Revised Explanatory Notes Relating to Income Tax

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Reference Changes

The reference to “February 23, 1998” in the October 1998 notes should be read as a reference to February 24, 1998 for each of the following *Income Tax Act* changes:

- paragraph 126(1)(*b*);
- paragraph 126(2.1)(*a*);
- paragraph 126(2.1)(*b*);
- the definition “tax-exempt income” in subsection 126(7); and
- 126(8)

Revised Notes

The following notes are new or replace parts of those that appeared in the October 1998 notes.

Clause 7

Leasing Properties

ITA
16.1(1)

Subsection 16.1(1) of the Act provides special rules which may apply in computing the income of a lessee of property, other than prescribed property, leased for a term of more than one year from an arm’s length person who is resident in Canada or who carries on business in Canada through a permanent establishment. These special rules apply only where the lessor and lessee jointly elect in a prescribed form that is filed by the lessee with the tax return for the year in which the lease was entered into.

If the election is filed, the lessee is treated as though it had borrowed an amount equal to the fair market value of the leased property and had acquired the property directly. For tax purposes, the rental payments made under the lease are treated not as rent but as blended payments of principal and interest on the loan. Interest is calculated in accordance with the prescribed rate in effect at the time the lease is entered into, determined under section 4302 of the *Income Tax Regulations* or, where a taxpayer elects in respect of a floating rate lease, at the prescribed rate in effect from time to time. To the extent that the property is used to earn income, the lessee is permitted to claim capital cost allowance in respect of the property and deduct the interest portion of each rental payment under the rules generally applicable under the Act.

This amendment removes the right to make such an election where the property in question is leased from a tax-exempt entity and is generally effective for leases entered into after 3:30 P.M., Eastern Daylight Saving Time, August 18, 1998.

Clause 8

Amount Owing by Non-resident

ITA
17

Section 17 will generally apply if a corporation resident in Canada loans money to a non-resident person and the loan remains outstanding for a year or more without interest on the loan computed at a reasonable rate being included in computing the corporation's income. However, there are two exceptions. Section 17 does not apply if Part XIII withholding tax was paid on the amount of the loan or if the non-resident is a subsidiary controlled corporation of the corporation resident in Canada that uses the money to earn business income.

The amendments to section 17 clarify and expand the scope of the general rule and modify the exceptions to that rule.

Under the expanded general rule, subsection 17(1) applies to any amount owing by a non-resident to a corporation resident in Canada, not just to loans.

In addition, a number of anti-avoidance rules have been added in subsections 17(2) to (6) that apply where a corporation resident in Canada has loaned an amount to a non-resident indirectly through an intermediary. In such cases, the non-resident is deemed to owe to the corporation resident in Canada an amount equal to, or equal to some portion of, the amount it owes to the intermediary. Subsection 17(1) then applies to the amount deemed to be owing to the corporation resident in Canada.

Although the amendments to section 17 apply only to taxation years that begin after February 23, 1998 (and in the case of subsections 17(2) and (3)), only to years beginning after 1999), the general anti-avoidance rule in section 245 of the Act will have application to avoidance transactions affecting earlier years. As the *Interpretation Act* provides, the amendment of a provision is not considered to involve a declaration as to the state of the law before the amendments.

Subsection 17(1) will continue not to apply if Part XIII withholding tax has been paid on the amount owing. The other exception currently provided in section 17 for subsidiary controlled corporations has been expanded to include any amount owing by a corporation that is a "controlled foreign affiliate" (as defined in subsection 17(15)) of the corporation resident in Canada, provided that the amount owing by the affiliate either is used to earn active business income or arose in the course of an active business carried on by the affiliate.

The amendments also add a new exception. Section 17 will not apply to debt owing by a non-resident to a corporation resident in Canada if the parties are unrelated, the debt arose in the ordinary course of business and the terms and conditions of the debt are such that arm's length parties would have been willing to enter into them.

The amendments to section 17 apply to taxation years that begin after February 23, 1998, except that subsections 17(2) and (3) do not apply to taxation years that begin before 2000.

Amount Owing by Non-resident

ITA
17(1)

Subsection 17(1) of the Act applies where a corporation resident in Canada has lent money to a non-resident and that loan remained outstanding for one year or longer without the corporation including interest on the loan, computed at a reasonable rate, in computing its income. Where subsection 17(1) applies, it treats the corporation as having received interest on the loan, computed at a prescribed rate, at the end of each taxation year during which the loan was outstanding.

Subject to the exceptions in new subsections (7), (8) and (9), new subsection 17(1) will apply to all amounts owing by a non-resident person to a corporation resident in Canada where at any time an amount owing has been outstanding for more than a year, or an amount owing at any time ultimately remains outstanding for more than a year, and a reasonable amount of interest has not been included in computing the corporation's income in respect of the amount owing for the portion of the corporation's taxation year during which the amount owing was outstanding.

Where amended subsection 17(1) applies, it provides some recognition of the amount, if any, the corporation has included in income in respect of interest on the amount owing under other provisions of the Act.

First, the subsection 17(1) income inclusion is reduced by any amount the corporation included in computing its income for the year in respect of interest on the amount owing under any other provision of the Act. For example, a corporation resident in Canada that makes a low-interest loan directly to a non-resident person will be required to include an amount in its income for the year with respect to interest actually paid or payable with respect to that loan. That amount will reduce the amount the corporation is required to include in income under subsection 17(1).

Second, the subsection 17(1) income inclusion is reduced by any amount the corporation includes in computing its income for the year or a subsequent year in respect of an amount received or receivable by the corporation from a trust, where that amount is reasonably attributable to interest on the amount owing in the year. This could apply, for example, where a corporation resident in Canada transfers property to a trust in which it holds a beneficial interest and the trust makes a low-interest loan to a non-resident. If the trust distributes to the corporation the interest it receives on the amount owing by the non-resident, the amount received by the corporation will reduce the amount the corporation is required to include in income under subsection 17(1) in respect of the amount owing (the look-through rule in subsection 17(5) will deem the non-resident to owe an amount to the corporation resident in Canada for the purpose of section 17).

Third, the subsection 17(1) income inclusion is reduced by any amount of foreign accrual property income the corporation includes in computing its income for the year or a subsequent year that is reasonably attributable to interest received on the amount owing by a controlled foreign affiliate of the corporation. This could apply, for example, where a corporation resident in Canada transfers property to a controlled foreign affiliate of the corporation that uses the property to make an interest bearing loan to a non-resident in respect of which it earns foreign accrual property income.

New subsection 17(1) applies to taxation years that begin after February 23, 1998.

Anti-Avoidance Rule – Indirect Loan

ITA
17(2)

New subsection 17(2) of the Act is an anti-avoidance rule intended to support subsection 17(1). If a non-resident person owes an amount to a particular person or partnership (other than a corporation resident in Canada) and it is reasonable to conclude that the particular person or partnership extended credit to the non-resident person because a corporation resident in Canada loaned or transferred property, directly or indirectly, to any person or partnership (not necessarily the particular person or partnership), then, unless the loan or transfer by the corporation resident in Canada is an exempt loan or transfer, as defined in new subsection 17(15), the non-resident is deemed to owe an amount to the corporation resident in Canada equal to the amount owing to the particular person or partnership. This rule also applies where the particular person or partnership extended credit because it anticipated that a corporation resident in Canada would make a loan or transfer of property.

New subsection 17(2) does not apply in the circumstances outlined below in new subsection 17(3).

New subsection 17(2) applies to taxation years that begin after 1999. As noted above, GAAR will have application to earlier taxation years. Given, however, that the new anti-avoidance provision in subsection 17(2) is in some respects more stringent than the existing policy of the Act – most notably, subsection 17(2) applies unless related non-residents involved are “controlled foreign affiliates” and not merely “foreign affiliates” of the corporation resident in Canada in question – the new rules apply only prospectively in order that any previous structures that were not captured under section 245 can be reorganized.

Exception to Anti-avoidance Rule – Indirect Loan

ITA
17(3)

New subsection 17(3) of the Act excepts certain amounts owing by non-resident persons from the application of the anti-avoidance rule in new subsection 17(2).

First, new subsection 17(2) does not apply to an amount owing by a non-resident person where both the non-resident person that owes the amount and the person or each member of the partnership, as the case may be, to which the amount is owing are "controlled foreign affiliates" (as defined in new subsection 17(15)) of the corporation resident in Canada.

Second, new subsection 17(2) does not apply to an amount owing by a non-resident person where three criteria are met. First, the non-resident person that owes the amount must not be related to the particular person or any member of the particular partnership, as the case may be, to which the amount is owing. Second, the terms and conditions under which the amount is owing, determined without reference to any loan or transfer of property by a corporation resident in Canada that is described under subsection (2) in respect of the amount owing, must be terms and conditions that arm's length parties

would have been willing to enter into. Third, the nature of the amount owing must be such that, if any interest payable on the amount owing were required to be included in computing the income of a foreign affiliate of the corporation resident in Canada described in subsection (2), that amount would not be required to be included in computing the foreign accrual property income of the affiliate.
New subsection 17(3) applies to taxation years that begin after 1999.

Anti-Avoidance Rule – Loan through Partnership

ITA
17(4)

New subsection 17(4) of the Act applies where a non-resident owes an amount to a partnership and that amount is not treated by subsection (2) as owing to a corporation resident in Canada. Where subsection 17(4) applies, it treats the non-resident as owing a portion of the amount owing to the partnership to each member of the partnership (on the same terms as that debt was owed to the partnership). Each member's portion of the debt is based on the fair market value of the member's interest in the partnership relative to the fair market value of all interests in the partnership.

Where a debt is treated as being owing to a member of a partnership and that member is itself another partnership, the portion of the debt treated as being owed to that other partnership will be treated in turn as owing to the members of that other partnership, and so on, up through any number of tiered partnerships. This subsection can also act in conjunction with subsection 17(5) to attribute an amount owing up through alternating partnerships and trusts.

The purpose of subsection 17(4) is to broaden the scope of amended subsection 17(1) by looking through any intervening partnerships in determining whether a corporation resident in Canada has made a loan to a non-resident.

New subsection 17(4) applies to taxation years that begin after February 23, 1998.

Anti-Avoidance Rule – Loan through Trust

ITA
17(5)

New subsection 17(5) of the Act applies where a non-resident owes an amount to a trust and that amount is not treated by subsection (2) as being owed to a corporation resident in Canada.

If the trust is a "non-discretionary trust" (as defined in new subsection 17(15)), paragraph 17(5)(*a*) treats the non-resident as owing to each beneficiary of the trust a portion of the amount owing to the trust (on the same terms as that debt was owed to the trust). The size of each beneficiary's portion is based on the fair market value of the beneficiary's interest in the trust relative to the fair market value of all the beneficial interests held in the trust at that time.

If the trust is not a non-discretionary trust, paragraph 17(5)(*b*) treats the non-resident as owing to each "settlor" in respect of the trust (as defined in new subsection 17(15)) an amount equal to the amount owing to the trust.

Where an amount owing to a trust is treated under this subsection as being owed to a beneficiary or a settlor of the trust and that beneficiary or settlor is itself another trust, the amount treated as being owed to that other trust will be treated in turn as being owed to either the beneficiaries or the settlor(s) of that other trust, and so on, up through any number of tiered trusts. This subsection can also act in conjunction with subsection 17(4) to attribute an amount owing up through alternating tiers of partnerships and trusts.

The purpose of subsection 17(5) is to broaden the scope of amended subsection 17(1) by looking through any intervening trusts in determining whether a corporation resident in Canada has made a loan to a non-resident.

New subsection 17(5) applies to taxation years that begin after February 23, 1998.

Anti-Avoidance Rule – Loan to Partnership

ITA
17(6)

New subsection 17(6) of the Act applies where a partnership owes an amount to any person or any other partnership (the "lender), and treats each member of the partnership as owing, for the purposes of section 17, a portion of the amount owed by the partnership to the lender (on the same terms as that amount was owed by the partnership to the lender). The portion of the partnership's debt that is treated as being owed by each member is based on the fair market value of the member's interest in the partnership relative to the fair market value of all interests in the partnership.

Where a member of a partnership is treated as owing an amount to the lender and that member is itself another partnership, portions of the amount treated as being owed by that other partnership will be treated in turn as being owed by the members of that other partnership, and so on, up through any number of tiered partnerships. The purpose of subsection 17(6) is to broaden the scope of amended subsection 17(1) by recognizing that a loan made to a partnership is effectively a number of smaller loans made to each of the partnership's members.

New subsection 17(6) applies to taxation years that begin after February 23, 1998.

Exception

ITA
17(7)

New subsection 17(7) of the Act is an amended version of former subsection 17(2). New subsection 17(7) provides that, where a non-resident owes an amount to a corporation resident in Canada and Part XIII tax has been paid on the amount owing, subsection (1) does not apply to the amount owing. However, if a portion of the amount owing is repaid, which would give rise to a refund of tax or a reduction of tax payable under subsection 227(6.1), tax will be deemed never to have been paid under Part XIII on that portion of the amount owing. Consequently, subsection 17(1) may apply to the amount owing from the time that the amount first became outstanding.

As a consequence of the addition of the look-through rules in new subsections 17(2) to (6), the provision now also applies to any amount treated as being owed to a corporation resident in Canada by a non-resident if Part XIII tax has been paid on that amount. New subsection 17(7) applies to taxation years that begin after February 23, 1998.

Exception

ITA
17(8)

New subsection 17(8) of the Act is an amended version of former subsection 17(3). New subsection 17(8) provides that subsection 17(1) will not apply in respect of an amount owing to a corporation resident in Canada by a "controlled foreign affiliate" (as defined in new subsection 17(15)) of the resident corporation if:

- the amount owing arose as a loan or advance to the affiliate that the affiliate has used, throughout the period (or part of the period that occurs before the end of the taxation year) during which the loan or advance has been owing, either to earn income that is "income from an active business" (as defined in subsection 95(1) of the Act) or, generally, to make a loan or advance to another foreign affiliate of the corporation that is an unrelated foreign affiliate or a controlled foreign affiliate (as defined in subsection 17(15)) provided that the other affiliate uses the loan or advance for the purpose of earning income from an active business; or

- the amount owing arose in the course of an "active business" (as defined in subsection 95(1) of the Act) that was carried on by the affiliate throughout the period that began when the amount owing arose and ended when the amount was repaid (or the end of the year, if earlier).

New subsection 17(8) applies to taxation years that begin after February 23, 1998.

Exception

ITA
17(9)

New subsection 17(9) provides that subsection 17(1) will not apply in respect of an amount owing by a non-resident to a corporation resident in Canada if three conditions are met.

First, the corporation can not be related to the non-resident for the period in the year during which the amount owing is outstanding. Second, the amount owing must have arisen in respect of goods sold or services supplied by the corporation in the ordinary course of its business. And third, the terms and conditions of the amount owing must be such that persons dealing at arm's length would have been willing to enter into them.

New subsection 17(9) applies to taxation years that begin after February 23, 1998.

Determination of Whether Related and Controlled Foreign Affiliate Status

ITA
17(10) to (12)

New subsection 17(10) of the Act contains two look-through rules that apply, for the purpose of section 17, in determining when persons are related, and when a non-resident corporation is a controlled foreign affiliate of a corporation resident in Canada.

First, under paragraph 17(10)(*a*), each member of a partnership is treated as owning a portion of the shares of any corporation owned by the partnership. Each member's portion is based on the fair market value of the member's interest in the partnership relative to the fair market value of all interests in the partnership.

Where a member of a partnership is treated as owning a portion of the shares owned by the partnership and the member is itself another partnership, the members of that other partnership will be treated, in turn, as owning a portion of the shares considered to be owned by that other partnership, and so on, up through any number of tiered partnerships.

Second, under paragraph 17(10)(*b*), each beneficiary of a "non-discretionary trust" (as defined in subsection 17(10)) is deemed to own a portion of the shares of any corporation owned by the trust. Each beneficiary's portion at any time is to be determined on the basis of the fair market value of the beneficiary's interest at that time in the trust relative to the fair market value of all the beneficial interests in the trust at that time.

Where shares owned by a trust are considered under paragraph 17(10)(*b*), subsection 17(11) or subsection 17(12) to be owned by a beneficiary or a settlor of the trust and that beneficiary or settlor is itself another trust, the shares treated as being owned by that other trust will be treated in turn to be owned by either the beneficiaries or the settlor(s) of that other trust, and so on, up through any number of tiered trusts.

Paragraph 17(10)(*b*), subsection 17(11) and subsection 17(12) can also act in conjunction with paragraph 17(10)(*a*) to attribute ownership of shares up through tiers of alternating partnerships and trusts.

The purpose of subsection 17(10) is to broaden the scope of the exception to subsection 17(1) provided under subsection 17(8) by looking through any intervening partnerships or trusts in determining whether a non-resident is a controlled foreign affiliate of a corporation resident in Canada. It also affects whether persons will be considered to be related for the purposes of subsections 17(3) and (9).

New subsection 17(11) of the Act contains a look-through rule that applies, for the purpose of section 17, in determining whether persons are related to each other.

Under new subsection 17(11), in determining whether persons are related to each other at any time, each "settlor" (as defined in subsection 17(15)) in respect of a discretionary trust is deemed to own the shares of any corporation owned by the trust at that time. In other words, if two persons would be related if each settlor in respect any discretionary trust was deemed to own all the shares of any class of any corporation owned by the trust, those two persons are deemed to be related.

New subsection 17(12) of the Act contains a look-through rule that applies, for the purpose of section 17, in determining whether a non-resident corporation is a controlled foreign affiliate of a corporation resident in Canada.

Under new subsection 17(12), each “settlor” (as defined in subsection 17(15)) in respect of a discretionary trust is deemed to own, at any time, an equal portion of the shares of any corporation owned by the trust at that time.

New subsections 17(10) to (12) apply to taxation years that begin after February 23, 1998.

Extended definition of controlled foreign affiliate

ITA
17(13)

New subsection 17(15) provides a definition of the term “controlled foreign affiliate” for the purposes of section 17. New subsection 17(13) extends this definition in providing that any non-resident corporation that is a controlled foreign affiliate of a particular corporation resident in Canada at a given time is deemed also to be a controlled foreign affiliate of any corporation resident in Canada that is related to the particular corporation at that time (otherwise than because of a right referred to in paragraph 251(5)(*b*)).

This deeming provision makes it possible for sister corporations that have made loans to each other's controlled foreign affiliates, for example, to take advantage of some of the exceptions set out in section 17.

New subsection 17(13) applies to taxation years that begin after February 23, 1998.

Anti-avoidance rule – where rights or shares issued, acquired or disposed of to avoid tax

ITA
17(14)

Subsection 17(14) is an anti-avoidance rule designed to prevent a taxpayer from avoiding including an amount in computing income under subsection 17(1) through the use of rights or the acquisition or disposition of shares.

Under paragraph 17(14)(*a*), where the principal purpose for the existence of any right to acquire shares is to reduce the amount of income that subsection 17(1) would otherwise require any corporation to include in computing its income, the shares are deemed to be owned by the person or partnership that owns the right.

Under paragraph 17(14)(*b*), where the principal purpose for the acquisition or disposition of any shares is to reduce the amount of income that subsection 17(1) would otherwise require any corporation to include in computing its income, the shares are deemed not to have been acquired or disposed of, as the case may be, and where previously unissued shares were acquired, those shares are deemed not to have been issued.

New subsection 17(14) applies to taxation years that begin after February 23, 1998.

Definitions

ITA
17(15)

New subsection 17(15) of the Act defines a number of terms that apply for the purpose of section 17. All of these definitions apply to taxation years that begin after February 23, 1998.

"controlled foreign affiliate"

The term "controlled foreign affiliate" is defined to have the same meaning as it does under subsection 95(1) of the Act, except that 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 for the purpose of section 17.

“exempt loan or transfer”

The term “exempt loan or transfer” means a loan or transfer of property made by a corporation resident in Canada to a person that is not related to the corporation, or to a partnership no member of which was related to the corporation, made under terms or conditions that arm's length parties would have been willing to enter into (if that determination were made without reference to any other loan or transfer of property to any person related to the corporation or to any partnership any member of which is related to the corporation), provided that the loan or transfer of property was not part of a series of transactions or events at the end of which the corporation was related to the person or any member of the partnership, as the case may be. For example, a commercial loan made at market rates by a Canadian bank to an unrelated customer that has no connection to any other loan or transfer would be an exempt loan or transfer of property.

"non-discretionary trust"

The term "non-discretionary trust" is defined as a trust in which all the interests were vested indefeasibly at the beginning of the trust’s taxation year in which the definition is being applied. In order for all the interests in the trust to have vested indefeasibly, the trust must have one or more beneficiaries, the trust arrangement must not permit the creation of any new beneficiaries in the future and the trust arrangement must not give anyone a discretionary power with respect to any of the income or capital of the trust.

"settlor"

The term "settlor" in respect of a trust is defined as a person or partnership that has made a loan or transfer of property, directly or indirectly, to or for the benefit of the trust at or before that time.
A loan or transfer made for the benefit of the trust would include, for example, a low-interest loan or a transfer at less than fair market value to an entity in which the trust has an interest. However, if, at any particular time, a person or partnership deals at arm’s length with the trust, any loan made directly to the trust at a reasonable rate of

interest, and any transfer made directly to the trust for fair market value consideration, at or before that time by that person or partnership will be ignored in determining whether the person or partnership is a settlor in respect of the trust at that time.

Subclause 9(2)

ITA
20(12.1)

The heading for the note for subsection 20(12.1) is changed to read:

Foreign Tax Where No Economic Profit

Clause 11

Scientific Research and Experimental Development

ITA
37

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

ITA
37(1)

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

ITA
37(1)(*c*.2) and (*c*.3)

The balance of this pool is reduced by investment tax credits claimed in respect of amounts that have been included in the pool. Amendments to the rules governing the investment tax credit in section 127 of the Act may, however, recapture a portion of a taxpayer's SR&ED investment tax credit (SR&ED ITC) in circumstances where a taxpayer disposes of, or converts to commercial use, property which has been the subject of an SR&ED ITC claim by the taxpayer. Accordingly, new paragraph 37(1)(*c*.2) increases a taxpayer's subsection 37(1) SR&ED pool by the total of all amounts added because of new subsection 127(27), (29) or (34) to the taxpayer's tax payable under Part I for any preceding taxation year (see commentary to new subsections 127(27), (29) and (34)). New paragraph 37(1)(*c*.3) increases a partnership's subsection 37(1) SR&ED pool by the total of all amounts added to a taxpayer's tax payable because of an ITC recapture occurring in relation to partnership property (see commentary to new subsection 127(30) of the Act).

This amendment applies to the 1998 and subsequent taxation years. For further information, see the commentary to the amendments to section 127 of the Act.

Clause 14

Adjustments to Cost Base

ITA
53

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

ITA
53(1)(*e*)

Paragraph 53(1)(*e*) lists amounts to be added to the adjusted cost base (ACB) of a partnership interest. New subparagraph 53(1)(*e*)(xiii) adds to the ACB of a partner's partnership interest amounts required to be added to the partner's tax payable by new subsection 127(30). That subsection may apply to add an amount to a partner's tax payable in the context of an investment tax credit (ITC) recapture (see commentary to new subsection 127(30)). New subparagraph 53(1)(*e*)(xiii) offsets the

ACB reduction under subparagraph 53(2)(*c*)(vi) in respect of an investment tax credit allocated to a partner.

This amendment applies to the 1998 and subsequent taxation years. For more information, see the commentary to the amendments to section 127.

ITA
53(1)(*h*)

Paragraph 53(1)(*h)* generally provides that property taxes and interest expenses in respect of vacant land are added to the adjusted cost base of the land.

Consequential on the introduction of the definition "housing loss" in new subsection 6(21), paragraph 53(1)(*h*) is being restructured to clarify the amounts that are required to be added to the adjusted cost base of a property under that provision.

Amended paragraph 53(1)(*h*) clarifies that amounts paid for property taxes and interest on debt relating to the acquisition of the land are to be added to the adjusted cost base of the land to the extent that the amounts

- were, because of subsection 18(2), not deductible by the taxpayer, or,

- where the amounts were paid by another taxpayer as described in paragraph (*b*) of the definition "interest on debt relating to the acquisition of land" in subsection 18(3) were, because of subsection (18)(2), not deductible by that other taxpayer and not recognized in the cost to the other taxpayer of any property (otherwise than because of paragraph 53(1)(*d*.3) or subparagraph (*e*)(xi).

This represents a clarification only and does not represent a change in the intended meaning of paragraph 53(1)(*h*).

This amendment applies to the 1998 and subsequent taxation years.

Clause 16

Saskatchewan Pension Plan – Spousal Contributions

ITA
60(*v*)(i)

Paragraph 60(*v*) of the Act provides for a deduction in computing an individual's income in respect of contributions made by the individual to a prescribed provincial pension plan. Subsection 7800(1) of the Regulations prescribes the Saskatchewan Pension Plan (SPP) for this purpose. Under subparagraph 60(*v*)(i), an individual's SPP deduction for a taxation year is limited to the previously undeducted contributions of the individual to the individual's SPP account in the year and the first 60 days of the following year. An individual's SPP deduction for a taxation year is also limited by subparagraphs 60(*v*)(ii) and (iii) to the individual's available RRSP room and a prescribed annual limit ($600).

Subparagraph 60(*v*)(i) is amended so that contributions to a spousal SPP account are likewise eligible to be taken into account in determining the deduction under paragraph 60(v). This amendment does not affect the limits for an individual under subparagraphs 60(*v*)(ii) and (iii).

This amendment applies to the 1998 and subsequent taxation years.

Clause 25

Foreign Accrual Property Income

ITA
95

Section 95 of the Act defines a number of terms and provides certain rules that apply for the purposes of subdivision i of Division B in Part I of the Act, which relates to shareholders of non-resident corporations.

ITA
95(2)(*d*)

Paragraph 95(2)(*d*) of the Act provides that, in determining foreign accrual property income, no gain or loss is recognized with respect to the disposition of shares of a foreign affiliate as a result of a foreign merger of that affiliate and another corporation to form a new foreign affiliate.

Paragraph 95(2)(*d*) is amended to add references to "foreign parent corporation" as a consequence of new subsections 87(8) and (8.1) of the Act which provide a tax-deferred rollover in respect of the disposition of shares of a predecessor foreign corporation in the case of a “triangular foreign merger”. Under a “triangular foreign merger”, the shareholder of the predecessor receives shares of the foreign corporation (the foreign parent) which controls the new corporation formed on the merger, rather than shares of the new corporation.

Amended paragraph 95(2)(*d*) of the Act applies to foreign mergers that occur after February 24, 1998 and to certain specified foreign mergers that occur before that day unless the taxpayer elects otherwise.

ITA
95(4.1)

Subsection 95(4.1) of the Act provides that, for the purposes of section 95 of the Act, certain expressions have the same meaning as in subsection 87(8.1) of the Act. This subsection is amended by adding a reference to "foreign parent corporation" as a consequence of the introduction of new subsections 87(8) and (8.1) of the Act which provide a tax-deferred rollover in respect of the disposition of shares of the predecessor foreign corporation for shares of a foreign parent corporation in the case of a “triangular foreign merger”. Under a “triangular foreign merger”, the shareholder of the predecessor receives shares of the foreign corporation (the foreign parent) which controls the new corporation formed on the merger, rather than shares of the new corporation.

Amended subsection 95(4.1) of the Act applies to foreign mergers that occur after February 24, 1998 and to certain specified foreign mergers that occur before that day unless the taxpayer elects otherwise.

Clause 43

Income Earned in a Province

ITA
120

Section 120 of the Act provides for two adjustments to the federal tax payable by individuals. These are the additional tax payable on income that is not taxable by the provinces, and the special Quebec abatement. These adjustments are determined as a percentage of the amount of tax otherwise payable under Part I. For this purpose, the amount of tax otherwise payable is defined in the definition “tax otherwise payable under this Part” in subsection 120(4). The amendment to this definition is consequential on the introduction of the rules requiring a recapture of investment tax credits (ITCs) under new subsections 127(27) to (35) of the Act. As amended, the definition “tax otherwise payable under this Part” provides that, for the purposes of these two adjustments, the tax otherwise payable is not changed by any amount added to tax because of the ITC recapture rules.

ITA
120(4)

Subsection 120(4) provides definitions that apply for the purposes of section 120.

“tax otherwise payable under this Part”

This definition generally equates to basic federal tax. The definition is amended to clarify that amounts added to tax because of the new investment tax credit (ITC) recapture measures in subsections 127(27) to (35) will not affect the calculation of an individual's surtaxes, and will not affect the calculation of an individual's provincial income tax payable.

This amendment applies to the 1998 and subsequent taxation years.

Clause 44

Canada Child Tax Benefit

ITA
122.6

“eligible individual”

Section 122.6 of the Act contains definitions for the purposes of the Canada child tax benefit (CCTB). This non-taxable benefit is delivered to eligible individuals in monthly payments based on family earnings, income, number of children and childcare expenses.

The definition "eligible individual" in section 122.6 is amended, with application after February 23, 1998, as a consequence of the repeal of paragraph 250(1)(*e*) of the Act. Paragraph 250(1)(*e*) currently applies to deem the spouses of certain individuals to be resident in Canada for the purposes of the Act. The definition "eligible individual" describes certain residency requirements that must be met in order for an individual to be eligible for the CCTB. Paragraph (*c*) of that definition is amended to ensure that individuals who would have qualified for the CCTB before the repeal of paragraph 250(1)(*e*) continue to qualify if the other requirements of the CCTB are satisfied.

Clause 45

Corporate Surtax

ITA
123.2

Section 123.2 levies a surtax on the federal tax payable under Part I by a corporation, other than a non-resident-owned investment corporation.

ITA
123.2(*a*)

Paragraph 123.2(*a*) of the Act is amended to provide that amounts added to tax because of the new investment tax credit (ITC) recapture measures in subsections 127(27) to (35) of the Act will not affect the calculation of a corporation's surtax payable.

This amendment applies to the 1998 and subsequent taxation years.

Clause 47

Foreign Tax Credit

Subclause 47(4)

No Economic Profit

ITA
126(4.1)

New subsection 126(4.1) of the Act denies a foreign tax credit for foreign taxes paid in respect of a property if it is reasonable to expect that the taxpayer will not realize an economic profit (newly defined in subsection 126(7) of the Act as profit net of foreign taxes) in respect of the property. The rule does not apply with respect to capital property.

The foreign tax credit operates on a country-by-country pooling basis, with the result that income from a source that is taxed in a foreign country at a higher rate than in Canada creates excess credits that may be used to reduce Canadian tax on income from other sources in the country that are taxed at rates lower than the Canadian rate. This cross-crediting can make an otherwise uneconomic transaction attractive to a taxpayer, and can amount to a subsidy by the Canadian tax system for such transactions. To limit this effect, the new rule denies the credit in situations where, without the credit, there is no expected economic profit.

The assessment of expected profitability is made as of the time the property is acquired. Profitability is estimated over the entire period for which it is expected that the property will be continuously held. If it is reasonably expected that there will not be an economic profit, the foreign tax paid in respect of the property and related transactions (also newly defined in subsection 126(7) of the Act) is not included in the taxpayer's “business-income tax” or “non-business-income tax”—the foreign taxes for which credit may potentially be claimed—for any taxation year. Where the credit is so denied, however, a deduction from income may be available for the foreign tax under new subsection 20(12.1) of the Act. If a related transaction involves acquisition of another property, the rule in subsection 126(4.1) of the Act is not applied independently in respect of the other property.

This amendment applies to properties acquired after February 23, 1998.

Deemed Dispositions Ignored

ITA
126(4.4)

New subsection 126(4.4) of the Act provides that dispositions and acquisitions of property that are either deemed to be made by certain provisions of the Act or made in the course of certain rollover transactions are not dispositions or acquisitions for the purposes of the limits on the foreign tax credit in new subsections 126(4.1) and (4.2) of the Act and the new definition “economic profit” in subsection 126(7) of the Act. As a result, such dispositions and acquisitions are not relevant in calculating the threshold holding period for the application of subsection 126(4.2) or the period of ownership over which profit is calculated under either tax credit limit. Likewise, proceeds received or deemed to be received on such dispositions and costs paid or deemed to be paid on such acquisitions are not taken into account in computing the taxpayer's profit for purposes of the tax credit limits.

The deemed dispositions and acquisitions included are:

- subsection 45(1) (change of use)
- section 70 (death of taxpayer)

- section 128.1 (immigration of taxpayer to Canada)
- paragraph 132.2(1)(*f*) (mutual fund restructuring)
- subsection 138(11.3) (change of use of designated insurance property)
- subsection 142.5(2) (mark-to-market property)
- paragraph 142.6(1)(*b*) (becoming a financial institution)
- subsection 149(10) (becoming or ceasing to be an exempt corporation)

The rollover provisions included are:

- section 51.1 (conversion of debt obligation)
- subsection 86(1) (exchange of shares in course of reorganization of capital)
- subsections 87(4) and (8) (foreign merger)

This amendment applies to the 1998 and subsequent taxation years.

Clause 48

Scientific Research and Experimental Development – Investment Tax Credit

Overview

Since the release of the October 27, 1998 draft proposals relating to the 1998 Budget, the draft legislation implementing the scientific research and experimental development (SR&ED) investment tax credit (ITC) recapture measure has been substantially revised. The revisions are primarily to deal with four issues that arose subsequent to the October release.

The first issue is the application of these provisions in the context of contract SR&ED that is performed in a non-arm's length situation.

These revisions introduce a rule to recognize a recapture of an ITC in the hands of an SR&ED performer in certain circumstances where the performer has transferred qualified expenditures to another taxpayer pursuant to the rules permitting the transfer of qualified expenditures incurred in the performance of a non-arm's length SR&ED contract (subsections 127(13) to (17)).

The second issue was the proper allocation of the reduction in the ITC pursuant to draft subsection 127(27) in circumstances where a taxpayer carried forward ITC entitlements from prior taxation years. For example, where a taxpayer earned ITCs in years 1 through 8, allowed the ITCs to be carried forward for those years, and a property that triggered an ITC recapture was first purchased and claimed as a qualified expenditure in year 3, and was sold in year 8, it was not clear whether the reduction in ITCs should be applied first to reduce ITCs earned in year 1, year 3 or year 8. In order to address this “ageing” problem, it became necessary to replace the original rule in subsection 127(27) with a rule that adds the recapture amount directly to the taxpayer's tax payable. The net effect of this approach is generally no different from the original rule. If the taxpayer has ITC available, that ITC can be applied to eliminate the tax payable under new subsection 127(27), (29) or (34). If the taxpayer does not have ITC available to offset the tax, then the situation is the same as that addressed by draft subsection 127(28) of the October release, which required the amount of the “negative ITC” to be added to tax payable.

The third issue concerns the meaning of “cost of a particular property”. For the purposes of the SR&ED ITC recapture rules, “cost of a particular property” is generally defined to be the laid-out cost for the initial acquisition of the property.

The fourth issue was the treatment of non-arm's length transfers of SR&RD property where the transferee continues to use the transferred property for SR&ED. New rules are added to prevent the triggering of the ITC recapture rules in these circumstances (see commentary to subsections 127(33) to (35)).

In addition, this revised version of the legislation contains more detailed rules applicable to ITCs earned in a partnership context.
As a result, the amendment to the definition “investment tax credit” proposed in October 1998 has been withdrawn. Consequentially, the

explanatory note to subsection 127(9) in the October 1998 version of the notes is deleted. The other explanatory notes to section 127 are replaced as follows:

ITA
127

Section 127 of the Act includes a set of provisions governing a taxpayer's entitlement to claim an investment tax credit (ITC).

Subclause 48(1)

Investment Tax Credit of Partnership

ITA
127(8)

Subsection 127(8) of the Act provides for the allocation of the ITC of a partnership to its partners. Subsection 127(8) is amended to provide that the allocation under that subsection is subject to subsection 127(28), the ITC recapture provision applicable to partnerships. For more information, see the commentary to new subsection 127(28) below.

Subclause 48(2)

Recapture of Investment Tax Credit

ITA
127(27)

New subsection 127(27) of the Act requires a taxpayer to add an amount to the taxpayer's tax payable under Part I in certain circumstances where an SR&ED property has been sold or converted to commercial use.

Paragraphs 127(27)(*a*) to (*d*) of the Act describe circumstances in which the addition to tax will occur. Generally, those circumstances are the disposition or conversion to commercial use of a property (after February 23, 1998), where the cost of that property was claimed as an SR&ED cost for SR&ED ITC purposes in the year or in any of the ten preceding taxation years. The amount of the addition to Part I tax is the lesser of the two amounts described in the "midamble" of subsection 127(27) and in paragraphs 127(27)(*e*) and (*f*). The first amount is the amount that can reasonably be considered to have been included in the taxpayer's investment tax credit in respect of the particular property. Where the property (or another property that incorporates the property) is disposed of to a person dealing at arm's length with the taxpayer, the second amount is the same percentage (for example, 20 per cent) that the taxpayer applied in calculating the original ITC claim in respect of the property multiplied by the proceeds of disposition of the property. In any other case (i.e., where the property is converted to commercial use or sold to a non-arm's length party), the second amount is the same percentage (for example, 20 per cent) that the taxpayer applied in calculating the original ITC claim in respect of the property multiplied by the fair market value of the property (or the other property that contains the property).

All amounts added to tax payable by a taxpayer under this provision for a taxation year will increase the amount of the taxpayer's subsection 37(1) SR&ED pool for the following year.

Recapture of Investment Tax Credit of Partnership

ITA
127(28)

New subsection 127(28) of the Act provides an ITC recapture rule that applies where the property that triggers the recapture belongs to a partnership. In the circumstances described in paragraphs 127(28)(*a*) to (*c*), the amount calculated as the partnership's ITC available for allocation under subsection 127(8) is reduced by the lesser of two amounts.

Generally, the circumstances which will cause the reduction in a partnership SR&ED ITC available for allocation are the disposition or conversion to commercial use (after February 23, 1998) of a property, where the cost of the property was claimed as an SR&ED cost for SR&ED ITC purposes in the fiscal period of the partnership or in any of the ten preceding fiscal years.

The amount of the reduction to the partnership's ITC available for allocation under subsection 127(8) is the lesser of the two amounts described in paragraphs 127(28)(*d*) and (*e*). The first amount is the amount that can reasonably be considered to have been included in respect of the particular property in the partnership's ITC available for allocation under subsection 127(8). Where the property (or another property that incorporates the property) is disposed of to a person dealing at arm's length with the partnership, the second amount is the same percentage (for example, 20 per cent) that the partnership applied in respect of the property in calculating the original partnership ITC available for allocation under subsection 127(8) multiplied by the proceeds of disposition of the property. In any other case (where the property is converted to commercial use or sold to a non-arm's length party), the second amount is the same percentage (20 per cent) that the partnership applied in respect of the property in calculating the original partnership ITC available for allocation under subsection 127(8) multiplied by the fair market value of the property (or the other property that contains the property).

Recapture of Investment Tax Credit of Allocating Taxpayer

ITA
127(29)

New subsection 127(29) provides an ITC recapture rule applicable in the context of contract SR&ED that is performed in a non-arm's length situation. New subsection 127(29) recognizes a recapture of an ITC (as an addition to Part I tax) in the hands of an SR&ED performer in certain circumstances where the performer has transferred qualified expenditures to another taxpayer pursuant to the rules permitting the transfer of qualified expenditures incurred in the performance of a non-arm's length SR&ED contract (subsections 127(13) to (17)). Any amounts added to tax payable under this new provision for a taxation year by a taxpayer will increase the amount of the taxpayer's subsection 37(1) SR&ED pool for the following year.

New subsection 127(29) applies where the circumstances described in paragraphs 127(29)(*a*) to (*d*) occur. Generally those circumstances are:

- the acquisition of a property where the cost of the property was claimed as an SR&ED cost for SR&ED ITC purposes in the year or in any of the ten preceding taxation years;

- the transfer by the taxpayer of qualified expenditures in respect of the property to a non-arm's length purchaser of SR&ED (referred to below and in the new provision as the “transferee”) pursuant to subsection 127(13); and

- the disposition or conversion to commercial use of the property (after February 23, 1998) by the taxpayer.

Under those circumstances, the taxpayer's tax payable under Part I is increased by the lesser of the two amounts described in paragraphs 127(29)(*e*) and (*f*). The first amount is the amount included in the transferee's ITC that relates to the property.

The second amount is the amount determined by the formula “A x B – C”. Variable A is the percentage used by the transferee to calculate its ITC that relates to the property. Variable B is one of two amounts. Where the property (or another property that incorporates the property) is disposed of to a person dealing at arm’s length with the taxpayer, variable B is the proceeds of disposition of the property. In any other case (where the property is converted to commercial use or sold to a non-arm’s length party), variable B is the fair market value of the property (or the other property that incorporates the property). Variable C reduces the amount to be added to the taxpayer's tax payable by any amount that is required to be added to the taxpayer's tax payable under subsection 127(27) in respect of the property. Variable C will apply where a taxpayer has transferred a portion of the qualified expenditure associated with a property, and has retained the remainder of the qualified expenditure.

EXAMPLE

A Co has no pre-existing qualified expenditure pool. In year 1, A Co purchases a $ 2 million telescope as a qualified expenditure. A Co has $3 million of other qualified expenditures in year 1. A Co transfers to B Co $2 million of qualified expenditures for year 1. In year 2, A Co sells the telescope to an arm's length third party for $1.5 million.

In this situation, it is reasonable to conclude that A Co transferred $2 million x 2/5 = $800,000 in respect of the telescope, and "kept" $1.2 million in respect of the telescope.

Assuming an ITC rate of 20 per cent for both A Co and B Co, A Co will incur an addition to tax of $240,000 pursuant to section 127(27) for the qualified expenditure amount it kept ($1.2 million). By applying the formula "A x B – C", A Co will incur an addition to tax of 20 per cent x $1.5 million - $240,000 = $60,000 pursuant to subsection 127(29). *A Co*'s total addition to tax is $300,000.

Had A Co transferred no qualified expenditures for year 1, its addition to tax pursuant to 127(27) would still have been $300,000 (20 per cent x $1.5 million proceeds) as the lesser of the two amounts described in subsection 127(27) in this situation.

Addition to tax

ITA
127(30)

New subsection 127(30) applies where, at the end of a taxation year, a taxpayer is a member of a partnership that does not have a large enough balance in the partnership's ITC otherwise available for allocation under subsection 127(8) to offset the ITC recapture required by subsection 127(28) or (35). In those circumstances, the total of all amounts which are added in calculating the partnership's ITC available for allocation under subsection 127(8) (referred to in this paragraph as the "partnership ITC" as a matter of convenience) would be less than the total of all amounts which reduce the partnership ITC. The amount by which the reductions to the partnership ITC exceed the additions to it can be viewed as a "negative" partnership ITC. The portion of the amount by which the partnership ITC is "negative" (the "excess") that can reasonably be considered to be the taxpayer's share is added to the taxpayer's tax payable under Part I for the year. Any amounts payable under this new provision for a taxation year by members of the partnership will increase the amount of the partnership's subsection 37(1) SR&ED pool for the following year. In addition, the adjusted cost base of the member's partnership interest will be increased by the amount added to the member's tax under new subsection 127(30). (See commentary to paragraph 53(1)(*e*).)

Tiered Partnership

ITA
127(31)

New subsection 127(31) applies where a partnership has a member that is a partnership, so that the provision in 127(30) for allocating an addition to a taxpayer's tax would not apply in respect of the member partnership because it is not a taxpayer. Subsection 127(31) directs partnerships and their members to continue allocating these amounts down through their members until a level is reached at which the members are taxpayers and not partnerships. This is accomplished by deeming the amount that would be the member partnership's addition to tax under subsection 127(30) if the member were a taxpayer, to be the amount of an ITC recapture under 127(28) in respect of the member partnership. Subsection 127(28) will then apply to reduce the ITC available for allocation by the lower-tier partnership under subsection 127(8). If the amount is, in turn, “negative”, subsection 127(30) will cause the lower-tier partnership to allocate the addition to tax to its members. If necessary, subsection 127(31) would apply again to allocate the addition to tax down a further level, if the members of the partnership at the second level were partnerships as well.

ITA
127(32)

New subsection 127(32) of the Act clarifies the scope of the meaning of “cost of the particular property” for the purposes of the scientific research and experimental development (SR&ED) investment tax credit (ITC) recapture provisions. For these purposes, “cost of the particular property” means the laid-out cost for the initial acquisition of the property and does not include inputs (such as overhead) which could otherwise be imputed to the cost of a property.

New subsection 127(32) applies to dispositions and conversions of property that occur after February 23, 1998.

ITA
127(33) to (35)

New subsections 127(33) to (35) apply in circumstances where a nonarm's length transfer of SR&ED property to another taxpayer would otherwise trigger the SR&ED ITC recapture provisions.

Subsection 127(33) provides that the SR&ED ITC recapture provisions do not apply to a taxpayer who disposes of SR&ED property to a non-arm's length purchaser if the purchaser continues to use the property all or substantially all for SR&ED.

Subsection 127(34) creates a recapture mechanism where a non-arm's length purchaser who has continued to use the property in SR&ED (such that subsection 127(33) applied to the vendor on the disposition of the property) subsequently sells the property or converts it to commercial use. Subsection 127(34) generally requires the non-arm's length purchaser to apply a recapture rule similar to the recapture rule in subsection 127(27) based on the rate at which the original ITC was generated on the property.

New subsection 127(35) provides a similar rule to subsection 127(34), applicable in respect of non-arm's length purchasers that are partnerships. Subsection 127(35) requires such a partnership to apply a recapture rule similar to the recapture rule in subsection 127(28) based on the rate at which the original ITC was generated on the property.

The amendments to subsections 127(33) to (35) apply to dispositions and conversions of property that occur after February 23, 1998.

Clause 49

Labour-Sponsored Funds Tax Credit

ITA
127.4(1)

"qualifying trust"

Subsection 127.4(2) of the Act entitles an individual to a tax credit for the acquisition of an "approved share", which is defined as a share issued by a prescribed labour-sponsored venture capital corporation (LSVCC). The LSVCC tax credit is available to an individual for a taxation year in connection with acquisitions by the individual or by a "qualifying trust" for the individual in the year and the first 60 days of the following year. A "qualifying trust" of an individual in respect of a share is an RRSP trust that uses the individual’s contributions to acquire the share and under which the individual or the individual’s spouse is the annuitant.

The definition "qualifying trust" is amended so that the acquisition by an RRSP trust can always be taken into account in claiming the LSVCC credit for the RRSP annuitant (or, in the case of a spousal RRSP, for the contributor spouse or the annuitant spouse who claims the LSVCC credit). This amendment is linked to the repeal of the “3-year cooling-off period” in subsection 127.4(3) and (4), since the existing definition prevents reinvestment in shares issued by LSVCCs in some cases.

This amendment applies to the 1998 and subsequent taxation years.

ITA
127.4(2), (3), (4) and (6)

Subsections 127.4(3) and (4) of the Act apply to an individual where a share of the capital stock of an LSVCC is redeemed, acquired or cancelled by the LSVCC and the original acquisition of the share was by the individual (or by a qualifying RRSP trust in respect of the individual). Where this is the case, an individual is generally not allowed to claim any tax credit under subsection 127.4(2) for the year of disposition and for each of the two following taxation years.

Subsections 127.4(3) and (4) are repealed in order to facilitate reinvestment in LSVCCs. The elimination of the "3-year cooling-off period" under these subsections was proposed in an August 31, 1998 press release issued by the Secretary of State (International Financial Institutions).

Subsections 127.4(2) and (6) are amended to remove cross-references to the repealed subsections.

These amendments apply to the 1998 and subsequent taxation years.

ITA
127.4(5)

The annual LSVCC tax credit limit for an individual under section 127.4 of the Act is $525, which corresponds to original acquisitions of LSVCC shares totalling $3,500 (i.e., $3,500 x 15 per cent = $525).

Subsection 127.4(5) is amended to increase the annual tax credit limit from $525 to $750, which corresponds to original acquisitions of LSVCC shares totalling $5,000. This measure was proposed in an August 31, 1998 press release issued by the Secretary of State (International Financial Institutions).

This amendment applies to the 1998 and subsequent taxation years.

Clause 50

Alternative Minimum Tax

ITA
127.52(1)(*a*)

The last sentence of the October 1998 note to the amendments to paragraph 127.52(1)(*a*) of the *Income Tax Act* is replaced by the following:

> However, this retroactive relief will apply only to the extent that they have been unable to totally recover during that period the ensuing additional tax, and only if those individuals were resident

in Canada throughout, and were not bankrupt at any time in, the period that began at the end of the year for which they had to pay minimum tax and that ended at the end of 1997. This relief is not available in respect of individuals who died before 1998.

Clause 53

Mortgage Investment Corporations

Section 130.1 of the Act sets out rules that apply to mortgage investment corporations and their shareholders.

Subclause 53(1)

Definition of Mortgage Investment Corporation

ITA
130.1(6)(*d*)

Subsection 130.1(6) defines "mortgage investment corporation" for the purposes of section 130.1.

Paragraph 130.1(6)(*d*) requires that no shareholder hold more than 25 per cent of the shares of the corporation. This amendment expands that rule so that no shareholder may hold more than 25 per cent of the shares of any class. For the purpose of this limit, a modified form of the "specified shareholder" concept from subsection 248(1) of the Act is adopted. Under this rule, a person is considered to own not only shares which that person owns personally, but also

- any shares owned by persons to whom that person is related, and

- a proportionate number of any shares held by a trust under which that person is a beneficiary or a partnership of which that person is a member.

In this context, the definition of "related persons" in the Act is narrowed so that an individual is considered to be related only to the individual's spouse, minor children and grandchildren, and corporations controlled by such persons, the individual, or a related group that includes such persons or the individual. This narrowed group with reference to an individual effectively limits the circumstances in which two corporations will be related for the purposes of these rules.

Specifically, amended paragraph 130.1(6)(*d*) provides that a corporation will be a MIC for a taxation year only if no person would have been a specified shareholder of the corporation at any time in the year. For this purpose, the definition “specified shareholder” in subsection 248(1) of the Act is modified in several respects:

- the definition is applied at each time in the year rather than for the year as a whole;
- the share ownership test is “more than 25 per cent” instead of “not less than 10 per cent”;
- the reference to shares of any other related corporation in the preamble is deleted;
- paragraph (*a*) of the definition is changed to encompass shares of related persons, as narrowly defined for this purpose, rather than persons not dealing at arm's length; and
- paragraph (*d*) of the definition, which is not relevant to MICs, is deleted.

The requirement that a MIC have at least twenty shareholders remains. The reference to subsections 130.1(7) and (8) is removed as being redundant, since it is clear that these provisions apply to paragraph 130.1(6)(*d*).

Coming-into-force provisions and transitional relief are set out in subclauses 53(3) to (10).

Subclause 53(2)

How Shareholders Counted

ITA
130.1(7)

Subsection 130.1(7) of the Act sets out rules relating to the counting of shareholders for the purpose of the share ownership limits in paragraph 130.1(6)(*d*). Subsection 130.1(7) is amended as a consequence of the amendment of those limits. The reference to trusts governed by registered retirement savings plans is removed as being superfluous, since there is no reason to treat such a trust as other than a single shareholder.

Coming-into-force provisions and transitional relief are set out in subclauses 53(3) to (10).

Subclauses 53(3) to (10)

Transitional Rules

Subclauses 53(3) to (10) contain coming-into-force provisions and transitional relief in respect of the amendments in subclauses 53(1) and (2). The general rule and the qualifications for entitlement to transitional relief are set out in subclause 53(3). Subclauses 53(4) and (5) contain general limits applicable to all MICs entitled to transitional relief. Additional restrictions on the transitional relief available if an existing specified shareholder engages in mortgage lending are set out in subclauses 53(6) and (7). Rules regarding trusts and partnerships, and estates, are in subclauses 53(8) and (9) respectively. Definitions are contained in subclause 53(10).

These amendments generally apply for taxation years that begin after January 14, 1998, as set out in subclause 53(3). Transitional relief in the form of a limited exemption from the new share ownership limit is provided to a corporation that was a MIC at the end of January 14, 1998 and had at that time one or more shareholders ("existing specified shareholders") whose holdings exceeded the new limit. Subclause 53(10) assigns "specified shareholder" the same meaning for the purpose of the transitional provisions as it is given by paragraph 130.1(6)(*d*) of the Act. Subject to a number of restrictions described below, the new limit will not apply to shares owned by such persons. The new limit will apply, however, to the corporation in respect of shares held by persons who are not existing specified shareholders. If the test applicable to either group of shareholders is not met, the corporation will not be considered a MIC for the relevant taxation year.

Subphrase 53(3)(*c*)(ii) provides a special extension of the transitional relief, made necessary by the adoption of the narrower meaning of “related” for the purpose of these rules. In some cases a shareholder may not have been a specified shareholder at the end of January 14, 1998 even though the shareholder would have received relief under the broader definition “specified shareholder” (based on the non-arm's length standard) used in the proposed amendments that were released on January 15, 1998 (the “January 15, 1998 proposals”). Relief is provided if such a shareholder complied with the requirements in the January 15, 1998 proposals yet at some time in the period between January 14, 1998 and August 14, 1998 was not in compliance with the limit under the revised narrower definition. For example, such a shareholder might not otherwise meet the new limit if the proportion of shares deemed to be held under the new test increased to be above 25 per cent at any time during the period after January 14, 1998 and before August 14, 1998 as a result of:

- redemption of shares held by non-related shareholders; or
- permitted acquisitions of shares from persons who were related in the broader sense used in the January 15, 1998 proposals, but not in the narrower sense used in the present amendments.

The general limit on transitional relief is in subclause 53(4). It provides that the transitional exemption from the new share ownership limit will cease to apply to the interest in a MIC of an existing specified shareholder if the shareholder acquires additional shares of the corporation (other than by permitted acquisitions) or contributes additional capital to it.

In a “permitted acquisition” as defined in subclause 53(10), an existing specified shareholder acquires shares from a related person (also defined in that subclause) or by way of a stock dividend (issued to either the specified shareholder or a related person). For this purpose, a related person must have been related to the specified shareholder throughout the period from the end of January 14, 1998 to the time of acquisition. A general condition for a permitted acquisition is that, immediately after the acquisition, the percentage of shares of the particular class held by the particular person and related persons not exceed the "permitted percentage", which is also defined in subclause 53(10).

For the purposes of the transitional rules, subclause 53(10) generally gives "related persons" the same meaning it has for the purpose of the new share limit in paragraph 130.1(6)(*d*) of the Act. However, since the January 15, 1998 proposals used "related" in the broader sense it has for the general purposes of the Act, that broader meaning will apply for the tests applicable to share acquisitions that take place after January 14, 1998 and before August 14, 1998. Thus, "permitted acquisitions" before August 14, 1998 are acquisitions from persons related in the broader sense, while those on or after that day are acquisitions from persons related in the narrower sense.

"Permitted percentage," in the case of share acquisitions after January 14, 1998 but before August 14, 1998, is defined to mean the percentage of shares of the particular class held at the end of January 14, 1998 by the particular person and persons with whom the particular person did not at that time deal at arm's length. By contrast, in the case of share acquisitions on or after August 14, 1998, the "permitted percentage" is the greater of the percentage held at the end of January 14, 1998 and the percentage held at the beginning of August 14, 1998, in both cases by the person and related persons (in the narrower sense). This formulation ensures that the threshold for intra-group trading by an existing specified shareholder takes into account trading during the period between January 14, 1998 and August 14, 1998, when taxpayers may have relied on the broader test contained in the January 15, 1998 proposals.

Subclause 53(5) provides for situations in which a person becomes related to an existing specified shareholder after January 14, 1998. Since an existing specified shareholder could effectively acquire an indirect interest in shares by becoming related to a person who holds the shares, subclause 53(5) applies the new limit to the corporation (thus ending the transitional relief) if a person newly related to a specified shareholder either holds shares of the corporation, whether directly or indirectly, or contributes capital to it.

Additional restrictions on the transitional relief apply where an existing specified shareholder is a corporate “mortgage lender”, as defined in subclause 53(10). In that case, subclause 53(6) stipulates that, in addition to the circumstances set out in subclauses 53(4) and (5), the new ownership restrictions will apply if any person contributes capital to the corporation or acquires a share from the corporation, other than as a stock dividend. Hence, if an existing specified shareholder is a mortgage lender, the MIC is only exempt from the new limits so long as no new shares are issued or capital contributed. If this restriction is breached, the new limits could apply as early as the taxation year that includes January 15, 1998. Transitional relief for mortgage investment corporations which have a mortgage lender as an existing specified shareholder is limited to ten taxation years. Subclause 53(7) provides that the new share limit in paragraph 130.1(6)(*d*) of the Act applies to a MIC for its first taxation year that ends after 2007 in which a specified shareholder is a mortgage lender and for all subsequent years.

Subclause 53(8) deals with shares held by partnerships and trusts. If a trust that existed at the end of January 14, 1998 distributes a share to a person who has been a beneficiary since that time, the share is deemed for the purposes of the transitional rules to have been owned by the beneficiary from the later of the end of January 14, 1998 and the time the trust last acquired the share to the time the beneficiary acquires it. This ensures that the beneficiary, who has acquired a share in which he or she in effect already had a beneficial interest, will not be treated as having acquired a share for the purposes of these transitional rules. Similar treatment is given where a partnership, which is being wound up or from which a member is retiring, distributes a share (or an interest in a share) to a person who has been a member of the partnership since the end of January 14, 1998. This rule ensures the appropriate result where, for example, more or fewer shares are attributed to a person under the “specified shareholder” definition than the person actually receives on a distribution.

The definition “specified shareholder” in subsection 248(1) of the Act, which is modified by amended paragraph 130.1(6)(*d*) of the Act, attributes to partners and trust beneficiaries a proportionate number of the shares held by the partnership or trust. Phrase 53(8)(*b*) applies this deeming principle to the acquisition and ownership of shares for the purposes of the transitional rules. That is, where that definition attributes a share held by a partnership or trust to a person, the person is deemed to own the share and to have acquired it at the later of the time the partnership or trust acquired it and the time the person last became a member of the partnership or a beneficiary of the trust. This ensures that share interests acquired by a person through a partnership or trust are considered to be acquisitions for the purposes of the transitional provisions.

Subclause 53(9) extends transitional relief for a three-year period to MIC shares received by the estate of an existing specified shareholder upon the shareholder's death. For three years from the date of death, the estate itself is deemed to be an existing specified shareholder. The estate is also deemed to be related to each person who, throughout the period from January 15, 1998 to the time of death, was related to the deceased person. This ensures that a bequest of shares by the deceased to a related person in what would otherwise be a "permitted acquisition" within the terms of the definition in subclause 53(10) does not prejudice the transitional relief by reason of the shares passing through the estate. However, so as not to offend the rule in subclause 53(5), the estate is deemed not to be a newly related person.

Also, to preserve the transitional relief, the acquisition of shares by the estate from the deceased is deemed to be a permitted acquisition. The estate is also deemed for the three-year period not to be a trust for the purposes of subphrase 53(8)(*a*)(i). This ensures that shares received by a beneficiary of the estate from the estate are considered to be received by the beneficiary only when actually received. Likewise, the estate is deemed not to be a trust for the purposes of paragraphs (*b*) and (*e*) of the definition "specified shareholder" in subsection 248(1) of the Act. This ensures that for the three-year period, shares held by the estate are not attributed to the estate's beneficiaries under the look-through rules in that definition.

Clause 54

Election to be Mutual Fund

ITA
132(6.1)

Subsection 132(6.1) of the Act provides that, where a trust becomes a mutual fund trust at any time on or before the 90th day after the end of the calendar year in which it was created and the trust so elects in its first income tax return, the trust is treated as having been a mutual fund trust from the day it was created.

Subsection 132(6.1) is amended so that the election is, instead, available where a trust becomes a mutual fund trust at any time on or before the 90th day after the end of its first taxation year. This amendment is consequential to new section 132.11 of the Act, which allows qualifying trusts to elect to have a December 15 year end for tax purposes rather than a December 31 year end. As described in the commentary below, a related amendment is being made to subsection 142.6(1) of the Act.

This amendment applies to the 1998 and subsequent taxation years.

Clause 55

Mutual Fund Trusts

ITA
132.11

New section 132.11 of the Act generally allows mutual fund trusts to elect to have taxation years that end on December 15, rather than on December 31.

Where this election is made, the trust's income must be adjusted to take into account investments in partnership interests and units of other trusts. Special provision is also made to allow for the allocation to unitholders of income paid or payable in the first 16 days following the end of the taxation year (i.e., from December 16 of a calendar year until the end of the calendar year). In addition, as explained more fully below, "overdistributions" by the trust to unitholders may be treated as income for those unitholders. The trust is generally allowed to deduct the amount of those overdistributions in computing its income for the following taxation year.

The purpose of section 132.11 is to allow mutual fund trusts to calculate their income and distributions for a taxation year on a more administratively workable basis, in order to allow for more accurate and timely reporting by mutual fund trusts and to minimize the risk of errors which can have adverse financial consequences for mutual fund trusts and their unitholders. The new mechanism for overdistributions ensures that mutual fund trusts can maximize their capital gain refunds and provides for more straightforward tax consequences for unitholders.

The new rules in subsections 132.11(2) to (4) apply to a trust for a taxation year only where the year ends on December 15 because of an election under subsection 132.11(1). If a taxation year of a trust begins on December 16 of a calendar year and ends before December 16 of the next calendar year as a consequence of a qualifying exchange under section 132.2, new subsections 132.11(2) to (4) do not apply to the trust for the year. However, the transferor mutual fund trust is permitted a deduction under subsection 132.11(7) for the year. In addition, the transferee mutual fund trust is permitted to make an election in accordance with subsection 132.11(1).

New section 132.11 applies to the 1998 and subsequent taxation years.

ITA
132.11(1)

Subsection 132.11(1) of the Act allows a trust to elect to have its taxation year end on December 15. The election must be made in the trust’s tax return for the taxation year for which the election is made. The trust must be a mutual fund trust on the 74th day of the following calendar year (i.e., on the 90th day following the December 15 year end). However, this election cannot be made if the trust is a prescribed trust. It is intended that mutual fund trusts treated as money market funds under provincial securities regimes will be prescribed for this purpose.

Where the election is made, each subsequent taxation year of an electing trust is deemed to start on December 16 of a calendar year and end on December 15 of the following calendar year (or at such earlier time as is determined in the event of a qualifying exchange under paragraph 132.2(1)(b) or under subsection 142.6(1) in the event that the trust loses its status as a mutual fund trust and becomes a "financial institution", as defined by subsection 142.2(1)).

Fiscal periods, as defined by section 249.1 of the Act, of an electing trust are likewise required to end in the taxation year in which they begin. As a consequence, paragraph 249.1(1)(*b*) is amended so that a fiscal period of an electing trust may straddle the end of a calendar year.

ITA
132.11(2) and (3)

Subsection 132.11(2) and (3) of the Act adjust the income of an electing trust for a particular taxation year that ends on December 15 of a calendar year to take into account the trust's interests in each partnership with a fiscal period that ends in the last 16 days of that calendar year and in each other trust that has a taxation year that ends in the same 16 days. An electing trust's share of partnership income and losses and its shares of different types of trust income are reallocated to the particular taxation year in these circumstances.
The purpose of subsections 132.11(2) and (3) is to limit the income deferral that would otherwise be available to electing mutual fund trusts as a consequence of having a December 15 year end.

ITA
132.11(4) and (5)

Under the existing income tax rules, a deduction is available for a trust under subsection 104(6) of the Act in connection with a distribution of income to a unitholder in a taxation year only if the distribution was made in the year or made payable before the end of the year. Such a distribution is included under subsection 104(13) in computing the income of the unitholder. Under subsection 52(6) of the Act, the unitholder's right to such a distribution (or to a right to a distribution out of capital gains for a taxation year acquired in the year) generally has a cost equal to the amount of the distribution.

Because of subsection 52(6), no capital gain generally arises because of the satisfaction of such a right (i.e., by receiving the payment). New subsection 132.11(4) applies where a particular taxation year of an electing trust ends on December 15 of a calendar year. In this circumstance, each amount paid, or made payable, by a trust beneficiary until the end of the calendar year is deemed to have been paid or payable to the beneficiary at the end of the particular year for the purposes of subsections 52(6) and 104(6) and (13) and for the purpose of subsections 132.11(5) and (6). This rule:

- allows income paid or payable to unitholders between December 16 and December 31, inclusive, of a calendar year to give rise to a deduction under subsection 104(6) for the electing trust for the particular year and a corresponding income inclusion under subsection 104(13) for the unitholders; and

- ensures that subsection 52(6) applies so that there is no capital gain from the disposition of a unitholder’s right to an amount paid out of income or a capital gain.

New subsection 132.11(5) applies in the event that a unitholder at the time an amount was paid (or made payable) by an electing trust for a taxation year was not a unitholder of the trust at the end of the year. Where this is the case because the unitholder did not exist (for example, the unitholder might be the estate of an individual who died shortly after the end of the year), the unitholder is deemed to exist at the end of the year and its first taxation year is extended back to include the end of the year. In addition, the unitholders at the time an amount was paid (or made payable) for a taxation year are deemed to be unitholders at the end of the year in order to make it clear that income can be allocated to these unitholders.

ITA
132.11(6) to (8)

New subsection 132.11(6) of the Act allows any mutual fund trust, as well as any electing trust with a December 15 year end, to choose an amount designated by it for a taxation year to be added in computing its income for the year. Note, however, that for administrative simplicity new subsection 132.11(6) does not apply for a taxation year if the trust has designated an amount under subsection 104(13.1) or (13.2) for the year.

The amount added in computing a trust's income under subsection 132.11(6) for a taxation year can be flowed-through to unitholders, to the extent that the amount is allocated to unitholders as income in the trust's tax return for the year and is in respect of amounts paid or payable in the year to unitholders (including amounts deemed by subsection 132.11(4) to be paid or payable). The amounts so paid or payable are treated as ordinary income distributions for the purposes of subsection 52(6) and subsections 104(6) and (13).

Subject to the anti-avoidance rule in subsection 132.11(8), subsection 132.11(7) allows the additional income allocated by a trust to its unitholders under subsection 132.11(6) for a taxation year to be deducted in computing the trust's income for the following year.

Subsection 132.11(8) provides that the deduction under 132.11(7) is not available for a taxation year where it is reasonable to consider that the designation under subsection 132.11(6) for the preceding taxation year was part of a series of transactions or events that included a change in the composition of unitholders under the trust. This might be the case, for example, where there has been an increase over the two taxation years in the percentage of units held by taxable investors after unusually large amounts of income had been flowed-through to tax-exempt investors as a consequence of the designation under subsection 132.11(6).

It will be up to each trust to determine the extent to which amounts are designated under subsection 132.11(6) and allocated to unitholders. In general, it is expected that a mutual fund trust would only designate an amount under subsection 132.11(6) if its tax payable for the year is nil (after taking into account the income inclusion from the designated amount and netting out its capital gains refund under subsection 132(1)). This would be the case for a mutual fund trust if, without reference to subsection 132.11(6), it has made an "overdistribution" for a taxation year (i.e., a distribution beyond the level required for its income tax payable for the year, net of the capital gains refund, to be nil).

Example of Operation of Section 132.11

A balanced mutual fund elects to have a taxation year of January 1, 1998 to December 15, 1998. The calculations below indicate how it is expected that the fund will compute its income for that year, taking into account the operation of section 132.11.

1. Step 1: Calculate income for that year from each source, before taking into account distributions and subsection 132.11(6).

	a. Dividends	b. Taxable Capital Gains	c. Other Income	d. TOTAL
1. Gross income	$11,070	$16,118	$20,000	$47,188
2. Add share of partnership income, as per ss.132.11(2). – **NOTE: This amount is ignored in computing income for the 1999 taxation year.**			50	50
3. Subtract total expenses in accordance with existing Revenue Canada administrative policy.	0	1,950	20,050	22,000
4. Net income before distributions and ss. 132.11(6) (lines 1 and 2, minus line 3).	$11,070	$14,168	0	$25,238

Step 2: Determine income and capital gains to be distributed, before taking into account subsection 132.11(6).

5. Dividends to be distributed–line 4a	$11,070
Capital gains to be distributed:	
6. Add grossed-up taxable capital gains (line 4b x 4/3)	18,891
7. Subtract capital gains assumed to be required to be retained by the trust to maximize the capital gains refund.	14,000
8. Optimal capital gains to be distributed–line 6 minus line 7.	$ 4,891

Step 3: Distribute to unitholders of record as of December 18, 1998.

9. Total to be distributed– line 5 plus line 8	$15,961
10. Actual distribution assumed to be made.	16,500
11. Overdistribution subsequently calculated (line 10 minus line 9), for which election is made under ss.132.11(6).	$ 539

Step 4: Summary of Information in Trust Return

12. Income before distributions and ss.132.11(6) –line 4d	$25,238
13. Add subsection 132.11(6) amount–line 11	539
14. Subtract dividend distributions–line 5	11,070
15. Subtract 75 per cent of capital gain distributions (line 8)	3,668
16. Subtract overdistribution (line 11), assuming full allocation of overdistribution made to unitholders	539
17. Total – Income of the trust for the year	10,500
18. Federal tax of trust for the year (line 17 x 29 per cent)	3,045
19. Assumed federal capital gains refund	3,045
20. NET FEDERAL INCOME TAX (line 18 minus line 19)	$ NIL

Step 5: T3 supplementaries issued to unitholders for 1998

21. Taxable dividends (line 5)	$11,070
22. Capital gains (line 8)	4,891
23. Other income (line 11) **–NOTE: This amount is deductible pursuant to ss.132.11(7) in computing the fund's income for the 1999 taxation year.**	$539

Clause 58

Becoming or Ceasing to be a Financial Institution

ITA
142.6(1)(*a*)(i)

Subsection 142.6(1) of the Act contains rules that apply where a taxpayer becomes, or ceases to be, 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.

Under paragraph (*b*) of the definition "financial institution" in subsection 142.2(1), a "financial institution" generally includes a trust more than 50 per cent of the fair market value of all interests in which are held by one or more financial institutions. However, mutual fund trusts are excluded under paragraph (*d*) of the definition.

Subparagraph 142.6(1)(*a*)(i) is amended, effective after 1997, to clarify that this year-end rule does not interfere with the operation of subsection 132(6.1). Subsection 132(6.1) treats a trust as a mutual fund trust from its inception where certain conditions are satisfied. This amendment, which is consequential to amendments to subsection 132(6.1), ensures that financial institutions will continue to be able to provide seed capital to start-up trusts without jeopardizing the status of those trusts at their inception as mutual fund trusts.

Clause 59
Saskatchewan Pension Plan – Spousal Transfers

ITA
146(21)

Subsection 146(21) of the Act provides for the tax-free transfer of amounts from prescribed provincial pension plans. In particular, it allows a lump sum amount to be transferred on behalf of a plan member directly from the plan to a registered retirement savings plan or registered retirement income fund under which the member is the annuitant or to acquire for the member an annuity described in paragraph 60(*l*). In addition, it allows such transfers on behalf of a spouse or former spouse of a plan member who becomes entitled to an amount under the plan as a consequence of marriage breakdown or death of the member. Subsection 7800(1) of the Regulations prescribes the Saskatchewan Pension Plan for this purpose.

Subsection 146(21) is amended so that an amount to which a spouse or former spouse of a prescribed provincial pension plan member becomes entitled under the plan on marriage breakdown or death of the member can also be transferred to the spouse's account under the plan.

This amendment applies to transfers made after 1994.

Clause 63.1

Assessments

ITA
152(3.1)

Subsection 152(3.1) of the Act defines the expression "normal reassessment period" for the purposes of various provisions in section 152. The subsection is being amended to add a reference to new subsection 152(9) in respect of appeals disposed of after Royal Assent.

ITA
152(9)

New subsection 152(9) of the Act is intended to ensure that the Minister of National Revenue may advance alternative arguments in support of an income tax assessment after the normal reassessment period has expired. This amendment is proposed in light of remarks by the Supreme Court of Canada in the case of The Queen v. Continental Bank of Canada to the effect that the Crown is not permitted to advance a new basis for assessment after the limitation period has expired.

The limitations found in paragraphs 152(9)(*a*) and (*b*) are intended to import the Court protection afforded to taxpayers that an alternative argument cannot be advanced to the prejudice of the right of a taxpayer to introduce relevant evidence to rebut the argument.

Subsection 152(9) is subject to other limitations in the Act, including subsection 152(5) which prevents the Minister from including amounts in a taxpayer's income which were not included prior to the expiration of the taxpayer's normal reassessment period.

This subsection applies to appeals disposed of after Royal Assent.

Clause 69

Labour-Sponsored Venture Capital Corporations – Recovery of Credit

ITA
204.82(2.1) and (2.2)

Subsection 204.82(2) of the Act imposes a tax on a labour-sponsored venture capital corporation (LSVCC) that has been registered under Part X.3 where, at any time after the fifth taxation year of the LSVCC that ends after it first issues Class A shares, it fails to meet a required level of eligible investment. This level, at any time in a particular taxation year, is 60 per cent of the lesser of two specified amounts: the LSVCC's shareholders' equity at the end of the preceding taxation year and its shareholders' equity determined at the end of the particular year (in both cases determined without taking into account any unrealized gains or losses on its eligible investments). If there is an investment shortfall (as defined by subsection 204.82(2.1)) at any time in a month, the LSVCC is required to pay a tax in respect of the month equal to the greatest such shortfall in the month multiplied by 1/60th of the prescribed rate of interest in effect for the month. Investment shortfalls in 12 consecutive months result in larger taxes and penalties (representing a recovery of federal LSVCC tax credits) applying under subsections 204.82(3) and (4).

Paragraph(*a*) of the description of A in subsection 204.82(2.1) is amended so that each of the above specified amounts in respect of an

LSVCC's current or preceding taxation year is reduced by a "specified adjustment" in respect of the LSVCC's shareholders' equity at the end of the current or preceding year, as the case may be. Under new paragraph 204.82(2.2)(*c*.1), the specified adjustment in respect of shareholders' equity in an LSVCC at the end of a taxation year is determined as follows:

- First, determine the shareholders' equity in the LSVCC at the end of the year.

- Second, using fair market values as of the end of the year, determine the portion of that shareholders' equity represented by pre-March 6, 1996 Class A shares outstanding for more than five years, post-March 5, 1996 Class A shares outstanding for more than eight years, Class A shares issued in the last 60 days of the year AND (where the LSVCC elects) shares of classes approved by the Minister of Finance in accordance with clause 204.81(1)(*c*)(ii)(C). (Note: It is proposed that, where an LSVCC does so elect for a taxation year, the LSVCC will not be an "eligible corporation" under Part LI of the Regulations after the sixth month after the year until the end of the sixth month after the end of the next year. This would mean that acquisitions of shares in the capital stock of the electing LSVCC would not be eligible to earn additional foreign property room pursuant to paragraph 206(2)(*c*).)

- Finally, subtract from the amount determined immediately above an amount by which shareholders' equity has already been reduced to take into account any expected subsequent redemption of shares. (Note: Existing paragraph 204.82(2.2)(*b*) affects the calculation of this amount.)

For the purposes above, subsection 204.82(2.2) has been amended to ensure that the rules for determining shareholders' equity set out in paragraphs 204.82(2.2)(*a*) to (*c*) apply.

Subsection 204.82(2.1) is also amended so that the investment shortfall of an LSVCC at any time in a taxation year is reduced to take into account the unrefunded portion of any taxes or penalties paid by the LSVCC before that time under subsection 204.82(3) or (4) and of any prescribed taxes and penalties paid by the LSVCC. In this regard, it is contemplated that corresponding provincial taxes and penalties will be prescribed in the event that corresponding taxes and penalties result in any material difference in the calculation of the investment shortfall.

These amendments apply to taxation years that begin after 1997.

Clause 70

Refunds for Federally-Registered LSVCCs

ITA
204.83(1)

Subsection 204.83(1) of the Act provides that Revenue Canada must refund 100 per cent of the tax payable by an LSVCC under subsection 204.82(3) and 80 per cent of the penalty payable by it under subsection 204.82(4) where, throughout any 12-month period that begins after the 12-month period in respect of which the tax became payable, it has maintained the required level of eligible investments. Revenue Canada would be expected to make this refund after the LSVCC files a tax return for the taxation year in which the second 12-month period ended.

Subsection 204.83(1) is amended to allow an LSVCC earlier access to the refund. The Minister is required to make the refund on or before the later of:

- the 30th day after receiving the application for the refund; and

- the 60th day after the end of the second 12-month period.

This amendment applies from the day on which Royal Assent to the enacting legislation is given, but applications for refunds under this subsection are treated as having been received no earlier than that day.

Clause 72

Payments Under RESPs – Charging Provision

ITA
204.94(2)

Subsection 204.94(2) of the Act sets out a special 20-per-cent tax on "accumulated income payments" from RESPs. Subject to a $40,000 lifetime limit, the tax can generally be reduced to the extent that the recipient of an accumulated income payment makes deductible RRSP contributions under subsection 146(5) or (5.1) for the year in which the payment is made.

Subsection 204.94(2) is amended in two ways. First, it is amended to reduce the tax rate from 20 per cent to 12 per cent where a parallel tax is payable by the recipient under a law of the province of Quebec. This amendment applies from the time of the introduction of subsection 204.94(2) (i.e., the 1998 and subsequent taxation years).

Second, it is amended to increase the $40,000 lifetime limit to $50,000, which will provide additional flexibility to individuals with limited resources attempting to save for both education and retirement. This amendment applies to 1999 and subsequent taxation years.

Clause 78

Designations and Allocations

ITA
220(3.21)

Subsections 220(3.2) to (3.7) of the Act allow for the late filing, amendment and revocation of certain elections made by taxpayers or partnerships. Subsection 220(3.21) provides that these measures apply to designations in forms prescribed for the purposes of the debt forgiveness rules in section 80 and subsection 80.03(7).

Subsection 220(3.21) is amended so that the rules in subsections 220(3.2) to (3.7) also apply in connection with designations and allocations under subsection 132.11(6).

This amendment applies from the day on which Royal Assent is given to the enacting legislation.

Clause 79

Transfer Pricing – Exclusion for Loans to Certain Controlled Foreign Affiliates

ITA
247(7)

Section 247 of the Act provides rules concerning transfer pricing and related matters.

Subsection 247(7) of the Act exempts loans described in subsection 17(3) of the Act – that is, loans made by a corporation resident in Canada to a non-resident subsidiary controlled corporation – from the application of the transfer pricing adjustment in subsection 247(2) of the Act.

The amendments to subsection 247(7) are consequential to the amendments to section 17 of the Act. Amended subsection 247(7) provides that where a non-resident person owes an amount to a corporation resident in Canada, the non-resident person is a controlled foreign affiliate of the corporation for purposes of section 17 and the amount owing is an amount owing described in either paragraph 17(8)(*a*) or (*b*), subsection 247(2) will not apply to adjust the amount of interest paid, payable or accruing in the year on the amount owing.

Subsection 247(7) permits a corporation resident in Canada to make an interest-free loan to a controlled foreign affiliate of the corporation or to charge no interest on an amount owing by a controlled foreign affiliate without 247(2) applying to deem interest to be payable on the amount owing, provided that the affiliate uses the money to earn active business income or the amount owing arose in the course of an active business carried on by the affiliate. Of course, while subsection 247(2) will not apply to the interest payable in such a case, it could still apply to any other term of the transaction. For example, subsection 247(2) could apply to adjust the amount that is actually owing where, for example, the amount owing is the unpaid purchase price of goods sold to the non-resident and the purchase price agreed to between the parties to the sale is not one that persons dealing at arm's length would have agreed to.

Amended subsection 247(7) applies to taxation years that begin after February 23, 1998.

Clause 80

Definitions

ITA
248(1)

"home relocation loan"

Before the 1998 budget, case law had indicated that certain employer-provided mortgage interest subsidies were not taxable benefits and were not described in subsection 80.4(1) of the Act. The provisions relating to home relocation loan benefits (new subsection 80.4(1.1)) introduced in the 1998 budget reversed this position. However, transitional relief was provided in respect of the change.

Loans provided in respect of eligible relocations that occurred before October 1998, continue to be subject to the previous regime until the end of the 2000 taxation year.

After that, section 80.4 will apply to determine the taxable benefit associated with these loans. At that time, taxpayers may claim the partial offsetting deduction available for home relocation loans under paragraph 110(1)(*j*) of the Act.

Under the existing definition "home relocation loan", the loan must be received "in the circumstances described in subsection 80.4(1)". Because of the case law holding that 80.4(1) did not apply to some of these loans, in conjunction with the sunsetting transitional relief, it is possible that some of these loans would not meet the definition “home relocation loan” and that no partial offsetting deduction would be available in these circumstances.

The definition “home relocation loan” is therefore amended to provide that the loan must either have been received in the circumstances described in subsection 80.4(1), or would have been so received if subsection 80.4(1.1) had applied to the loan at the time it was received.

This amendment applies after February 23, 1998.

Clause 81

Definition of “taxation year”

ITA
249.1(1)(*b*)(i) and (i.1)

Subsection 249.1(1) of the Act is amended as a consequence of the introduction of the rules in new subsection 132.11(1) to allow mutual fund trusts to elect to have a December 15 taxation year end.

For further information, see the commentary on new subsection 132.11(1) of the Act.

Clause 84

Definitions

Income Tax Conventions Interpretation Act
5

Section 5 of the Act defines a number of terms both for the purpose of interpreting Canada’s tax conventions ("tax treaties") and for the purpose of applying the Act itself. Several of these terms are amended, with application to amounts paid after 1996, to ensure that the tax conventions deal as intended with various sorts of income. It should be noted that, under this amendment, "annuity" excludes any payment from any of the various types of plan listed in the definition "pension," whether or not the payment itself falls within that definition.

"annuity"

The definition "annuity" is amended to provide that no pension payment is an annuity. This amendment is made possible by the clarification of what a "pension" is, as described below.

"periodic pension payment"

The existing definition "periodic pension payment" excludes certain pension payments arising in Canada. The definition does not, however, provide clear positive guidance as to what a periodic pension payment is. This amendment improves the definition by clarifying that a periodic pension payment is, where the payment arises in Canada, any pension payment other than one of the excluded payments. The amendment thus relies on the new definition of "pension," described below.

"pension"

Subsection 5.1(1) of the Act currently defines "pension", but does so only to the extent of including certain payments arising in Canada, and only for the purposes of the existing definitions "annuity" and "periodic pension payment". That partial definition is replaced by a definition, in section 5, that applies both to the Act and to the conventions.

This new definition provides that, in respect of payments arising in Canada, the meaning of "pension" depends on the terms of the convention under consideration. If the convention does not itself define "pension", paragraph (a) of the new definition applies. Under paragraph (*a*), a pension is a payment under any of a list of plans and arrangements – including registered pension plans, RRSPs, RRIFs, and so on – that would ordinarily be considered pension or retirement plans under Canada's domestic system.

If the convention does define "pension," paragraph (*b*) applies. Under paragraph (*b*), a pension is not only a payment included in the convention's definition, but also a periodic payment under any of the plans listed in paragraph (*a*). Mechanically, this effect is achieved by including in "pension" under paragraph (*b*) any payment (other than of social security benefits) that would be a "periodic pension payment" if the paragraph (*a*) meaning of "pension" were used (as it would be if the convention did not define "pension").

These amendments apply to amounts paid after 1996.

Clause 85

Definition of "pension"

Income Tax Conventions Interpretation Act
5.1(1)

Subsection 5.1(1) of the Act provides a limited definition of "pension." As discussed above, this definition is replaced with a more complete definition in section 5 of the Act. The repeal of subsection 5.1(1) applies with respect to amounts paid after 1996.

Clause 86

Gains arising in Canada

Income Tax Conventions Interpretation Act
6.3

New section 6.3 of the Act confirms that income, gains or losses on taxable Canadian property are considered to arise in Canada, unless a convention expressly provides otherwise.

Under some conventions, one country can tax certain amounts realized by residents of the other country if the amounts "arise in" the first country. The *Income Tax Act* subjects non-residents to Canadian tax on their gains on "taxable Canadian property." New section 6.3, which applies to dispositions that occur after February 23, 1998, makes the relationship between these two principles more explicit.

Clause 91

Foreign Reporting – Information Returns

S.C. 1997, c.25
ITA 69(3)

Subsection 69(3) of the *Income Tax Budget Amendments Act, 1996* generally requires that the filing, under sections 233.3 and 233.6 of the *Income Tax Act*, of foreign property information returns by specified Canadian entities be done for taxation years and fiscal periods that begin after 1997. Subsection 69(3) further provides that a return for a year or period that ends in 1996, 1997 or 1998 is required to be filed on or before the later of the day on or before which the return is otherwise required to be filed and April 30, 1998.

The subsection is amended to deal only with section 233.3 of the *Income Tax Act*. It now provides that such returns do not have to be filed for taxation years and fiscal periods that ended before 1998. The subsection is also amended to give legislative effect to the October 2, 1997 joint announcement by the Minister of National Revenue and the Minister of Finance that the Government would postpone for one year (to April 30, 1999) the deadline for first reporting the holding of foreign investment property, while the Auditor General examined this reporting requirement.

The coming into force for the filing, under section 233.6 of the *Income Tax Act*, of foreign property information returns by specified Canadian entities that are beneficially interested in non-resident trusts is reflected in new subsection 69(3.1) of the *Income Tax Budget Amendments Act, 1996*. The new subsection still provides that the first of such returns be filed for taxation years and fiscal periods that begin after 1995, and that the deadline for filing returns for 1996, 1997 and 1998 is still April 30, 1998. However, subsection 69(3.1) also provides that, with respect to returns for 1996, 1997 and 1998 in respect of taxation years and fiscal periods that began before 1998, subsection 233.6(2) is to be read without reference to paragraph 233.6(2)(c). It further provides that, for returns for taxation years and fiscal periods that began after 1995 and before 1998, the reference to "specified Canadian entity" in subsection 233.6(1) has the meaning assigned that expression by subsection 233.3(1), notwithstanding that the provisions of section 233.3 are not in force for taxation years and fiscal periods that begin before 1998.

These amendments are deemed to have come into force on April 25, 1997, being the day on which the *Income Tax Amendments Act, 1996* received Royal Assent.

Clause 92

Investment Corporations

Section 130 of the *Income Tax Act* sets out rules that apply to investment corporations and their shareholders.

Subclause 92(1)

Definition of Investment Corporation

ITA
130(3)(*a*)

Paragraph 130(3)(*a*) of the Act sets out the conditions under which a corporation is considered to be an investment corporation. Among those conditions is, in subparagraph 130(3)(*a*)(vii), a requirement that no person have been a specified shareholder of the corporation in the year if the percentage threshold in the definition "specified shareholder" in subsection 248(1) of the Act were read as "more than 25 per cent" rather than "not less than 10 per cent". Under paragraph (*a*) of the definition, a taxpayer is deemed to own shares owned by any person with whom the taxpayer does not deal at arm's length.

This amendment modifies the specified shareholder concept in this context in a manner substantially similar to that used for mortgage investment corporations in paragraph 130.1(6)(*d*) of the Act. Specifically, a taxpayer will only be deemed to own shares owned by persons with whom the taxpayer is related. For this purpose, the definition "related persons" in section 251 of the Act is narrowed so that an individual will be considered to be related only to the individual's spouse, minor children and grandchildren, and corporations controlled by such persons, the individual, or a related group that includes such persons or the individual. This narrowed group with reference to an individual effectively limits the circumstances in which the two corporations will be related for the purposes of these rules. Paragraph (*d*) of the definition "specified shareholder", which is not relevant to investment corporations, is not incorporated for this purpose.

This amendment generally applies to taxation years that begin after June 20, 1996, the first period for which the specified shareholder concept was incorporated into paragraph 130(3)(*a*) of the Act pursuant to the *Income Tax Amendments Act, 1997*, ("ITAA 1997"). Transitional relief was provided in ITAA 1997 for corporations that were investment corporations on June 20, 1996 and that had one or more shareholders ("existing 26-per-cent specified shareholders") who would otherwise violate the new share limit. Those transitional provisions are modified by the present amendments.

Subclause 92(2)

Transitional Rules

ITAA 1997
155(4)

Since these amendments narrow the scope of the specified shareholder concept as applied to ownership limits in investment corporations, they reduce the class of persons eligible for transitional relief from the new share limit under ITAA 1997. Therefore, new subparagraph 155(4)(*c*)(ii) of ITAA 1997 extends transitional relief to a shareholder who was not a specified shareholder on June 20, 1996, but would have been given relief under the broader definition of "specified shareholder" in ITAA 1997. Relief is provided if such a shareholder complied with the requirements in ITAA 1997, yet at some time in the period between June 20, 1996 and August 14, 1998 was not in compliance with the limit under the revised narrower definition. For example, such a shareholder might not otherwise meet the new limit if the proportion of shares deemed to be held under the new test increased to be above 25 per cent during the period after June 20, 1996 and before August 14, 1998 as a result of:

- redemption of shares held by non-related shareholders; or

- acquisitions of shares from persons who were related in the broader sense used in ITAA 1997, but not in the narrower sense used in the present amendments.

New subsection 155(11) of ITAA 1997, added by subclause 92(5), assigns “specified shareholder” the same meaning for the purposes of the transitional provisions that it is given by subparagraph 130(3)(*a*)(vii) of the *Income Tax Act.*

Subclauses 92(3) and (4)

ITAA 1997
155(5) and (8)

Subsection 155(8) of ITAA 1997 allows an existing 26-per-cent specified shareholder to acquire shares from related persons without losing its transitional exemption from the new share limit. This provision is repealed by subclause 92(4). In its place, the general conditions for transitional relief in subsection 155(5) of ITAA 1997 are modified by subclause 92(3) to provide an exception from the prohibition on acquisition of shares for “permitted acquisitions”. This term is defined in new subsection 155(11) of ITAA 1997, which is added by subclause 92(5).

Subclause 92(5)

ITAA 1997
155(10) and (11)

Subclause 92(5) adds, to ITAA 1997, new subsections 155(10), dealing with estates, and (11), containing definitions.

New subsection 155(10) of ITAA 1997 extends transitional relief for a three-year period to shares in an investment corporation received by the estate of an existing 26-per-cent specified shareholder upon the shareholder’s death. For three years from the date of death, the estate itself is deemed to be an existing specified shareholder. The estate is also deemed to be related to each person who, throughout the period from June 20, 1996 to the time of death, was related to the deceased person. This ensures that a bequest of shares by the deceased to a related person in what would otherwise be a "permitted acquisition" within the terms of the definition in subsection 155(11) of ITAA

1997 does not prejudice the transitional relief by reason of the shares passing through the estate. However, so as not to offend the rule in subsection 155(6) of ITAA 1997, the estate is deemed not to be a newly-related person.

Also, to preserve the transitional relief, the acquisition of shares by the estate from the deceased is deemed to be a permitted acquisition. The estate is also deemed for the three-year period not to be a trust for the purposes of subparagraph 155(9)(*a*)(i) of ITAA 1997. This ensures that shares received by a beneficiary of the estate from the estate are considered to be received by the beneficiary only when actually received. Likewise, the estate is deemed not to be a trust for the purposes of paragraphs (*b*) and (*e*) of the definition "specified shareholder" in subsection 248(1) of the *Income Tax Act*. This ensures that for the three-year period, shares held by the estate are not attributed to the estate's beneficiaries under the look-through rules in that definition.

In a “permitted acquisition,” as defined in new subsection 155(11) of ITTA 1997, an existing 26-per-cent specified shareholder acquires shares from a related person (as defined in that subsection) or by way of a stock dividend (issued to either the specified shareholder or a related person). For this purpose, a related person must have been related to the specified shareholder throughout the period from June 20, 1996 to the time the share was acquired. A general condition of a permitted acquisition is that immediately after the acquisition, the percentage of shares of the particular class held by the particular person and related persons not exceed the “permitted percentage”, also defined in subsection 155(11).

For the purposes of the transitional provisions in ITAA 1997, subsection 155(11) gives “related persons” the same special meaning it is given for the purpose of the revised share limit in subparagraph 130(3)(*a*)(vii) of the *Income Tax Act*. Since ITAA 1997 used “related” in the sense it has for the general purposes of the *Income Tax Act*, that broader meaning will apply for the tests applicable to share acquisitions that take place on or after June 20, 1996 and before August 14, 1998. Thus, “permitted acquisitions” before August 14, 1998 are acquisitions from persons related in the broader sense, while those on or after that date are acquisitions from persons related in the narrower sense.

“Permitted percentage,” in the case of share acquisitions on or after June 20, 1996 but before August 14, 1998, is defined to mean the greatest percentage of the shares of any class of the corporation's capital stock that was held at the end of June 20, 1996 by the particular person and persons with whom the person did not at that time deal at arm's length. By contrast, in the case of share acquisitions on or after August 14, 1998, the “permitted percentage” is the greater of the greatest percentage held at the end of June 20, 1996 and the greatest percentage held at the beginning of August 14, 1998, in both cases by the person and related persons (in the narrower sense). This formulation ensures that the threshold for intra-group trading by an existing 26-per-cent specified shareholder takes into account trading during the period between June 20, 1996, the date of the original Notice of Ways and Means Motion for this measure, and August 14, 1998, when taxpayers may have relied on the broader test set out in ITAA 1997.