is eligible for the political contributions tax credit is to be reduced by the amount of any advantage or benefit, as defined by subsection 248(32), to which the taxpayer is entitled in respect of the contribution. This amendment is generally applicable to monetary contributions made after December 20, 2002.

It is proposed that subsections 2000(1) and (6) of the Regulations be amended to provide that every official receipt issued by a registered party in respect of a contribution contain, in addition to the information already prescribed, the eligible amount and the amount of the advantage, if any, in respect of the contribution.

For additional details, see the commentary to new subsections 248(31) and (32) regarding the amount of the advantage in respect of a contribution.

Allocation of Amount Contributed Among Partners

ITA
127(4.2)

Subsection 127(4.2) of the Act allows the tax benefits of political contributions made by a partnership to be flowed through to its members. Subsection 127(4.2) is amended consequential to the amendment of subsection 127(3) of the Act, applicable to contributions made after December 20, 2002, to provide the amount of a contribution that is eligible for a tax credit because of a taxpayer's membership in a partnership.

Investment Tax Credits

ITA
127(5) to (35)

Subsections 127(5) to (35) of the Act provide rules concerning investment tax credits.

Recapture of Investment Tax Credit

ITA
127(27)

Subsection 127(27) of the Act provides for the recapture of investment tax credits in respect of property used for scientific research and experimental development (SR&ED) where the property is sold or converted to commercial use. This recapture is effected by way of an addition to tax payable of an amount equal to the lesser of

- the amount that can reasonably be considered to have been included in the taxpayer's investment tax credit in respect of the particular property (i.e., the amount that is obtained by multiplying the amount of the qualified expenditure by the ITC rate that applied to that expenditure), and
- the amount that is obtained by multiplying the ITC rate (that applied to the qualified expenditure) by
  - the proceeds of disposition of the particular property (or of property that incorporates the particular property) if the property is disposed of to a person who deals at arm's length with the taxpayer. (See paragraph 127(27)(*e*) of the Act.)
  - in any other case, the fair market value of the particular property (or the other property) at the time of its conversion or disposition. (See paragraph 127(27)(*f*) of the Act.)

Concern has been expressed about the application of subsection 127(27) of the Act in the context of shared-use equipment, only 25% or 50% of the cost of which is a "qualified expenditure" under subsection 127(9) because of subsection 127(11.5) of the Act. This concern is illustrated by the following example.

Example:

- *Year 1: Taxpayer acquires shared-use equipment for $100. The ITC rate is 20% and the taxpayer claims an ITC for first term shared-use-equipment of $5 (20% x $25 [1/4 of its $100 cost under paragraph 127(11.5)(c)]).*
- *Year 2: Taxpayer claims an ITC for second term shared-use-equipment of $5 (20% x $25 [1/4 of its $100 cost under paragraph 127(11.5)(c)]).*
- *Year 4: Taxpayer sells the property for $80.*
- *Recapture under subsection 127(27):*

  $10 being the lesser of:

  - *$10 (20% x $100 x 50% because the property is second term shared-use-equipment), and*
  - *$16 (20% x $80 proceeds of disposition).*

However, in this example the $16 amount should be $8 given that only a portion (50%) of the cost of the second term shared-use-equipment is a qualified expenditure.

As well, the government is concerned that subsection 127(27) should apply where the disposition or conversion relates to property acquired pursuant to an expenditure that would have been a qualified expenditure incurred in a taxation year but for the application of the 180-day-unpaid-amount rule in subsection 127(26) of the Act.

To address these concerns, subsection 127(27) is amended in four respects.

First, paragraphs 127(27)(*b*) and (*c*) are amended to refer to the "cost, or a portion of the cost, of the particular property" instead of to the "cost of the particular property".

Second, paragraphs 127(27)(*b*) and (*c*) are amended to provide that the reference therein to a qualified expenditure included in a taxpayer's investment tax credit be read without reference to subsection 127(26) relating to unpaid amounts.

Third, consequential changes are made to the wording between paragraphs 127(27)(*d*) and (*e*) of the Act. In particular, the first of the two amounts in the "lesser of" formula is moved to new paragraph 127(27)(*e*). The second of these two amounts is described in amended paragraph 127(27)(*f*), which combines former paragraphs 127(27)(*e*) and (*f*).

Fourth, paragraph 127(27)(*f*), which combines former paragraphs 127(27) (*e*) and (*f*), is changed to account for circumstances where the property that is disposed of or converted is first term shared-use-equipment or second term shared-use-equipment.

These amendments apply to dispositions and conversions that occur after December 20, 2002.

Clause 124

Labour-sponsored Venture Capital Corporations

ITA
127.4

Section 127.4 of the Act provides for a tax credit for individuals (other that trusts) that acquire shares issued by a labour-sponsored venture capital corporation (LSVCC).

Definitions

ITA
127.4(1)

"approved share"

Subsection 127.4(2) of the Act allows an individual (other than a trust) a tax credit for the acquisition of an "approved share", which is defined in subsection 127.4(1) as, generally, a share issued by a prescribed LSVCC. LSVCCs prescribed for this purpose under section 6701 of the Regulations include LSVCCs registered under Part X.3 of the Act, as well as specified provincially registered LSVCCs. Paragraph (*b*) of the definition "approved share" excludes from the definition certain shares issued by a provincially-registered LSVCC that is not a federally-registered LSVCC. This exclusion applies only in the event that, at the time of the issue of the shares, no assistance is available in respect of the acquisition of such shares because of a suspension or termination of assistance to the LSVCC under the laws of every province in which the LSVCC is registered.

Paragraph (*b*) of the definition "approved share" is amended to provide that an approved share does not include a share issued by a provincially-registered LSVCC (that is not a federally-registered LSVCC) if, at the time of the issue, no province under the laws of which the corporation is an LSVCC that is a prescribed LSVCC provides assistance in respect of the acquisition of the share. This amendment is provided to have the definition "approved share" better reflect the policy that a federal income tax credit be available in respect of a share issued by a provincially-registered LSVCC (that is not a federally-registered LSVCC) only if a provincial income tax credit is also available in respect of the share.

Paragraph (*b*) of the definition will continue to apply if, at the time of the issue by such an LSVCC of a share, no assistance is available in respect of the acquisition of shares of the LSVCC because of a suspension or termination of assistance to the LSVCC under the laws of every province in which the LSVCC is registered.

Amended paragraph (*b*) of the definition will also apply where there has not been a suspension or termination of assistance with respect to the issuance of the LSVCC's shares generally, but assistance is not available with respect to the acquisition of a particular share. For example, if under the laws of a province under which an LSVCC is a prescribed LSVCC, a taxpayer who acquires a share is not entitled to any assistance in respect of the acquisition either because of having reached the age of 65 years or because of the province of residence of the taxpayer, the share will not be treated as an approved share.

This amendment applies to acquisitions of shares that occur after 2003.

"qualifying trust"

Subsection 127.4(1) of the Act contains the definition of "qualifying trust". In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of the definition of "qualifying trust", were overlooked. This definition is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

Clause 125

Minimum Tax

ITA
127.52

Section 127.52 of the Act defines the "adjusted taxable income" of an individual for a taxation year for the purpose of determining the individual's minimum tax liability under Division E.1 of Part I of the Act.

ITA
127.52(1)(*d*)

Paragraph 127.52(1)(*d*) of the Act provides that in computing an individual's adjusted taxable income for minimum tax purposes, the total amount of capital gains and losses is to be taken into account. In some cases, because of subsection 104(21.6) of the Act (which in some cases deems a taxpayer to have realised a larger capital gain than was actually realised) more than the total amount of capital gains and losses would be taken into account. Excess capital gains are deemed by subsection 104(21.6) to have been realized in order that the inclusion rate for capital gains realized on property disposed of by a trust prior to February 28, 2000 is ¾ and property disposed of by a trust after February 27, 2000 and before October 18, 2000 is 2/3. Paragraph 127.52(1)(*d*) is therefore amended to ensure that only the actual amount of the gain is included in computing the alternative minimum tax.

This change applies to the 2000 and subsequent taxation years.

Clause 126

Returning Trust Beneficiary

ITA
128.1(7)

The French version of subsection 128.1(7) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 127

Private Corporations - “refundable dividend tax on hand”

ITA
129(3)(*a*)

Section 129 of the Act allows a private corporation that pays a taxable dividend to obtain a partial refund of the income taxes it has paid on its investment income. For this purpose, paragraph 129(3)(*a*) adds to the refundable dividend tax on hand of a Canadian-controlled private corporation at the end of a taxation year the least of three amounts.

One of these amounts, which is described in subparagraph 129(3)(*a*)(ii), is 26 2/3% of a corporation’s taxable income, less income that either benefited from the section 125 small business deduction or supported a foreign tax credit (FTC). Income that supported an FTC is measured by multiplying both the corporation’s non-business- and its business-income FTCs by factors that reflect assumed Canadian tax rates. Subparagraph 129(3)(*a*)(ii) is amended to adjust the factor for foreign business income. The factor for business-income FTCs will become 3. This implies an assumed tax rate of 33.3%.

This amendment applies to the 2003 and subsequent taxation years.

Clause 128

Definition “mutual fund trust”

ITA
132(6)(*c*)

Subsection 132(6) of the Act sets out the definition “mutual fund trust”. Under paragraph 132(6)(*c*), a trust will qualify at any time as a mutual fund trust only if at that time it meets prescribed conditions relating to the number of its unit holders, dispersal of ownership of trust units issued by it and public trading of trust units issued by it.

Paragraph 132(6)(*c*) is amended so that the prescribed conditions that a trust may be required to satisfy in order to qualify as a mutual fund trust are not limited to those relating to ownership and trading of its units.

This amendment applies to the 2000 and subsequent taxation years.

The regulations setting out these prescribed conditions for a mutual fund trust are found in Part XLVIII of the *Income Tax Regulations*. In particular, Regulation 4801 sets out conditions that apply to a class of units issued by a trust in order for the trust to be considered a mutual fund trust. It is intended that proposed amendments to Part XLVIII of the Regulations would include the following:

- The French language version would be amended to correct a technical deficiency in the use of the expression “appel public à l’épargne” (“qualified for distribution to the public”). The amendments to the French version of the Regulations would clarify that, as is the case in the English version, the defined expression in subsection 4803(2) of the Regulations applies in determining whether a class of units is qualified for distribution to the public in paragraph 4801(*a*) of the Regulations.
- Paragraph 4801(*a*) of the Regulations would be amended so that subparagraph 4801(*a*)(ii) applies to a trust created before 2000, for its 2004 and subsequent taxation years, if the trust elects by notifying the Minister of National Revenue in writing in its return of income for the taxation year of the trust that ends in the calendar year in which the amending regulations are published in Part II of the Canada Gazette. As a result of the proposed change, if there has been a lawful distribution in a province to the public of units of a class of units of a trust created before 2000 and a prospectus, registration statement or similar document was not required under the laws of the province to be filed in respect of the distribution, the trust could rely upon subparagraph 4801(*a*)(ii) to meet, in its 2004 and later taxation years, the condition prescribed under paragraph 4801(*a*).

These amendments to the Regulations would, except as described above, be proposed to apply to the 2000 and subsequent taxation years of trusts.

Clause 129

Taxation Year of Mutual Fund Trust

ITA
132.11(1)

Section 132.11 of the Act generally allows a mutual fund trust to elect to have taxation years that end on December 15, rather than on December 31.

Where a trust makes this election, each subsequent taxation year of the trust is deemed to start on December 16 of a calendar year and to end on December 15 of the following calendar year, unless any of certain events intervenes. One of the events that can intervene, and that results in an earlier year-end, is a qualifying exchange under section 132.2 of the Act.

As a consequence of the restructuring of section 132.2, the reference in paragraph 132.11(1)(*b*) to paragraph 132.2(1)(*b*) is replaced by a reference to paragraph 132.2(3)(*b*).

This amendment applies after 1998 except that, in applying the amended version of paragraph 132.11(1)(*b*) to taxation years that end before 2000, the paragraph is to be read as though it did not contain the words "subject to subsection (1.1)".

Paragraph 132.11(1)(*c*) generally provides that each fiscal period of a mutual fund trust that has made an election under subsection 132.11(1) shall end no later than the end of the trust's taxation year that ends on December 15th.

The French-language version of paragraph 132.11(1)(*c*) is amended to clarify that the paragraph applies to each fiscal period of the trust that either begins in a taxation year of the trust that ends on December 15 because of an election under paragraph 132.11(1)(*a*) or that ends in a subsequent taxation year of the trust. This technical change does not represent a change in policy.

This amendment applies to the 1998 and subsequent taxation years.

Amounts Paid or Payable to Beneficiaries

ITA
132.11(4)

Subsection 132.11(4) of the Act is designed to permit distributions made in the last 16 days of a calendar year in respect of a trust's taxation year ending on December 15 of the calendar year to be treated as if they were made at the end of that taxation year.

Subsection 132.11(4) of the Act is amended so that it applies for the purpose of paragraph (*i*) of the definition "disposition" in subsection 248(1). As a result, in the case of a mutual fund trust that has elected under section 132.11 to have a December 15th taxation year-end, distributions from the trust in respect of a taxpayer's capital interest made in the last 16 days of a calendar year will not result in a disposition of the interest.

This amendment applies to amounts that, after 1999, are paid or have become payable by a trust.

Clause 130

Mutual Fund Qualifying Exchanges

ITA
132.2

Section 132.2 of the Act provides rules to allow two mutual fund trusts, or a mutual fund trust and a mutual fund corporation, to merge on a tax-deferred basis. Such a merger is referred to as a “qualifying exchange”.

In addition to introducing several substantive improvements to the rules in section 132.2, these amendments restructure the provision as a whole. In general terms, the section is now organized as follows: new subsection 132.2(1) sets out definitions that apply for the section; subsection (2) describes the order in which the events that make up a qualifying exchange are considered to have occurred; subsection (3) provides a set of general rules; subsection (4) deals with non-depreciable property that is transferred on the qualifying exchange; and subsection (5) deals with depreciable property that is transferred. Subsection (6) establishes the due date for the election to treat a transfer as a qualifying exchange; and subsection (7) provides authority for the Minister of National Revenue to allow that election to be amended or revoked.

Despite this restructuring, the basic principles of section 132.2 remain unchanged, as do most aspects of its operation. The exceptions – the areas where these amendments change the provision substantively – have to do with depreciable property that is transferred on a qualifying exchange, and with the election to treat a transaction as a qualifying exchange. Further modifications have been made to prevent the creation of artificial or “phantom” losses, generally in circumstances where one fund holds units or shares of the other fund immediately before the transfer time.

Transfers of Depreciable Property

In its current form, section 132.2 does not deal comprehensively with transfers of depreciable property between mutual funds. In particular, the deemed timing of the transfer, in relation to the deemed year-end of the funds, may prevent either fund from claiming capital cost allowance (CCA) for the last taxation year that began before the qualifying exchange. The transferor has disposed of the property two moments before the end of its year, and the transferee will not acquire it until the last moment of its own year.

To ensure that one CCA claim is available for that last year, new subsection 132.2(5) provides a special regime for qualifying exchanges that include transfers of depreciable property. A key aspect of these special rules is the ordering of events in accordance with new subsection 132.2(2). That subsection provides that, starting with the actual (i.e., legal) transfer of property between a transferor fund and a transferee fund that carry out a qualifying exchange, the following series of times occurs, each immediately after the previous one:

Name of Time	Description	Reference
the transfer time	The actual transfer of the property between the funds takes place.	definition "qualifying exchange" in 132.2(1)
the first intervening time	The funds are treated as having disposed of and reacquired non-transferred property (other than depreciable property).	132.2(3)(*a*)
the acquisition time	The transferee is treated as having acquired transferred property (other than depreciable property); the funds' taxation years are treated as ending.	132.2(4)(*a*); 132.2(3)(*b*)
the beginning of the funds' first post-exchange years		132.2(3)(*b*)
the depreciables disposition time	The transferor is deemed to have disposed of any transferred property that is depreciable property.	132.2(5)(*a*)
the second intervening time	The funds are treated as having disposed of and reacquired any non-transferred property that is depreciable property.	132.2(3)(*c*)
the depreciables acquisition time	The transferee is deemed to have acquired any transferred property that is depreciable property.	132.2(5)(*b*)

As a result of this timing, the transferor fund will be treated as owning, until after its first post-exchange year has begun, any depreciable property that is being transferred. This will ensure that the transfer does not prevent the transferor from deducting CCA in respect of property of that class, for its taxation year that ends at the acquisition time. The new rule also ensures that the transferee does not duplicate that deduction, by treating the transferee as having acquired the property only after its new taxation year has begun.

This treatment of depreciable property applies, along with most aspects of the restructuring of section 132.2, to qualifying exchanges that take place after 1998.

Timing of Election

For section 132.2 to apply to a transfer of property between mutual funds, the definition "qualifying exchange" currently requires the funds to file their joint election in prescribed form with the Minister of National Revenue within six months after the transfer time. This timing requirement is changed to allow greater flexibility. The amended definition "qualifying exchange" requires that the funds' election be made before the election's "due date", defined in new subsection 132.2(6) to mean either the day that is six months after the day that includes the transfer time or any later day that the Minister accepts, on joint application by the funds. An example of a case in which the Minister might accept such an application would be one in which the Minister has already decided to accept a late filing of the funds' returns of income for the taxation year that includes the qualifying exchange.

In certain cases, mutual funds that have elected to treat a transfer as a qualifying exchange may wish to amend, or even revoke, their election. New subsection 132.2(7) allows the funds to do this, on joint application and with the permission of the Minister.

New subsections 132.2(6) and (7), and the amended definition “qualifying exchange” in subsection 132.2(1), apply to qualifying exchanges that take place after June 1994.

Definition “designated beneficiary”

Rules of General Application

ITA
132.2(3)(*g*)(iii) and 132.2(1)(*j*)(iii)

New subparagraph 132.2(3)(*g*)(iii) of the Act applies in determining whether a person is a “designated beneficiary” (as defined in section 210 of the Act) of a trust. Under the definition designated beneficiary, certain persons or partnerships that are beneficiaries under a trust may be treated (or may cause trusts or partnerships of which they are beneficiaries or members to be treated) as designated beneficiaries under the trust, unless the relevant interest in the trust is held at all times by the person or partnership, as the case may be, or by another person exempt because of subsection 149(1) of the Act from tax, under Part I of the Act, on all of the other person’s taxable income.

In a qualifying exchange, a mutual fund trust or mutual fund corporation (transferor) transfers all or substantially all of its property to another mutual fund trust (transferee) and takes back units of the transferee. Those units are then provided by the transferor to its investors in exchange for their shares or units of the transferor. New subparagraph 132.2(3)(*g*)(iii) ensures that, in these circumstances, the transferor is treated, for the purpose of the definition designated beneficiary, as not having held the units of the transferee.

This amendment applies for qualifying exchanges that occur after 1998. A similar rule, in former subparagraph 132.2(1)(*j*)(iii), applies for qualifying exchanges that occurred after June 1994 and before 1999.

Rules of General Application - Losses

ITA
132.2(3)(*f*) and (*g*)

New paragraphs 132.2(3)(*f*) and (*g*) of the Act are amended to ensure that the mutual fund merger rules do not apply inappropriately to create artificial or “phantom” losses. Although the changes reflected in these new provisions are not expected to be relevant to most qualifying exchanges, the following is a description of their purpose and effect.

Under the definition “qualifying exchange” in new subsection 132.2(1), all or substantially all of the outstanding shares issued by the transferor must be disposed of to the transferor within the 60 days after the transfer time, and every person so disposing of shares of the transferor must receive only units of the transferee as consideration. The second leg of a qualifying exchange is thus a set of transactions in which the transferor’s investors replace their shares of the transferor with units of the transferee. The tax effect of those transactions are governed by paragraphs 132.2(1)(*f*) and (*g*). For clarity, these notes reflect the legislation by referring to investments in the transferor – whether a corporation or a trust – as shares, reserving the term “units” to refer to the units of the transferee mutual fund trust.

Existing paragraph 132.2(1)(*i*) provides that if, within 60 days after the transfer time, the transferor fund disposed of units of the transferee in exchange for shares of itself, its proceeds of disposition are deemed to be nil. Since the units acquired by the transferor in return for its property are deemed, under existing paragraph 132.2(1)(*h*) (now new paragraph 132.2(3)(*e*)), also to have had a cost of nil, this provision allows the transferor to roll those units out to its investors with no tax consequences to it. New paragraph 132.2(3)(*f*) provides that if, within 60 days after the transfer time, the transferor fund disposes of units of the transferee in exchange for shares of itself, its proceeds of disposition will be deemed to be equal to the cost amount of the units to the transferor immediately before the disposition. This change – from nil proceeds to proceeds equal to cost amount – ensures appropriate results if the transferor held units of the transferee that were acquired otherwise than as a result of the qualifying exchange. In this situation, that first tranche of units will have a cost

base that, pursuant to section 47 of the Act, will be averaged with the second tranche of units (i.e. the units that the transferor acquired in the qualifying exchange). Existing paragraph 132.2(1)(*i*) deems the proceeds of the disposition of the second tranche of units to be nil, an inappropriate result in that it creates a phantom loss. New paragraph 132.2(3)(*f*), deeming the proceeds of disposition equal to the cost amount of the units to the transferor immediately before the disposition, ensures that the transferor can still roll units of the transferee out to its investors with no tax consequences to it, and avoids the creation of a phantom loss.

Existing subparagraph 132.2(1)(*j*)(i) provides that, where a taxpayer disposes of shares of the transferor in exchange for units of the transferee within that same 60-day period, both the taxpayer's proceeds of disposition of the shares and the taxpayer's cost of the units are deemed to be equal to the cost amount of the shares immediately before the transfer time. New subparagraph 132.2(3)(*g*)(i) provides that, where a taxpayer disposes of shares of the transferor in exchange for units of the transferee within that same 60-day period, both the taxpayer's proceeds of disposition of the shares and the taxpayer's cost of the units are deemed to be equal to the cost amount of the shares immediately before the disposition. This change – from measuring the cost amount of the shares immediately before the transfer time to measuring it immediately before the disposition – ensures that the transferor's investors will not realize any gain or loss on their exchange of their shares for units of the transferee.

Paragraph 132.2(3)(*g*) also includes a new subparagraph 132.2(3)(*g*)(iv) to address the disposition by certain persons or partnerships of the units in the transferee that they received on the qualifying exchange. Those affected by this new provision are those who, when they acquire the units, are affiliated with one or both of the funds. This could include, for example, the transferee itself, or a corporation it controls.

The subparagraph first deems the units received in the qualifying exchange not to be identical to any other units of the transferee. This segregates the new units from the averaging effect of section 47 of the Act.

Next, the subparagraph specifies the effects of disposing of the new units. If the taxpayer is the transferee, and the units cease to exist when the taxpayer acquires them (if, for example, the units are cancelled immediately on receipt), clause 132.2(3)(*g*)(iv)(B) provides two effects. First, to prevent any possible question in this regard, the taxpayer is deemed to have acquired those units. This ensures, among other things, that subparagraph (i) establishes the taxpayer's cost of the units. Second, the taxpayer is treated as having disposed of those units immediately after it acquired them, for proceeds of disposition equal to the cost amount to the taxpayer of those units at that time. This ensures, for greater certainty, that a transferee that had an investment in the transferor prior to the qualifying exchange will not incur a phantom loss as a result of exchanging its shares in the transferor in return for units of itself.

If the taxpayer is affiliated with one or both of the funds, but is not the transferee, clause 132.2(3)(*g*)(iv)(C) provides that, for the purpose of computing any gain or loss of the taxpayer from the taxpayer's first disposition of each of those units, the proceeds of disposition of the unit will depend on whether the disposition is a renunciation or surrender of the unit or some other disposition.

New subclause 132.2(3)(*g*)(iv)(C)(I) provides that, if the disposition is a renunciation or surrender of the unit by the taxpayer for no consideration, and is not in favour of any person other than the transferee, the taxpayer's proceeds of disposition of that unit are deemed to be equal to that unit's cost amount to the taxpayer immediately before that disposition. This ensures that an affiliated taxpayer will never incur a phantom loss or gain on the renunciation or surrender of the unit.

If the disposition is not a renunciation or surrender of the unit described in subclause 132.2(3)(*g*)(iv)(C)(I), the affiliated taxpayer's proceeds of disposition of that unit are deemed by subclause 132.2(3)(*g*)(iv)(C)(II) to be equal to the greater of that unit's fair market value and its cost amount to the taxpayer immediately before that disposition. This ensures that the taxpayer will never incur a loss, including a phantom loss, on a disposition of one of those units, but may incur a gain.

Two additional points should be noted with respect to the operation of new subparagraph 132.2(3)(g)(iv).

- The deeming, by subclause 132.2(3)(g)(iv)(C)(II), of a taxpayer's proceeds of disposition of the units the taxpayer acquired on the qualifying exchange applies only to the first disposition of each unit. It is possible that a taxpayer might dispose of a unit and then reacquire the same unit (under, for example, the change in residence rules in section 128.1 of the Act). The subclause will not apply to any subsequent disposition of the unit by that taxpayer.
- In some circumstances, an affiliated taxpayer may have a latent loss on a share of the transferor prior to the qualifying exchange, and may wish to realize that loss. This can be done, if the affiliated taxpayer disposes of the share prior to the qualifying exchange. However, the possible application of the Act's "superficial loss" and loss deferral rules would have to be borne in mind.

New paragraphs 132.2(3)(*f*) and (*g*), together with the rest of new subsection 132.2(3), generally apply to qualifying exchanges that occur after 1998. A limited exception applies in respect of certain qualifying exchanges in respect of which a return of income, claiming the losses sought to be prevented by these amendments, was filed by the transferee mutual fund before July 18, 2005.

Clause 131

Non-resident-owned Investment Corporations - Transition

ITA
134.1(2)

Section 134.1 of the Act was enacted, along with section 134.2, in 2001 to provide transitional relief for corporations that cease to be non-resident owned investment corporations (NROs). The essence of the relief provided in section 134.1 is to allow such a corporation to recover refundable tax by paying a dividend in its "first non-NRO year". In its current form, the section applies only in respect of dividends paid to a non-resident person or another NRO. There is, however, another kind of shareholder to whom an NRO may pay a dividend in respect of which it is appropriate to apply the section - a trust for the benefit of non-resident persons or their unborn issue. Since such a trust could, under the rules that have governed NROs themselves, have held the shares and debt of an NRO, a dividend to the trust ought to support a refund of the former NRO's refundable tax. Subsection 134.1(2) is therefore amended to include such dividends within the section's scope.

In addition, subsections 104(10) and (11) of the Act are added to the list of provisions in subsection 134.1(2) for which a former NRO is deemed to be an NRO during its first non-NRO year. Prior to the repeal of the NRO system, a trust that received a dividend from an NRO and that did not in turn distribute the amount of the dividend to its non-resident beneficiaries was entitled to deduct that amount from the trust's income under subsection 104(10). Subsection 104(11) then deemed the amount deducted under subsection 104(10) to have been paid to a non-resident beneficiary, with the result that Part XIII withholding tax would typically be payable. These two subsections are included in subsection 134.1(2) in order to allow a trust to benefit from these provisions in the year it receives the final payment of dividends from the former NRO.

Both of these amendments apply on the same basis as section 134.1: that is, to a corporation that ceases to be an NRO because of a transaction or event that occurs, or a circumstance that arises, in a taxation year of the corporation that ends after February 27, 2000.

Clause 132

Cooperative Corporations

ITA
136

Section 136 of the Act provides rules that apply to cooperative corporations.

Subsection 136(1) provides that a cooperative corporation that would otherwise be a private corporation is treated as a private corporation for the purposes of specified provisions of the Act. The subsection is amended to include among those provisions section 123.4 of the Act, which in effect provides reductions in corporate tax rates. This subsection is amended, for the 2001 and subsequent taxation years, to provide that a cooperative corporation that otherwise qualifies as a Canadian-controlled private corporation (CCPC) may use the special rate reduction provided for CCPCs.

Subsection 136(2) of the Act sets out conditions that a corporation must meet in order to be a cooperative corporation. The condition in current paragraph 136(2)(*c*) has two parts: at least 90% of its members must be individuals, other cooperative corporations, or corporations or partnerships that carry on the business of farming; and at least 90% of its shares, if any, must be held by those persons or partnerships.

The second part of this condition is modified to accommodate cases where the shares of a cooperative are held not only by the members themselves, but also by their registered plans (RRSPs, RRIFs, or RESPs). If shares are held by a trust that is governed by such a plan, provided a member of the cooperative is the plan's subscriber or annuitant, as the case may be, those shares will be counted in the same way as if they were held by a member personally. Amended paragraph 136(2)(*c*) and new paragraph 136(2)(*d*), which give effect to this change, apply to the 1998 and subsequent taxation years.

Clause 133

Credit Unions

ITA
137(6)

"member"

Section 137 of the Act provides rules that apply to credit unions. Among the definitions set out in subsection 137(1) is "member," meaning essentially a member of record who is entitled to the services of the credit union. This definition is amended, for the 1996 and subsequent taxation years, to treat as a member a registered retirement savings plan, registered retirement income fund, or registered education savings plan, provided that the annuitant or subscriber under the plan is a person who meets the existing definition of "member".

Credit Union not Private Corporation

ITA
137(7)

Subsection 137(7) of the Act provides that a credit union that would otherwise be a private corporation is treated as a private corporation for the purposes of specified provisions of the Act. The subsection is amended to include among those provisions section 123.4 of the Act, which in effect provides reductions in corporate tax rates. This amendment, which applies to the 2001 and subsequent taxation years, provides that a credit union that otherwise qualifies as a Canadian-controlled private corporation (CCPC) may use the special rate reduction provided for CCPCs.

Clause 134

Deposit Insurance Corporations

ITA
137.1

Section 137.1 of the Act provides rules for the taxation of deposit insurance corporations (DICs), including rules that affect the computation of income. In general terms, the premiums that a member institution pays to a DIC are deductible in computing the member's income and are not included in computing the income of the DIC, while any assistance that the DIC provides to the member or the member's depositors is not deductible for the DIC and is included in computing the member's income.

In certain circumstances, two or more DICs may share responsibilities toward a group of members. In such a case, it may be necessary for one DIC to pay to another an amount in respect of premiums. To ensure the appropriate tax consequences of such a payment, subsections 137.1(2) and (4) are amended. New paragraph 137.1(2)(*b*) excludes from the income of a DIC any amount it receives from another DIC, to the extent the amount can reasonably be considered to have been paid out of premiums or assessments received or receivable by the other DIC from its member institutions. New paragraph 137.1(4)(*d*), on the other hand, precludes the paying DIC from deducting the amount in computing its own income. These amendments apply to the 1998 and subsequent taxation years.

Clause 135

Insurance Corporations

ITA
138

Section 138 of the Act provides detailed rules relating to the taxation of insurance corporations.

Insurer's Income or Loss

ITA
138(2)

Subsection 138(2) of the Act provides rules for the purpose of computing the income of a life insurer resident in Canada where the life insurer carries on an insurance business in Canada and in a country other than Canada. The subsection provides that the insurer's income from carrying on an insurance business is the amount of its income from carrying in the insurance business in Canada computed in accordance with the Act. As well, the subsection provides that the insurer's taxable capital gains and allowable capital losses from property used or held in the course of carrying on an insurance business is the insurer's taxable capital gains and allowable capital losses from designated insurance property.

Subsection 138(2) is being amended to extend its application to non-resident insurer's that carry on an insurance business in Canada. As well, it is being amended to provide, for greater certainty, the following:

1. In computing a multinational insurer's income from an insurance business carried on by it in Canada, no amount is to be included in respect of the insurer's gross investment revenue for a taxation year derived from property used or held in the course of carrying on an insurance business that is not designated insurance property of the insurer. Subsection 138(9) of the Act provides that in computing a multinational insurer's income from an insurance business carried on by it in Canada the insurer must include its gross investment revenue for the year from its designated insurance property for the year plus the amount prescribed in respect of the insurer for the year. Designated insurance property is defined in section 2400 of the *Income Tax Regulations*.

2. In computing a multinational insurer’s taxable capital gains and allowable capital losses for the year from the disposition of property used or held in the course of carrying on an insurance business there is to be included the insurer’s taxable capital gains and allowable capital losses from dispositions of its designated insurance property for the year. It also provides that the insurer’s taxable capital gains and allowable capital losses for the year from the disposition of property used or held in the course of carrying on an insurance business that is its designated insurance property for the year are not to be included in computing a multinational insurer’s taxable capital gains and allowable capital losses for the year.

The amendments are applicable to taxation years that end after 1999.

Computation of Income of Non-resident Insurer

ITA
138(11.91)

Subsection 138(11.91) of the Act provides rules for the purpose of computing the income of a non-resident insurer that at any time in a particular taxation year commences to carry on business in Canada or that ceases to be exempt from tax under Part I of the Act.

Paragraph 138(11.91)(*f*) of the English Version of the Act applies where the non-resident insurer’s capital cost of a depreciable property exceeds the property’s fair market value immediately before the commencement of the particular taxation year. To ensure that on a later disposition of the property the non-resident insurer is subject to recapture of any excess capital cost allowance claimed before the particular taxation year, this paragraph preserves the property’s capital cost, and treats the excess as having been allowed as capital cost allowance.

Since it is inappropriate to provide for the recapture of capital cost allowance that was claimed when the business was not carried on in Canada or when the non-resident insurer was exempt from tax under Part I of the Act, paragraph 138(11.91)(*f*) of the English version of the Act is repealed.

Paragraph 138(11.91)(*d*) of the French version of the Act is repealed for the same reason.

This amendment applies to taxation years that end after 1999.

Clause 136

Mark-to-market Rules

ITA
142.6(1)

Subsection 142.6(1) of the Act contains rules that apply where a taxpayer becomes (or ceases to be) a financial institution. This is most likely to happen where the change of status occurs because the taxpayer becomes (or ceases to be) controlled by a financial institution.

If a taxation year of the taxpayer does not end immediately before the time at which its status as a financial institution changes, subparagraph 142.6(1)(*a*)(i) deems the taxpayer’s taxation year that would otherwise have included that time to end immediately before that time. A new taxation year begins at that time, and the taxpayer is permitted to adopt a new fiscal period. One purpose for the deemed year-end is to ensure the proper application, in taxation years in which the taxpayer is a financial institution, of the rules, commonly known as the mark-to-market rules,

- in section 142.3 of the Act for specified debt obligations, and
- in section 142.5 of the Act for market-to-market properties.

The expressions “financial institution”, “specified debt obligation” and “mark-to-market property” are defined in section 142.2 of the Act.

Paragraph 142.6(1)(*b*) applies where a taxpayer becomes a financial institution. This paragraph generally provides for a deemed disposition at fair market value of each property held by the taxpayer that is

- a specified debt obligation (other than a specified debt obligation that is a mark-to-market property to which subparagraph 142.6(1)(*b*)(ii) applies)[1], or
- a mark-to-market property for the taxpayer's taxation year that ends immediately before the time of the change of status[2].

This deemed disposition under paragraph 142.6(1)(*b*) is intended to ensure that amounts brought, because of the mark-to-market rules in sections 142.3 and 142.5, into the taxpayer's income for the taxpayer's subsequent taxation year (i.e., the taxation year that includes the time of the change of status) do not include gains or losses accrued before the beginning of that subsequent taxation year.

Paragraph 142.6(1)(*b*) is amended to ensure that this is achieved in connection with mark-to-market properties. Amended paragraph 142.6(1)(*b*) results in the taxpayer being deemed to have disposed of, immediately before the end of its particular taxation year that ends immediately before the time of the change of status, and for proceeds equal to its fair market value at the time of that disposition, a mark-to-market property of the taxpayer

- for the particular taxation year, or
- for the subsequent taxation year.

Paragraph 142.6(1)(*c*) provides for a deemed disposition of specified debt obligations (other than mark-to-market property) in the opposite situation of change of status, i.e., where the taxpayer ceases to be a financial institution. Paragraph 142.6(1)(*d*) provides that the taxpayer is deemed to have reacquired, at the end of the taxation year referred to in paragraph 142.6(1)(*b*) or (*c*), each property deemed by that paragraph to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property.

Consequential to the amendments to paragraph 142.6(1)(*b*), paragraph 142.6(1)(*d*) is amended to provide that the taxpayer is deemed to have reacquired, at the end of its taxation year that ends immediately before the time of the change of status, each property deemed by paragraph 142.6(1)(*b*) or (*c*) to have been disposed of by the taxpayer, at a cost equal to the proceeds of disposition of the property.

Amended paragraphs 142.6(1)(*b*) and (*d*) apply to taxation years that end after 1998.

Clause 137

Authorized Foreign Banks – Conversion

ITA
142.7(8)(*d*)

Section 142.7 of the Act provides time-limited rules to facilitate foreign banks' transformation of certain Canadian operations, currently carried out through subsidiaries, into Canadian branches (known as "authorized foreign banks") of the foreign banks themselves.

When an authorized foreign bank assumes certain debt obligations of its Canadian affiliates, subsection 142.7(8) applies to govern the tax consequences of the assumption.

Subparagraph 212(1)(*b*)(vii) of the Act provides an exemption from Part XIII tax in respect of interest payments on certain long- and medium-term corporate debt. The exemption can depend upon, among other things, the time at which a debt is issued. New paragraph 142.7(8)(*d*) is added to treat, for the purpose of subparagraph 212(1)(*b*)(vii), a debt obligation assumed by an authorized foreign bank from its Canadian affiliate as having been issued at the time that the debt was issued by the Canadian affiliate.

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[1] Subparagraph 142.6(1)(*b*)(i)

[2] Subparagraph 142.6(1)(*b*)(ii)

This amendment applies after June 27, 1999.

Clause 138

Communal Organizations

ITA
143

Section 143 of the Act sets out rules governing the taxation of communal organizations (referred to in that section as “congregations”) that do not allow their members to own property in their own right.

Election in Respect of Gifts

ITA
143(3.1)

Subsection 143(3.1) of the Act allows a communal organization that makes an election under subsection 143(2) of the Act to elect to have its total charitable, Crown, cultural and ecological gifts flowed through to those members (the “participating” members) of the congregation for whom an amount is included in income for the year under subsection 143(2).

Subsection 143(3.1) is amended consequential to the addition of new subsection 248(31) of the Act, in respect of gifts made after December 20, 2002, to refer to the “eligible amount” of a gift made because of a person being a participating member in the communal organization.

Clause 139

Limited-recourse Debt in Respect of a Gift or Monetary Contribution

ITA
143.2(6.1)

New subsection 143.2(6.1) of the Act describes limited-recourse debt in respect of a gift or monetary contribution made after February 18, 2003. Such an amount is an advantage under subsection 248(32) of the Act, such that it reduces the eligible amount of a gift or political contribution determined under subsection 248(31) of the Act. For additional details regarding the amount of an advantage, see the commentary to new subsection 248(32).

A limited-recourse debt includes the unpaid principal of any indebtedness for which recourse is limited, even if that limitation applies only in the future or contingently. It also includes any other indebtedness of the taxpayer, related to the gift or contribution, if there is a guarantee, security or similar indemnity or covenant in respect of that or any other indebtedness. For example, if a donor (or any other person mentioned below) enters into a contract of insurance whereby all or part of a debt will be paid upon the occurrence of either a certain or contingent event, the debt is a limited-recourse debt in respect of a gift if it is in any way related to the gift.

Such an indebtedness is also a limited-recourse debt if it is owed by a person dealing non-arm’s length with the taxpayer or by a person who holds an interest in the taxpayer.

Information Located Outside Canada

ITA
143.2(13)

Subsection 143.2(13) of the Act applies where information related to an indebtedness in respect of an expenditure is located outside Canada, and the Minister of National Revenue is not satisfied that the indebtedness is not a limited-recourse amount. In such a case, the indebtedness is deemed to be a limited-recourse amount in respect of the expenditure. Subsection 143.2(13) is extended to also apply in respect of an indebtedness that relates to a gift or political contribution made after February 18, 2003.

Clause 140

Expenditure – Limitations

ITA
143.3

New section 143.3 of the Act reduces, if applicable, the amount of a taxpayer's expenditure by certain amounts for the purposes of computing the taxpayer's income, taxable income and tax payable or an amount considered to have been paid on account of the taxpayer's tax payable.

Definitions

ITA
143.3(1)

New subsection 143.3(1) of the Act provides definitions that apply for the purposes of section 143.3. Those definitions are:

"expenditure"

"Expenditure" of a taxpayer, which means an expense, expenditure or outlay made or incurred by the taxpayer, or that is a cost or capital cost of property acquired by the taxpayer.

"option"

"Option", which means an option, warrant or similar right, issued or granted by the taxpayer, giving the holder the right to acquire an interest in the taxpayer or in another taxpayer with which the taxpayer does not, at the time the option, warrant or similar right is issued or granted, deal at arm's length.

"taxpayer"

"Taxpayer", which is defined to include a partnership.

Options – limitation

ITA
143.3(2)

New subsection 143.3(2) of the Act provides that, in computing a taxpayer's income, taxable income or tax payable or an amount considered to have been paid on account of the taxpayer's tax payable, an expenditure of the taxpayer is deemed not to include any portion of the expenditure that would – if the Act were read without reference to subsection 143.3(2) – be included in determining the expenditure because of the taxpayer having granted or issued an option on or after November 17, 2005. In essence, the value of an option granted by a taxpayer is not considered to be an expenditure for income tax purposes.

Corporate Shares – Limitation

ITA
143.3(3)

New subsection 143.3(3) of the Act provides for two reductions that apply to an expenditure that would – if the Act were read without reference to subsection 143.3(3) – include an amount because of a corporation (or another corporation not dealing at arm's length with the corporation) having issued a share of its capital stock at any particular time on or after November 17, 2005. The reductions apply to the corporation in computing its income, taxable income or tax payable or an amount considered to have been paid on account of the corporation's tax payable.

New paragraph 143.3(3)(a) applies on the issuance of the share (other than on the exercise of an option). Generally, the corporation is to reduce the related expenditure by the amount, if any, by which

(i) the fair market value of the share

exceeds

(ii) if the transaction under which the share is issued is a transaction to which section 85, 85.1 or 138 of the Act applies, the amount determined under that section to be the cost to the corporation of the property acquired in consideration for the issuance of the share, or

(iii) in any other case, the amount of consideration that is the fair market value of the property transferred to, or the services provided to, the issuing corporation for issuing the share.

In addition, under new paragraph 143.3(3)(b), if the issuance of the share is a consequence of the exercise of an option, generally the corporation is to reduce the related expenditure by the amount, if any, by which

(i) the fair market value of the share

exceeds

(ii) that portion of the amount paid, pursuant to the terms of the option, by the holder to the issuing corporation for issuing the share.

Example

Facts

In its 2006 taxation year, Corporation X grants an option to Y in return for $1,000 worth of paintings by a little-known Canadian artist. Corporation X does not give cash or any other consideration for the paintings. The option gives Y the right to acquire one share of Corporation X for $10,000 in 2007. (At the time the option is granted one share of Corporation X has a fair market value of $10,000.)

In 2007, Y exercises the option and pays Corporation X $10,000 cash for the share. The share has a fair market value of $15,000 at the time of issue.

Corporation X files its 2007 income tax return on the basis that the cost of the paintings is $5,000, representing the difference between the fair market value of the share when it was issued and the cash paid by Y for the share.

Application of section 143.3 of the Act

1. On granting the option:

- *New subsection 143.3(2) applies to clarify that there is no expenditure by Corporation X resulting from it issuing the option.*

2. On the exercise of the option:

When issuing the share on the exercise of the option, new paragraph 143.3(3)(b) ensures that an expenditure, if any, of Corporation X is reduced by $5,000 – being the amount by which

$15,000 (the fair market value of the share – see subparagraph (b)(i))

exceeds

$10,000 (the amount paid for the share – see subparagraph (b)(ii).

However, and as noted in the explanatory note accompanying new subsection 143.3(5), the reductions provided for under subsections 143.3(3) and (4) do not apply to reduce an expenditure if the expenditure itself does not include an amount determined to be excesses described in those subsections.

Non-corporate Interests – Limitation

ITA
143.3(4)

New subsection 143.3(4) of the Act provides for two reductions that apply to a non-corporate taxpayer's expenditure that would – if the Act were read without reference to subsection 143.3(4) – include an amount because the taxpayer (or another taxpayer not dealing at arm's length with the taxpayer) issues or creates an interest in itself at any particular time on or after November 17, 2005. The reductions apply to the taxpayer in computing its income, taxable income or tax payable or an amount considered to have been paid on account of the taxpayer's tax payable.

In general terms, under new paragraph 143.3(4)(*a*), if the issuance or creation of the interest in a taxpayer is not a consequence of the exercise of an option, the taxpayer is to reduce the expenditure by the amount, if any, by which

(i) the fair market value of the interest

exceeds

(ii) if the transaction under which the interest is issued or created is a transaction to which paragraph 70(6)(b), subsection 97(2), paragraph 73(1.01)(c), subsection 73(1.02), section 107.4 or 132.2 of the Act applies, the amount determined under that provision to be the cost to the taxpayer of the property acquired for the interest, or

(iii) in any other case, the amount of the consideration that is the fair market value of the property transferred to, or the services provided to, the taxpayer for the interest.

In addition, under new paragraph 143.3(4)(*b*), if the issuance or creation of the interest is a consequence of the exercise of an option, the taxpayer is to reduce the expenditure by the amount, if any, by which

(i) the fair market value of the interest

exceeds

(ii) the amount paid, pursuant to the terms of the option, by the holder to the taxpayer for the interest.

However, and as noted in the explanatory note accompanying new subsection 143.3(5), the reductions provided for under subsections 143.3(3) and (4) do not apply to reduce an expenditure if the expenditure itself does not include an amount determined to be excesses described in those subsections.

Clarification

ITA
143.3(5)

New subsection 143.3(5) of the Act provides four rules for greater certainty.

First, paragraph 143.3(5)*(a)* clarifies that subsection 143.3(2) does not reduce an expenditure that is a commission, fee or other amount for services rendered by a person as a salesperson, agent or dealer in securities in the course of the issuance of the option.

Second, paragraph 143.3(5)(*b*) clarifies that subsections 143.3(3) and (4) do not apply to reduce an expenditure to the extent that the expenditure does not include an amount determined to be an excess under those subsections. For example, if a corporation were to issue shares of its capital stock having a fair market value of $100 in consideration for having acquired property or services having a fair market value of $40, no excess exists under paragraph 143.3(3)(*a*) if the expenditure of the corporation for the property or services claimed by the corporation without reference to section 143.3 is, for income tax purposes, $40. To the extent the

corporation seeks to claim an expenditure in excess of that $40, paragraph 143.3(3)(*a*) would reduce that excess to nil. Paragraph 143.3(5)(*b*) recognizes that the jurisprudence that would treat an expenditure of the type reduced by subsections 143.3(3) and (4) currently applies only to scientific research and experimental development (SR&ED) tax credits, and is limited to a single decision of the Tax Court of Canada. It may very well transpire that future jurisprudence may constrain or eliminate any such expenditure that may be considered to arise in these circumstances.

Third, paragraph 143.3(5)(*c*) clarifies that section 143.3 does not determined the cost or capital cost of property determined under certain tax-deferral rules. For example, if section 85 of the Act deems a transferee corporation that acquires non-depreciable capital property to do so at a cost of $100 in circumstances where the corporation issued a share of its capital stock having a fair market value of $200, this section does not decrease or increase the $100 cost for the property to the corporation, as determined under section 85.

Fourth, paragraph 143.3(5)(*d*) clarifies that section 143.3 does not determine the amount of a taxpayer's expenditure if the amount of the expenditure as determined under section 69 of the Act is less than an amount determined under section 143.3.

Clause 141

Registered Retirement Savings Plans

ITA
146

Section 146 of the Act provides rules relating to registered retirement savings plans (RRSPs).

Definitions

ITA
146(1)

"earned income"

Subsection 146(1) of the Act defines "earned income", which is relevant in determining the maximum tax-deductible contributions that a taxpayer may make to RRSPs. The definition includes references to a number of provisions that have previously been repealed or re-numbered. The definition is amended to remove these references and update the numbering, with application from the time the provisions were repealed or re-numbered.

Deemed Receipt of Refund of Premiums

ITA
146(8.1)

Subsection 146(8.1) of the Act deals with situations in which an amount paid from a deceased individual's RRSP to the individual's estate would have been a "refund of premiums" if it had been paid by the RRSP to a beneficiary under the estate. An amount paid out of an RRSP as a consequence of the death of the annuitant is defined, by subsection 146(1) of the Act, to be a "refund of premiums" if the recipient was, immediately before the death of the RRSP annuitant, a spouse or common-law partner of the annuitant or a financially dependent child or grandchild of the annuitant.

Subsection 146(8.1) allows the legal representative of a deceased RRSP annuitant's estate and a qualifying beneficiary under the estate to elect jointly to have the RRSP proceeds that were paid to the estate treated as a refund of premiums received by the beneficiary from the RRSP. When such an election is made, the beneficiary may include the deemed refund of premiums in income. If a corresponding amount is used to acquire a qualifying annuity or is paid into an RRSP or registered retirement income fund of the beneficiary and certain other conditions are satisfied, the beneficiary will be entitled to an offsetting deduction under paragraph 60(*l*) of the Act.

Subsection 146(8.1) is amended to provide that the expression "beneficiary" under a deceased RRSP annuitant's estate has the meaning assigned by subsection 108(1) of the Act. This has the effect of extending the provisions of subsection 146(8.1) to an individual who is "beneficially interested" in a deceased RRSP annuitant's estate (as defined in subsection 248(25)), but who is not a beneficiary under the estate. This could occur, for example, where an individual has only an indirect interest in the deceased RRSP annuitant's estate by virtue of being a beneficiary under a trust that is a beneficiary under the estate – a structure typically contemplated in the estate planning of parents of mentally infirm children.

This change applies after 1988.

Where Tax Payable

ITA
146(10.1)

Subsection 146(10.1) of the Act provides that income earned by a trust governed by a retirement savings plan from non-qualified investments is taxable under Part I. Subparagraph 146(10.1)(*b*)(ii) provides that income for this purpose includes the full amount of capital gains in excess of capital losses. This subparagraph is reworded for clarity, applicable on Royal Assent.

Clause 142

Home Buyers' Plan

ITA
146.01

Section 146.01 of the Act set out the requirements for the Home Buyers' Plan (HBP), which allows the tax-free withdrawal of RRSP funds for the purchase of a home.

Definitions

ITA
146.01(1)

"quarter"

Subsection 146.01(1) of the Act contains the definition "quarter" for purposes of the rules relating to the HBP. This definition is repealed as a consequence of the repeal of subsection 146.01(8) of the Act, where this definition applied. The repeal of this definition applies for the 2002 and subsequent taxation years.

Filing of Prescribed Form

ITA
146.01(8)

In order for an RRSP withdrawal to qualify as an HBP withdrawal, the taxpayer must make a written request in prescribed form to the RRSP issuer. The prescribed form for this purpose is the T1036. Under subsection 146.01(8) of the Act, an RRSP issuer to whom a T1036 is submitted must file the form with the Minister of National Revenue no later than 15 days after the quarter in which it was so submitted.

Subsection 146.01(8) is repealed. Rather than reporting HBP withdrawals on a quarterly basis by filing the relevant T1036, RRSP issuers are instead required (by subsection 214(1) of the Regulations) to report such withdrawals on an annual basis using the T4RSP.

The repeal of subsection 146.01(8) applies for the 2002 and subsequent taxation years.

Clause 143

Registered Education Savings Plans - Conditions for Registration

ITA
146.1(2)(*g*.3) and (2.3)

Subsection 146.1(2) of the Act sets out the conditions that must be satisfied in order for an education savings plan to be accepted for registration.

New paragraph 146.1(2)(*g*.3) is introduced to preclude non-residents and individuals who have not yet been assigned a Social Insurance Number (SIN) from becoming a beneficiary under a registered education savings plan (RESP) or from benefiting from RESP contributions.

Specifically, paragraph 146.1(2)(*g*.3) requires that an education savings plan not permit an individual to be designated as a beneficiary under the plan, and not allow a contribution for an individual who is a beneficiary under the plan, unless the individual's SIN has been provided to the promoter of the plan and the individual is resident in Canada.

If an individual is designated as a beneficiary under an RESP in conjunction with the transfer of property into the plan from another RESP under which the individual was a beneficiary immediately before the transfer, the requirement that the individual be resident in Canada in order to be designated as a beneficiary does not apply. However, subject to the exceptions in new subsection 146.1(2.3), the individual's SIN has to be provided to the promoter in order for the individual to be designated as a beneficiary under the transferee RESP. This special rule is intended primarily to accommodate transfers from an RESP to a replacement RESP after the beneficiary has ceased to be resident of Canada. (It should be noted that the transfer itself, as a contribution to an RESP, is not subject to the SIN and residency conditions that apply to ordinary contributions.)

New subsection 146.1(2.3) provides two additional exceptions to the SIN condition that are primarily of relevance to RESPs that were entered into before 1999 and RESPs that replace such plans. These exceptions recognize that the Canada Revenue Agency only began requiring the beneficiary's SIN to be provided on the application for registration for plans entered into after 1998.

The first new exception allows an education savings plan that was entered into before 1999 to not require that an individual's SIN be provided in respect of a contribution to the plan. Such contributions, however, continue to be ineligible for the Canada Education Savings Grant. It should be noted that this exception is only relevant for contributions made for existing beneficiaries under such plans. An individual without a SIN is prevented from being designated as a new beneficiary under such a plan.

Under the second new exception, an education savings plan may permit a non-resident individual who does not have a SIN to be designated as a beneficiary under the plan provided that the designation is being made in conjunction with a transfer of property into the plan from another RESP under which the individual was a beneficiary immediately before the transfer. This exception is intended, in particular, to accommodate the transfer of property from an RESP that was entered into before 1999, under which the beneficiary had always been non-resident or had ceased to be resident in Canada before having been assigned a SIN, to a replacement RESP (and successive transfers).

Paragraph 146.1(2)(*g*.3) and subsection 146.1(2.3) apply after 2003.

Clause 144

Registered Retirement Income Funds

ITA
146.3

Section 146.3 of the Act provides rules relating to registered retirement income funds (RRIFs).

Definitions

ITA
146.3(1)

"annuitant"

Subsection 146.3(1) of the Act contains the definition "annuitant" for purposes of the rules relating to RRIFs. Paragraph (*b*) of the definition allows the spouse or common-law partner of a deceased annuitant to become the successor annuitant under the RRIF, if the deceased annuitant so elected or the legal representative of the deceased annuitant consents. When this paragraph was amended by S.C. 2000, c. 12 (the *Modernization of Benefits and Obligations Act*, formerly Bill C-23), the word "or" in the English version was inadvertently removed. The definition is amended to correct this error, and to improve the readability of this paragraph, with the same application as the initial amendment in Bill C-23.

Acceptance of Fund for Registration

ITA
146.3(2)

Subsection 146.3(2) of the Act outlines the conditions that must be satisfied in order for a retirement income fund to be registered as a RRIF.

Paragraph 146.3(2)(*c*) of the English version refers to a carrier who "is a person referred to as a depository in section 146". This paragraph is amended to replace the word "depository" with the word "depositary", which is the term used in section 146. This amendment applies after 2001.

Paragraph 146.3(2)(*f*) prohibits a RRIF from receiving property, other than property transferred from sources listed in that paragraph. The paragraph is amended so that a RRIF may receive property transferred directly from a deferred profit sharing plan (DPSP) in accordance with subsection 147(19) of the Act. This amendment is consequential on an amendment to subsection 147(19) that permits direct transfers from DPSPs to RRIFs. For more details, see the commentary to that subsection. This amendment applies after March 20, 2003.

Amount Included in Income

ITA
146.3(5.1)

In 2000, the Act was amended to include common-law partners, but some provisions, including the English version of subsection 146.3(5.1), were overlooked. This subsection is therefore amended to correct this omission. The amendment applies, in general, to the 2001 and subsequent taxation years. However, it may apply as of 1998 if the common-law partners jointly choose to be deemed as such, beginning in that year, for the purposes of the application of the Act.

Tax Payable on Income from Non-qualified Investment

ITA
146.3(9)

Subsection 146.3(9) of the Act provides that, if a trust governed by a RRIF acquires a non-qualified investment, any income earned by the trust from the investment is taxable under Part I.

Subsection 146.3(9) is amended to clarify that income from property that was a qualified investment at the time it was acquired but later became non-qualified is also taxable in respect of the non-qualified period. This amendment, which applies to the 2003 and subsequent taxation years, is consistent with the tax treatment of income earned by RRSP trusts from non-qualified investments under subsection 146(10.1) of the Act.

Subparagraph 146.3(9)(*b*)(ii) is reworded for clarity, applicable on Royal Assent.

Clause 145

Deferred Profit Sharing Plans

ITA
147

Section 147 of the Act provides rules relating to DPSPs.

Acceptance of Plan for Registration

ITA
147(2)(*e*)

Subsection 147(2) of the Act sets out the conditions that a profit sharing plan must satisfy in order to be registered as a DPSP. Paragraph 147(2)(*e*) requires that such a plan include a provision stipulating that no right of an employee who is a beneficiary under the plan is capable of surrender or assignment.

Paragraph 147(2)(*e*) is amended in two ways. First, it is amended to extend the application of the provision to require that the stipulation apply to all persons who have rights under a DPSP, not just employee beneficiaries. Second, it is amended to provide that the stipulation is not required to prohibit:

- an assignment under a court order or written agreement relating to the division of property on the breakdown of a marriage or common-law partnership;
- an assignment by a deceased individual's legal representative on the distribution of the individual's estate; and
- a surrender of benefits to avoid revocation of the plan's registration.

These new provisions are similar to the rule in Regulation 8502(*f*) that applies to registered pension plans (RPPs). The new provisions are, in part, consequential on amendments to subsection 147(19) of the Act that accommodate the division of DPSP assets on the breakdown of a marriage or common-law partnership.

These amendments apply after March 20, 2003.

Compensation

ITA
147(5.11)

Subsection 147(5.1) of the Act sets out the employer contribution limits for DPSPs. In general terms, the maximum employer contributions in respect of an individual for a calendar year cannot exceed the lesser of: (i) 18% of the individual's compensation for the year from the employer; and (ii) 1/2 of the year's money purchase limit. For this purpose, "compensation" and "money purchase limit" are generally as defined in

subsection 147.1(1). Additional cross-plan limits apply if the individual also participates in an RPP sponsored by the employer or in a DPSP or RPP sponsored by a non-arm's length employer.

If the contribution limits are not respected for a calendar year, the Minister of National Revenue may revoke the registration of the DPSP. In addition, the employer is denied a deduction for all contributions made in the year, except as expressly permitted in writing by the Minister.

Subsection 147(5.11) provides a special relieving rule that applies when an employee who is a beneficiary under a DPSP terminates employment with a participating employer in a calendar year. In this circumstance, for the purposes of determining whether the contribution limits have been satisfied, the employee's compensation can be based on the compensation for the immediately preceding year, if it is more than the compensation for the year of termination.

This rule recognizes that it is common practice for an employer to make contributions to a DPSP only after its fiscal year-end, since this is when profits are determined. This can often result in employer contributions being made based (in whole or in part) on employees' earnings in the previous calendar year, but being included in the employees' contribution limits for the current calendar year. This in turn can give rise to over-contributions when an employee terminates employment later in the year before having earned sufficient compensation to support the contribution. However, subsection 147(5.11) generally ensures that such over-contributions do not result in adverse tax effects by allowing the contribution limits to be based on the employee's compensation from the preceding calendar year.

There are, however, two policy concerns with the approach used in subsection 147(5.11). The first concern is that the provision deals only with over-contributions that involve employees who terminate employment. It does not provide relief for similar over-contributions that arise where an employee takes an unpaid leave of absence before having earned sufficient compensation to support any contributions that the employer had already made on his or her behalf. The second concern is that the provision allows DPSP contributions to be made in situations where there is no supporting employment income.

To address these concerns, subsection 147(5.11) is repealed and replaced by a broader relief mechanism in section 8301 of the Regulations. The new mechanism will provide relief in both of the situations described above by allowing over-contributions to be ignored for purposes of the DPSP contribution limits, provided the excess is refunded from the plan.

The repeal of subsection 147(5.11) applies to cessations of employment that occur in 2003 and subsequent calendar years, while the new refund mechanism in the Regulations applies for 2002 and subsequent calendar years. As a result, for excess contributions relating to cessations of employment that occur in 2002, employers will be entitled to relief either by relying on existing 147(5.11) or by using the new refund mechanism.

Transfer to RPP, RRSP, RRIF or DPSP

ITA
147(19)

Subsection 147(19) of the Act provides for the tax-free transfer on behalf of an individual of a lump sum amount from a DPSP to an RPP, an RRSP or another DPSP for the individual's benefit. Currently, direct transfers may be made on behalf of an individual only if the individual is an employee or former employee of an employer who participated in the plan or was a spouse or common-law partner of a deceased employee as at the date of the employee's death.

A number of technical amendments are being made to subsection 147(19) to provide greater consistency with the transfer provisions that apply to RPPs.

Subsection 147(19) is amended so that the direct transfer on the death of an employee may be made on behalf of a former spouse or common-law partner of the deceased employee. It is also amended to allow for direct transfers of DPSP assets to be made on behalf of a spouse or common-law partner, or former spouse or common-law partner, of an employee or former employee, where the transfer relates to a division of property arising on the breakdown of their marriage or common-law partnership.

Finally, subsection 147(19) is amended to allow for direct transfers from DPSPs to RRIFs. This is primarily of relevance where the surviving spouse or common-law partner of a deceased employee is over 69 years of age and, therefore, cannot transfer the DPSP assets to an RRSP. In this regard, the French version of paragraph 147(19)(*d*) is amended in order to add a reference to the word "*fonds*".

These amendments apply to amounts transferred after March 20, 2003.

Clause 146

Amounts Included in Computing Policyholder's Income

ITA
148(1)(*e*)

Subsection 148(1) of the Act requires the inclusion in income of certain amounts from the disposition of a life insurance policy, but excludes from this rule annuities described in paragraph 148(1)(*e*).

Paragraph 148(1)(*e*) describes

- an annuity the payment for which was deductible under paragraph 60(*l*) in computing the policyholder's income, and
- an annuity acquired by a policyholder in circumstances to which subsection 146(21) applies (i.e., an annuity described in paragraph 60(*l*) and acquired with funds paid out of the Saskatchewan Pension Plan).

An annuity described in paragraph 148(1)(*e*) is defined, by paragraph 304(1)(*b*) of the *Income Tax Regulations*, to be a "prescribed annuity contract" and, as such, is not subject to the accrual rules set out in section 12.2 of the Act. This treatment reflects the fact that the policyholder acquiring such an annuity does so with tax-deferred funds, and is generally meant to be taxed only when amounts are paid out of the annuity.

Subsection 148(1) is amended to include, in the annuities described in paragraph (*e*), an annuity that is a "qualifying trust annuity" with respect to a taxpayer (as defined in new subsection 60.011(2)), the payment for which was deductible by the taxpayer under paragraph 60(*l*). This reflects the fact that a qualifying trust annuity will typically be held by a trust, rather than by the taxpayer who is entitled to the deduction under paragraph 60(*l*), and ensures that it is treated, for tax purposes, in the same manner as if it were held by the taxpayer.

This amendment applies after 1988.

Transfer to spouse at death

ITA
148(8.2)

The French version of subsection 148(8.2) of the Act is amended to correct a terminology error. In effect, the term "attribué" is replaced by "distribué" so that it is clear that an interest in a life insurance policy is actually distributed to the spouse or common-law partner of the policyholder and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 147

Eligible Funeral Arrangements

ITA
148.1

Section 148.1 of the Act provides for the tax-free build-up of income earned on contributions made under an eligible funeral arrangement (EFA), which is an arrangement that provides for the pre-funding of expenses with respect to funeral and cemetery services.

Contributions made to an EFA are not deductible, and income earned in an EFA accrues tax-free. Distributions from an EFA as payment for the provision of funeral or cemetery services are not taxable. Other distributions from an EFA are generally treated first as a distribution of earnings, which is taxable, then as a return of contributions, which is not taxable.

Definitions

ITA
148.1(1)

"relevant contribution"

A "relevant contribution" to a particular arrangement is the amount of any contribution that is not made by way of a transfer from another eligible funeral arrangement or the amount of any other contribution made directly to another eligible funeral arrangement that can reasonably be considered to have been transferred into the particular arrangement.

Paragraph (*b*) of the French version of the definition "relevant contribution" refers to « *l'arrangement visé à l'alinéa a)* » (the arrangement referred to in paragraph (*a*)). This is a source of confusion as paragraph (*a*) refers to two arrangements: the particular arrangement and an eligible federal arrangement. For clarification purposes, the French version of the definition is reformulated in order to introduce the notion of « *arrangement donné* » (a particular arrangement), making it clear which arrangement is referred to in paragraph (*b*).

This amendment applies on Royal Assent.

Transfer of Funds

General Discussion

ITA
148.1(3) to (5)

Section 148.1 is amended to provide specific rules relating to transfers from one EFA account to another. In general terms, the changes are as follows:

- A new provision (paragraph 148.1(4)(*a*)) deems the transferred amount to be distributed to the individual from whose EFA account the amount is transferred. However, if that individual is deceased, the amount is deemed to be distributed to the individual to whose EFA account the amount is transferred. This ensures that the transfer is included in income (to the extent that it does not exceed the income accumulated in the transferor account).
- A new provision (paragraph 148.1(4)(*b*)) deems the transferred amount to be a contribution made to the recipient EFA account other than by way of transfer. This ensures that the earnings portion of the transferred amount is not taxed again when it is distributed from the recipient EFA account.
- The provision that requires EFA distributions to be included in income (subsection 148.1(3)) is amended to ensure that the determination of the amount that can subsequently be distributed from the transferor EFA account on a tax-free basis is reduced by the portion of the transferred amount that was not included in income (i.e., that portion of the transferred amount that represents a return of contributions).

- A new provision (subsection 148.1(5)) provides that these new rules do not apply if the transferor and the recipient EFA accounts are in respect of the same person, the entire balance in the transferor account is transferred to the recipient account and the transferor EFA account is terminated immediately after the transfer.

These changes are described in more detail below.

Income Inclusion on Return of Funds

ITA
148.1(3)

Subsection 148.1(3) of the Act provides for an income inclusion by a taxpayer in the event that there is a distribution of funds from an individual's EFA account to the taxpayer (otherwise than as a payment for the provision of funeral or cemetery services with respect to the individual). The amount of the income inclusion is the lesser of the distributed amount and a second amount. In general terms, this second amount is determined by the formula:

$$A + B - C$$

where

A is the balance in the EFA account immediately before the distribution,

B is the total of all payments made from the EFA account before the distribution for the provision of funeral or cemetery services, and

C is the total of all "relevant contributions" in respect of the EFA account that were made before the distribution.

For the purpose of the description of C, an amount is defined in subsection 148.1(1) to be a "relevant contribution" in respect of a particular EFA account if

- the amount was contributed to the particular EFA account otherwise than by way of transfer from another EFA account, or
- the amount was contributed to another EFA account (otherwise than by way of transfer) and subsequently transferred (either from the original or a subsequent EFA account) to the particular EFA account.

The effect of subsection 148.1(3) is to include in the income of the taxpayer the lesser of the amount received and an amount which generally represents the income accumulated in the EFA account. If the amount received by the taxpayer is greater than the amount included in the taxpayer's income, the excess generally represents a non-taxable refund of relevant contributions (represented by the variable C in the formula).

The description of C is amended so that its value is reduced, in effect, by any relevant contributions previously transferred from the EFA account to another EFA account. This ensures that the amount of the transferred relevant contribution (which, by virtue of subsection 148.1(3), can be distributed from the recipient EFA account tax-free) cannot also be used to support a subsequent tax-free withdrawal from the transferor EFA account.

The description of C is amended to provide that its value is determined by the formula

$$D - E$$

For this purpose, the value of D is the amount determined under the existing description of C. The value of E is the total of all amounts each of which is

- an amount which was previously transferred from the EFA account and deemed, by new subsection 148.1(4), to be a distribution

minus

- the portion of the deemed distribution that was required, by subsection 148.1(3), to be included in computing a taxpayer's income.

This amendment applies to transfers made after December 20, 2002.

Deemed Distribution on Transfer

ITA
148.1(4)

New subsection 148.1(4) of the Act contains rules that apply when an amount is transferred from one EFA account to another EFA account of the same or another person.

Paragraph 148.1(4)(*a*) deems the transfer to be a distribution from the transferor EFA account. If the individual from whose account the amount is transferred is alive at the time of the transfer, that individual is deemed to be the recipient of the distribution. Otherwise, the recipient is deemed to be the individual to whose EFA account the amount is transferred. This deeming provision ensures that subsection 148.1(3) applies to the transfer. Consequently, the transferred amount will be included in computing the income of the deemed recipient, except to the extent that the transferred amount exceeds the income accumulated in the transferor EFA account.

Paragraph 148.1(4)(*b*) of the Act deems the amount transferred to be a contribution made (otherwise than by way of transfer) under the recipient EFA account. This ensures that the income portion of the transferred amount (which is included in income, under subsection 148.1(3), as a distribution from the transferor account) is considered to be a "relevant contribution" in respect of the recipient EFA account (which it would not otherwise be, because of the definition "relevant contribution" in subsection 148.1(1)). This allows it to subsequently be withdrawn from the recipient EFA account on a tax-free basis.

New subsection 148.1(4) applies to transfers made after December 20, 2002.

Non-application of Subsection (4)

ITA
148.1(5)

New subsection 148.1(5) of the Act provides that new subsection 148.1(4) does not apply when the entire balance of an individual's EFA account is transferred to another EFA account of the same individual and the transferor EFA account is terminated immediately after the transfer. Consequently, there will be no deemed distribution resulting from such a transfer.

New subsection 148.1(5) applies to transfers made after December 20, 2002.

The following examples illustrate the application of the amendments to subsection 148.1.

Example 1

Paul sets up an EFA account for the pre-funding of his funeral expenses. He contributes $10,000 to his account, and earns $7,000 of interest in the account. Paul transfers $3,000 to an EFA account which he establishes for his daughter, Gaby.

The transferred amount is deemed to be a distribution to Paul under new paragraph 148.1(4)(a). Consequently, Paul includes in his income, under subsection 148.1(3), an amount of $3,000, which is the lesser of

- *$3,000, which is the amount distributed, and*
- *$7,000, which is the amount determined by the formula under subsection 148.1(3):*

A + B – C (where C = D – E)
= $17,000 + $0 – ($10,000 - $0)

The transfer is treated, in effect, as a distribution of a portion of the income accumulated in the plan.

Under new paragraph 148.1(4)(b), the transferred amount is also deemed to be a contribution made, other than by way of transfer, to Gaby's EFA account. Thus, the $3,000 is considered to be a relevant contribution in respect of Gaby's EFA account, and can subsequently be withdrawn tax-free.

Example 2

The facts are the same as in Example 1, except that Paul transfers $13,000 to Gaby's EFA.

The transferred amount is deemed to be a distribution to Paul under new paragraph 148.1(4)(a). Consequently, Paul includes in his income, under subsection 148.1(3), an amount of $7,000, which is the lesser of

- *$13,000, which is the amount distributed, and*
- *$7,000, which is the amount determined by the formula under subsection 148.1(3):*

A + B – C (where C = D – E)
= $17,000 + $0 – ($10,000 – $0)

The transfer is treated, in effect, as a distribution of all of the income accumulated in the plan ($7,000), which is taxable, plus a return of a portion of the relevant contributions in respect of the EFA ($6,000), which is not taxable.

Under new paragraph 148.1(4)(b), the transferred amount is also deemed to be a contribution made, other than by way of transfer, to Gaby's EFA account. This has no particular significance with respect to the portion of the transfer that represents relevant contributions in respect of Paul's EFA account, since this amount would be considered to be a relevant contribution to Gaby's EFA account under the existing rules. However, it does have significance with respect to the portion of the transfer that represents income in Paul's EFA account, in that it allows that portion to become a relevant contribution in respect of Gaby's EFA account which can then be withdrawn from Gaby's account tax-free.

Example 3

The facts are the same as in Example 2. After the transfer of $13,000, the balance in Paul's EFA account is $4,000, all of which represents relevant contributions in respect of the account. Over the next few years, the account earns an additional $2,500 of interest. Paul then withdraws the entire balance from the account.

The withdrawal is a distribution under subsection 148.1(3). Consequently, Paul includes $2,500 in his income, which is the lesser of:

- *$6,500, which is the amount of the withdrawal, and*
- *$2,500, which is the amount determined by the formula under subsection 148.1(3):*

A + B – C (where C = D – E)
= $6,500 + 0 - ($10,000 - $6,000)

The value of E ($6,000) is the excess of the amount that was previously transferred and to which subsection 148.1(4) applied ($13,000) over the portion of that amount that was included in income under subsection 148.1(3) ($7,000).

Clause 148

Exemptions

ITA
149

Section 149 of the Act provides that no tax is payable under Part I on certain persons' taxable income for a period in a taxation year during which the person is a person listed in that section.

Exemptions - Municipalities and Other Governmental Public Bodies

ITA
149(1)(*d*.5)

Paragraph 149(1)(*d*.5) of the Act exempts from tax, subject to an income test, the taxable income of any corporation, commission or association at least 90% of the capital of which is owned by one or more municipalities in Canada.

In accordance with the Tax Court of Canada decision in *Otineka Development Corporation Limited and 72902 Manitoba Limited* v. *The Queen*, 94 D.T.C. 1234, [1994] 1 C.T.C. 2424, an entity could be considered a municipality for the purpose of this paragraph on the basis of the functions it exercised. More recently, however, the decision in *Tawich Development Corporation* v. *Deputy Minister of Revenue of Quebec*, [1997] 2 C.N.L.R. 187 (Que. Civil Chamber), aff'd 2001 D.T.C. 5144 (Que. C.A.), a decision under the *Taxation Act* (Quebec), held that an entity could not attain the status of a municipality by exercising municipal functions but only by statute, letters patent or order. From a tax policy perspective, it is desired that the entities previously entitled to the exemption on the basis of the *Otineka* decision continue to have access to the exemption. This amendment resolves the uncertainty resulting from the two conflicting cases. The exemption in paragraph 149(1)(*d*.5) is therefore extended to include any corporation, commission or association at least 90% of the capital of which was owned by one or more entities each of which is a municipal or public body performing a function of government in Canada, which is consistent with the bodies described in paragraph 149(1)(*c*) of the Act.

This amendment applies to taxation years that begin after May 8, 2000.

Exemptions - Subsidiaries of Municipal Corporations

ITA
149(1)(*d*.6)

Paragraph 149(1)(*d*.6) of the Act exempts from tax, subject to an income test, a wholly-owned subsidiary of a corporation, commission or association referred to in paragraph 149(1)(*d*.5) of the Act. As a consequence of the amendment to paragraph 149(1)(*d*.5), the geographical boundaries of the entities referred to in subparagraphs (i) and (ii) of paragraph 149(1)(*d*.6) are expanded to include references to all of the entities in the amended 149(1)(*d*.5).

This amendment applies to taxation years that begin after May 8, 2000.

Trusts established because of the *Environment Quality Act* (Quebec) or the *Nuclear Fuel Waste Act*

ITA
149(1)(*z*.1) and (*z*.2)

New paragraph 149(1)(*z*.1)) exempts from tax under Part I a trust created because of a requirement imposed by section 56 of the *Environment Quality Act* (Quebec). That provision requires certain residual materials elimination facilities to provide financial guarantees by way of establishment of a social trust to cover certain costs after the closure of the facility. This exemption applies only where no persons are beneficially interested in the trust other than Her Majesty in right of Canada, Her Majesty in right of a province and municipalities that are exempt from taxation under subsection 149(1) of the ITA.

Similarly, new paragraph 149(1)(*z*.2) exempts from tax under Part I a trust created because of a requirement imposed by subsection 9(1) of the *Nuclear Fuel Waste Act* (NFWA). That provision requires specified entities to contribute moneys to a trust fund for the management of nuclear fuel waste. In this case, the exemption only applies where no persons are beneficially interested in the trust other than Her Majesty in right of Canada, Her Majesty in right of a province, a Crown-owned nuclear energy corporation that is exempt from taxation under subsection 149(1) of the ITA or the waste management organization that is required to be set up under the provisions of the NWFA (provided that all the shares of the waste management organization are owned by nuclear energy corporations).

These provisions ensure that the tax consequences to a municipality or Crown-owned nuclear energy corporation that is required by federal or provincial legislation to set up a trust to fund an environmental obligation are the same as if the municipality or the Crown-owned nuclear energy corporation accumulated the funds internally rather than in a trust.

These amendments apply to the 1997 and subsequent taxation years.

Income Test

ITA
149(1.2)

Subsection 149(1.2) of the Act excludes, for the purposes of paragraphs 149(1)(*d*.5) and (*d*.6) of the Act, certain income from the determination of where an entity to which either of those paragraphs applies derives its income. As a consequence of the amendment to paragraph 149(1)(*d*.5), a written agreement in subsection 149(1.2) is expanded to include reference to a municipal or public body.

In addition, subparagraph 149(1.2)(*a*)(vi) is added to clarify that the geographical boundary of a municipal or public body performing a function of government in Canada is defined to be the area described in new subsection (11).

This amendment applies to taxation years that begin after May 8, 2000.

Votes or de Facto Control

ITA
149(1.3)

Subsection 149(1.3) of the Act provides that, for the purposes of applying paragraph 149(1)(*d*.5) and subsection 149(1.2) of the Act to a corporation, 90% of the capital of the corporation is considered to be owned by one or more municipalities only if the municipalities are entitled to at least 90% of the votes associated with the shares of the corporation.

As a consequence of the amendment to paragraph 149(1)(*d*.5), subsection 149(1.3) is amended applicable to taxation years that begin after May 8, 2000, to include reference to municipal or public bodies performing a function of government in Canada.

In addition, subsection 149(1.3) is replaced, applicable to taxation years that begin after December 20, 2002, to provide that paragraphs 149(1)(*d*) to (*d*.6) do not apply to exempt a person's taxable income for a period in a taxation year in two cases.

First, under new paragraph 149(1.3)(*a*), a corporation is not exempt from tax on its taxable income for a period in a taxation year if at any time during the period the corporation has issued shares that are owned by one or more persons (other than certain tax-exempts) that, in total, give them more than 10% of the votes that could be cast at a meeting of shareholders. For this purpose, it is necessary to determine whether more than 10% of the votes could be cast at a meeting of the shareholders by a person or persons other than:

- Her Majesty in right of Canada or of a province,
- a municipality in Canada,
- a municipal or public body performing a function of government in Canada, or
- a commission, an association or a corporation, to which any of paragraphs 149(1)(*d*) to (*d*.6) apply.

Second, under new paragraph 149(1.3)(*b*), a person is not exempt because of any of paragraphs 149(1)(*d*) to (*d*.6) from tax on taxable income for a period in a taxation year if at any time in the period the person is, or would be if the person were a corporation, controlled, directly or indirectly in any manner whatever, by a person (or by a group of persons that includes a person) other than:

- Her Majesty in right of Canada or of a province,
- a municipality in Canada,
- a municipal or public body performing a function of government in Canada, or
- a commission, an association or a corporation, to which any of paragraphs 149(1)(*d*) to (*d*.6) apply.

For further details about the expression "controlled, directly or indirectly in any manner whatever", reference should be made to subsections 256(5.1) and (6) of the Act. In general, the expression refers to a controller, who has any direct or indirect influence that, if exercised, would result in control in fact of the person.

Geographical Boundaries - Body Performing Government Functions

ITA
149(11)

Subsection 149(11) of the Act is added to define, for the purposes of section 149, the geographical boundaries of a municipal or public body performing a function of government in Canada. Those boundaries are defined as encompassing the area in respect of which an Act of Parliament or an agreement given effect by an Act of Parliament recognizes or grants to the body a power to impose taxes; or if there has been no such recognition or grant, the area within which the body has been authorized by the laws of Canada or of a province to exercise that function.

For example, if a particular self-governing First Nation meets the definition of "a public body performing a function of government in Canada," it is intended that the relevant geographic boundary would delineate the area where the self-government agreement, or the statute enacting self-government powers, provides the First Nation authority to impose direct taxes. As a second example, if a particular Indian Band meets the definition of "a public body performing a function of government in Canada," it is intended that the geographic boundary of the Indian Band be the band's reserves as defined in the *Indian Act*. Similarly, if a particular school board meets the definition of "a municipal or public body performing a function of government in Canada" it is intended that the geographic boundary of the school board be the area of jurisdiction of the board as defined by provincial legislation or regulation.

This amendment applies to taxation years that begin after May 8, 2000.

Clause 149

Charities

ITA
149.1

Section 149.1 of the Act provides the rules that must be met for charities to obtain and keep registered status. A registered charity is exempt from tax on its taxable income and can issue receipts which entitle its donors to claim tax relief for their donations.

Definitions

ITA
149.1(1)

Subsection 149.1(1) of the Act contains definitions that are relevant for the purposes of section 149.1.

"charitable organization"

The definition "charitable organization" provides that more than 50% of the directors, trustees, officers or similar officials of a charitable organization must deal with each other and with each of the other directors, trustees, officers or similar officials at arm's length.

For a charity that has applied for registration after February 15, 1984 and which has been designated as a private or public foundation, the definition "charitable organization" also requires that not more than 50% of the charity's capital be contributed by a person or group of persons not dealing with each other at arm's length. This definition is amended to replace the "contribution" test with a "control" test. As a result, a charity will not be disqualified from being treated as a charitable organization solely because a person, or a group of persons not dealing with each other at arm's length, has contributed more than 50% of the charity's capital. However, such a person or group is not permitted to control the charity in any way, nor may the person or the members of the group represent more than 50% of the directors, trustees, officers and similar officials of the charity.

This amendment generally applies after 1999.

"disbursement quota"

The "disbursement quota" for a taxation year of a charitable foundation or organization is defined in subsection 149.1(1) of the Act for the purpose of determining the amount that the charity is required to spend on charitable activities or gifts to other charities. One factor in calculating the disbursement quota is a specified proportion of donations for which tax receipts are issued.

Consequential to the addition of new subsection 248(31) of the Act, the definition "disbursement quota" is to be read in respect of gifts made after December 20, 2002 and in a taxation year that begins before March 23, 2004, to provide that the amount of a gift for which a tax receipt is issued refers to the "eligible amount" of the gift. For additional information, see the commentary to new subsection 248(31).

“enduring property”

The English version of the definition “enduring property”, which applies for the purpose of the definition “disbursement quota” to taxation years that begin after March 22, 2004, is amended to correct a cross-reference in its paragraph (*d*).

“public foundation”

The definition “public foundation” provides that more than 50% of the directors, trustees, officers or similar officials of a public foundation must deal with each other and with each of the other directors, trustees, officers or similar officials at arm’s length.

This definition requires that not more than 50% (75% in some cases) of the foundation’s capital can be contributed by a person or group of persons not dealing with each together at arm’s length. The “contribution” test in the definition is replaced by a “control” test. As a result, a foundation will not be disqualified from being treated as a public foundation solely because a person, or a group of persons not dealing with each other at arm’s length, has contributed more than 50% of the foundation’s capital. However, such a person or group is not permitted to control the foundation in any way, nor may the person or the members of the group represent more than 50% of the directors, trustees, officers and similar officials of the foundation.

This amendment generally applies after 1999.

Revocation of Registration

ITA
149.1(2), (3) and (4)

Subsections 149.1(2), (3) and (4) of the Act set out the reasons for which the Minister of National Revenue may revoke the registration of a charitable organization, a public foundation and a private foundation, respectively. These subsections are amended to permit the revocation of the registration of such entities if they make gifts (other than gifts made in the course of their charitable activities) to persons or entities that are not qualified donees. A “qualified donee” is essentially a person or entity to which a tax deductible or tax creditable donation may be made.

These amendments apply to gifts made after December 20, 2002.

Accumulation of Property

ITA
149.1(9)

Subsection 149.1(8) of the Act permits a registered charity, with the approval of the Minister of National Revenue, to accumulate property over a specified period for a particular purpose. The amount of such property accumulated is deemed to have been expended in the taxation year of the charity in which it was accumulated. If in fact the charity defaults on this responsibility by not using the property for the approved purpose within the specified period, subsection 149.1(9) treats that property as income of the charity and the amount of a gift for which it issued a receipt. This affects the calculation of the disbursement quota of the charity, with the result that the amount of the property must be actually disbursed in the year following default.

Subsection 149.1(9) is amended consequential to the addition of new subsection 248(31) of the Act, in respect of gifts made after December 20, 2002, to provide that the amount of a gift for which a tax receipt is issued refers to the “eligible amount” of a gift. For additional information, see the commentary to new subsection 248(31).

Information May be Communicated

ITA
149.1(15)(*b*)

Section 241 of the Act prohibits the use or communication by an official of information obtained under the Act unless specifically authorized by one of the exceptions found in that section. Paragraph 149.1(15)(*b*) of the Act, which deals with charities, provides that, notwithstanding section 241, the Minister of National Revenue may publish a listing of all registered or previously registered charities indicating the name, location, registration number and, where the charity is no longer registered, the effective date of the revocation, annulment or termination of the charity's registration. This provision does not currently allow for the release of similar information in respect of registered Canadian amateur athletic associations. Since taxpayers who make donations to such associations obtain the same tax relief that is available in respect of donations to registered charities and, since subsection 149.1(15) is intended to provide transparency for the benefit of potential donors, paragraph 149.1(15)(*b*) is amended, effective after Royal Assent to this measure, to allow for the release of such information in respect of Canadian amateur athletic associations.

Clause 150

Assessment

ITA
152

Section 152 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 amounts of tax deemed to have been paid by a taxpayer.

Provisions Applicable

ITA
152(1.2)

Subsection 152(1.2) is amended to delete the reference to section 126.1 of the Act, consequential to the repeal of that section. For additional information, see the commentary to section 126.1.

This change applies in respect of forms filed after March 20, 2003.

Determination of UI Premium Tax Credit

ITA
152(3.4)

This subsection enables a taxpayer to request the Minister of National Revenue to determine the amount deemed by subsection 126.1(6) or (7) of the Act to be an overpayment on account of the taxpayer's liability under Part I of the Act.

This subsection is repealed consequential to the repeal of section 126.1. For additional information, see the commentary to section 126.1.

This change applies in respect of forms filed after March 20, 2003.

Notice of Determination

ITA
152(3.5)

Subsection 152(3.5) of the Act requires the Minister of National Revenue to respond to a request for a determination of the UI premium tax credit. This subsection is repealed consequential to the repeal of section 126.1. For additional information, see the commentary to section 126.1.

This change applies in respect of forms filed after March 20, 2003.

Clause 151

Withholding

Section 153 of the Act requires the withholding of tax from certain payments, described in paragraphs (*a*) to (*t*). The person making such a payment is required to remit the amount withheld to the Receiver General on behalf of the payee. Paragraph (*d*.1) is amended consequential to the introduction of the new Quebec Parental Insurance Plan introduced on January 1, 2006. This amendment applies to the 2006 and subsequent taxation years.

Clause 152

Instalments

ITA
157(3)

Section 157 of the Act requires a corporation to pay monthly instalments of its total tax payable under Parts I, I.3, VI, VI.1 and XIII.1 of the Act. Subsection 157(3) allows corporations to reduce each monthly instalment by 1/12 of the amount of certain tax refunds, including the "dividend refund" under section 129 of the Act. For most mutual fund corporations, the dividend refund amount is computed according to rules set out in subsection 131(5) of the Act. Paragraph 157(3)(*c*), which allows a mutual fund corporation to apply its dividend refund to reduce its instalments, therefore refers to subsection 131(5). However, prescribed labour-sponsored venture capital corporations (LSVCCs), which are by definition mutual fund corporations, do not use subsection 131(5) to compute their dividend refunds – instead, they use special rules in subsection 131(11) of the Act. To ensure that subsection 157(3) applies appropriately to LSVCCs, this amendment adds to paragraph 157(3)(*c*) a reference to subsection 131(11). The amendment applies for the 1999 and subsequent taxation years.

Clause 153

Person Acting for Another – Personal Liability

ITA
159(3)

Subsection 159(1) of the Act provides, in part, that a legal representative acting for another person is jointly and severally liable for each amount payable by the other person under the Act, to the extent that the representative has possession and control of the other person's assets. If the representative distributes assets of the other person before obtaining a certificate from the Minister of National Revenue that the other person's tax debts have been paid, the Minister may, under subsection 159(3) of the Act, assess the representative for the amount of the debt.

Subsection 159(3) is amended to clarify that a legal representative so assessed after December 20, 2002 is subject to interest on the assessment without any limit on the amount of interest for which the representative may be liable.

Clause 154

Tax Liability – Non-arm's Length Transfers of Property

ITA
160

Section 160 of the Act contains rules regarding the joint and several liability of a taxpayer for the income tax liability of another person (the "tax debtor") who, when not dealing at arm's length with the taxpayer, transferred property to the taxpayer for consideration less than its fair market value.

ITA
160(1)(*e*)

The amount that a taxpayer is liable to pay in respect of the transfer of property from a non-arm's length tax debtor is determined under subsection 160(1) of the Act. The Minister may assess the taxpayer for such a liability under subsection 160(2) of the Act. Paragraph 160(1)(*e*) is amended, in respect of assessments made after December 20, 2002, to clarify that the assessment of the taxpayer is subject to interest, without any limit on the amount of interest for which the taxpayer may be liable.

Joint Liability Where subsection 69(11) Applies

ITA
160(1.1)

Subsection 160(1.1) of the Act provides that where subsection 69(11) of the Act applies to deem a disposition of property to have occurred at fair market value, both the person disposing of the property and the person acquiring the property are jointly and severally liable for the payment of each other's liabilities arising under the Act as a result of that disposition. The Minister of National Revenue may assess the person for such a liability under subsection 160(2) of the Act. Subsection 160(1.1) is amended, in respect of assessments made after December 20, 2002, to clarify that the assessment of the taxpayer is subject to interest.

Joint Liability – Tax on Split Income

ITA
160(1.2)

Subsection 160(1.2) of the Act, which applies in respect of tax owing on split income, is amended in two respects.

First, paragraphs 160(1.2)(*a*), (*b*) and (*d*) are amended to replace the phrase "goods or services" with the phrase "property or services" as a consequence of the same changes made to paragraphs (*b*) and (*c*) of the definition "split income" in subsection 120.4(1). These amendments apply after December 20, 2002.

Second, a "postamble" is added to subsection 160(1.2) to clarify that, in respect of assessments made under subsection 160(2) after December 20, 2002, the assessment is subject to interest.

Assessment

ITA
160(2)

Subsection 160(2) of the Act allows the Minister of National Revenue to assess a taxpayer at any time in respect of liabilities arising under section 160, with such assessment having the same effect as if it had been made under section 152 of the Act. Subsection 160(2) is amended, in respect of assessments made after December 20, 2002, to clarify that the assessment is subject to interest.

Clause 155

Where Excess Refunded

ITA
160.1(3)

Subsection 160.1(3) of the Act allows the Minister of National Revenue to assess a taxpayer in respect of excess refunds and overpayments for which the taxpayer is jointly and severally liable under subsection 160.1(1), (1.1), (2.1) or (2.2) of the Act. Subsection 160.1(3) is amended, in respect of such assessments made after December 20, 2002, to clarify that such an assessment is subject to interest, except that no interest is payable to the extent that the excess refund is attributable to the overpayment of a GST tax credit or a child tax benefit.

Clause 156

Joint and Several Liability – Amounts Received out of or under RRSP

ITA
160.2(1), (2) and (3)

Subsection 160.2(1) of the Act provides that a taxpayer who receives benefits out of another person's registered retirement savings plan is jointly and severally liable for the portion of that other person's tax that is attributable to those benefits. Subsection 160.2(2) of the Act provides a similar result with respect to benefits received out of another person's registered retirement income fund. The Minister may assess the taxpayer for such a liability under subsection 160.2(3) of the Act.

Subsections 160.2(1), (2) and (3) are amended, in respect of assessments made after December 20, 2002, to clarify that the assessment is subject to interest, without any limit on the amount of interest for which the taxpayer may be liable.

Joint and Several Liability in Respect of a Qualifying Trust Annuity

ITA
160.2(2.1)

New subsection 160.2(2.1) applies to annuities that are "qualifying trust annuities" with respect to a taxpayer (as defined in new subsection 60.011(2)).

A distinguishing feature of a qualifying trust annuity with respect to a taxpayer is that the annuitant thereunder is a trust under which the taxpayer is a beneficiary. Such an annuity will typically be acquired and held either by the trust that is the annuitant under the annuity, or by the estate of a deceased spouse, common-law partner, parent or grandparent of the taxpayer which acquired the annuity with proceeds received from a registered retirement savings plan or registered retirement income fund of the deceased individual or from a registered pension plan in which the deceased individual participated.

Where the cost of a qualifying trust annuity with respect to a taxpayer is deductible by the taxpayer under paragraph 60(*l*) and the taxpayer has not died before 2006, new section 75.2 deems amounts payable out of or under the annuity after 2005 and before the taxpayer's death to have been received by the taxpayer. Section 75.2 also deems the taxpayer to have received, immediately before death, an amount out of or under the annuity equal to the fair market value of the annuity. By virtue of paragraph 56(1)(*d.2*), the taxpayer is required to include these amounts in computing income under Part I.

New subsection 160.2(2.1) provides that, where a taxpayer is deemed by section 75.2 to have received an amount from a qualifying trust annuity, the annuitant and the policyholder (which may be one and the same) are jointly and severally, or solidarily, liable for the portion of the taxpayer's tax that is attributable to the amounts that the taxpayer is deemed to have received from the annuity. The Minister of National Revenue may reassess the annuitant and the policyholder for such a liability under subsection 160.2(3) of the Act.

Subsection 160.2(2.1) applies to assessments made after 2005.

No Limitation on Liability

ITA
160.2(2.2)

New subsection 160.2(2.2) of the Act provides that the provisions of new subsection 160.2(2.1), which make the annuitant and policyholder of a "qualifying trust annuity" with respect to a taxpayer (as defined in new subsection 60.011(2)) jointly and severally, or solidarily, liable for a portion of the taxpayer's tax, do not limit the liability of the taxpayer under any provision of the Act. It also provides that there is no limitation on the liability of the annuitant or policyholder for the interest for which the annuitant or policyholder is liable under the Act on an assessment in respect of an amount that the annuitant or policyholder is liable to pay because of subsection 160.2(2.1).

Subsection 160.2(2.2) applies to assessments made after 2005.

Rules Applicable – Qualifying Trust Annuity

ITA
160.2(5)

New subsection 160.2(5) of the Act provides that a payment by the annuitant or policyholder of a "qualifying trust annuity" with respect to a taxpayer (as defined in new subsection 60.011(2)), on account of the annuitant's or policyholder's joint liability for a portion of the taxpayer's tax, directly reduces the joint liability to the extent of the payment. However, a payment by the taxpayer on account of the taxpayer's tax liability reduces the joint liability of the annuitant and the policyholder only to the extent that the payment reduces the total liability of the taxpayer to an amount that is less than the amount in respect of which the annuitant and policyholder were made jointly liable under subsection 160.2(2.1).

Subsection 160.2(5) applies to assessments made after 2005.

Clause 157

Liability – Amounts Received out of or under RCA Trust

ITA
160.3(1) and (2)

Subsection 160.3(1) of the Act provides that a person who receives benefits from a retirement compensation arrangement that relate to another taxpayer's employment is jointly and severally liable for the portion of that other taxpayer's tax that is attributable to such benefits. The Minister of National Revenue may assess the person for such a liability under subsection 160.3(2) of the Act. Subsections 160.3(1) and (2) are amended, in respect of assessments made after December 20, 2002, to clarify that such an assessment is subject to interest, without any limit on the amount of interest for which the person may be liable.

Clause 158

Liability – Transfers by Insolvent Corporation

ITA
160.4(1) to (3)

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

In addition, subsection 160.4(2) of the Act provides for joint and several liability of subsequent non-arm's length transferees for the corporation's Part I tax if the original transferee makes a further non-arm's length transfer and one of the reasons that the transfer was made was to prevent the enforcement of section 160.4.

Under subsection 160.4(3) of the Act, the Minister of National Revenue may assess a transferee for a liability arising under subsections 160.4(1) or (2).

Subsections 160.4(1), (2) and (3) are amended, in respect of assessments made after December 20, 2002, to clarify that such an assessment is subject to interest, without any limit on the amount of interest for which the transferee may be liable.

Clause 159

Penalties

ITA
162

Section 162 of the Act imposes penalties for infractions such as the failure to file a return for a taxation year.

Failure to Provide Identification Number

ITA
162(6)

Subsection 162(6) of the Act provides a penalty for failure by a person or partnership to provide on request their social insurance number or their business number to any person who is required to make an information return in their regard. The French version of this subsection refers to individuals instead of persons, thereby excluding corporations. The provision is therefore amended to replace the word « *particulier* » by the word « *personne* ».

This amendment applies after June 18, 1998, the date on which the penalty in subsection 162(6) was extended to corporations in respect of business numbers.

Clause 160

False Statements or Omissions – GSTC Payments

ITA
163(2)(*c*.1)

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 for the purposes of the Act. The penalty is determined with reference to the understatement of tax or the overstatement of amounts deemed to be paid on account of tax. Paragraph 163(2)(*c*.1) imposes a penalty where the false statement relates to the goods and services tax credit (GSTC).

The GSTC provisions were recently amended (S.C. 2002, chapter 9, formerly Bill C-49) to make the credit more responsive to changes in family circumstances by providing that the eligibility to the credit and the amount paid in each quarter reflect such changes that occurred before the end of the preceding quarter rather than in the preceding taxation year.

Paragraph 163(2)(*c*.1) is amended to reflect the new quarterly calculation of the GSTC. This amendment applies to amounts deemed to be paid during months specified for the 2001 and subsequent taxation years.

Clause 161

Refunds

ITA
164

Section 164 of the Act contains rules relating to refunds of taxes, including provisions dealing with repayments, application to other debts, and interest.

Refund of Instalment – Hardship

ITA
164(1.51) to (1.53)

New subsections 164(1.51) to (1.53) of the Act, which apply on Royal Assent, allow the Minister of National Revenue to refund excessive instalment amounts paid on account of a taxpayer's tax liability. In order for such a refund to be made, four conditions must be met. Three of these are set out in new subsection 164(1.51). First, the taxpayer must have paid one or more instalments of tax under Part I or, where the taxpayer is a corporation, Part I.3, VI, VI.1 or XIII of the Act. Second, it must be reasonable to conclude that the total amount of the instalments the taxpayer has paid exceeds the total amount of taxes payable by the taxpayer under those Parts for the year. Third, the Minister must be satisfied that the payment of the instalments has caused or will cause the taxpayer undue hardship.

The last condition is implied in new subsection 164(1.52) of the Act. The availability of an instalment refund in a particular case is a matter of the Minister's discretion. The final condition is therefore that the Minister agree to make the refund. Similarly, new subsection 164(1.52) makes it clear that the amount of any instalment refund is to be decided by the Minister: the Minister may refund all or any part of an excessive instalment.

New subsection 164(1.53) of the Act provides that, for the purposes of computing interest and penalties, a taxpayer that receives an instalment refund is treated as not having paid the instalment to that extent.

Refund of UI Premium Tax Credit

ITA
164(1.6)

Subsection 164(1.6) of the Act provides rules concerning refunds of the UI premium tax credit. This subsection is repealed consequential to the repeal of section 126.1. For additional information, see the commentary to section 126.1.

This change applies in respect of forms filed after March 20, 2003.

Interest on Refunds and Repayments

ITA
164(3)

Subsection 164(3) of the Act provides for the payment of interest on tax refunds. Two amendments are made to the subsection. First, the preamble of that subsection is being amended to adapt the wording to the new terminology now used elsewhere the Act. Second, the reference to section 126.1 is deleted consequential on the repeal of that section.

These changes apply in respect of forms filed after March 20, 2003.

Clause 162

Large Corporations Tax

ITA
Part I.3

Part I.3 of the Act imposes a tax (generally known as the "large corporations tax") on the amount by which a large corporation's taxable capital employed in Canada exceeds a $50 million "capital deduction" (shared among related corporations).

Definitions

ITA
181(1)

"financial institution"

Subsection 181(1) of the Act sets out definitions for the purposes of the Part I.3 tax on large corporations. Among these is the term "financial institution," which is relevant for a number of purposes. Most importantly, corporations that are financial institutions compute their capital for the purposes of Part I.3 differently from other corporations. The status of a particular corporation is also relevant to corporations that invest in the particular corporation or hold its debt, since whether certain of those investments are counted in the investor corporation's "investment allowance" – and thus whether they will reduce their own tax under Part I.3 – depends, in part, on whether the particular corporation is a financial institution.

In addition to listing several types of corporations, the definition "financial institution" provides, in its paragraph (*g*), that the definition applies as well to a prescribed corporation. Currently, such corporations are prescribed under section 8604 of the Regulations. Paragraph (*a*) of that regulation provides that a corporation of which all or substantially all of the assets of which are shares or indebtedness of a financial institution (as defined in subsection 181(1) of the Act) to which the corporation is related, is itself prescribed to be a financial institution; the remaining paragraphs list particular corporations by name.

Paragraph (*g*) of the definition is amended to reflect a fundamental change in the technique by which these corporations will be identified as financial institutions. Rather than listing corporations in a regulation, this new approach is to list them in a schedule to the Act. Amended paragraph (*g*) therefore refers to corporations that are either listed in the schedule, as per new subparagraph (*g*)(i), or that are described in new subparagraph (*g*)(ii), currently paragraph (*a*) of section 8604 of the Regulations.

These changes to paragraph (*g*) of the definition apply after December 22, 1997.

As a consequence to the changes to paragraph (*g*) of the definition, section 8604 of the Regulations is to be repealed and a schedule is added at the end of the Act. Subject to a number of deletions due primarily to name changes and amalgamations, the schedule lists those corporations that are currently prescribed under section 8604 immediately before its repeal. The schedule also lists a number of corporations that are not currently prescribed, but meet the requirements for treatment as financial institutions and have asked to be treated as such.

Transitional rules for paragraph (*g*) of the definition ensure that corporations prescribed before the repeal of Regulation 8604 retain the status that they would have had under paragraph (*g*) had it not been amended to exclude prescribed corporations.

As described above, a number of corporations currently not prescribed are listed in the schedule, effective as of dates that precede December 20, 2002. Transitional rules ensure that, for any taxation year that begins before December 20, 2002, no corporation that deals at arm's length with any of these corporations will lose an investment allowance as a result the corporation's change in status to a financial institution under paragraph (*g*) of the definition.

Clause 163

Taxable Capital Employed in Canada

ITA
181.2

Section 181.2 of the Act provides rules for determining the capital, taxable capital, taxable capital employed in Canada and investment allowance of corporations (other than financial institutions) resident in Canada for the purposes of the Part I.3 tax on large corporations.

Section 181.2 is amended in two respects. First, subsections 181.2(3) and (5) of the Act are amended to clarify the effect of tiered partnerships: structures in which one partnership is a member of another partnership. Second, an amendment is made to subsection 181.2(3) to accommodate a change to the accounting presentation of redeemable preferred shares.

Tiered Partnerships

Subsection 181.2(3) defines the "capital" of a corporation, and in paragraph 181.2(3)(*g*) includes in a corporation's capital a pro-rata share of the reserves, deferred foreign exchange gains and indebtedness of any partnership of which it is a member. To determine those amounts, the relevant paragraphs of subsection 181.2(3) are applied to the partnership in the same way as they apply to corporations. Paragraph 181.2(3)(*g*) is amended so that it itself applies on this basis. As a result, the proration of the reserve, deferred gain and debt amounts will carry through any number of tiered partnerships.

Subsection 181.2(4) of the Act provides for the "investment allowance" by which, in broad terms, one corporation's investment in another is excluded from the first corporation's taxable capital. Subsection 181.2(5) determines the carrying value of an interest of a corporation in a partnership for this purpose. Subsection 181.2(5) is amended to ensure that the carrying value of an interest of a corporation in a particular partnership, for the purposes of subsection 181.2(4), includes the carrying value of an interest of the particular partnership in another partnership.

These changes to paragraph 181.2(3)(*g*) and subsection 181.2(5) apply after December 20, 2002.

Preferred Shares

In general, a corporation's tax payable under Part I.3 of the Act is computed with reference to amounts reflected in the balance sheet of the corporation, as prepared in accordance with generally accepted accounting principles (GAAP).

The Canadian Institute of Chartered Accountants' *Handbook* (the Handbook), which is the principal authority of GAAP in Canada, requires that a liability of a corporation in respect of a redeemable preferred share be reflected on the corporation's balance sheet. The Handbook provides that this liability may be accounted for in one of two ways. Under the first method, the difference between the stated capital of a share and its redemption value is charged to retained earnings, which in some cases may result in the corporation having negative retained earnings or a deficit. Retained earnings are unaffected under the second method, under which a line account is set up reflecting the redemption liability of the preferred shares.

Current paragraph 181.2(3)(*i*) of the Act allows for a reduction of a corporation's capital, to the extent of any deficit deducted in computing the corporation's shareholders' equity. To accommodate the alternative presentation of a provision for the redemption of preferred shares, the paragraph is amended to refer explicitly to the amount of such a provision.

This amendment applies to taxation years that begin after 1995.

Clause 164

Taxable Capital Employed in Canada of Financial Institution

ITA
181.3

Section 181.3 of the Act provides rules for determining the capital, taxable capital, taxable capital employed in Canada and investment allowance of a financial institution (as defined in subsection 181(1)) for the purposes of the Part I.3 tax on large corporations.

Section 181.3 is amended in two respects. First, changes are made to several paragraphs of subsection 181.3(3) to accommodate a change to the accounting presentation of redeemable preferred shares. Second, a new subparagraph and a new clause are added, respectively, to paragraph 181.3(3)(*c*) and subparagraph 181.3(3)(*d*)(iv) to reflect the manner in which property and casualty insurers are required to account for claims reserves.

Preferred Shares

The accounting procedures described in the notes to amended section 181.2 of the Act are relevant to financial institutions as well as to other corporations, and readers may consult those notes for additional background. As in that section, the amendments introduced to section 181.3 include, in the computation of a deficit deducted in computing shareholders' equity, the amount of any provision for the redemption of preferred shares. This inclusion is added to three specific provisions: subparagraph 181.3(3)(*a*)(v) in respect of financial institutions other than insurers and authorized foreign banks; subparagraph 181.3(3)(*b*)(iv) in respect of Canadian-resident life insurance corporations; and subparagraph 181.3(3)(*c*)(v) in respect of other Canadian-resident insurance companies.

These amendments apply to taxation years that begin after 1995.

Claims Reserves

In general, a corporation is required to compute amounts relevant in determining its tax payable under Part I.3 of the Act using generally accepted accounting principles (GAAP).

The Canadian Institute of Chartered Accountants' *Handbook* (the Handbook), which is the principle authority of GAAP in Canada, requires that property and casualty insurers account for claims reserves on a gross basis, rather than net of reinsurance.

Paragraphs 181.3(3)(*c*) and (*d*) of the Act stipulate the amounts to be included in determining the capital of an insurance corporation resident in Canada (other than a life insurance corporation) and an insurance corporation not resident in Canada, respectively. Among other things, claims reserves are required under these paragraphs to be included in computing the capital of such a corporation.

New subparagraph 181.3(3)(*c*)(vii) and clause 181.3(3)(*d*)(iv)(F) allow such corporations to reduce their capital by an amount that is recoverable through reinsurance, to the extent that the amount relates to an amount that was included in capital as a claims reserve. In this way, claims reserves are included on a net of reinsurance basis under paragraphs 181.3(3)(*c*) and (*d*).

New subparagraph 181.3(3)(*c*)(vii) and clause 181.3(3)(*d*)(iv)(F) apply to taxation years that begin after 1995.

Clause 165

Additional Tax on Excessive Elections

ITA
Part III

Under section 83 of the Act, a private corporation can identify a dividend as a “capital dividend,” with the result that the dividend is not taxable to the shareholders who receive it. In concept, a capital dividend is a distribution of the non-taxable portion of the corporation’s capital gains, which portion is recorded in the corporation’s “capital dividend account”. A similar mechanism allows mutual fund corporations and mortgage investment corporations to designate a dividend as a “capital gains dividend” – which is taxable to the shareholder, but as a capital gain.

Part III of the Act (sections 184 and 185) applies a special tax to a corporation that designates as a capital dividend or a capital gains dividend an amount that exceeds the amount available to be paid as such a dividend. If the corporation obtains the consent of its shareholders, it can avoid the special tax by treating the excess amount as a separate taxable dividend.

These amendments simplify Part III and update its language, reduce the rate of the special tax, and modify the requirement for shareholder consent to the recharacterization of an excessive dividend. These amendments apply to dividends that are paid by a corporation after its 1999 taxation year, with a special transitional rule for elections, described below in the notes to subsection 184(5) of the Act.

Tax on Excessive Elections

ITA
184(2)

Subsection 184(2) of the Act applies the tax under Part III of the Act to the amount by which a dividend paid by a corporation as a capital dividend or a capital gains dividend exceeds the amount eligible to be so designated. For greater clarity, the subsection is amended to refer to the full amount of the initial dividend as the “original dividend.” That term is then used elsewhere in amended Part III.

The rate of tax imposed by subsection 184(2) is also changed, as part of a series of amendments that reflect recent and planned reductions in tax rates. The rate is reduced from 75% of the excess capital gains dividend to 60% of the excess.

Reduction of Excess

ITA
184(2.1)

Subsection 184(2.1) of the Act is a transitional rule that applies to certain dividends that became payable before June 18, 1987. That subsection has lapsed and is repealed.

Election to Treat Excess as Separate Dividend

ITA
184(3)

Subsection 184(3) of the Act allows a corporation that would otherwise be liable to tax under Part III in respect of an excessive capital dividend or capital gains dividend to treat the excess as a separate taxable dividend, and thus to avoid the tax. The subsection is amended to update and clarify its language.

Concurrence with Election

ITA
184(4)

Subsection 184(4) of the Act sets out the requirements for shareholders' consent to the recharacterization, under subsection 184(3), of an excessive capital dividend or capital gains dividend. This subsection is amended to update and clarify its language.

Exception for Non-taxable Shareholders

ITA
184(5)

New subsection 184(5) of the Act provides an exception to the shareholder consent requirements of subsection 184(4). Where a corporation wishes to recharacterize an excessive dividend under subsection 184(3), and the dividend was paid on a class of shares all of the holders of which are persons all of whose taxable income is exempt from tax (for example, registered plans), the corporation need not obtain the shareholders' consent. Instead, the only requirement imposed by new subsection 184(5) is that the corporation's election be made within 30 months after the time that the original (excessive) dividend became payable.

An election under new subsection 184(5) will be deemed to have been made in a timely manner if it is made within 90 days after these amendments receive Royal Assent.

Clause 166

Revocation Tax

ITA
188(1)

Subsection 188(1) of the Act imposes a tax payable by a registered charity in respect of the revocation of the charity's registration. The tax is generally equal to the total of the value of the assets of the charity plus the amount of receipted donations and inter-charity gifts received by the charity after the "valuation day" of the charity's assets, net of certain eligible disbursements.

Subsection 188(1) is amended consequential to the addition of new subsection 248(31) of the Act, in respect of gifts made after December 20, 2002, to refer to the "eligible amount" of a gift for which a receipt was issued by the charity. For additional information, see the commentary to new subsection 248(31).

Clause 167

Financial Institutions Capital Tax

ITA
190.13

Section 190.13 of the Act contains the rules for determining the capital of a financial institution for the purpose of Part VI of the Act. Section 190.13 is amended to accommodate a change to the accounting presentation of provisions for the redemption of preferred shares.

Generally accepted accounting principles (GAAP) are relevant to the determination of amounts referred to in section 190.13. The accounting procedures described in the notes to amended section 181.2 of the Act are therefore relevant in the context of Part VI of the Act, and readers may consult those notes for additional background. As in that section, the amendments introduced to section 190.13 include, in the computation of a deficit deducted in computing shareholders' equity, the amount of any provision for the redemption of preferred shares. This inclusion is added to two specific provisions: subparagraph 190.13(*a*)(v), in respect of financial institutions other than life insurers and authorized foreign banks; and subparagraph 190.13(*b*)(iv) in respect of Canadian-resident life insurance corporations.

These amendments apply to taxation years that begin after 1995.

Clause 168

Excluded Dividend – Partner

ITA
191(6)

Section 191 of the Act sets out a number of rules relating to the taxes imposed, under Part VI.1 of the Act, on taxable Canadian corporations that pay dividends of certain kinds. Those taxes are not payable in respect of "excluded dividends," a term defined in subsection 191(1) of the Act. Dividends paid by a corporation to a shareholder that holds a "substantial interest" in the corporation are excluded dividends.

"Substantial interest" is itself defined in subsection 191(2) of the Act. In general, a shareholder has a substantial interest in a corporation if the shareholder is related to the corporation (otherwise than because of a right under paragraph 251(5)(*b*)) or if the shareholder's holdings meet certain thresholds in terms of votes and value.

If a shareholder has a substantial interest in a corporation, and is also a member of a partnership that holds shares of the corporation, it is appropriate that a dividend paid by the corporation to the partnership be an excluded dividend, to the extent of the shareholder's interest in the dividend. To ensure this result, new subsection 191(6) is added to the rules that govern the Part VI taxes. The new subsection provides that a dividend paid to a partnership is, for the purposes of the "excluded dividend" definition, considered to have been paid ratably to each member of the partnership.

Three technical aspects of the new rule bear special mention. First, the apportionment of the dividend among the partners is based upon each partner's share of the partnership's income for its last fiscal period that ended before the corporation paid the dividend. (If the dividend was paid during the partnership's first fiscal period, the apportionment looks to that period.)

Second, to ensure appropriate effects where there is more than one tier of partnerships between the dividend-paying corporation and the person that holds a substantial interest in the corporation, the new provision applies to itself. That is, if a member of a partnership is itself a partnership, the rule will treat the dividend-paying corporation as having paid a proportionate amount as a dividend not only to the second partnership, but also to that second partnership's members.

Third, in apportioning a dividend among members of a partnership, new subsection 191(6) uses the new definition of "specified proportion," which is added to subsection 248(1) of the Act. For further information, see the commentary to that amendment.

New subsection 191(6) applies to dividends paid after December 20, 2002.

Clause 169

Tax on Taxable Dividends

ITA
191.1(1)(*a*)

Subsection 191.1(1) of the Act provides for a tax to be paid by a corporation that has paid taxable dividends on taxable preferred shares. In the case of short-term preferred shares, paragraph 191.1(1)(*a*) sets the rate of the tax at 66 2/3% of the dividend. This rate produces an amount of tax equal to the amount of income tax that would have been collected had a corporate shareholder sought the same after-tax return in the form of interest. That result obtains, at the current 66 2/3 percent rate, if interest income is assumed to be taxed at 40%.

As part of a series of amendments reflecting recent and planned reductions in income tax rates, the rate of tax under paragraph 191.1(1)(*a*) is reduced to 50% of the dividend amount. This provides the desired result on the basis of an assumed tax of 33.3% on interest income, as shown below.

	Dividend	Interest
Issuer		
To Holder	$66.67	$100.00
191.1(1)(*a*) tax	33.33	n/a
Total paid	$100.00	$100.00
Shareholder		
Receives	$66.67	$100.00
Part I tax	NIL	33.33
After tax	$66.67	$66.67

This amendment applies to the 2003 and subsequent taxation years.

Clause 170

Distribution Deemed Disposition

ITA
200

The French version of section 200 of the Act is amended to correct a terminology error. In effect, the concept of “attribution” is replaced by “distribution” so that it is clear that the property is actually remitted to the trust’s beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 171

Labour-sponsored Venture Capital Corporations

ITA
204.81(1), (1.1) and (1.2)

Section 204.81 of the Act sets out the conditions for the registration of labour-sponsored venture capital corporations (LSVCCs). Subsection 204.81(1) permits the Minister of National Revenue to register a corporation as an LSVCC under Part X.3 if its articles satisfy specified conditions, and other requirements are met. Subparagraph 204.81(1)(*c*)(v) sets out the requirements of a federally-registered LSVCC’s articles regarding the circumstances in which the LSVCC may redeem shares of its capital stock. The current rule generally provides, pursuant to clause 204.81(1)(*c*)(v)(E), a minimum holding period of eight years for corporations that are incorporated after March 5, 1996.

Clause 204.81(1)(*c*)(v)(E) is amended to require that the articles of a federally-registered LSVCC provide that the LSVCC shall not redeem its shares unless the redemption occurs either

- more than eight years after the day on which the share was issued, or
- in February or on March 1st but not more than 31 days before the day that is eight years after the day on which the share was issued.

This amendment applies to corporations after February 6, 2000 regardless of when they were incorporated.

However, federally-registered LSVCCs that were incorporated before March 6, 1996 may contain statements in their articles that provide that the LSVCC shall not redeem certain of its shares unless the redemption occurs more than five years after the day on which such a share was issued. New subsection 204.81(1.1) provides that in applying clause 204.81(1)(*c*)(v)(E), at any time before 2004, in respect of a corporation incorporated before March 6, 1996, the references in that clause to the word “eight” are replaced with references to the word “five” if, at that time, the relevant statements in the corporation’s articles refer to the word “five”. This is intended to ensure that the extended (February, or March 1st) redemption provisions required of a federally-registered LSVCC’s articles apply equally to shares originally subject to a minimum five year holding period and those subject to a minimum eight year holding period.

New subsection 204.81(1.2) is a transitional rule that provides a federally-registered LSVCC, incorporated before February 7, 2000, with a reasonable amount of time to amend its articles as required by clause 204.81(1)(*c*)(v)(E). Subsection 204.81(1.2) provides that, in applying subsection 204.81(1) at any time before 2004 to such an LSVCC, if the LSVCC's articles comply with subclause 204.81(1)(*c*)(v)(E)(I) (as modified by subsection 204.81(1.1)) those articles are deemed to provide the statement required by subclause 204.81(1)(*c*)(v)(E)(II).

New subsections 204.81(1.1) and (1.2) apply after February 6, 2000. These amendments are part of a set of amendments, announced by the Minister of Finance (News Release 2000-009, dated February 7, 2000) concerning the redemption requirements for federally-registered LSVCCs. For information on a related amendment, see the commentary to subsection 211.8(1) of the Act.

Clause 172

Transfers Between Plans

ITA
204.9(5)

The French version of section 200 of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 173

Foreign Property Rules

ITA
Part XI

Part XI of the Act set out rules for a 1% per month penalty tax on excess foreign property held by deferred income plans. Part XI was repealed, effective for months that end after 2004, in *Budget Implementation Act, 2005, S.C. 2005, c.30*. A number of amendments are being made to Part XI that are effective prior to its repeal.

Definitions

ITA
206(1)

"cost amount"

"Cost amount" is defined in subsection 206(1) of the Act for the purposes of Part XI. The definition was introduced in 2001 to deal with arrangements that provided for trust income to be "capitalized" without the trust issuing new units. Under the definition, the cost amount otherwise determined of a taxpayer's interest in such a trust reflects the capitalized amounts. For months that end after December 20, 2002 and before 2005, the definition is to be read to clarify that it applies to trusts under which all beneficiaries are registered plan trusts (e.g., trusts described in paragraph (*e*) of the definition "trust" in subsection 108(1)).

"foreign property"

"Foreign property" is defined in subsection 206(1) of the Act. Under paragraph (*d*.1) of the definition, foreign property includes certain shares and debt issued by Canadian corporations, if shares of the corporation may reasonably be considered to derive their value primarily from foreign property. Paragraph (*g*) of the definition treats as foreign property the indebtedness of a non-resident person other than indebtedness issued by various international organizations or indebtedness issued by an authorized foreign bank and payable at a Canadian branch of that bank.

For months that end after October 2003 and before 2005, paragraphs (*d*.1) and (*g*) are to be read to provide that a mortgage obligation that is fully secured by real property situated in Canada is not foreign property.

“specified proportion”

Subsection 206(1) of the Act includes a definition of a partner’s “specified proportion” of a partnership for a fiscal period. To enable the definition to be used for other purposes as well, it is moved to subsection 248(1) of the Act, and is repealed in subsection 206(1), effective after December 20, 2002.

Acquisition of Qualifying Security

ITA
206(3.1)

The French version of subsection 206(3.1) of the Act is amended to correct an erroneous reference. The reference to subparagraph 206(2)(*a*)(iii), which does not exist in the French version of the Act, is replaced by a reference to subparagraph 206(2)(*a*)(ii). This amendment applies to months that end after 1997, which corresponds to the application of the last amendment to subsection 206(3.1).

Clause 174

Tax Payable by Recipient of an Ecological Gift

ITA
207.31

Section 207.31 of the Act imposes a tax on charities and Canadian municipalities where, without the approval of the Minister of the Environment, they dispose of or change the use of property donated to them as an ecological gift. The tax is equal to 50% of the amount that is the fair market value of the property at the time of the disposition or change in use as determined for the purposes of section 110.1 or 118.1 of the Act.

Section 207.31 is amended, in respect of dispositions of or changes of use of property after July 18, 2005, to clarify that it also applies to a public body performing a function of government in Canada. For more information, refer to the commentary for subsection 118.1(1) and paragraph 149(1)(*d*.5).

Clause 175

Tax on Designated Income of Certain Trusts

ITA
Part XII.2

Part XII.2 of the Act imposes a special tax on the designated income (as defined in subsection 210.2(2) of the Act) of certain trusts that are resident in Canada with respect to distributions to non-residents and other designated beneficiaries. One of the objectives of Part XII.2 tax is to prevent the minimization of tax on specified Canadian-source income that would otherwise arise where a Canadian trust’s income is distributed to a non-resident and is subject only to Part XIII tax. Part XII.2 tax is also meant to discourage transactions between taxable and tax-exempt beneficiaries designed to allow taxable income earned by a trust to be flowed-through to tax-exempt beneficiaries after the acquisition of a trust unit by the tax-exempt beneficiary from the taxable beneficiary.

Definitions and Application

ITA
210

Section 210 of the Act defines “designated beneficiary” for the purpose of Part XII.2.

Section 210 is amended so that a number of definitions that apply for the purposes of Part XII.2 are now found in new subsection 210(1). In addition, new subsection 210(2) replaces section 210.1 of the Act, which is being repealed.

Definitions

ITA
210(1)

New subsection 210(1) of the Act contains the definitions "designated beneficiary" (previously found in section 210 of the Act) and "designated income" (previously found in subsection 210.2(2) of the Act). These definitions apply in Part XII.2.

"designated beneficiary"

Under paragraphs (*a*) and (*b*) of the definition "designated beneficiary", a designated beneficiary includes, respectively, a non-resident person and a non-resident-owned investment corporation. Under paragraph (*c*) of the definition, a person exempt from tax under Part I of the Act is treated as a designated beneficiary because of owning an interest in a trust (acquired from a beneficiary under the trust) unless, generally speaking, no taxable entity previously owned that interest. Under paragraph (*d*) of the definition, a trust is a designated beneficiary of another trust if a beneficiary of the trust includes, generally, either a person or partnership described in any of paragraphs (*a*), (*b*), (*c*) or (*e*) of the definition or another trust (other than a testamentary trust resident in Canada). Under paragraph (*e*) of the definition, a partnership is a designated beneficiary of a trust if a member of the partnership is a person described in paragraph (*a*), (*b*) or (*d*) of the definition, another partnership or a person exempt from tax under Part I by reason of subsection 149(1) of the Act.

The opening words of the definition "designated beneficiary" are amended so that the references in the definition to a "trust" under which there may be a designated beneficiary are references to a "particular trust".

Paragraph (*c*) of the definition "designated beneficiary" is amended to clarify that a designated beneficiary of a particular trust includes, except as provided in subparagraphs (*c*)(i) and (ii) of the definition, a person who is, because of subsection 149(1), exempt from tax under Part I on all or part of their taxable income and who acquired an interest in the particular trust after October 1, 1987 directly or indirectly from a beneficiary under the particular trust.

Paragraph (*d*) of the definition "designated beneficiary" is amended so that a designated beneficiary of a particular trust includes another trust (in this commentary referred to as the "other trust") having as a beneficiary any one of the following persons or partnerships:

- under subparagraphs (*d*)(i) and (ii) of the definition, a non-resident person (including a trust) or a non-resident-owned investment corporation;
- under subparagraphs (*d*)(iii) of the definition, any trust, other than
  - a testamentary trust (however, note that if the testamentary trust were non-resident, the other trust would be treated as a designated beneficiary of the particular trust because of subparagraph (*d*)(i)),
  - a mutual fund trust,
  - a trust that is exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income (however, note that under subparagraph (*d*)(iv), described below, such a trust may cause the other trust to be a designated beneficiary of the particular trust), and
    - a trust none of the beneficiaries under which is, at that time, a designated beneficiary under it and whose interest, at that time, in the other trust was held, at all times after the day on which the interest was created, either by it or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income;

- under subparagraph (*d*)(iv) of the definition, a person (including a trust) or partnership that
  - is a designated beneficiary under the other trust because of paragraph (*c*) of the definition (i.e., a person who is, because of subsection 149(1), exempt from tax under Part I on all or part of their taxable income and who acquired an interest in the particular trust after October 1, 1987 directly or indirectly from a beneficiary under the particular trust) or because of paragraph (*e*) of the definition, or
    - would, based on the assumptions set out it in clause (*d*)(iv)(B), be a designated beneficiary under the particular trust because of paragraph (*c*) or (*e*) of the definition.

Note that a person or partnership that is a beneficiary of the other trust need only be described in any of one of subparagraphs (*d*)(i) to (iv) in order for the other trust to be a designated beneficiary of the particular trust. Note also that references in paragraph (*d*) of the definition to the expression "resident in Canada" are removed as these are unnecessary given that paragraph (*a*) of the definition provides that a non-resident person is a designated beneficiary.

Paragraph (*d*) of the definition is also amended to provide that the other trust will not be treated, under that paragraph, as a designated beneficiary of the particular trust if it is a testamentary trust, a mutual fund trust, or a trust that is exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income. However, these excluded trusts may be treated as designated beneficiaries of the particular trust under paragraphs (*a*) or (*c*) of that definition (e.g., a non-resident testamentary trust).

Amended paragraph (*e*) of the definition provides, in new subparagraph (*e*)(i), that a designated beneficiary of a particular trust includes a particular partnership any of the members of which is another partnership. However, no such other partnership will cause the particular partnership to be a designated beneficiary under the particular partnership if

- all such other partnerships are Canadian partnerships (as defined in subsection 102(1) of the Act),
- the interest of each such other partnership in the particular partnership is held, at all times after the day on which the interest was created, by the other partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income,
- the interest of each member, of each such other partnership, that is a person exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income was held, at all times after the day on which the interest was created, by that member or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income, and
- the particular partnership's beneficial interest in the particular trust is held, at all times after the day on which the interest was created, by the particular partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income.

Under subparagraphs (*e*)(ii) to (iv), a particular partnership will be a designated beneficiary under a particular trust if any one of the partnership's members is a non-resident person, a non-resident-owned investment corporation, or a specified person. For this purpose, a specified person means a trust that is a designated beneficiary of the particular trust because of paragraph (*d*) of the definition or a trust that would be such a designated beneficiary on the following assumptions: the other trust were at that time a beneficiary under the particular trust whose interest as a beneficiary under the particular trust were

- acquired from each person or partnership from whom the particular partnership acquired its interest as a beneficiary under the particular trust, and
- held at all times after the later of October 1, 1987 and the day on which the particular partnership's interest as a beneficiary under the particular trust was created, by the same persons or partnerships that held at those times that interest of the particular partnership.

New subparagraph (*e*)(v) of the definition provides that a particular partnership will be a designated beneficiary of a particular trust if any of the members of the particular partnership is a person exempt because of

subsection 149(1) from tax under Part I on all or part of its taxable income, unless the interest of the particular partnership in the particular trust was held, at all times after the day on which the interest was created, by the particular partnership or by persons who were exempt because of subsection 149(1) from tax under Part I on all of their taxable income.

Note that, for the purposes of the definition “designated beneficiary”, a new rule in section 132.2 applies in respect of certain trust units acquired by a beneficiary under a “qualifying exchange” (as defined in subsection 132.2(1)). For more detail, see the commentary on section 132.2.

Note as well that paragraph 210.2(3)(*b*) is amended to ensure that subsection 210.2(3) does not apply to a non-resident person that would be a designated beneficiary under the trust if the definition “designated beneficiary” in subsection 210(1) were read without reference to its paragraph (*a*). This amendment applies to the 1996 and subsequent taxation years.

This amendment applies to the 1996 and subsequent taxation years.

“designated income”

The tax under Part XII.2 of the Act is calculated by reference to a trust’s “designated income” (as determined under subsection 210.2(2)).

Subsection 210.2(2) is being replaced (for more detail, see the commentary below) and the definition “designated income” is now found in subsection 210(1) of the Act.

Paragraphs (*a*), (*b*) and (*d*) of the new definition “designated income” in subsection 210(1) are largely unchanged from the equivalent provisions found in repealed subsection 210.2(2).

Paragraph (*c*) of the new definition replaces paragraph 210.2(2)(*b*). Under subparagraph (*c*)(i), designated income is calculated by reference to taxable capital gains and allowable capital losses from dispositions of the trust’s taxable Canadian property. Subparagraph (*c*)(ii) provides that a trust’s designated income is also calculated by reference to taxable capital gains and allowable capital losses from a disposition by the trust of particular property (other than property described in any of subparagraphs 128.1(4)(*b*)(i) to (iii) of the Act).

In this context, particular property (or property for which the particular property is a substitute) must be property (referred to in this commentary as the “transferred property”) that was transferred to a particular trust in circumstances in which subsection 73(1) or 107.4(3) of the Act applied. This condition will be met whether the particular trust is the trust in respect of which the designated income is being determined, or any other trust to which the transferred property was transferred in circumstances in which subsection 73(1) or 107.4(3) applied and that subsequently transferred, directly or indirectly, the property to the trust in respect of which the designated income is being determined.

In addition, clauses (*c*)(ii)(A) and (B) of the definition require

- that it be reasonable to conclude that the transferred property was, at a particular time, transferred to the particular trust in anticipation of the emigration of a person beneficially interested at the particular time in the particular trust and that a person (whether the anticipated person or another) beneficially interested at that time in the particular trust subsequently ceases to reside in Canada, or
- at the particular time that the transferred property was transferred to the particular trust, that the terms of the particular trust satisfy the conditions in subparagraph 73(1.01)(*c*)(i) or (iii) of the Act and that it be reasonable to conclude that the transfer was made in connection with the cessation of residence, on or before that time, of a person who was, at that time, beneficially interested in the particular trust and a spouse or common-law partner, as the case may be, of the transferor of the transferred property to the particular trust.

These amendments generally apply for the 1996 and subsequent taxation years. Subparagraph (*c*)(ii) of the definition as described above applies, in effect, to dispositions, of property by a trust, that occur after December 20, 2002.

Application of Part XII.2

ITA
210(2) and 210.1

Section 210.1 of the Act provides a list of types of trusts to which Part XII.2 does not apply.

Section 210.1 is being repealed. The list of types of trusts to which Part XII.2 does not apply is now found in new subsection 210(2). New subsection 210(2), consequential on the amendments to the definition "designated beneficiary" (described in the commentary above), also clarifies that it applies only to determine to which trusts the special Part XII.2 tax does not apply. Subsection 210(2) does not apply, for example, to determine whether a trust referred to in that subsection may have a designated beneficiary.

This amendment applies to the 1996 and subsequent taxation years.

Clause 176

Amateur Athlete Trusts

ITA
210.2(2)

Subsection 210.2(1.1) of the Act extends the tax under Part XII.2 to amateur athlete trusts, which are provided for in section 143.1, in circumstances where amounts are distributed by such trusts to non-resident beneficiaries.

Subsection 210.2(1.1) of the Act is amended by renumbering it as subsection 210.2(2). In addition, the reference in that subsection to section 210.1 is, given that section's renumbering as subsection 210(2), replaced with a reference to subsection 210(2). The amended subsection also replaces the existing reference to the phrase "36% of 100/64" with the numerical equivalent of "56.25%". Finally, the provision is amended to clarify that Part XII.2 tax applies to a trust for a particular taxation year of the trust on the amount that is required by subsection 143.1(2) to be included in computing the income under Part I for a taxation year of a beneficiary under the trust, only if

- the beneficiary is at any time in the particular taxation year a designated beneficiary under the trust, and
- the particular taxation year ends in that taxation year of the beneficiary.

This amendment applies to the 1996 and subsequent taxation years.

Clause 177

Part XII.4

ITA
211.6(1)

Part XII.4 imposes a special tax on qualifying environmental trusts, as defined under subsection 248(1). Subsection 211.6(1) is the charging provision of Part XII.4. It requires a qualifying environmental trust to pay a tax equal to 28% of its income for the year.

Subsection 211.6(1) is amended to provide that a trust that is described by new paragraphs 149(1)(z.1) or (z.2), even if it is a qualifying environmental trust, is not subject to Part XII.4 tax.

This amendment applies to the 1997 and subsequent taxation years.

Clause 178

Recovery of Labour-sponsored Funds Tax Credit

ITA
Part XII.5

Part XII.5 of the Act (sections 211.7 to 211.9) provides for a special tax that is designed to recover the federal tax credit under section 127.4 of the Act with respect to the original acquisition of a share issued by a labour-sponsored venture capital corporation (LSVCC). This tax applies where there is a disposition of an "approved share", as defined in subsection 127.4(1) of the Act.

Disposition of Approved Share

ITA
211.8(1)

Subsection 211.8(1) of the Act provides that the special tax under Part XII.5 generally applies where shares in a federally-registered LSVCC that qualify for the federal LSVCC tax credit are redeemed prior to the expiry of a minimum period. In the case of shares the "original acquisition" (as defined in subsection 127.4(1) of the Act) of which occurred before March 6, 1996, there is no recovery of the tax credit for a share redeemed more than five years after the day on which the share was issued. For shares the original acquisition of which occurs after March 5, 1996, the recovery generally applies where a share is redeemed less than eight years after the day on which it was issued.

Subsection 211.8(1) is amended so that there is no Part XII.5 tax in respect of the redemption by a federally-registered LSVCC of a share the original acquisition of which was after March 5, 1996, if the redemption occurs on a day that is in February or on March 1st of a calendar year and that day is no more than 31 days before the day that is eight years after the day on which the share was issued. For a share the original acquisition of which occurred before March 6, 1996, the circumstances in which there is no recovery of the tax credit are extended to include the redemption of the share on a day that is in February or on March 1st of a calendar year if that day is no more than 31 days before the day that is five years after the day on which the share was issued.

This amendment applies to redemptions, acquisitions, cancellations and dispositions that occur after November 15, 1995.

This amendment is part of a set of amendments, announced by the Minister of Finance (News Release 2000-009, dated February 7, 2000) concerning the redemption requirements for federally-registered LSVCCs. The set of amendments is intended to accommodate taxpayers wishing to acquire new LSVCC shares in the first 60 days of a year using the proceeds from the redemption of LSVCC shares. Other related changes include amendments to section 204.81 of the Act. For additional information, see the commentary on those provisions.

Example 1

On February 2nd, 1998 a federally-registered LSVCC redeemed 200 Class A shares owned by Charles. The original acquisition by Charles of the shares was on March 1, 1993, the same day on which the shares were issued. The issuing LSVCC was incorporated on December 1, 1992. The LSVCC's Articles comply with the applicable registration requirements.

Results:

1. *Under new clause (i)(C) of the description of B in paragraph 211.8(1)(a), there will be no recovery of the tax credit on the redemption of the 200 shares because the original acquisition of the shares was before March 6, 1996 and the redemption occurred on a day in February not more than 31 days before the day that is five years after the day on which the shares were issued.*
2. *Because of new subsection 204.81(1.2), subsection 204.81(6) of the Act would not apply to allow the Minister of National Revenue to revoke the LSVCC's registration solely because of the redemption.*

Example 2

On February 15, 2005 a federally-registered LSVCC redeemed 200 Class A shares owned by Marguerite. The circumstances of the redemption are not described in any of the provisions, described in clauses 204.81(1)(c)(v)(A) to (D) of the Act, of the LSVCC's articles. The original acquisition by Marguerite of the first 100 shares was on March 1, 1997, although the shares were issued on March 12th, 1997. The original acquisition by Marguerite of the second 100 shares was on February 29, 2000, the same day on which the shares were issued. The LSVCC was incorporated on May 1, 1996.

Results:

1. *Under new subparagraph (i.1) of the description of B in paragraph 211.8(1)(a), there will be no recovery of the tax credit on the redemption of the first 100 shares because the redemption occurred in February on a day not more than 31 days before the day that is eight years after the day on which the shares were issued. Subparagraph (i) of the description of variable B in paragraph 211.8(1)(a) does not apply because the original acquisition of the shares was not before March 6, 1996.*
2. *Under new subparagraph (i.1) of the description of B in paragraph 211.8(1)(a), there will be a recovery of the tax credit on the redemption of the second 100 shares because the redemption occurred less than eight years after the day on which the share was issued and more than 31 days before the day that is eight years after the day on which the shares were issued.*
3. *Because of new subsection 204.81(1.2), subsection 204.81(6) would not apply to allow the Minister of National Revenue to revoke the LSVCC's registration solely because of the redemption of the first 100 shares. However, the early redemption by the corporation of the second 100 shares, in violation of the provisions of its articles described in clause 204.81(1)(c)(v)(E), authorizes the Minister of National Revenue to revoke the LSVCC's registration under subsection 204.81(6).*

Clause 179

Taxation of Non-residents

ITA
Part XIII

Part XIII of the Act applies a tax on certain amounts paid by a person resident in Canada to a non-resident person.

Non-resident Withholding Tax – Interest

ITA
212(1)(*b*)(iv)

Paragraph 212(1)(*b*) of the Act both applies tax under Part XIII of the Act to interest paid or credited by a person resident in Canada to a non-resident person and includes a number of exemptions from the tax. One of these, in subparagraph 212(1)(*b*)(iv), is for interest payable to an arm's length person who holds a valid "certificate of exemption". These certificates, issued by the Minister of National Revenue under the authority provided by subsection 212(14) of the Act, are generally available to foreign pension entities, charities and certain other tax-exempt entities.

In its current form, subparagraph 212(1)(*b*)(iv) applies only to interest on a "bond, debenture or similar obligation." Since this restriction may unduly limit the scope of the provision, it is broadened to encompass all forms of indebtedness. It should be noted, however, that no change is made to the requirement that the Canadian-resident payer of the interest and the non-resident recipient deal at arm's length.

This amendment applies to the 1998 and subsequent taxation years.

ITA
212(1)(*b*)(xii)

Subparagraph 212(1)(*b*)(xii) provides an exemption for interest payable under certain securities lending arrangements by registered or licensed securities dealers resident in Canada. Given the current definition of "securities lending arrangement" in subsection 260(1) of the Act, this exemption is only available to dealers who are dealing at arm's length with the other parties to the arrangements.

Consequential to the amendments to the definition of "securities lending arrangement" in subsection 260(1), which now includes certain arrangements between non-arm's length parties, the amendment to subparagraph 212(1)(*b*)(xii) confirms that the exemption is limited to arm's length arrangements.

This amendment applies to arrangements made after 2002.

Non-resident Withholding Tax - Interest

ITA
212(1)(*b*)(xiii)

Securities lending arrangements often include an obligation for one party to compensate the other for certain income amounts. In the absence of special rules, these compensation payments may be subject to tax under Part XIII if they are paid by a person resident in Canada to a non-resident person.

New subparagraph 212(1)(*b*)(xiii) exempts from tax under Part XIII certain interest compensation payments made to a non-resident by a borrower resident in Canada under a securities lending arrangement. For this exemption to apply,

- the payments must be made by the borrower in the course of carrying on its business outside of Canada; and
- the borrowed securities must be issued by a non-resident issuer.

This amendment applies to securities lending arrangements entered into after May 1995, except that, before 2002, the reference to "subparagraph 260(8)(*c*)(i)" should be read as "subparagraph 260(8)(*a*)(i)".

Estate and Trust Income

ITA
212(1)(*c*)

The French version of paragraph 212(1)(*c*) is amended to replace the term "paiement" with the term "distribution" for consistency with other provisions of the Act dealing with amounts distributed by trusts and estates. This amendment will come into force on Royal Assent.

Rents, Royalties, etc.

ITA
212(1)(*d*)

Paragraph 212(1)(*d*) of the Act describes various amounts, in the nature of rent, royalties and similar payments, on which tax under Part XIII of the Act is imposed. Subparagraphs 212(1)(*d*)(vi) through (xi) list payments to which the tax does not apply. Three changes have been made to paragraph 212(1)(*d*).

First, subparagraph 212(1)(*d*)(iv), which concerns payments made in respect of an agreement between a person resident in Canada and a non-resident person under which the non-resident person agrees not to use or not to permit any other person to use any thing referred to in subparagraph (*d*)(i), is amended so that it does not apply to certain restrictive covenant amounts to which new paragraph 212(1)(*i*) applies. This change applies to amounts paid or credited after October 7, 2003.

Second, subparagraph 212(1)(*d*)(xi), which currently provides that Part XIII tax does not apply to payments made to an arm's length person for the use of property that is an aircraft, certain attachments thereto as well as to spare parts for such property, is amended, applicable after July 2003, to also apply to air navigation equipment utilized in the provision of services under the *Civil Air Navigation Services Commercialization Act*, and to computer software that is necessary to the operation of that equipment that is used by the payer for no other purpose.

Third, new subparagraph 212(1)(*d*)(xii) clarifies that subsection 212(5) of the Act, which is amended as described below, is the sole provision in Part XIII that applies the tax to payments for rights in or to use a film or video that is used or reproduced in Canada. This change applies for the 2000 and subsequent taxation years.

Restrictive Covenant Amount

ITA
212(1)(*i*)

New paragraph 212(1)(*i*) of the Act includes, as amounts subject to the withholding tax, two amounts. First, the withholding tax applies to an amount in respect of a restrictive covenant to which new subsection 56.4(2) applies. Second, the withholding tax applies to an amount to which new paragraph 56(1)(*m*) applies (an amount received on a bad debt previously deducted).

New paragraph 212(1)(*i*) applies to amounts paid or credited after October 7, 2003.

Exempt Dividends

ITA
212(2.1)

New subsection 212(2.1) is added to exempt from Part XIII tax certain dividend compensation payments made to a non-resident by a Canadian securities borrower under a securities lending arrangement if

- the payments were deemed to be dividends by subparagraph 260(8)(*c*)(i) of the Act;
- the payments were made by the borrower in the course of carrying on its business outside of Canada; and
- the borrowed securities were issued by a non-resident issuer.

This amendment applies to securities lending arrangements entered into after May 1995, except that, before 2002, the reference to "subparagraph 260(8)(*c*)(i)" should be read as "subparagraph 260(8)(*a*)(i)".

Replacement Obligations

ITA
212(3)

Among the exceptions to the imposition of tax under Part XIII of the Act on interest is one found in subparagraph 212(1)(*b*)(vii) for interest paid by a corporation resident in Canada on its medium- and long-term arm's length debt. Subsection 212(3), which applies for the purpose of subparagraph 212(1)(*b*)(vii), allows a corporation in certain circumstances of financial difficulty to treat a debt obligation that replaces another as having been issued when that other obligation was issued. The circumstances in which this is possible are set out in paragraphs 212(3)(*a*) to (*c*). Paragraph 212(3)(*b*) requires that, for the subsection to apply, it must be possible to regard the proceeds of the replacement borrowing as being used in financing an active business that was carried on in Canada, by the issuing company or one with which it does not deal at arm's length, immediately before the replacement obligation was issued.

There is no clear basis in tax policy for this requirement. The condition in paragraph 212(3)(*b*) is repealed for replacement debt obligations that are issued after 2000.

Motion Picture Films

ITA
212(5)

Subsection 212(5) of the Act applies tax under Part XIII to, in general terms, any amount that a person resident in Canada pays to a non-resident person for a right in or to the use of a motion picture film or video product that has been or is to be used or reproduced in Canada (otherwise than for a news program). As presently worded, the subsection can be read as applying even if the payment in question is not for that Canadian use or reproduction, but relates instead to employment of the film or video in some other country. Accordingly, subsection 212(5) is amended to impose tax only to the extent that the amount of the payment relates to the use or reproduction of the product in Canada. This amendment applies to the 2000 and subsequent taxation years.

Exemptions

ITA
212(9)

Subsection 212(9) of the Act provides an exemption from withholding tax under Part XIII of the Act with respect to certain amounts of a trust's income that are paid or credited to a non-resident beneficiary under the trust and that would otherwise be subject to withholding tax under paragraph 212(1)(*c*). The exemption currently applies only in respect of amounts that are attributable to income of the trust in the form of: dividends or interest received by the trust from a non-resident-owned investment corporation; certain artistic royalties; and interest, where the trust is a mutual fund maintained primarily for the benefit of non-resident persons.

If no Part XIII tax would have been payable with respect to the dividends, interest or royalties if they had been paid directly to the beneficiary, no Part XIII tax is payable with respect to a distribution from trust income to non-resident beneficiaries that derives from the dividends, interest or royalties.

Subsection 212(9) is amended to add a fourth type of trust income to this list of exemptions. In certain circumstances, Canada's Superintendent of Financial Institutions may require a non-resident reinsurer that reinsures Canadian risks to place assets in a trust in Canada. Such a "reinsurance trust" may earn dividend or interest income, which is payable to the non-resident. In recognition of the regulatory requirement for these trusts, subsection 212(9) is amended to provide that, if the dividends or interest would not have borne Canadian tax if the non-resident had earned them directly, they may be distributed to the non-resident free of Part XIII tax.

This amendment applies to amounts paid or credited to non-residents after 2000.

Rent and Other Payments

ITA
212(13)

Subsection 212(13) of the Act imposes non-resident withholding tax on certain payments made by one non-resident to another non-resident. Subsection 212(13) is amended to add new paragraph (*g*), which imposes non-resident withholding tax on amounts paid or credited by a non-resident for a restrictive covenant to which new paragraph 212(1)(*i*) applies, if the amount affects, or is intended to affect, in any way whatever,

- the acquisition or provision of property or services in Canada,
- the acquisition or provision of property or services outside Canada by a person resident in Canada, or
- the acquisition or provision outside of Canada of a taxable Canadian property.

New paragraph 212(13)(*g*) applies to amounts paid or credited after October 7, 2003.

Application of Part XIII Tax Where Non-Resident Operates in Canada

ITA
212(13.2)

Subsection 212(13.2) of the Act is one of several provisions that extend Part XIII tax to apply in particular circumstances - in this case, for the most part, the payment by a non-resident of royalties and similar amounts in respect of a Canadian income source. The principle that underlies subsection 212(13.2) is that if a non-resident has Canadian-source business or resource income, and can deduct in computing that income (strictly speaking, in computing "taxable income earned in Canada") a payment to another non-resident, that payment ought to be treated for purposes of Part XIII tax as though it had been made by a person resident in Canada. This is accomplished by treating the first non-resident - the one making the payment - as a person resident in Canada for those purposes.

In its current form, subsection 212(13.2) applies only if the non-resident making the payment carries on business principally in Canada, manufactures or processes goods in Canada or carries out any of various resource activities here. On the other hand, the rule does not explicitly link that business or activity to the deductibility of the payment: it can be read as applying whether or not the payment is made in relation to the particular business or activity.

Accordingly, subsection 212(13.2) is amended to apply in respect of any portion of a payment (other than one to which the generally comparable rule in subsection 212(13) applies) made by one non-resident person to another that is deductible in computing the first non-resident's taxable income earned in Canada from any source. The only exceptions are payments that are deductible in respect of treaty-protected businesses or treaty-protected properties (as defined in subsection 248(1) of the Act).

This amendment applies to amounts paid or credited under obligations entered into after December 20, 2002.

Tax on Registered Securities Dealers

ITA
212(19)

Subsection 212(19) of the Act imposes a tax on Canadian-resident registered securities dealers that enter into certain securities lending arrangements described in subparagraph 212(1)(*b*)(xii) of the Act. The tax is calculated, by formula, based in Part on the capital or the margin requirement of the relevant provincial laws governing the registration or license of securities dealers.

An earlier amendment to subsection 212(19) removed a reference to the provincial laws under which the taxpayer is registered or licensed. The subsection is further amended, as a consequence of that earlier change, to replace the words "those laws" in subparagraph (*b*)(i) of the description of B in the formula (which no longer have any clear antecedent), with a specific reference to the provincial legislation that govern the registration or license of securities dealers.

This amendment applies to securities lending arrangements entered into after May 28, 1993.

Clause 180

Deemed Payments

ITA
214(3)

The French version of paragraph 214(3)(*k*) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 181

Alternative re Rents and Timber Royalties

ITA
216

Section 216 of the Act allows a non-resident person to file a return of income under Part I in respect of rent on real property in Canada or timber royalties and to pay, instead of the non-resident withholding tax under Part XIII, tax under Part I on the basis of the non-resident's income from the rent or royalties.

Subsection 216(1), which provides the basic rule permitting a non-resident to be taxed under Part I of the Act on this income, is amended to improve its structure and language. Most of the changes are stylistic; the amendment also updates the subsection's reference to the form of the non-resident's Part I tax return, to reflect the implementation of a special return for these non-residents. This amendment applies to taxation years that end after December 20, 2002.

In general terms, subsection 216(5) of the Act requires that a person who has previously made an election under subsection 216(1), and who has claimed capital cost allowance in computing income under the subsection, must file a return of income for the year in which the property that was the subject of the election is disposed of. Subsection 216(5) is modified in the same manner as subsection 216(1), again with the main change being an updated description of the relevant form. This amendment applies to taxation years that end after December 20, 2002.

Subsection 216(7) of the Act provides that the rules in section 61 of the Act, dealing with income averaging annuity contracts, do not apply in computing a non-resident person's income for a taxation year in respect of which subsection 216(5) applies to the person. Since section 61 is no longer relevant to any current transaction, subsection 216(7) is repealed. This repeal takes effect on Royal assent.

Clause 182

Administration and enforcement

ITA
220

Section 220 of the Act sets out a number of rules relating to the administration and enforcement of the Act.

Waiver of filing of documents

ITA
220(2.2)

Under subsection 220(2.1) of the Act, if a provision of the Act or the Regulations requires a person to file a prescribed form, receipt or other document, or to provide prescribed information, the Minister may waive the requirement, but the document or information shall be provided at the Minister's request.

New subsection 220(2.2) provides that subsection 220(2.1) does not extend to a prescribed form, receipt, document or information, or prescribed information, that is filed on or after the day specified – in respect of the form, receipt, document or information – in subsection 37(11) or paragraph (*m*) of the definition "investment tax credit" in subsection 127(9) of the Act. Those provisions provide, in general, that a taxpayer's claim for SR&ED treatment be made in a prescribed form that must be received by the Minister no later than 12 months after the taxpayer's filing-due date for the taxation year in which the expenditures were made.

The effect of new subsection 220(2.2) is that a person cannot deduct a scientific research and experimental development (SR&ED) expenditure under section 37 of the Act, or claim an investment tax credit in respect of an expenditure, if the person takes more than the additional 12 months allowed to make a claim with the Minister.

In general, new subsection 220(2.2) applies on and after November 17, 2005.

Security for Tax on Distributions of Taxable Canadian Property to Non-resident Beneficiaries

ITA
220(4.6) and (4.61)

The French version of subsections 220(4.6) and (4.61) of the Act is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Clause 183

Records and Books

ITA
230(2)

Subsection 230(2) of the Act requires that registered charities and registered Canadian amateur athletic associations keep books and records containing information that will enable the Minister of National Revenue to determine whether there are grounds for the revocation of their registration.

The French version of this subsection is amended to replace the expression « *motifs d'annulation* » by the expression « *motifs de révocation* » in order to be consistent with the terminology used in sections 149.1 and 168 of the Act, which authorize the Minister to revoke the registration of these charities and associations.

This amendment applies on Royal Assent.

ITA
230(3)

Subsection 230(3) provides that where a person has failed to keep adequate records and books of account, the Minister of National Revenue may require them to keep such records and books as the Minister specifies. The French version of this subsection is amended to correct grammatical errors.

This amendment applies on Royal Assent.

Clause 184

Requirement to Provide Documents or Information

ITA
231.2(1)

Subsection 231.2(1) of the Act provides that, notwithstanding any other provision of the Act, the Minister of National Revenue may by notice require that any person provide information or any document for any purpose relating to the administration or enforcement of the Act. An exception is made where the information or document relates to an unnamed person or persons, in which case the procedure set out in subsections 231.1(2) to (6) of the Act must be followed.

Subsection 231.2(1) is amended to provide that the Minister may by notice require any person to provide information or any document relating to the administration or enforcement of the Act, of a listed international agreement or, for greater certainty, of a tax treaty with another country.

A "listed international agreement" is newly defined in subsection 248(1) to mean the *Convention on Mutual Administrative Assistance in Tax Matters*, concluded at Strasbourg on January 25, 1988 and the *Convention between the Government of Canada and the Government of the United Mexican States for the Exchange of Information with Respect to Taxes*, signed at Mexico City on March 16, 1990. A "tax treaty" is defined in subsection 248(1) to mean a comprehensive agreement for the elimination of double taxation on income between the Canadian and foreign government that has the force of law in Canada at that time.

This amendment applies on Royal Assent.

Clause 185

Tax Shelters

Definitions

ITA
237.1(1)

Subsection 237.1(1) of the Act provides definitions of terms that apply for the purpose of tax shelter identification and the definition of "tax shelter investment" in subsection 143.2(1) of the Act. The definition "gifting arrangement" includes an arrangement in respect of which it may reasonably be expected, having regard to representations made, that if a taxpayer makes a gift or political contribution under the arrangement, a person (whether or not it is the taxpayer) will incur an indebtedness in respect of which recourse is limited. This definition is amended in respect of gifts and contributions made after 6:00 p.m. (EST), December 5, 2003, to also refer to a limited-recourse debt determined under new subsection 143.2(6.1) of the Act. For additional details regarding limited-recourse debt in respect of a gift, see the commentary to subsection 143.2(6.1).

Clause 186

Provision of Information

ITA
241

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

Disclosure of Information – Registered Charities

ITA
241(3.2)

Paragraph 241(3.2)(*h*) of the Act permits a government official to release information that a registered charity has filed in support of an application for special status or an exemption under the Act, as well as any response to such an application (e.g., a request for permission to accumulate assets). Paragraph 241(3.2)(*h*) is amended, applicable upon Royal Assent, to include information relating to an application made under subsection 149.1(5) of the Act for an amount to be deemed an expenditure on charitable activities carried on by the charity.

Information may be communicated

ITA
241(3.3)

New subsection 241(3.3) of the Act, which applies on Royal Assent, is added to provide authority to the Minister of Canadian Heritage to publish certain information relevant to the Canadian film or video production tax credit program. The information includes the title of a film or video production in respect of which a certificate has been issued or revoked by that Minister, as well as the names of producers and artists in respect of which that Minister has allotted "points" in determining whether the production is a "Canadian film or video production" under proposed section 1106 of the Regulations.

Disclosure of Taxpayer Information

ITA
241(4)

Subsection 241(4) of the Act authorizes the limited communication of information to government officials outside of the Canada Revenue Agency.

New subparagraph 241(4)(*d*)(xv) allows information in respect of film or video productions to be communicated to officials of an office or agency of the government of Canada or of a province that provides a program of assistance for such productions. The information may be communicated only for the purpose of administration or enforcement under the program. New subparagraph 241(4)(*d*)(xvi) extends this authority to communicate information to an official of the Canadian Radio-television and Telecommunications Commission, solely for the purpose of the administration or enforcement of a regulatory function of that Commission.

New subparagraphs 241(4)(*d*)(xv) and (xvi) apply on Royal Assent.

Subparagraph 241(4)(*e*)(xii) is amended to provide that an official may provide taxpayer information, or allow the inspection of or access to taxpayer information under and solely for the purposes of a provision contained in a tax treaty or in a listed international agreement.

A "listed international agreement" is newly defined in subsection 248(1) to mean the *Convention on Mutual Administrative Assistance in Tax Matters*, concluded at Strasbourg on January 25, 1988 and the *Convention between the Government of Canada and the Government of the United Mexican States for the Exchange of Information with Respect to Taxes*, signed at Mexico City on March 16, 1990. A "tax treaty" is defined in subsection 248(1) to mean a comprehensive agreement for the elimination of double taxation on income between the Canadian and foreign government that has the force of law in Canada at that time.

This amendment applies on Royal Assent.

Clause 187

Interpretation

ITA
248

Section 248 of the Act defines a number of terms that apply for the purposes of the Act, and sets out various rules relating to the interpretation and application of various provisions of the Act.

Definitions

ITA
248(1)

"common-law partner"

An individual becomes the common-law partner of another individual once they have cohabited in a conjugal relationship for at least one year. Paragraph (*a*) of the definition "common-law partner" in subsection 248(1) is amended, effective for the 2001 and subsequent taxation years, to clarify that, for an individual to be considered the common-law partner of another person at a particular time, the individual and that other person need to have cohabited in a conjugal relationship throughout the twelve-month period that ends at that particular time.

"disposition"

The expression "disposition" is used throughout the Act, particularly in provisions relating to transactions involving property.

The definition "disposition" was added to subsection 248(1) by S.C. 2001, chapter 17, ss. 188(5) [formerly Bill C-22]. In general, that definition is applicable to transactions and events that occur after December 23, 1998. The former definition "disposition" was contained in section 54 of the Act, applicable to transactions and events that occurred before December 24, 1998.

Under the definition "disposition" in subsection 248(1), a "disposition" of any property includes a transaction or an event described in any of paragraphs (*a*) to (*d*) of that definition but does not include a transaction or an event described in any of paragraphs (*e*) to (*m*) of that definition.

Under subparagraph (*b*)(i) of that definition, a disposition of a property includes any transaction or event by which, where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property "is redeemed in whole or in Part or is cancelled".

The definition "disposition" in subsection 248(1) is amended in the following ways.

First, subparagraph (*b*)(i) of the definition now provides that a disposition of property includes any transaction or event by which, where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property "is in whole or in Part redeemed, acquired or cancelled". This amendment makes it clear that a disposition will also include a transaction or event by which the property is acquired.

Second, paragraph (*n*) is added to the definition. New paragraph (*n*) provides that a redemption, an acquisition or a cancellation of a share, or of a right to be issued a share, (which share or which right, as the case may be, is referred to as the "security") of the capital stock of a corporation (the "issuing corporation") held by another corporation (the "disposing corporation") is considered not to be a "disposition" in the case where

- the redemption, acquisition or cancellation occurs as part of a particular merger or combination of two or more corporations (including the issuing corporation and the disposing corporation) to form one corporate entity (referred to as the "new corporation"),
- the particular merger or combination
  - is an amalgamation (within the meaning assigned by subsection 87(1) of the Act) to which subsection 87(11) of the Act does not apply,
  - is an amalgamation (within the meaning assigned by subsection 87(1)) to which subsection 87(11) applies, if the issuing corporation and the disposing corporation are described by subsection 87(11) as the parent and the subsidiary, respectively, or
  - is a merger or combination of non-resident corporations (referred to in these Notes as a "subject merger") that would be a foreign merger (within the meaning assigned by subsection 87(8.1) of the Act) if subparagraph 87(8.1)(*c*)(ii) were read without reference to the words "that was resident in a country other than Canada", and
- either
  - the disposing corporation receives no consideration for the security, or
  - in the case of where the particular merger or combination is a subject merger, the disposing corporation receives no consideration for the security other than property that was, immediately before the particular merger or combination, owned by the issuing corporation and that, on the foreign merger, becomes property of the new corporation.

Both amendments apply to redemptions, acquisitions and cancellations that occur after December 23, 1998, and, where the redemption, acquisition or cancellation takes place before December 21, 2002, the Minister of National Revenue shall, notwithstanding subsections 152(4) to (5) of the Act, make any assessment of a taxpayer's tax, interest and penalties payable under the Act for any taxation years that include the time at which such a redemption, acquisition or cancellation occurred that is necessary to take into account the application of the amendments.

In connection with redemptions, acquisitions and cancellations that occur before December 24, 1998, see the commentary to new subsection 248(1.1) of the Act.

Third, the definition "disposition" in subsection 248(1) is also amended by restricting the circumstances in which a transfer of property between trusts will not be treated as a disposition. In particular, paragraph (*f*) of the definition is amended so that a transfer of property from a trust to another trust will avoid, under that paragraph, characterization as a disposition only if both trusts are, at the time of the transfer, resident in Canada.

This amendment applies to transfers that occur after February 27, 2004.

"dividend rental arrangement"

A "dividend rental arrangement" is, in general terms, an arrangement under which one person receives a dividend on a share that has been borrowed from another person who retains the risk of loss or opportunity for gain from fluctuations in the share value. To clarify its application where a partnership is a party to the arrangement, the definition is restructured and amended; its language is also updated in certain respects.

Under the amended definition, the "person" who is the subject of the arrangement - that is, the person who enters into the arrangement in order to receive a dividend - may be a partnership or a person as otherwise defined.

Existing paragraph (*c*) of the definition ensures that the definition includes an arrangement under which a corporation receives a taxable dividend that would be deductible but for subsection 112(2.3) of the Act, and is obligated to make dividend compensation payments. This paragraph is replaced by new paragraph (*b*), which adds to the arrangements described one in which it is not the corporation receiving the dividend that is obligated to make the compensation payment, but rather a partnership of which the corporation is a member.

At first reading, new paragraph (*b*) may seem asymmetrical, in that it expressly covers the case where a partnership is obligated to make the compensation payment, but not the case where a partnership receives the taxable dividend. In fact, the paragraph covers both: since in the latter case the corporate partner is itself already considered to receive the dividend, it is not necessary to add a reference to the partnership in that regard.

The reference to "subsection 260(5)" in this definition is replaced with "subsection 260(5.1)" consequential to the amendments to section 260. This amendment applies to paragraph (*d*) of the former definition and clause (*b*)(ii)(B) of the amended definition.

The amendment to paragraph (*d*) of the former definition applies between January 1, 2002 and December 20, 2002 unless an election noted below is filed.

The amended definition applies to arrangements made after December 20, 2002; it also applies to an arrangement made after November 2, 1998 and before the day after December 20, 2002, if the parties jointly elect in writing filed with the Minister of National Revenue within 90 days after this Act has been assented to, except that before 2002 the reference to "subsection 260(5.1)" in the amended definition should be read as "subsection 260(5)".

"foreign resource property"

The definition "foreign resource property" in subsection 248(1) of the Act is structured to parallel the definition "Canadian resource property" in subsection 66(15) of the Act, with the necessary modifications to reflect the location of the property outside Canada. This definition is amended, effective for property acquired after December 20, 2002, as a consequence of changes to the definition "Canadian resource property".

"former business property"

The definition "former business property" in subsection 248(1) of the Act describes properties the voluntarily disposition of which by a taxpayer are eligible for elections under subsections 13(4) and 44(1) of the Act to defer the recapture of depreciation and capital gains. Subject to certain exceptions, a former business property is generally real property or an interest in real property used primarily in a business. The definition is amended, applicable after December 20, 2002, to include a franchise, concession or license for a limited period that is wholly attributable to the carrying on of a business in a fixed place and that is the subject of a valid election under new subsection 13(4.2) of the Act. For further information, refer to the commentary to new subsections 13(4.2) and (4.3).

"listed international agreement"

The definition of "listed international agreement" is added to subsection 248(1) as a consequence of the amendments to subsection 231.2(1) and subparagraph 241(4)(*e*)(xii). The agreements included in the definition are the *Convention on Mutual Administrative Assistance in Tax Matters*, concluded at Strasbourg on January 25, 1988 and the *Convention between the Government of Canada and the Government of the United Mexican States for the Exchange of Information with Respect to Taxes*, signed at Mexico City on March 16, 1990.

This amendment applies on Royal Assent.

"qualifying environmental trust"

The French version of the definition of "qualifying environmental trust", in subsection 248(1) of the Act, is amended to correct a terminology error. In effect, the concept of "attribution" is replaced by "distribution" so that it is clear that the property is actually remitted to the trust's beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

“qualifying trust annuity”

The term “qualifying trust annuity” is added to subsection 248(1) of the Act, and is defined to have the meaning assigned by new subsection 60.011(2). A distinguishing feature of a qualifying trust annuity is that the annuitant is a trust. Special provisions relating to qualifying trust annuities are set out in sections 60.011, 75.2, 148 and 160.2 of the Act. (Refer to the explanatory notes on those provisions for further details.)

“scientific research and experimental development”

Paragraph (*d*) of the definition “scientific research and experimental development” in subsection 248(1) of the Act includes, for the purposes of applying that definition in respect of a taxpayer, certain work (listed therein) undertaken by or on behalf of a taxpayer if the work is commensurate with the needs, and directly in support, of work described in paragraphs (*a*) to (*c*) of that definition that is undertaken by or on behalf of the taxpayer. “Engineering” work is among the work listed in paragraph (*d*). The French version of paragraph (*d*) of the definition is changed, effective upon Royal Assent, to refer to *“travaux de genie”* instead of *“travaux techniques”*.

“specified proportion”

The definition “specified proportion” of a member of a partnership for a fiscal period of the partnership is currently found in subsection 206(1) of the Act. The apportionment that results from the definition is, however, useful for many purposes of the Act, and a number of other provisions apply the same concept. For simplicity, the definition is moved to subsection 248(1) of the Act. As a result, for all purposes of the Act a partner’s specified proportion for the period is that proportion of the partnership’s total income or loss for that period that is the member’s share. If the partnership’s income or loss for the period is nil, the proportion is computed as if the partnership had $1 million of income for the period.

This amendment applies after December 20, 2002.

Non-Disposition Before December 24, 1998

ITA
248(1.1)

The definition “disposition” was added to subsection 248(1) of the Act by S.C. 2001, chapter 17, subsection 188(5) [formerly Bill C-22]. In general, that definition applies to transactions and events that occur after December 23, 1998. The former definition “disposition” was contained in section 54 of the Act, applicable to transactions and events that occurred before December 24, 1998.

New paragraph (*n*) is added to the definition “disposition” in subsection 248(1), applicable to redemptions, acquisitions and cancellations of certain securities that occur after December 23, 1998. For more detail, see the commentary to subsection 248(1).

New subsection 248(1.1) of the Act is added to deal, in a corresponding fashion, with such redemptions, acquisitions and cancellations that occurred before December 24, 1998.

New subsection 248(1.1) provides that a redemption, an acquisition or a cancellation, at any particular time after 1971 and before December 24, 1998, of a share or of a right to acquire a share (which share or which right, as the case may be, is referred to as the “security”) of the capital stock of a corporation (referred to as the “issuing corporation”) held by another corporation (referred to as the “disposing corporation”) is not a disposition of the security within the meaning of the definition “disposition” in section 54 (as that section read in its application to transactions and events that occur at the particular time), if

- the redemption, acquisition or cancellation occurred as part of a particular merger or combination of two or more corporations (including the issuing corporation and the disposing corporation) to form one corporate entity (referred to as the “new corporation”),

- the particular merger or combination
  - is an amalgamation (within the meaning assigned by subsection 87(1) of the Act as it read at the particular time) to which subsection 87(11) of the Act if in force, and as it read, at the particular time did not apply,
  - is an amalgamation (within the meaning assigned by subsection 87(1) as it read at the particular time) to which subsection 87(11) if in force, and as it read, at the particular time applies, if the issuing corporation and the disposing corporation are described by subsection 87(11) (if in force, and as it read, at the particular time) as the parent and the subsidiary, respectively,
  - occurred before November 13, 1981 and is a merger of corporations that is described by subsection 87(8) (as it read in respect of the particular merger or combination), or
  - is a merger or combination of non-resident corporations (referred to in these Notes as a "subject merger") that occurred after November 12, 1981 and
    - s a foreign merger (within the meaning assigned by subsection 87(8.1) as it read in respect of the particular merger or combination), or
    - all of the following conditions are met, namely
      - 1. the particular merger or combination is not a foreign merger (within the meaning assigned by subsection 87(8.1) as it read in respect of the particular merger or combination),
      - 2. subsection 87(8.1), as read in respect of the particular merger or combination, contained a subparagraph (c)(ii), and
      - 3. the particular merger or combination would be a foreign merger (within the meaning of subsection 87(8.1), as it read in respect of the particular merger or combination) if that subparagraph 87(8.1)(c)(ii) were read as follows:
        - "(ii) if, immediately after the merger, the new foreign corporation was controlled by another foreign corporation (in this subsection referred to as the "parent corporation"), shares of the capital stock of the parent corporation," and
- either
  - the disposing corporation received no consideration for the security, or
  - in the case where the particular merger or combination is a subject merger, the disposing corporation received no consideration for the security other than property that was, immediately before the particular merger or combination, owned by the issuing corporation and that, on the particular merger or combination, became property of the new corporation.

New subsection 248(1.1) applies on Royal Assent and, notwithstanding subsections 152(4) to (5) of the Act, the Minister of National Revenue may make any assessment of a taxpayer's tax, interest and penalties payable under the Act for a taxation year that includes the time at which a redemption, acquisition or cancellation occurred that is necessary to take into account the application of new subsection 248(1.1) in respect of the redemption, acquisition or cancellation.

Bare Ownership - Gifts to Charity

ITA
248(3.1)

Under civil law, where a property is subject to dismemberment such as a usufruct or a right of use established in favour of an individual while another has the bare ownership, subsection 248(3) of the Act deems the property subject to such a usufruct or right of use to have been transferred to a trust. The whole property will thus be disposed of. Subsection 248(3), as it now reads, does not provide for any exception where the bare ownership of

an immovable is gifted to a registered charity. New subsection 248(3.1) provides relief, similar to the exception found in subsection 43.1(1) of the Act for life interests created at common law, where the usufruct or right of use of an immovable is retained by a taxpayer but the bare ownership of the immovable is gifted in circumstances where the gift generates entitlement to a charitable donations credit.

Under new subsection 248(3.1) and subsection 69(1), the dismemberment will entail a disposition only of the bare ownership of an immovable for an amount equal to its fair market value (FMV). In the case of capital property, the adjusted cost base (ACB) of the property will be divided under subsection 43(1) of the Act pro rata between the bare ownership and usufruct or right of use. The usufruct or right of use will be considered to have been disposed of only when it is actually disposed of or is otherwise deemed to be disposed of by the taxpayer.

Example

Mrs. A, whose property is governed by the civil law of the province of Québec, owns as capital property an immovable worth $100,000, which has an ACB of $10,000. She creates a dismemberment of the property by giving the bare ownership (FMV of $60,000) to a registered charitable organization and retaining the right of use (FMV of $40,000).

Under the present rules, subsections 248(3) and 69(1) of the Act apply and Mrs. A is considered to have disposed of the immovable at its FMV ($100,000) in favour of a deemed trust. A gain of $90,000 is triggered ($100,000 - $10,000).

Because of new subsection 248(3.1) and subsection 69(1), there is a disposition only of the bare ownership for proceeds of disposition equal to its FMV, i.e. $60,000. This amount can be included in the calculation of her charitable gifts credit. The ACB attributable to the bare ownership is $6,000 ($10,000 X 6/10). This transaction will give rise to a gain of $54,000 ($60,000 - $6,000). Mrs. A retains the right of use of the immovable and there is no disposition of this right. At death, a deemed disposition of her right of use will occur at FMV (established in the same way as for a life estate and remainder interest).

Occurrences as a Consequence of Death

ITA
248(8)

The French version of subsection 248(8) of the Act is amended to correct a terminology error. In effect, the concept of “attribution” is replaced by “distribution” so that it is clear that the property is actually remitted to the trust’s beneficiary and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Goods and Services Tax - Input Tax Credit and Rebate

ITA
248(16)

Subsection 248(16) of the Act provides rules under which amounts received by, or credited to, a taxpayer as an input tax credit or rebate with respect to the goods and services tax (GST) are deemed to be assistance from a government received by a taxpayer. As a consequence, such amounts are either included in income or reduce the cost or capital cost of the related property, or the amount of the related expenditure or expenditure pool, for tax purposes.

Subsection 248(16) also specifies the time at which the receipt (or credit) of an input tax credit or rebate is deemed to be received as assistance. With respect to input tax credits, subparagraph 248(16)(*a*)(i) provides that the assistance (i.e., the input tax credit) is considered to be received by a taxpayer at the time the GST in respect of the input tax credit was paid or became payable by the taxpayer if the GST was paid or became payable in the same reporting period under the *Excise Tax Act* in which the input tax credit was claimed. If a taxpayer does not claim the input tax credit in the same reporting period in which the GST was paid or became payable, subparagraph 248(16)(*a*)(ii) includes the amount of assistance in the taxpayer's income for the taxation year that includes the end of the reporting period in which the taxpayer claimed the input tax credit.

Subsection 248(16) is amended in three respects for input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002.

First, subparagraph 248(16)(*a*)(i) is amended to extend its application to cases where the input tax credit is claimed by a taxpayer in a reporting period that is subsequent to the period in which the related GST was paid or became payable if

- the taxpayer's threshold amount (as determined under subsection 249(1) of the *Excise Tax Act*) is greater than $500,000 for the taxpayer's fiscal year (as defined by that Act) that includes the earlier of the time that the GST in respect of the input tax credit was paid and the time that it became payable, and
- the taxpayer claimed the input tax credit at least 120 days before the end of the normal reassessment period (as determined under subsection 152(3.1) of the *Income Tax Act*) for the taxpayer in respect of the taxation year that includes that earlier time.

In general, the change to this subparagraph means that an input tax credit of a taxpayer (who is a GST filer with a threshold amount greater than $500,000 for GST purposes) is considered to have been received at the time the related GST was paid or became payable, even though the input tax credit is claimed in a later GST reporting period. However, this is the case only if the taxpayer claims the input tax credit at least 120 days before the taxation year in which the GST was paid or became payable becomes statute-barred for income tax purposes.

Second, subparagraph 248(16)(*a*)(ii) is amended to provide that an input tax credit is considered to be received at the end of the reporting period in which it is claimed only if

- subparagraph 248(16)(*a*)(i) does not apply, and
- the taxpayer's threshold amount (as determined under subsection 249(1) of the *Excise Tax Act*) is $500,000 or less for the fiscal year of the taxpayer that includes the earlier of the time that the GST in respect of the input tax credit was paid or became payable.

Thus, subparagraph 248(16)(*a*)(ii) does not apply if subparagraph 248(16)(*a*)(i) applies. Where subparagraph 248(16)(*a*)(i) does not apply, subparagraph 248(16)(*a*)(ii) provides that the input tax credit is considered to have been received at the end of the reporting period in which it is claimed only if the taxpayer's threshold amount for GST purposes was $500,000 or less at the time the GST was paid or became payable.

Third, new subparagraph 248(16)(*a*)(iii) is added to apply in any other case. If applicable, that subparagraph provides that the input tax credit is considered to have been received on the last day of the taxpayer's earliest taxation year

- that begins after the taxation year that includes the earlier of the time that the GST in respect of the input tax credit was paid and the time that it became payable, and
- for which the normal reassessment period for the taxpayer ends at least 120 days after the time at which the input tax credit was claimed.

Reference should also made to the commentary to new subsection 248(17.1) of the *Income Tax Act* which provides a special rule in respect of the timing of a claim in respect of certain input tax credits assessed under the *Excise Tax Act*.

Quebec Sales Tax - Input Tax Refund and Rebate

ITA
248(16.1)

New subsection 248(16.1) of the Act provides special rules for amounts received, or credited to, a taxpayer as an input tax refund or rebate in respect of Quebec sales tax. Such amounts are either included in a taxpayer's income or reduce the cost or capital cost of the related property, or the amount of the related expenditure or expenditure pool, for tax purposes.

In general, an input tax refund in respect of Quebec sales tax may - depending on the circumstances - have to be included in a taxpayer's income in the taxation year in which the taxpayer may first claim the refund, rather than the year in which it is received. A rebate of Quebec sales tax is included in income at the time the rebate is received or credited. For a more detailed explanation of the application of subsection 248(16.1), reference should be made to the commentary accompanying amendments to subsection 248(16), which provides analogous special rules in respect of the timing of the inclusion in income of certain input tax credits and rebates assessed under the *Excise Tax Act*.

Subsection 248(16.1) applies in respect of Quebec input tax refunds and rebates that become eligible to be claimed in taxation years that begin after February 27, 2004.

Application of Subsection (16) to Passenger Vehicles and Aircraft

ITA
248(17)

Subsection 248(17) of the Act applies in the case of an input tax credit in respect of a passenger vehicle or aircraft claimable by an individual or partnership where the credit is determined by reference to capital cost allowance in respect of the vehicle or aircraft (i.e., where there is less than exclusive use in commercial activity). Subsection 248(17) is amended to reflect the amendments made to subsection 248(16) as described in the commentary to that subsection.

The amendments to subsection 248(17) apply in respect of input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002.

Application of Subsection (16.1) to Passenger Vehicles and Aircraft

ITA
248(17.1)

New subsection 248(17.1) of the Act applies in the case of an input tax refund of Quebec sales tax, in respect of a passenger vehicle or aircraft, claimable by an individual or partnership where the credit is determinable by reference to capital cost allowance in respect of the vehicle or aircraft (that is, where there is less than exclusive use in commercial activity). In general, this subsection defers the time the input tax refund is considered to be received for income tax purposes to the taxation year or fiscal period following that in which Quebec sales tax in respect of the property is considered as payable for the purposes of determining the input tax refund. This avoids circularity with subsection 248(16.1). The provision preserves the proper timing between the input tax refund entitlement and the adjustment to the capital cost. This change applies in respect of Quebec input tax refunds that become eligible to be claimed in taxation years that begin after February 27, 2004.

Input Tax Credit on Assessment

ITA
248(17.2)

New subsection 248(17.2) of the Act determines, in respect of input tax credits that become eligible to be claimed in taxation years that begin after December 20, 2002, the time at which an input tax credit is considered to have been claimed in respect of certain input tax credit assessments made under the *Excise Tax Act* (ETA).

This subsection provides that, if an amount in respect of an input tax credit is deemed by subsection 296(5) of the ETA to have been claimed in a return or application filed under Part IX of that Act, the input tax credit is deemed to have been claimed for the GST reporting period that includes the time the Minister of National Revenue makes the GST assessment.

Accordingly, the rule in clause 248(16)(*a*)(i)(A) of the *Income Tax Act* (ITA) relating to the time at which an input tax credit is considered to have been received cannot apply to an input tax credit to which subsection 296(5) of the ETA applies. However, the other rules in paragraph 248(16)(*a*) of the ITA that determine the time at which an input tax credit is received are to be applied on the basis that an input tax credit (to which subsection 296(5) of the ETA applies) is not claimed by the taxpayer until the reporting period that includes the time at which the input tax credit is actually assessed - i.e., not the reporting period to which the assessment relates but the reporting period in which the input tax credit is deemed to be claimed for GST purposes.

Quebec Input Tax Credit on Assessment

ITA
248(17.3)

New subsection 248(17.3) of the Act provides that an input tax refund of Quebec sales tax, that is deemed to be claimed by section 30.5 of *An Act respecting the Quebec Revenue Minister*, is deemed to be claimed for the reporting period under *An Act respecting Quebec Sales Tax* that includes the day on which an assessment is issued to the taxpayer indicating that the refund has been allocated to the taxpayer. This change applies in respect of Quebec input tax refunds and rebates that become eligible to be claimed in taxation years that begin after February 27, 2004.

Repayment of Quebec Input Tax Refund

ITA
248(18.1)

New subsection 248(18.1) of the Act provides that an amount added in determining net tax of a taxpayer under *An Act respecting Quebec Sales Tax* in respect of an input tax refund relating to a property or service that had previously been deducted in computing such net tax is treated as assistance repaid under a legal obligation to repay that assistance. Such an amount could be so added under Quebec law pursuant to an assessment of Quebec sales tax. As a consequence, such an amount will either be deducted in computing income under paragraph 20(1)(*hh*) or will increase the cost or capital cost of the related property or the amount of the related expenditure or expenditure pool for tax purposes (as provided under subsection 13(7.1), paragraphs 37(1)(*c*) and 53(2)(*k*) and under the definitions “cumulative Canadian exploration expense” in subsection 66.1(6), “cumulative Canadian development expense” in subsection 66.2(5) and “cumulative Canadian oil and gas property expense” in subsection 66.4(5)). This change applies after February 27, 2004.

Transfers after death

ITA
248(23.1)

The French versions of paragraphs 248(23.1)(*a*) and (*b*) are amended to correct a terminology error. In effect, the term “attribué” is replaced by “distribué” so that it is clear that property of a taxpayer is actually distributed to the spouse or common-law partner of the taxpayer and not simply set aside for him or her. This amendment will come into force on Royal Assent.

Trust-to-trust Transfers

ITA
248(25.1)

Subsection 248(25.1) of the Act applies where there is a transfer of a property from a particular trust to another trust (other than a RRSP trust or RRIF trust) in circumstances to which paragraph (*f*) of the definition "disposition" in subsection 248(1) (see the commentary above) applies. The result of the application of paragraph (*f*) is that the transfer does not constitute a disposition. Where this is the case, subsection 248(25.1) deems the other trust after the particular time to be the same trust as, and a continuation of, the particular trust.

Subsection 248(25.1) is amended, for greater certainty, to ensure that where the transferred property is deemed under a number of specified provisions to be taxable Canadian property of the particular trust, the property continues to be taxable Canadian property of the other trust.

This amendment applies in respect of transfers that occur after December 23, 1998.

Cost of Trust Interest

ITA
248(25.3)

Subsection 248(25.3) of the *Income Tax Act* applies where a trust (other than a personal trust or a trust prescribed for the purpose of subsection 107(2) of the Act) issues particular units of the trust to a taxpayer directly in satisfaction of a right to a qualifying amount payable from the trust in respect of the taxpayer's capital interest in the trust. In such a case, the cost to the taxpayer of the particular units is deemed to equal the amount so payable. Subparagraph 248(25.3)(*c*)(i) provides that in the case of particular units of a trust that are capital property, a qualifying amount payable is one that causes, or but for clauses 53(2)(*h*)(i.1)(A) and (B) would cause, a reduction under subparagraph 53(2)(*h*)(i.1) of the Act to the adjusted cost base of the taxpayer's capital interest in the trust.

Subparagraph 248(25.3)(*c*)(i) is amended to provide that, in the case of particular units of a trust that are capital property, a qualifying amount payable is an amount payable that does not represent proceeds of disposition of a capital interest in the trust.

This amendment applies to trust units issued after December 20, 2002.

Gifts and Contributions

ITA
248(30) to (41)

At common law, it is generally the view that a gift includes only a property transferred voluntarily, without any contractual obligation and with no advantage of a material character returned to the transferor.

In contrast, under section 1806 of the *Civil Code of Quebec* ("CCQ"), a gift in Quebec is a contract by which ownership of property is transferred by gratuitous title. However, the rights of ownership may be separated, such that it may be possible for a transferor to transfer part of the rights of ownership without any material advantage returned (i.e., by way of gift) and to transfer the other Part separately for consideration. It is therefore possible, in Quebec, to sell a property to a charity at a price below fair market value, resulting in a gift of the difference.

Under both the common law and the CCQ, it is generally accepted that a transfer of property is not a gift unless the donor is impoverished by the transfer to the benefit of the donee and it is the donor's intention to enrich the donee without consideration.

At common law there is generally no ability to separate the rights of ownership of a single property in the course of making a gift. As such, at common law a contract to dispose of a property to a charity at a price below fair market value would not generally be considered to include a gift.

Nevertheless, there have been certain decisions made under the common law where it has been found that a transfer of property to a charity was made partly in consideration for services and partly as a gift.

Subsections 248(30), (31) and (32) are added to the Act to clarify the circumstances under which taxpayers and donees may be eligible for tax benefits available under the Act in respect of the impoverishment of a taxpayer in favour of a donee. In addition to the clarification provided by these new rules, on December 24, 2002, the Canada Revenue Agency released guidelines (*Income Tax Technical News No. 26*) that describe how it will apply the new rules to various situations and fundraising methods commonly used in the charitable sector. Subsection 248(34) provides technical rules regarding the repayment of debt that previously reduced the eligible amount of a gift. Subsections 248(35) to (39) provide technical rules, regarding the eligible amount of a gift or the value of property transferred and benefits receivable, that apply in calculating the eligible amount of a gift or political contribution. New subsection (40) provides that the rule in subsection 248(30) does not generally apply to inter-charity transfers. New subsection (41) deems the eligible amount of a gift to be nil if a donor fails to provide that information.

In general, these provisions are intended to reflect the policy that the amount eligible for an income tax benefit to a donor, by way of a charitable donation deduction or credit or a political contributions tax credit, should reflect the economic impact on the donor (before considering the income tax benefit) of the gift or contribution.

Intention to Give

ITA
248(30)

For the transfer of property to qualify as a gift, it is necessary that the transfer be voluntary and with the intention to make a gift. At common law, where the transferor of the property has received any form of consideration or benefit, it is generally presumed that such an intention is not present. New subsection 248(30) of the Act, which applies in respect of transfers of property after December 20, 2002 to qualified donees (such as registered charities), allows the opportunity to rebut this presumption. New paragraph 248(30)(*a*) provides that the existence of an amount of an advantage to the transferor will not necessarily disqualify the transfer from being a gift if the amount of the advantage does not exceed 80% of the fair market value of the transferred property.

Example

Mr. Short transfers land and a building with a fair market value of $300,000 to a registered charity. The charity assumes liability for an outstanding $100,000 mortgage on the property. The assumption of the mortgage by the charity does not necessarily disqualify the transfer from being a gift for the purposes of the Act.

If the value of the mortgage is equal to the outstanding amount (e.g., the interest rate and terms and conditions are representative of current market conditions), the eligible amount of the gift, in respect of which Mr. Short may be entitled to a tax credit under subsection 118.1(3), is $200,000.

If the amount of an advantage in respect of a transfer of property exceeds 80% of the fair market value of the transferred property, new paragraph 248(30)(*b*) provides that the transfer will not necessarily be disqualified from being a gift if the transferor can establish to the satisfaction of the Minister of National Revenue that the transfer was made with the intention to make a gift.

In the above example, if the amount of the mortgage outstanding had been greater than $240,000, Mr. Short (or the charity on Mr. Short's behalf) could apply to the Minister of National Revenue for a determination as to whether the transfer was made with the intention to make a gift.

It is generally accepted that the tax benefit available to a taxpayer, by way of a charitable donation deduction or credit, is not considered an advantage or benefit that would reflect a lack of donative intent on the part of a taxpayer. However, there may be circumstances where the intention of a taxpayer to make a gift is in doubt because of the combination of tax and other benefits to the taxpayer. If the primary motivation of a taxpayer for entering into a transaction or series of transactions is to return a profit to the taxpayer by way of a combination of tax and other benefits, the taxpayer may not be impoverished by the transfer of a property to a charity. Subsection 248(30) is not intended to allow a taxpayer to profit by the making of a gift.

Eligible Amount of Gift or Monetary Contribution

ITA
248(31)

New subsection 248(31) of the Act, which applies in respect of gifts and political contributions made after December 20, 2002, defines the eligible amount of a gift or contribution as the amount by which the fair market value of the property that is the subject of the gift or contribution exceeds the amount of the advantage, if any, in respect of the gift or contribution. Subsection 248(31) is added concurrently with amendments to subsections 110.1(1) and 118.1(1) of the Act, which describe the types of gifts in respect of which an eligible amount will qualify for a deduction (for corporations) or a tax credit (for individuals). The amount of the advantage in respect of a gift or contribution is described in new subsection 248(32) of the Act.

It is proposed that subsections 3501(1), (1.1) and (6) of the Regulations be amended to provide that official receipts issued by a registered organization in respect of a gift made after December 20, 2002 contain, in addition to the information already prescribed, the eligible amount of the gift.

Amount of Advantage

ITA
248(32)

New subsection 248(32), which generally applies in respect of gifts or political contributions made after December 20, 2002, describes the amount of an advantage in respect of a gift or contribution as, in general, the total value of all property, services, compensation or other benefits to which the donor of a property is entitled.

Subsection 248(32) is added concurrently with the addition of subsection 248(31) of the Act, which defines the eligible amount of a gift or contribution, and with the amendment of subsection 127(3) of the Act in respect of contributions to a political party. The amount of an advantage reduces the eligible amount of a gift or contribution.

In general, new subsection 248(32) is intended to apply in respect of any transaction or series of transactions having either the purpose or the effect of reducing the economic impact to a donor of a gift or contribution. This includes, for instance, situations where a charity invests funds or acquires property in a manner that benefits the donor. The reduction to an eligible amount also includes an advantage that is partial consideration for, or in gratitude for, the gift or contribution, or is in any way related to the gift or contribution. An example would include the option of a donor to satisfy or pay a loan by assigning or transferring to another person a property (including the rights under an insurance policy) that has less economic value than the amount of loan outstanding. Another example would include an assumption of a donor's risk by a charity, where the acquisition, directly or indirectly, of an interest in a property of the donor by the charity may have the effect of reducing the potential loss of the donor from that investment. (However, a tax credit or deduction resulting from a charitable donation is not considered a benefit.)

An advantage may exist even though it is not received at the time of the gift or contribution. For example, it may have been received prior to the time of the gift or may be contingent or receivable in the future. The advantage may accrue either to the donor or to a person not dealing at arm's length with the donor. It is not necessary that the advantage be receivable from the donee.

Paragraph 248(32)(*b*) includes as an advantage any limited-recourse debt in respect of the gift or contribution. For additional details regarding limited-recourse debt, see the commentary to new subsection 143.2(6.1) of the Act.

It is proposed that subsections 2000(1) and (6) and 3501(1), (1.1) and (6) of the Regulations be amended to provide that official receipts issued by a registered organization or political party in respect of a gift or contribution contain, in addition to the information already prescribed, the eligible amount and the amount of the advantage, if any, in respect of the gift or contribution.

Cost of Property Acquired by Donor

ITA
248(33)

New subsection 248(33) of the Act, which applies in respect of gifts or political contributions made after December 20, 2002, provides that the cost to a taxpayer of property acquired by the taxpayer in the course of the making of a gift or contribution by the taxpayer is the fair market value of the property at the time of the making of the gift or contribution. The fair market value of such a property is relevant in computing the amount of the advantage in respect of the gift or contribution under subsection 248(32).

Repayment of Limited Recourse Debt

ITA
248(34)

New subsection 248(34) of the Act, which applies in respect of gifts or political contributions made after February 18, 2003, generally provides that a repayment of the principal amount of a limited-recourse debt in respect of a gift or political contribution is deemed to be a gift in the year it is paid. However, in some circumstances the total amount of limited-recourse debt and other advantages to the donor may exceed the fair market value of the property transferred to a charity, resulting in no eligible amount to the donor under subsection 248(31) of the Act. In this case, the donor must pay off the excess amount before any amount will be allowed as a gift. Also, a payment financed by other limited-recourse debt or made by way of assignment or transfer of a guarantee, security or similar indemnity or covenant is not recognized for these purposes. For example, the assumption of a taxpayer's limited-recourse debt by another person, in exchange for an insurance policy in favour of the taxpayer that guarantees a particular rate of return on an investment held by any person, would not qualify as a deemed gift under subsection 248(34).

Deemed Fair Market Value

ITA
248(35)

New subsection 248(35) of the Act, which applies in respect of gifts made after 6:00 p.m. (EST), December 5, 2003, provides that the fair market value of a property that is the subject of a gift is, for the purposes of determining the eligible amount of a gift under subsection 248(31), deemed to be the lesser of the actual fair market value of the property and its cost to the donor. This rule applies if the property was acquired by the donor as part of a gifting arrangement that is a tax shelter. For more information on gifting arrangements, refer to the commentary for subsection 237.1(1) of the Act.

Unless the donation is made as a consequence of the donor's death, this rule also applies if the property was acquired

- less than three years before the time of donation, or
- less than 10 years before that time, if one of the main purposes of acquisition was to gift the property to a qualified donee.

Non-arm's Length Transactions

ITA
248(36)

New subsection 248(36) of the Act applies in conjunction with subsection 248(35), to "look-back" to discern whether a donated property was previously acquired by a person dealing non-arm's length with the donor. If subsection 248(35) applies because the donor acquired the property within the three years of donation, then if a non-arm's length person owned that property within that three-year period, the value of the gift to the donor will be the lower of the taxpayer's cost and the lowest cost to any such non-arm's length person.

Similarly, the rule will apply if subsection (35) applies because the taxpayer acquired the property within the last ten years and one of the main reasons of the acquisition was to gift the property, if a non-arm's length person acquired that property within that ten-year period.

Subsection 248(36) applies to gifts made on or after July 18, 2005.

Non-application of Subsection (35)

ITA
248(37)

New subsection 248(37) of the Act provides exceptions to the application of subsection 248(35) of the Act where the property that is the subject of a gift is an ecological gift, inventory, real property situated in Canada, publicly-traded securities or cultural property, the value of which is certified by the *Cultural Property Export Review Board*.

In some circumstances, a shareholder might transfer a property to a controlled corporation in exchange for shares issued by the corporation, and then donate the shares. Alternatively, the corporation might donate the property it received. If subsection 248(35) would not have applied to a gift of a property by a shareholder, either because it is a type of property referred to above or because subsection 248(35) would not apply to the shareholder in any event, and if the shareholder donates the share, subsection 248(37) will further exempt the share from the application of subsection 248(35). If subsections 85(1) or 85(2) of the Act applied to the transfer of such an exempt property to the corporation, then subsection 248(37) will preclude the application of subsection 248(35) to that property if it is then donated by the corporation.

Similarly, sometimes a donor will make a gift of a property that was acquired in circumstances where subsection 70(6) or (9) or 73(1), (3) or (4) of the Act applied. In such a case, the donor has acquired the property from a transferor (such as a spouse) on a tax-deferred "rollover" basis. Unless the transferor acquired the property within the 3-year period referred to in subsection 248(35) (or the 10-year period, if applicable), subsection 248(37) provides that subsection 248(35) will not apply in these circumstances to deem the value of the gift to be the donor's rollover cost or adjusted cost base.

Artificial Transactions

ITA
248(38)

New subsection 248(38) of the Act applies in respect of gifts made after 6:00 p.m. (EST), December 5, 2003, to prevent a donor from avoiding the application of subsection 248(35) by disposing and reacquiring a property before donating it to a qualified donee. If this is the purpose of any transaction or series of transactions that includes a disposition or acquisition of a property, for such gifts made before July 18, 2005, the cost of the property to the donor for the purpose of subsection 248(35) is deemed to be the lowest cost incurred by the taxpayer at any time to acquire that property or an identical property.

For gifts made on or after July 18, 2005, the eligible amount is deemed to be nil if a transaction or series of transactions

- has, as one of its purposes, the avoidance of the application of subsection 248(35), or
- would otherwise result in a tax benefit to which the General Anti-Avoidance Rule in subsection 245(2) would otherwise apply.

For example, the eligible amount of a gift resulting from a transaction or series to which subsection 248(38) would apply, if the gift were made before July 18, 2005, would be deemed to be nil if instead the gift were made on or on or after July 18, 2005.

The objectives of the provisions in the Act related to gifting are generally described above under the heading “Gifts and Contributions”, but are not limited to that description.

Substantive Gift

ITA
248(39)

New subsection 248(39) of the Act, which applies in respect of gifts made after February 26, 2004, prevents a donor from avoiding the application of subsection 248(35) by disposing a property (the “substantive gift”) to a qualified donee and donating the proceeds, rather than donating the property itself. The provision applies similarly in respect of political contributions. The fair market value of the gift or contribution of the proceeds, for the purpose of determining its eligible amount under subsection 248(31), is deemed to be the lesser of the fair market value of the property sold and its cost. Subsection 248(39) does not apply if subsection 248(35) would not have applied to a gift by the taxpayer of that property.

Reasonable Inquiry

ITA
248(40)

The July 18, 2005 proposal in respect of subsection 248(40) of the Act has been removed and replaced with an unrelated amendment.

Inter-charity gifts

ITA
248(40)

New subsection 248(30) of the Act allows the opportunity for a donor to rebut the general presumption that the receipt of any form of consideration or benefit reflects that lack of an intention to make a gift. Such a rule is unnecessary in the context of inter-charity transfers and could lead to complication of the “disbursement quota” calculation of a charity under section 149.1 of the Act. New subsection 248(40) therefore precludes the application of subsection 248(30) to transfers made by a registered charity to a qualified donee. Consequently, the eligible amount of a gift under new subsection 248(31) should always equal its fair market value.

New subsection 248(40) of the Act applies in respect of transfers made on or after ANNOUNCEMENT DATE .

Information Not Provided

ITA
248(41)

New subsection 248(41) of the Act, which applies in respect of gifts and monetary contributions made after 2005, provides that the eligible amount of a gift is nil if, before an official charitable receipt is issued by a donee, the donor fails to inform the donee of information that would be relevant to the application of subsections 248(31), (35), (36), (38) or (39) of the Act. The donee requires such information for correct preparation of the receipt.

Clause 188

Taxation Year

ITA
249(1) and (1.1)

Subsection 249(1) of the Act sets out, for purposes of the Act, the definition "taxation year". Paragraph 249(1)(*a*) provides that in the case of a corporation, a taxation year is a fiscal period. Paragraph 249(1)(*b*) provides that the taxation year of an individual is the calendar year. Subsection 249(1) also provides that when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year.

Subsection 249(1) is amended to clarify that the definition "taxation year" contained in that subsection applies for purposes of the Act except as otherwise provided. For examples of exceptions, which apply for limited purposes, see the definitions "taxation year" in subsections 95(1) and 149.1(1).

Subsection 249(1) is also amended to add new paragraph 249(1)(*c*), which provides that the taxation year of a testamentary trust is the period for which the accounts of the trust are made up for purposes of assessment under the Act. This definition was previously contained in paragraph 104(23)(*a*), which is being repealed.

New subsection 249(1.1) of the Act provides that, when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or taxation years that coincide with, or that end in, that calendar year. This rule combines the identical rules previously found in paragraph 104(23)(*b*), which is repealed, and subsection 249(1).

These amendments apply after December 20, 2002. For a related set of amendments, see the commentary on paragraphs 104(23)(*a*) and (*b*).

Testamentary Trusts

ITA
249(5)

New subsection 249(5) of the Act is added consequential on the repeal of paragraph 104(23)(*a*) of the Act.

Subsection 249(5) provides that the period for which the accounts of a testamentary trust are made up for purposes of assessment under the Act may not exceed 12 months and that no change in the time when such a period ends may be made for the purposes of the Act without the concurrence of the Minister of National Revenue. The rule was previously found in paragraph 104(23)(*a*) of the Act, which is being repealed.

This amendment applies after December 20, 2002. For a related set of amendments, see the commentary on paragraphs 104(23)(*a*) and (*b*) and subsection 249(1) and (1.1).

Loss of Testamentary Trust Status

ITA
249(6)

New subsection 249(6) of the Act provides a set of rules that apply where a trust or estate loses its status under the Act as a "testamentary trust". This loss of status will generally occur where property has been contributed or loaned to the trust or estate in circumstances described in any of paragraphs (*b*) to (*d*) of the definition "testamentary trust" in subsection 108(1) or where the trust or estate has been created by someone other than the deceased person on and as a consequence of whose death the trust or estate arose (in this regard, see paragraph (*a*) of that definition). Under the existing rules in the Act, where a transaction or event described in any of those paragraphs occurs at a particular time, the trust or estate will lose its status as a testamentary trust for its entire taxation year that would otherwise include that time. As a result, the trust will be treated as an *inter vivos* trust at all times after the end of its last taxation year, if any, throughout which it was a testamentary trust.

As such, its first taxation year after that last taxation year will be, given the definition “taxation year” in subsection 249(1), the calendar year.

New subsection 249(6) provides transitional relief for trusts or estates that lose their “testamentary trust” status. Under that subsection, if at a particular time after December 20, 2002 a transaction or event, described in any of paragraphs (*b*) to (*d*) of the definition “testamentary trust” in subsection 108(1), occurs and as a result of that occurrence a trust or estate is not a testamentary trust, a number of special rules apply in determining its taxation years and fiscal periods. (Note that a trust or estate that fails to qualify as a testamentary trust because of paragraph (*a*) of the definition “testamentary trust” will be an *inter vivos* trust from its creation and is, therefore, not in need of this transitional relief.) In particular,

- under paragraph 249(6)(*a*), the fiscal period, for a business or property of the trust or estate, that would , if the Act were read without reference to subsection 249(6) and paragraphs (*b*) to (*d*) of the definition “testamentary trust”, have included the particular time, is deemed to have ended immediately before the particular time. Subsection 249.1(3) ensures that the next fiscal period starts at the particular time and subsection 249.1(1) requires that that next fiscal period end no later than the calendar year in which it began (i.e. the new taxation year) – this is because the trust would then have become an *inter vivos* trust.
- the taxation year of the trust or estate that would, if this Act were read without reference to this subsection and paragraphs (*b*) to (*d*) of the definition “testamentary trust”, have included the particular time is deemed to have ended immediately before the particular time. As a result, the trust or estate maintains testamentary trust status until the offside event occurs.
- a new taxation year of the trust or estate is deemed to have started at the particular time.
- in determining the fiscal period for a business or property of the trust or estate after the particular time, the trust or estate is deemed not to have established a fiscal period before that time.

New subsection 249(6) of the Act applies after ANNOUNCEMENT DATE. However, if a trust or estate elects in writing filed with the Minister of National Revenue on or before its filing-due date for its taxation year in which the subsection receives Royal Assent, it also applies to that trust or estate, as the case may be, after December 20, 2002.

Example:

Trust A was created on and as a consequence of the death of John Smith in 2004. Trust A has a November 30 year-end. For its 2004 and 2005 taxation years, Trust A is a testamentary trust. On April 15, 2006, Trust A becomes indebted to a beneficiary of the trust by way of an interest-free loan.

Results:

(i) Existing scheme of the Act

Because of paragraph (d) of the definition "testamentary trust", Trust A cannot qualify as a testamentary trust at any time in its taxation year that began December 1, 2005. Therefore, Trust A becomes an inter vivos trust effective December 1, 2005. Trust A would, as an inter vivos trust, have a December 31, 2005 year-end, with an April 1, 2006 filing-due date.

(ii) New Subsection 249(6)

Because of paragraph (d) of the definition "testamentary trust", Trust A cannot qualify as a testamentary trust. Its taxation year that began December 1, 2005 is deemed to have ended immediately before April 15, 2006 – that is to say, on April 14, 2006 (Assume that a reference to time in the legislation is to a day.) Therefore, Trust A maintains its status as a testamentary trust throughout the stub year that began on December 1, 2005 and ended on April 14, 2006. The trust would have 90 days from the end of that taxation year to file its return of income for the stub year. A new taxation year is deemed to begin April 15, 2006. As the April 15, 2006 loan occurs in the new taxation year, Trust A is an inter vivos trust throughout the new taxation year, which, accordingly, will end on December 31, 2006. As a result, Trust A is able to maintain testamentary trust status until the time immediately before the offside event. With respect to any late-filing for the stub year, relief may be available under the provisions in section 220 of the Act.

Clause 189

Arm's Length

ITA
251(1)

Subsection 251(1) of the Act provides a set of rules that determine whether persons are considered, for the purposes of the Act, to deal with each other at arm's length. Paragraph 251(1)(*a*) deems related persons not to deal with each other at arm's length. Paragraph 251(1)(*b*) deems a taxpayer and a personal trust (other than a trust described in any of paragraphs (*a*) to (*e*.1) of the definition "trust" in subsection 108(1) of the Act) not to deal with each other at arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, is beneficially interested in the trust. Paragraph 251(1)(*c*) provides that, where paragraph 251(1)(*b*) does not apply, it is a question of fact whether persons not related to each other are at a particular time dealing with each other at arm's length.

Paragraph 251(1)(*c*) is amended to clarify that it applies in any case where paragraphs (*a*) and (*b*) do not apply.

This amendment applies after December 23, 1998.

Clause 190

Extended Meaning of “spouse” and “former spouse”

ITA
252(3)

Subsection 252(3) of the Act extends the meaning of the terms “spouse” and “former spouse” to include, for a number of purposes, a party to a void or voidable marriage.

The provision is amended consequential on amendments to Part XII.2 of the Act, which add a new reference to “spouse” in the definition “designated income” and maintain the existing references to “spouse” and “former spouse” in the definition “designated beneficiary” in subsection 210(1) of the Act. For more detail, see the commentary on subsection 210(1).

This amendment generally applies to the 1996 and subsequent taxation years.

Clause 191

Investments in Limited Partnerships

ITA
253.1

Section 253.1 of the Act applies for specified provisions of the Act and Regulations where a trust or corporation holds an interest as a limited partner in a limited partnership. It provides that the trust or corporation will not, solely because of its acquisition and holding of the limited partnership interest, be considered to carry on any business or other activity of the partnership.

Section 253.1 is amended so that it also applies for the purpose of paragraph 146.1(2.1)(*c*) of the Act, which provides that the registration of a registered education savings plan (RESP) is revocable if a trust governed by the plan carries on a business. The amendment to section 253.1 ensures that the acquisition and holding of a limited partnership interest by an RESP trust does not jeopardize the registered status of the plan, provided the interest is a qualified investment for the trust.

This amendment generally applies after 1997.

Clause 192

Acquisition of Control of a Corporation

ITA
256

Section 256 of the Act provides rules for determining whether corporations are to be considered to be associated and whether control of a corporation has been acquired for the purposes of the Act.

Control in Fact

ITA
256(6)

Subsection 256(6) of the Act treats a controlled corporation as not being controlled by a person or partnership if certain conditions are met.

The French version of subparagraph 256(6)(*b*)(ii) is amended to replace an erroneous reference to the « *entité dominante* » (controller) by a reference to the « *société contrôlée* » (controlled corporation), which is what was intended.

This amendment applies on Royal Assent.

Acquiring Control

ITA
256(7)

Subsection 256(7) of the Act describes circumstances in which control of a corporation will be deemed to have been acquired (or not to have been acquired) for specific provisions of the Act.

ITA
256(7)(*a*)

Paragraph 256(7)(*a*) of the Act describes the circumstances where control of a corporation (or a corporation controlled by the corporation) is considered not to have been acquired for the purposes of certain provisions of the Act. That paragraph is amended in two ways.

First, subparagraph 256(7)(*a*)(i) is amended effective with respect to the acquisition of shares after 2000 to add clause (E) which precludes an acquisition of control of a corporation on a distribution (within the meaning assigned by subsection 55(1) of the Act) by a specified corporation (within the meaning assigned by that subsection) if a dividend is received in the course of a spin-off distribution in which no portion of the dividend is treated as a capital gain by the anti-avoidance rule in subsection 55(2) of the Act because of the application of the exception for certain reorganizations under paragraph 55(3)(*b*) of the Act.

Example:

Facts:

Pubco is a specified corporation under the butterfly rules in section 55 and a person or group of persons does not control it. Pubco owns all of the shares of Subco. In the course of a distribution (as defined by subsection 55(1)), Pubco distributes the Subco shares to Newco, which is established in the course of the reorganization for the purposes of the distribution. The same shareholders that own all of the shares of Pubco own all of the shares of Newco. Because there is no person or group of persons that control Pubco and Newco, an acquisition of control of Subco would occur upon Newco's acquisition of the Subco shares on the distribution despite the fact the same shareholders own Pubco and Newco.

Application:

In this example, new clause 256(7)(a)(i)(E) provides that there is no acquisition of control of Subco by Newco if Pubco's distribution of its Subco shares to Newco is a distribution to which the anti-avoidance rule in subsection 55(2) does not apply because the distribution complies with the exception in paragraph 55(3)(b).

Second, new subparagraph 256(7)(*a*)(iii), which applies to the acquisition of shares after 2000, provides that, where there is an acquisition of any shares of a corporation, there is no acquisition of control of the corporation by a related group of persons if each member of each group of persons that controls the corporation was related to the corporation immediately before the change of control.

Example:

Facts:

Corporation X has issued 100 common shares with 1 vote per share. There are no other issued shares. Mr. X owns 51% of Corporation X's issued shares. Ms. D who is the daughter of Mr. X owns 49% of the common shares issued by Corporation X. Mr. X has de jure control of Corporation X.

Mr. X disposes of 10 shares of Corporation X to Mr. Z, an arm's length person. Consequently, Mr. X no longer has de jure control, and a group of persons acquires de jure control of Corporation X.

Application:

If Mr. X and Ms. D form a related group of persons that otherwise acquires control of Corporation X upon the disposition of shares by Mr. X, new subparagraph 256(7)(a)(iii) deems no acquisition of control if no other group of persons that includes Mr. Z acquires control of Corporation X. It is a question of fact whether Mr. X and Ms. D form a group of persons that would otherwise acquire control of Corporation X and, if so, whether there exists another group of persons that also acquires control. Depending on the circumstances, Mr. X and Ms. D; Mr. X and Mr. Z; Ms. D and Mr. Z; or Mr. X, Ms. D and Mr. Z could form a group of persons that acquires control of Corporation X. Consequently, new subparagraph 256(7)(a)(iii) applies only if, in this example, Mr. X and Ms. D form a group of persons that control Corporation X and there exists no other group of persons (which includes Mr. Z) that acquires control of Corporation X.

ITA
256(7)(*e*)

Paragraph 256(7)(*e*) of the Act provides that, where certain conditions are satisfied, control of a particular corporation will be considered not to have been acquired solely because of a disposition of all of the shares of the particular corporation for consideration consisting solely of shares of the acquiring corporation. These conditions include a requirement that, immediately after the disposition, the acquiring corporation is not controlled by a person or group of persons and that the fair market value of the shares of the particular corporation is not less than 95% of the fair market value of all of the assets of the acquiring corporation.

Paragraph 256(7)(*e*) is amended, for shares acquired after 1999, to ensure that it applies on the acquisition of any shares of the capital stock of the particular corporation by the acquiring corporation if, immediately after the acquisition, the acquiring corporation owns all of the shares of the capital stock of the particular corporation (other than shares of a specified class) and the 95% test is met. This provision is also amended to deem control not to be acquired if shares of the particular corporation are acquired as part of a plan of arrangement and, upon completion of the arrangement, the acquiring corporation owns all the shares of the capital stock of the particular corporation (other than shares of a specified class) and the 95% test is met. Thus, amended paragraph 256(7)(*e*) may apply in circumstances where the acquiring corporation owns shares of the capital stock of the particular corporation before the acquisition being examined. In addition, amended paragraph 256(7)(*e*) excludes shares of a specified class, as defined in paragraph 88(1)(*c*.8) of the Act, from the determination of whether the acquiring corporation has acquired all of the shares of the particular corporation. Shares of a specified class are excluded on the basis that they are non-voting securities similar to debt and should not be considered in determining whether control has been acquired for the purpose of paragraph 256(7)(*e*).

This amendment also ensures that, in circumstances where the acquisition occurs as part of a plan of arrangement, the acquiring corporation includes a new corporation formed on an amalgamation of the acquiring corporation and a subsidiary controlled corporation of the acquiring corporation. As a result, paragraph 256(7)(*e*) may apply to a situation where the acquiring corporation owns shares of the particular

corporation indirectly through a subsidiary controlled corporation if the acquiring corporation and the subsidiary controlled corporation are amalgamated as part of a plan of arrangement that includes the acquisition.

Clause 193

Proportional Holdings in Properties

ITA
259(1)

Subsection 259(1) of the Act provides a "look-through" rule that applies to certain taxpayers (including trusts governed by RRSPs) that acquire units of a "qualified trust". If the qualified trust so elects, each taxpayer is deemed to acquire, hold and dispose of its proportionate interest in the underlying assets of the qualified trust. This rule can benefit a taxpayer where the direct investment in the units of the qualified trust would constitute a non-qualified investment. By "looking through" to the underlying assets of the qualified trust, a taxpayer may be able to reduce or eliminate the tax penalties that result from holding non-qualified investments.

Subsection 259(1) is amended so that it applies for the purpose of the registration rules for registered education savings plans (RESPs). Under subsection 146.1(2.1), the registration of an RESP is revocable if a trust governed by the plan holds a non-qualified investment. This amendment will permit an RESP trust to make a direct investment in a qualified trust that is itself a non-qualified investment, without jeopardizing the registered status of the RESP, provided the qualified trust restricts its holdings to qualified investments.

This amendment applies to the 2000 and subsequent taxation years.

Clause 194

Securities Lending Arrangements

ITA
260

Section 260 of the Act sets out special rules that apply to securities lending arrangements.

Definitions

ITA
260(1)

Subsection 260(1) of the Act provides definitions that apply for the purposes of the special rules for securities lending arrangements. The existing definitions are modified, and additional definitions are added, as follows:

"dealer compensation payment"

"Dealer compensation payment" is one of the newly-defined terms, introduced not to effect any substantive change to the relevant rules but only for simplicity and clarity. A dealer compensation payment is an amount paid or received as compensation for an underlying payment by a registered securities dealer who is resident in Canada and who pays or receives the amount in the ordinary course of its business of trading in securities.

This new definition applies to securities lending arrangements made after 2001.

"qualified security"

The securities lending arrangement rules apply only to securities that are qualified securities. A new paragraph (*e*) is added to the definition "qualified security" to include a qualified trust unit.

This amended definition applies to securities lending arrangements made after 2001.

“qualified trust unit”

A “qualified trust unit” is defined to mean a unit of a mutual fund trust that is listed on a prescribed stock exchange.

This new definition applies to securities lending arrangements made after 2001.

“securities lending arrangement”

There are three amendments to the definition “securities lending arrangement”.

Paragraph (*a*) of the existing definition provides that in order for there to be a securities lending arrangement, the lender and the borrower of a security must be dealing at arm’s length. The amendment to paragraph (*a*) extends the definition to include an arrangement entered into by non-arm’s length parties. New paragraph (*e*) provides that where the lender and borrower do not deal with each other at arm’s length, the arrangement must be of a term not exceeding 270 days and must not be part of a series of securities lending arrangements, loans or other transactions intended to be in effect for more than 270 days.

Paragraph (*c*) of the existing definition provides that where a borrowed security is a share, the borrower must be obligated to pay to the lender a dividend compensation payment in order for the transaction to be a securities lending arrangement. This paragraph is amended to apply a comparable requirement in respect of all arrangements. This recognizes and codifies the commercial reality that compensation payments are required to be made by the borrower to the lender in all securities lending arrangements, and not just those arrangements involving shares.

The amendment to paragraph (*c*) applies to arrangements made after 2001. The amendments to paragraphs (*a*) and (*e*) apply to arrangements made after 2002.

“security distribution”

“Security distribution” is a newly-defined term, introduced not to effect any substantive change to the relevant rules but only for simplicity and clarity. A security distribution is an amount, in respect of a borrowed security, that is either an underlying payment paid by the issuer of the security (for example as a dividend or a trust distribution) or a dealer compensation payment, or an SLA compensation payment.

This definition applies to securities lending arrangements made after 2001.

“SLA compensation payment”

“SLA compensation payment” is a newly-defined term, introduced not to effect any substantive change to the relevant rules but only for simplicity and clarity. An SLA compensation payment is an amount paid pursuant to a securities lending arrangement as compensation for an underlying payment.

This definition applies to securities lending arrangements made after 2001.

“underlying payment”

“Underlying payment” is a newly-defined term. As with most of the other new definitions in this subsection, this term is defined for simplicity and clarity. An underlying payment is an amount paid on a qualified security by the issuer of the security.

This definition applies to securities lending arrangements made after 2001.

Deemed Character of Compensation Payments

ITA
260(5) and (5.1)

Subsection 260(5) of the Act, in its current form, treats dividend compensation payments that are received under specified circumstances as dividends. The subsection also, however, denies this dividend treatment where the amount is received by a corporation and one of the main reasons for the corporation entering into the arrangement was to enable it to receive an amount that would be treated as a dividend by the subsection.

Subsection 260(5) is reorganized into two subsections, and these subsections incorporate three newly-defined terms: “dealer compensation payment”, “SLA compensation payment” and “underlying payment”.

New subsection 260(5) describes the circumstances under which the compensation payment deeming rule, now found in new subsection 260(5.1), applies. The deeming rule applies where an amount is received under a securities lending arrangement under one of these circumstances: from a person resident in Canada, from a person not resident in Canada where the amount was paid in the course of carrying on business in Canada through a permanent establishment, or from or by a registered securities dealer. These are essentially the same as the circumstances specified prior to the amendment.

Also, the anti-avoidance rule in this subsection – which currently addresses only the case of an amount that would otherwise be received by a corporation as a dividend – is amended to include all otherwise non-taxable amounts that may be received under a securities lending arrangement, by any person. This amendment recognizes that with the introduction of qualified trust units as “qualified securities,” a person may be treated as having received any of several kinds of non-taxable amounts.

New subsection 260(5.1) of the Act treats a given compensation payment as one of three things: a dividend, an amount paid by a trust and having the same characteristics, source and purpose as the “underlying payment” amount paid by the trust directly, or interest. The overall effect of the provision is, in addition to replicating the former dividend deeming rule, to deem compensation payments in respect of payments from a trust to have the same characteristics, source and purpose as if the amounts were paid by the trust.

These amendments apply to securities lending arrangements made after 2001 except that if the parties to an arrangement file a joint election in writing within 90 days after Royal Assent of this amendment with the Minister of National Revenue, the parties may elect such that either one or both of the deeming rules in paragraph 260(5.1)(*b*) or (*c*) will not apply with respect to non-dividend compensation payments received before February 28, 2004. Taxpayers may wish to make this election to leave open the possibility that these non-dividend compensation payments had a different characterization under the law prior to these amendments.

Deductible Compensation Payment Amount

ITA
260(6)

Subsection 260(6) of the Act limits the extent to which a person who makes a dividend compensation payment under a securities lending arrangement may deduct the payment in computing income from a business or property. In brief, the subsection denies a deduction for any dividend compensation payment made by persons other than registered securities dealers, and provides that registered securities dealers may deduct up to 2/3 of the dividend compensation payments they make.

Amended subsection 260(6) retains this 2/3 dividend compensation payment deduction for registered securities dealers. It also allows any taxpayer - including but not limited to registered securities dealers - a deduction in respect of compensation payments, either SLA compensation payments or dealer compensation payments, that are not dividend compensation payments. The amount of this new deduction is computed differently depending on the actions of the taxpayer in question (the one who made the payment and seeks to deduct it). If the taxpayer has disposed of the borrowed security and has included any resulting gain or loss in computing business income, the compensation payment is fully deductible. In any other case, new subsection 260(6) allows a deduction to the extent of the lesser of (i) the compensation payment and (ii) the amount, to which the compensation payment relates, included in the taxable income of the taxpayer or persons related to it.

Amended subsection 260(6) applies to securities lending arrangements made after 2001.

Deduction - Compensation Payments

ITA
260(6.1)(*a*)

Subsection 260(6.1) of the Act provides a deduction for dividend compensation payments made pursuant to certain dividend rental arrangements. The amount deductible is the lesser of the amount the corporation is obligated to pay as compensation under the arrangement and the amount of the dividends received by the corporation under the arrangement that were identified in its return of income as amounts which are not deductible because of subsection 112(2.3) of the Act.

Paragraph 260(6.1)(*a*) of the Act is amended to clarify that the amount described in that paragraph is the total of all amounts that the corporation becomes obligated in the taxation year to pay to another person as compensation under certain dividend rental arrangements.

Also, paragraph 260(6.1)(*a*) of the English version of the Act is amended, as a consequence of the amendments to the definition “dividend rental arrangement” in subsection 248(1) of the Act, by replacing the reference to “paragraphs (*c*) and (*d*)” of that definition to a reference to “paragraph (*b*)” of that definition.

This amendment applies to dividend rental arrangements made after December 20, 2002 and, if the parties jointly elect within 90 days after this Act has been assented to, it also applies to dividend rental arrangements made after November 2, 1998 and on or before December 21, 2002, except that before 2002 the reference to “subsection 260(5.1)” should be read as “subsection 260(5)”.

For arrangements made after 2001 and before December 21, 2002 that are not the subject of the election described in the previous paragraph, the definition “dividend rental arrangement” in effect before December 21, 2002 is applicable, except that the reference to “subsection 260(5)” in that definition should be read as “subsection 260(5.1)”.

Dividend Refund

ITA
260(7)

Subsection 260(7) of the Act provides that, where a corporation makes a payment which is deemed by the former subsection 260(5) to be a taxable dividend, the corporation will also be entitled to treat the amount as the payment of a dividend for the purposes of section 129 of the Act.

Subsection 260(7) is amended to replace the reference “subsection 260(5)” with “subsection 260(5.1)” and is reorganized for clarity and simplicity and specifically not to effect any substantive changes to the rule.

This amendment applies to securities lending arrangements made after 2001.

Non-resident Withholding Tax

ITA
260(8), (8.1) and (8.2)

Subsection 260(8) of the Act applies special rules, for the purposes of Part XIII of the Act, to payments made under securities lending arrangements. The subsection has two main aspects: rules that ensure the appropriate treatment for Part XIII purposes of compensation payments; and a rule that in certain circumstances will treat a borrower as having paid to a lender a "borrow fee".

In addition to incorporating the newly added definitions, SLA compensation payments and underlying payments (which do not effect any substantive changes), the subsection is rearranged into three separate subsections. Amended subsection 260(8) retains the previous rules for compensation payments relating to interest and dividends, confining them to amounts paid on a security that is not a qualified trust unit. Subsection 260(8) also provides for compensation payments made in respect of a borrowed qualified trust unit: these are treated as payments from a trust and as having the same character and composition as the trust payments for which they compensate.

New subsection 260(8.1) provides for a deemed borrow fee, on the same basis as the existing paragraph 260(8)(*b*). New subsection 260(8.2) similarly preserves the effect of the existing postamble to subsection 260(8) in relation to tax treaties.

These subsections apply to securities lending arrangements made after 2001.

Partnerships

ITA
260(10), (11), and (12)

A "securities lending arrangement" (SLA) is defined in subsection 260(1) of the Act as a particular transaction between two persons: the "lender" and the "borrower" of a security. A partnership - which for most purposes of the Act is not a person - can be a party to a transaction that would be an SLA if the partnership were a person. In such a case, it is appropriate in policy terms for the arrangement to be treated as an SLA. New subsections (10), (11) and (12) are added to section 260 to bring partnerships within the SLA rules.

New subsection 260(10) provides that, for the purposes of section 260, a person includes a partnership. This allows a partnership to be either the borrower or the lender in respect of an SLA. The subsection also treats a partnership as a registered securities dealer, if all of its members are themselves registered securities dealers.

A transaction's status as an SLA is relevant to, among other things, the tax treatment of amounts paid and received in compensation for dividends or interest on the security that is transferred or lent. New subsections 260(11) and (12) are added to ensure the appropriate treatment of these amounts in a case where a corporation or an individual is a member of a partnership that has entered into an SLA.

- Under new paragraph 260(11)(*a*), a corporation that is a member of a partnership is treated for the purpose of subsection 260(5) as having received its "specified proportion" (now defined in subsection 248(1) of the Act) of each compensation payment or amount in respect of proceeds of disposition that is described in subsection 260(5) and was received by the partnership. It is also treated as being the same person as the partnership, thus ensuring that the partnership's reasons for entering into the arrangement (which are relevant to the applicability of the subsection) are attributed to the corporation.
- New paragraph 260(11)(*b*) treats the corporation as being obligated to pay its specified proportion of each dividend compensation payment described in paragraph 260(6.1)(*a*).
- New paragraph 260(11)(*c*) treats the corporation, for the purpose of applying the dividend refund rules in section 129 of the Act, as having paid its specified proportion of each non-deductible dividend compensation payment made by the partnership.

- New paragraph 260(12)(*a*) performs for individuals who are members of a partnership the same functions as new paragraph 260(11)(*a*) does for corporations that are partners.
- New paragraph 260(12)(*b*) treats an individual partner as having paid, for the purpose of clause 82(1)(*a*)(ii)(B) of the Act, the individual's specified proportion of each dividend compensation payment paid by the partnership that is deemed by new subsection 260(5.1) to have been received by another person as a taxable dividend.

These amendments apply to SLAs made after December 20, 2002 and, if the parties jointly elect within 90 days after this Act has been assented to, they also apply to SLAs made after November 2, 1998 and on or before December 20, 2002, except that before 2002, the reference to "subsection 260(5.1)" should be read as "subsection 260(5)".

Clause 195

ITA
Schedule

For information about this new schedule, see the commentary to subsection 181(1) of the Act.

Act to Amend the Income Tax Act (Natural Resources)

Clause 196

Repeal of Paragraph 18(1)(m)

Subsection 2(5) of the *Act to Amend the Income Tax Act (Natural Resources)* repealed paragraph 18(1)(*m*) of the Act effective for taxation years that begin after 2006. Subsection 2(5) is being amended with the result that paragraph 18(1)(*m*) is now being repealed effective for taxation years that begin after 2007. This amendment is being made to accommodate a reimbursement made in a taxation year of the taxpayer that begins after 2006 and before 2008 in circumstances where the taxpayer's taxation year does not coincide with the taxation year or fiscal period of the recipient, as would normally be the case where the recipient of the reimbursement is a partnership of which the taxpayer is a member.

Clause 197

Amendment to *An Act to Amend the Income Tax Act (Natural Resources)*

Subsection 80.2 of the Act was repealed by section 9 of *An Act to Amend the Income Tax Act (Natural Resources)*, S.C. 2003, c.28, effective for taxation years that begin after 2006. Section 9 of that Act is being repealed with the result that section 80.2 will continue in force. However, section 80.2 will apply only to specified amounts paid in respect of original amounts that are paid or become payable or receivable in taxation years or fiscal periods of the recipient that begin before 2007. As a result, section 80.2 will only apply to a reimbursement if the recipient is subject to restrictions on the deductibility of the reimbursed Crown charge (*i.e.*, the Crown charge is described in paragraph 18(1)(*m*)) or is required to include some portion of the Crown charge in income (*i.e.*, the Crown charge is described in paragraph 12(1)(*o*)).

The repeal of section 9 of the *Act to Amend the Income Tax Act (Natural Resources)* extends the possible application of section 80.2 to a reimbursement that is made in a taxation year of the taxpayer that begins after 2006 (assuming the reimbursed Crown charge was imposed in a taxation year or fiscal period of the recipient that begins before 2007). This extension of section 80.2, along with the extension of paragraph 18(1)(*m*) will accommodate, among other things, a reimbursement of a Crown charge by a member of a partnership, as described in new subsection 80.2(4), where such reimbursement is made in a taxation year of the member that begins after 2006 and before 2008.

Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation Act

Clause 198

Nova Scotia Capital Tax

The *Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation Act* (Accord Act) was introduced consequential to the Canada-Nova Scotia Offshore Petroleum Resources Accord, which was entered into by the Government of Canada and the Government of Nova Scotia on August 26, 1986. Under the Accord Act, the federal government imposes, collects and remits to the province the corporate income tax, consumption tax and insurance premiums tax on corporations operating in the offshore area that would be levied by Nova Scotia if the offshore area were a part of the province. Subsequent to the introduction of the Accord Act, Nova Scotia established a tax on the capital of large corporations (LCT). This measure amends the Accord Act to include capital tax among those taxes imposed, collected, and remitted under it.

This change is deemed to have come into force on April 1, 1997, the effective date of the LCT.

Federal – Provincial Fiscal Arrangements Act

Clause 199

Deduction for Federal Tax

FPFAA
12.2

Part IV.1 of the *Federal-Provincial Fiscal Arrangements Act* (FPFAA) provides a revenue-sharing mechanism in respect of the tax collected under Part VI.1 of the *Income Tax Act (Canada)* (ITA). A province is entitled to a portion of the federal tax collected from corporations that operate in the province in a year, if two conditions are met. First, it must be the case either that Canada collects the province's corporate income tax under a tax collection agreement, or that the province's law allows a multiple of the Part VI.1 tax to be deducted in computing taxable income. Second, the province itself must not impose taxes similar to those imposed under Parts IV.1 and VI.1 of the ITA.

The condition that the province itself provide a deduction is currently set out, in paragraph 12.2(1)(*b*) of the FPFAA, as requiring a deduction of at least 9/4 of a corporation's ITA Part VI.1 tax. The 9/4 figure is taken from the deduction under ITA paragraph 110(1)(*k*). With the adjustment of that ITA deduction, the figure 9/4 is no longer appropriate. Paragraph 12.2(1)(*b*) of the FPFAA is, therefore, amended to require a deduction, for provincial tax purposes, that is not less than the amount deductible under the ITA provision. By referring to the ITA rule itself, rather than specifying a given figure, amended paragraph 12.2(1)(*b*) will not need to be further amended if the multiple provided in the ITA should change at some future time.

To ensure that provinces have an opportunity to make any necessary amendments to provincial legislation, this amendment applies after 2003.

Income Tax Amendments Act, 2002

Clause 200

S.C. 2000, c. 17, ss. 59(2)

Debt Forgiveness Rules

Subsection 59(2) of the *Income Tax Amendments Act, 2000* is amended to provide that, in computing a debtor's income for a particular taxation year, the fraction in paragraph 38(*a*) of the *Income Tax Act* to be applied in respect of the settlement of a commercial debt obligation is the fraction in that paragraph that applied to the debtor in the debtor's taxation year in which the obligation was deemed to have been settled instead of the fraction in that paragraph that applies to the debtor in the particular taxation year.

This change corrects a technical deficiency, and is deemed to have come into force on June 14, 2001.

Clause 201

S.C. 2000, c. 17, ss. 70(11)

Disposition of Shares in a Foreign Affiliate

ITA
93(1.2)

Section 93 of the *Income Tax Act* contains a number of rules relating to the disposition of shares of a foreign affiliate of a taxpayer resident in Canada.

Subsection 93(1.2) provides that, where a particular corporation resident in Canada or a foreign affiliate of the particular corporation (each of which is referred to as the "disposing corporation") would, but for this subsection, have a taxable capital gain from a partnership from the disposition by the partnership of shares of a class of the capital stock of a foreign affiliate of the corporation, and the disposing corporation so elects in prescribed manner in respect of the gain, the amount designated will reduce the taxable capital gain and will be grossed up and recharacterized as a dividend received on the share by the disposing corporation.

Paragraph 93(1.2)(*a*) provides that twice the amount designated by the disposing corporation in respect of the shares (or where subsection 93(1.3) applies, twice the amount determined under that subsection) will be treated as a dividend received on the shares by the disposing corporation from the foreign affiliate.

Before the present amendment, subsection 93(1.2) was applicable to taxation years that end after February 27, 2000. This amendment ensures that, for a taxation year of a taxpayer that includes either February 28, 2000 or October 17, 2000 or began after February 28, 2000 and ended before October 17, 2000, the reference to the word "twice" is to read as references to the reciprocal of the capital gains inclusion rate applicable to the corporation resident in Canada or to the foreign affiliate for the taxation year. This amendment corrects a technical deficiency.

Part 3

Amendments Related to Bijuralism

As part of the harmonization of federal legislation, the Government has undertaken to review all its legislation where provincial private law concepts are found in order to reflect appropriately the common law and the civil law, in both official languages.

As part of this harmonization initiative, federal tax legislation is being reviewed. Several changes to the legislation have already been implemented, namely by way of the *Income Tax Amendments Act, 2000*, S.C. 2001, c. 17. The proposed amendments continue this harmonization initiative.

This Part proposes amendments to the *Income Tax Act* concerning the concepts of “joint and several liability” / ”solidary liability”, “tangible property” / ”corporeal property”, “intangible property” / ”incorporeal property”, “personal property” / ”movable property”, “real property” / ”immovable property”, “interest” / ”right” which are further described below. The proposed amendments are not intended to change the current application of the amended provisions; they purport to reflect the concepts and terminology of the common law and the civil law in both official languages. They will come into force on Royal Assent to this Bill.

Joint and Several Liability and Solidary Liability

The French version of the current tax legislation uses the term “*solidairement*”, which is appropriate for both civil law and common law. Therefore, the French version does not need to be amended.

In the English version of the current tax legislation, only the term “jointly and severally” is used. This term is maintained for common law purposes. The term “jointly and severally” is no longer adequate in civil law in English and has been replaced with the term “solidarily”. Therefore, it is appropriate to add the term “solidarily” in the English version in order to reflect the civil law.

Tangible and Corporeal Property

In the French version of the current tax legislation, only the civil law terminology “*bien corporel*” is used. In the English version, only the common law term “tangible property” is used.

In the French version of the legislation, it is appropriate to add the term “*bien tangible”* in order to reflect the common law.

In the English version of the legislation, it is appropriate to add the term “corporeal property*”* in order to reflect the civil law.

Intangible and Incorporeal Property

In the French version of the current tax legislation, only the civil law terminology “*bien incorporel*” is used. In the English version, only the common law term “intangible property” is used.

In the French version of the legislation, it is appropriate to add the term ”*bien intangible”* in order to reflect the common law. Where it is appropriate to do so, the shared elements of the relevant terms are combined in the phrase “*bien incorporel ou intangible*”, which refers to both systems of law.

In the English version of the legislation, it is appropriate to add the term “incorporeal property*”* in order to reflect the civil law. Where it is appropriate to do so, the shared elements of the relevant terms are combined in the phrase “intangible or incorporeal property”, which refers to both systems of law.

Personal Property and Movable Property

In the French version of the current tax legislation, only the civil law terminology “*bien meuble*” is used. In the English version, the terms “personal property” and “chattels” are used to reflect the common law.

It is therefore appropriate to add in the French version a reference to the term “*bien personnel*” in order to reflect the common law. Where it is appropriate to do so, the shared elements of the relevant terms are combined in the phrase “*bien meuble ou personnel*”, which refers to both systems of law.

In the English version of the legislation, the term “movable” is added in order to reflect the civil law. Where it is appropriate to do so, the shared elements are combined in the phrase “personal or movable property”, which refers to both systems of law.

Real Property and Immovable Property

In the French version of the current tax legislation, only the civil law terminology “*bien immeuble*” is used. In the English version, only the common law concept of “real property” is used.

It is therefore appropriate to add a reference, in the French version, to the term “*bien réel*” in order to reflect the common law. Where it is appropriate to do so, the shared elements of the relevant terms are combined in the phrase “*bien immeuble ou réel*”, which refers to both systems of law.

In the English version of the legislation, the term “immovable” is added in order to reflect the civil law. Where it is appropriate to do so, the shared elements of the relevant terms are combined in the phrase “real or immovable property”, which refers to both systems of law.

Interest and Right

Generally, in the current tax legislation, the common law term “interest” and the civil law term “*droit*” are used to refer to the relationship that exists between a person and property. At common law, it is possible to have a right or an interest in property; an interest in property necessarily involves rights in property while the reverse is not always true.

For purposes of the civil law, it is appropriate to limit the application of the term “*droit*” in the French version to the civil law, unless otherwise provided. In the English version, it is appropriate to add a reference to the concept of “right” in order to address the civil law audience and to similarly limit the application of this term to the civil law, unless otherwise provided.

The term “interest” is a common law concept that is translated into French by the term “*intérêt*”. It is therefore appropriate to add a reference to the concept of “*intérêt*” in the French version in order to address the common law audience.

Subsections 20(17) and 20(18)

Subsections 20(17) and 20(18) are repealed, as the provision to which they relate has been repealed.

Subsections 248(4) and 248(4.1): Interest in Real Property and Real Right in Immovables

Subsection 248(4) of the current legislation uses the term “*droit sur un bien immeuble*” in the French version as equivalent for the term “interest in real property” used in the English version. The term refers to the relationship between a person and property and for purposes of the I.T.A. includes a leasehold interest but not an interest as security.

Subsection 248(4) is amended so as to provide, for common law purposes, the scope of the term “interest in real property.” Reference to the civil law term “hypothecary claim” is removed from the English version of the provision. Furthermore, the term “*intérêt sur un bien réel*” is added in the French version of the Act. This term is the French equivalent of the common law term “interest in real property”.

For civil law purposes, new subsection 248(4.1) is added in both linguistic versions of the Act. The scope of the civil law term “real right in immovables” / “*droit réel sur un immeuble*” is adjusted in a similar manner as its common law counterPart by including the lease and excluding security rights.