RECENT DEVELOPMENTS IN CORPORATE TAXATION

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A large number of amendments to the Income Tax Act (Canada) have been made or proposed during the past year, many of which affect how corporations will conduct acquisitions and mergers in the future. The paper reviews certain of those amendments which will affect corporations engaged in the petroleum industry.

During the past year, a number of amendments to the Income Tax Act (Canada) have been proposed or enacted which have had a direct effect on corporate taxpayers, including corporations engaged in the petroleum and natural gas industry. The purpose of this paper is to summarize the effect of certain of those amendments which were announced on January 15, 1987 and in the federal budget of February 18, 1987.

This paper was originally delivered at the Canadian Petroleum Law Foundation Conference in Jasper, Alberta on June 12, 1987. On June 9, 1987, first reading was given in the House of Commons to Bill C-64, An Act to amend the Income Tax Act, a related Act, the Canada Pension Plan and the Unemployment Insurance Act, 1971. Bill C-64 contains all of the amendments discussed herein, but because the Bill has amended many of the proposals, the paper was updated to take into account the changes made by the Bill.

I. PROPOSED AMENDMENTS RELATING TO TRADING IN TAX LOSSES

On January 15, 1987, the Minister of Finance issued a press release[1] outlining a series of draft amendments to the Income Tax Act (Canada)[2] (the "Act") which were introduced to limit transfers of losses, tax deductions, tax credits and cost base of assets between unrelated corporate taxpayers. The press release indicated that the Minister had become aware of a variety of loss-trading transactions motivated largely or exclusively to avoid tax and that "as a matter of tax fairness, it is necessary to introduce legislation to make it clear that such transactions will not be accepted as a means of avoiding payment of taxes that are properly owing". The press release indicated the Minister's commitment to prevent the "inappropriate transfer of unusable tax deductions and credits to unrelated taxpayers", and also indicated that the government was examining whether similar amendments ought to be made relating to the use of partnerships and trusts that might be established to circumvent the new rules.

Attached to the January 15, 1987 press release was draft wording of the proposed amendments along with a set of Technical Notes prepared by the Department of Finance which usefully attempt to outline the perceived abuses sought to be corrected by the proposed amendments. All of the proposals are contained in Bill C-64, but in many cases the wording of the amendments has been altered or the numbering has been changed from the January 15, 1987 draft. Nevertheless, most of the proposals will, when enacted, take effect from January 15, 1987.

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1. Department of Finance Release No. 87-09, dated 15 January 1987.
2. Income Tax Act, S.C. 1970-71-72, c. 63 as am. (referred to herein as "ITA").

The January 15, 1987 amendments, as restated by Bill C-64, are designed to restrict the opportunities for acquisition of a corporation with unused tax shelter by a purchaser who might use the tax shelter to reduce his or its own income, or to create further losses which might result in a refund of previously paid taxes by the target corporation. The proposed amendments therefore have the effect of tainting or in some cases eliminating the tax shelter that may exist within a corporation at the time of an acquisition of control of that corporation.

A. NEW SUBSECTION 249(4): ACQUISITION OF CONTROL WILL CAUSE TAXATION YEAR-END

> 249(4) Where, at any time, control of a corporation has been acquired by a person or group of persons, the following rules apply:
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> (a) except where paragraph (c) applies, the taxation year of the corporation that would, but for this paragraph, have included that time shall be deemed to have ended immediately before that time;
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> (b) a new taxation year of the corporation shall be deemed to have commenced at that time;
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> (c) subject to paragraphs 88.1(c), 128(1)(d) and 149(10)(a), and notwithstanding subsections (1) and (3), where the last taxation year of the corporation ending before that time exceeds seven days and would, but for this paragraph, have ended within the seven day period ending at that time, that taxation year shall be deemed to end immediately before that time where the corporation so elects in its return of income under Part I for that taxation year; and
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> (d) for the purpose of determining the corporation's fiscal period after that time, the corporation shall be deemed not to have established a fiscal period before that time.

Proposed new subsection 249(4) will have the effect of triggering a taxation year-end of a corporation upon acquisition of control of the corporation. Specifically, the subsection will provide that where control of a corporation has been acquired, the taxation year of the corporation in which the acquisition of control occurred will be deemed to end immediately before the change of control, and a new taxation year will be deemed to commence at that time.

This amendment is closely related to the amendments to section 111 which are described below. The main purpose of the amendment is to require a separate determination of the income or losses realized by a corporation for the portion of its fiscal period that is prior to the time when control of the corporation is acquired in order that the loss carry-over restrictions contained in section 111 will be applicable to losses realized and accrued during that portion of the fiscal period, although its effect extends beyond this apparent objective. These concepts are discussed in further detail below, but some additional consequences of the deemed year-end can be appropriately discussed at this point.

(a) The deemed year-end will divide the normal taxation year in which control is acquired into two taxation years. The first of these will be the normal taxation year that commenced at the time the year normally commences and will end immediately prior to the time of the acquisition of control. The second taxation year will commence at the time of the acquisition of control and will end at the time the normal taxation year would end.

For the purposes of this new rule, new subsection 256(9) is to be added to the Act to clarify the timing of the acquisition of control.

256(9) For the purposes of this Act, where control of a corporation is acquired by a person or group of persons at a particular time on a day, control of the corporation shall be deemed to have been acquired by the person or group of persons, as the case may be, at the commencement of that day and not at the particular time unless the corporation elects in its return of income under Part I filed for its taxation year ending immediately before the acquisition of control not to have this subsection apply.

Subsection 256(9) provides that control will be deemed to have been acquired at the *commencement of the day* in which control is acquired, unless the corporation elects that the subsection not apply, in which case control will be treated as having been acquired at the time it *was actually acquired*. Subsection 256(9) will therefore allow the corporation control of which is acquired to choose whether its taxation year in which control is acquired will end at the last moment of the day prior to the day in which control was acquired or will end immediately prior to the actual time when control was acquired, in which case the corporation must so elect.

For example, assume a corporation which has adopted the calendar year as its taxation year undergoes an acquisition of control on July 17, 1987. Its first taxation year in calendar year 1987 will have commenced on January 1, 1987. Unless the corporation elects that the rule in new subsection 256(9) *not* apply, the acquisition of control will, pursuant to that rule, be deemed to occur at the commencement of July 17, 1987, *i.e.* at midnight between July 16th and July 17th. Therefore, new subsection 249(4) will deem the taxation year of the corporation which began on January 1, 1987 to end "immediately before" the acquisition of control, *i.e.* at an instant before midnight on July 16, 1987. A second taxation year will be deemed to commence at midnight. If, however, the corporation were to elect that the rule in subsection 256(9) *not* apply, then the acquisition of control will occur when it actually occurs and the taxation year would be deemed to end "immediately before" the actual time when control was acquired. Presumably, if the effective time of the acquisition of control was 11:00 a.m. on July 17, 1987, being the effective time when property passed in respect of the relevant shareholder interest or interests, the taxation year would be deemed to end at the instant prior to 11:00 a.m. A second taxation year would then be deemed to commence at 11:00 a.m. on July 17, 1987. In either case, the result is two taxation years within one normal fiscal period.

Paragraph (d) of subsection 249(4) will allow the corporation to select a new taxation year. The corporation will therefore be entitled to continue to use the calendar year as its normal taxation year or to select a new fiscal period, for example, one that coincides with the fiscal period of its new parent corporation.

Paragraph (c) of subsection 249(4) will provide that if the normal taxation year of the corporation ended within the 7 day period prior to the time when control was acquired, the corporation may elect to extend that last taxation year so that it ends immediately prior to the acquisition of control. By so doing, the corporation can avoid having two taxation year ends within a period of less than a week. For example, a corporation which has adopted the calendar year as its taxation year and which undergoes an acquisition of control on January 5th may elect to have its taxation year that ended on December 31 extended to end just before midnight on January 4th (or to just prior to the actual time on January 5th when control is acquired where the corporation elects that the rule in subsection 256(9) not apply). This 7 day rule can only apply, however, where the last taxation year was more than 7 days long. Note that if the change of control of a corporation were to occur on the day following its normal taxation year-end, by not electing that the rule in subsection 256(9) not apply, the acquisition of control would be deemed to occur at the end of its normal taxation year, thereby resulting in only one taxation year without an extension of the normal taxation year.

(b) The creation of a taxation year-end results in a number of other consequences which normally arise when a year-end occurs. These would include the filing of tax returns for the year deemed to end at the time of the acquisition of control as well as the payment of taxes for that period, an acceleration of the time for the repayment of shareholder loans under subsection 15(2), a prorating of the capital cost allowance deduction[3] and a prorating of the small business deduction.[4] In addition, Bill C-64 proposes to add new subsection 66(13.1) to the Act which will require the prorating of deductions relating to cumulative Canadian development expense and cumulative Canadian oil and gas property expense where the taxpayer has a taxation year less than 51 weeks in length. Subsection 66(13.1) is to be applicable to taxation years commencing after June 5, 1987.

(c) The creation of an additional taxation year also has the effect of shortening the carryforward and carryback periods of seven years and three years, respectively, that non-capital losses can be carried over pursuant to paragraph 111(1)(a) of the Act. Where non-capital and farm losses are allowed to be carried forward under the amendments proposed to subsection 111(5), as discussed below, the acquisition of control and creation of a taxation year-end essentially means that losses realized in a prior taxation year will be aged by one additional year effectively shortening their carryover period from seven years to six years. Similarly, the carryback period will be shortened from three years to two years. Non-capital or farm losses realized in the taxation year deemed to end immediately prior to the acquisition of control may be carried forward for only six taxation years following the end of the second new taxation year which will end at the normal year-end of the corporation, and non-capital and farm losses of the corporation that are realized in the second taxation year that is deemed to commence at the time of the acquisition of control can be carried back for only two taxation years prior to the commencement of the first taxation year. The point is that the acquisition of control results in an additional taxation year

3. Sub-s. 1100(3) of the Income Tax Regulations, C.R.C. 1978, c. 945 as am.

4. ITA, *supra* n. 2, para. 125(5)(b).

which must be counted in the seven year and three year carryover periods.[5]

These effects which result from the deemed taxation year end occur whether or not the purpose of the acquisition of control is to acquire the loss carryforwards of the target corporation or, indeed, whether the corporation has any losses at all.

B. AMENDMENT TO SUBSECTION 111(5): EFFECT OF ACQUISITION OF CONTROL ON DEDUCTIBILITY OF NON-CAPITAL LOSSES

It is proposed that subsection 111(5) be amended to read as follows:

> 111(5) Where, at any time, control of a corporation has been acquired by a person or group of persons, no amount in respect of its non-capital loss or farm loss for a taxation year ending before that time is deductible by the corporation for a taxation year ending after that time and no amount in respect of its non-capital loss or farm loss for a taxation year ending after that time is deductible by the corporation for a taxation year ending before that time except that
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> (a) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending before that time as may reasonably be regarded as its loss from carrying on a business is deductible by the corporation for a particular taxation year ending after that time
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> (i) only if that business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year, and
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> (ii) only to the extent of the aggregate of the corporation's income for the particular year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services; and
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> (b) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending after that time as may reasonably be regarded as its loss from carrying on a business is deductible by the corporation for a particular taxation year ending before that time
>
> (i) only if throughout the taxation year and in the particular year that business was carried on by the corporation for profit or with a reasonable expectation of profit, and
>
> (ii) only to the extent of the corporation's income for the particular year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services.

Paragraph 111(1)(a) of the Act allows a taxpayer to carry a non-capital loss realized in a taxation year ahead for deduction against taxable income earned over the next seven taxation years and back for deduction against taxable income earned during the previous three taxation years. A "non-capital loss" is essentially a loss from a business, a loss realized in the course of earning income from property, a loss from an office or employment or an allowable business investment loss, determined in each

5. Unless the rule in sub-s. 256(9) or the application of the 7 day rule in para. 249(4)(c) were to prevent the creation of an extra taxation year.

case under paragraph 111(8)(b).[6] Farm losses, as defined in paragraph 111(8)(b.1), can be carried forward for ten subsequent years and back for three previous years.[7] Subsection 111(5) currently restricts the deductibility of non-capital losses and farm losses that were realized in taxation years that ended prior to, or commenced following, the acquisition of control but has no application to losses realized during the taxation year in which the acquisition of control occurs. The proposed amendment to subsection 111(5) would have the following effects.

(a) Upon acquisition of control of a corporation, none of its non-capital losses and farm losses for taxation years ending prior to the acquisition of control, including losses realized in the taxation year deemed to end immediately prior to the acquisition pursuant to new subsection 249(4), will be available for carryforward and deduction by the corporation in any taxation year ending after the acquisition, nor will any of its non-capital losses and farm losses for taxation years ending after the acquisition be available for carryback and deduction in any taxation year ending before the acquisition of control, including the taxation year deemed to end immediately prior to the acquisition, except in the following limited circumstances:

(i) the portion of the corporation's non-capital or farm losses realized in any taxation year that ended prior to the time of the acquisition of control that was realized from the carrying on of a business will be available for carryforward to taxation years ending after the time of the acquisition of control but only if that same business is carried on by the corporation for profit or a reasonable expectation of profit throughout the particular subsequent taxation year and only to the extent of its income from that business; and

(ii) the portion of the corporation's non-capital or farm losses realized in any taxation year that ends after the time of the acquisition of control that is realized from the carrying on of a business will be available for carryback to taxation years ending before that time but only if that same business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular prior taxation year and only to the extent of its income from that business.

In both cases, the corporation's income for a particular taxation year from that business includes, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before the acquisition of control, any income from any other business substantially all the income of which was derived

6. An allowable business investment loss is one-half of a taxpayer's capital loss from a disposition to an arm's length party (or a disposition to which sub-s. 50(1) applies) of shares of a small business corporation or of a debt owing to the taxpayer by a small business corporation, as determined and subject to the rules set out in paras. 38(c) and 39(1)(c) and sub-ss. 39(9) and 39(10) of the Act.

7. Restricted farm losses, being losses of hobby farmers which are restricted under s. 31 of the Act, are also subject to a ten year carryforward and three year carryback but may be applied only against incomes from farming businesses pursuant to para. 111(8)(c).

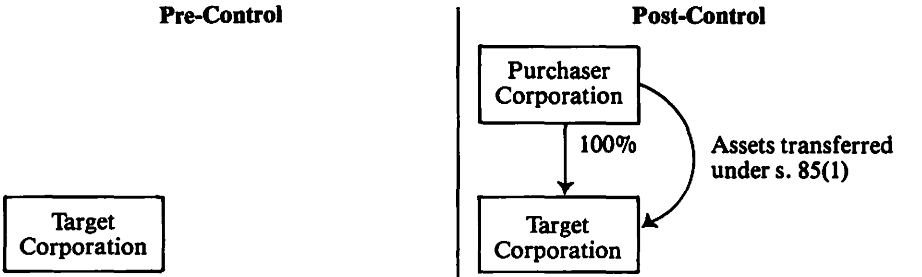
from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services.

(b) When the amendments to subsection 111(5) are analyzed in light of the new deemed year-end provision in subsection 249(4), the result is to restrict the carryover of losses realized in the normal taxation year and prior to the acquisition of control under the same rules as non-capital and farm losses realized in taxation years ending prior to the normal taxation year. That is to say, subsection 111(5) restricts the carryover of non-capital and farm losses realized in taxation years that end prior to the time at which control is acquired, but since currently there is no deemed year-end at that time, losses that are realized *during* the taxation year and prior to the time of acquisition of control are not subject to the carryover restrictions in subsection 111(5). The effect of subsection 249(4) will be to effect a year-end immediately prior to the time control is acquired and, therefore, applying subsection 111(5), non-capital and farm losses realized in the taxation year deemed to have so ended will be losses for a taxation year ending prior to the acquisition of control and will therefore be subject to the restrictions in subsection 111(5).

Similarly, non-capital and farm losses realized by the corporation in that portion of the normal taxation year which is deemed to be a new taxation year commencing at the time of the acquisition of control will be losses for a taxation year ending after the acquisition and will be subject to the carryback restrictions in subsection 111(5).

For example, suppose Target Corporation has adopted the calendar year as its taxation year and it realizes a non-capital loss in a particular taxation year. Control of Target Corporation could be acquired by Purchaser Corporation in that taxation year and the non-capital loss of Target Corporation realized in that taxation year and prior to the time of acquisition of control would, under current law, be unaffected by subsection 111(5). Following the acquisition,

Assume control of Target Corporation is acquired by Purchaser Corporation on July 17, 1987



-Uses calendar year as taxation year
-Realizes losses during year prior to acquisition of control, i.e. January 1, 1987 to July 17, 1987

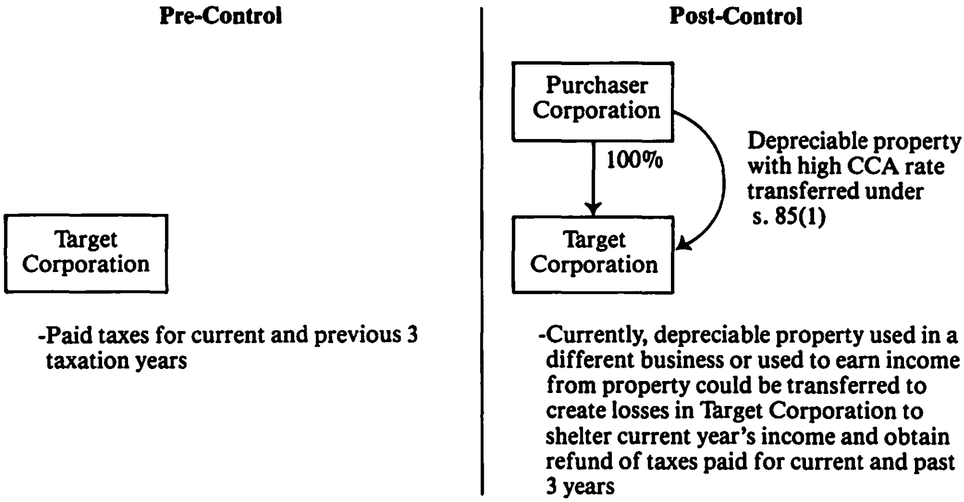
-Currently, assets could be transferred to Target by Purchaser to produce income in Target to be sheltered by current year losses of Target
-New rules will allow this to occur only if income is from same business as loss was realized

Purchaser Corporation could transfer any income producing assets to Target Corporation (using a subsection 85(1) election to allow the transfer to occur on a tax-free basis) and Target Corporation would be free to use the non-capital loss to shelter such income. This would apply regardless of whether the assets so transferred produced income from property or from a business, and if from a business, regardless of whether it was the same business in which Target Corporation had realized the loss.

Now subsection 249(4) will deem a taxation year-end to occur immediately before the acquisition of control so that the non-capital loss of Target Corporation realized in the portion of its ordinary taxation year deemed to end just before the acquisition will become a loss of a prior taxation year and will therefore be subject to the rules in subsection 111(5). Therefore, the loss will be available for use by Target Corporation against the income from the assets transferred to it by Purchaser Corporation *only* if the income from those assets is income from a business carried on by Target Corporation and that business was the same business carried on by it in which the non-capital loss was realized.

(c) The amendments to subsection 111(5) also prevent Purchaser Corporation from acquiring Target Corporation and then, in the same taxation year, transferring to Target Corporation depreciable property, eligible capital property or Canadian resource properties thereby allowing Target Corporation to create losses through the deduction of capital cost allowance on the depreciable property, eligible capital deductions in respect of the eligible capital property or Canadian oil and gas property expense in respect of the Canadian resource property (Canadian development expense if the property were a mining resource property). Currently, the losses would be available to shelter other income of Target Corporation realized during that taxation year or the three previous taxation years. There was evidence that this kind of transaction was becoming more popular at the time of the January 15, 1987 announcement.

For example, suppose Target Corporation has an accrued tax liability in its current taxation year for which it has made installment payments and had also paid taxes in each of the three previous taxation years. Following its acquisition by Purchaser Corporation, Purchaser Corporation would be in a position to transfer depreciable property to Target Corporation having a high rate of capital cost allowance thereby allowing Target Corporation to claim capital cost allowance on the depreciable property for the year in which the acquisition occurs. If the capital cost allowance was large enough, it would be sufficient to offset the accrued tax liability for that taxation year and would also allow Target Corporation to obtain refunds of the tax liabilities paid for the three previous taxation years. Indeed, in some cases, transactions were being consummated whereby the vendor of Target Corporation would first strip its assets out under a "butterfly" transaction using the provisions of paragraph 55(3)(b) of the Act and then sell the stripped down corporation to Purchaser Corporation which would inject the tax shelter and eliminate the tax liability of Target Corporation for that current taxation year and obtain a refund for past taxation years. Purchaser Corporation would be paid a fee for sheltering the income of Target Corporation for the current taxation year and would pay a fee for the ability to obtain cash refunds for prior taxation years. The net cash payment changed hands between the vendor of Target Corporation and Purchaser Corporation through the price paid for the shares and/or the amount of any cash left in Target Corporation at the time of acquisition of control.



The amendment to subsection 111(5) together with new subsection 249(4) will prevent this from occurring except where the loss from the injected tax shelter is a non-capital loss from the same business as the business carried on by Target Corporation in the current and the three previous taxation years. This is because subsection 249(4) will provide for a taxation year-end at the time of the acquisition of control such that the loss from the injected shelter will be a loss of a subsequent taxation year which can only be carried back and used against income from prior taxation years (including the one deemed to have ended on the acquisition of control) from the same business.

(d) Currently, subsection 111(5) only applies to restrict the carryover of non-capital losses or farm losses realized from the carrying on of a business. Non-capital losses that are not realized from the carrying on of a business, such as losses from property not used in the course of carrying on a business and losses that are allowable business investment losses, are unaffected by subsection 111(5). For example, if Target Corporation has a non-capital loss from the deduction of interest on monies borrowed to gain or produce income from property, such as stock of a subsidiary, the loss is currently unaffected on an acquisition of control and can therefore be used to shelter income of Target Corporation from any assets that might be transferred to it by Purchaser Corporation.

The revised wording to subsection 111(5) denies the carryover of *any* non-capital loss or farm loss *except* non-capital losses or farm losses realized from the carrying on of a business, which may be carried over in accordance with the rules set out above. The effect of the amendment will be to terminate the carryover of losses from property and allowable business investment losses.

(e) Currently, non-capital and farm losses from the carrying on of a business may be used to shelter net taxable capital gains of Target Corporation realized in the seven year carryforward period from the disposition of property owned by Target Corporation at or before the time of acquisition of control, subject to certain limitations. The amendment to subsection 111(5) would prevent non-capital and farm loss carryforwards from being deducted against such capital gains.

As a related amendment, the rules in subsection 88(1) of the Act which allow non-capital losses, farm losses, restricted farm losses and limited partnership losses of a 90% owned subsidiary corporation to be transferred up to the parent on a winding-up are to be amended to give the same result upon an acquisition of control as under the amendments to subsection 111(5). Paragraph 88(1.1)(e) is to be amended to provide that where control of the subsidiary has been acquired, including by the parent, or control of the parent has been acquired, none of the non-capital or farm losses of the subsidiary for a taxation year ending before the particular acquisition of control, including losses realized in a taxation year deemed to end immediately prior to the acquisition of control of the subsidiary, will be available to be moved up to the parent on the winding-up except for the portion of the subsidiary's non-capital loss or farm loss from carrying on a business but only if that business is carried on by the parent for profit or with a reasonable expectation of profit throughout the particular year in which the loss is being deducted and only to the extent of the parent's income from that business for the particular year. Again, where properties are sold, leased, rented or developed or services are rendered in the course of carrying on that business before the acquisition of control, any income from any other business substantially all of the income of which was derived from the sale, leasing, rental or development of similar properties or the rendering of similar services is treated as income of that business.

C. NEW SUBSECTIONS 13(24) AND (25) AND 66(11.4) AND (11.5): ACQUISITION OF DEPRECIABLE PROPERTY OR RESOURCE PROPERTY PRIOR TO AN ACQUISITION OF CONTROL

13(24) Where, at any time, control of a corporation has been acquired by a person or group of persons and within the twelve-month period ending immediately before that time, the corporation, or a partnership of which it was a majority interest partner (within the meaning assigned by subsection 97(3.1)), acquired depreciable property (other than property that was owned by the corporation, partnership or a person or persons related to the corporation throughout the period commencing immediately before the twelve-month period and ending at the time the property was acquired by the corporation or partnership) that was not used, or acquired for use, by the corporation or partnership in a business that was carried on by it immediately before that twelve-month period, for the purposes of subparagraph (21)(f)(i) and sections 127 and 127.1, the property shall be deemed not to have been acquired by the corporation or partnership before that time and shall be deemed to have been acquired by it immediately after that time, except that, where the property was disposed of by it before that time and the property was not reacquired by it before that time, for the purpose of subparagraph (21)(f)(i), the property shall be deemed to have been acquired by the corporation or partnership immediately before the property was disposed of.

13(25) For the purposes of subsection (24), where the corporation referred to in that subsection has been incorporated or otherwise formed during the twelve-month period referred to in that subsection, it shall be deemed to have been, throughout the period commencing immediately before the twelve-month period and ending immediately after it was incorporated or otherwise formed,

(a) in existence; and

(b) related to the person or persons to whom it was related (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) throughout the period of its existence commencing when it was incorporated or otherwise formed and ending immediately before control of the corporation was acquired.

66(11.4) Where,

(a) at any time, control of a corporation has been acquired by a person or group of persons,

(b) within the twelve-month period ending immediately before that time, the corporation, or a partnership of which it was a majority interest partner (within the meaning assigned by subsection 97(3.1)) acquired a Canadian resource property or a foreign resource property (other than a property that was owned by the corporation, partnership or a person or persons related to the corporation throughout the period commencing immediately before the twelve-month period and ending at the time the property was acquired by the corporation or partnership), and

(c) immediately before the twelve-month period commenced, the corporation was not a principal-business corporation and the partnership, if it were a corporation, would not be a principal-business corporation,

for the purposes of subsection (4) and sections 66.2 and 66.4, except as those provisions apply for the purposes of section 66.7, the property shall be deemed not to have been acquired by the corporation or partnership before that time and shall be deemed to have been acquired by it at that time, except that, where the property has been disposed of by it before that time and not reacquired by it before that time, the property shall be deemed to have been acquired by the corporation or partnership immediately before it disposed of the property.

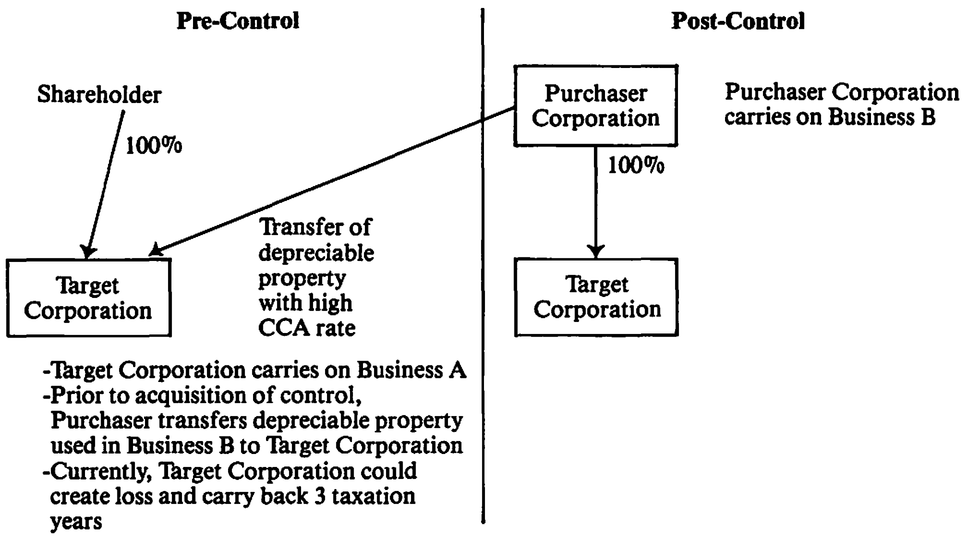
66(11.5) For the purposes of subsection (11.4), where the corporation referred to in that subsection was incorporated or otherwise formed during the twelve-month period referred to in that subsection, it shall be deemed to have been, throughout the period commencing immediately before the twelve-month period and ending immediately after it was incorporated or otherwise formed,

(a) in existence; and

(b) related to the person or persons to whom it was related (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) throughout the period commencing when it was incorporated or otherwise formed and ending immediately before control of the corporation was acquired.

The combined effect of subsection 249(4) and subsection 111(5) in terms of preventing Purchaser Corporation from acquiring Target Corporation, injecting tax shelter to create losses, and then using the losses to shelter income realized in the year and prior to the acquisition of control and for the three previous taxation years might be avoided if Purchaser Corporation were to transfer depreciable property or resource properties relating to a particular business to Target Corporation prior to but in contemplation of the acquisition of control.

For example, suppose Target Corporation has adopted the calendar year as its taxation year and suppose it carries on Business A. Suppose Purchaser Corporation carries on Business B and owns a depreciable property with a high rate of capital cost allowance which it uses in Business B but in respect of which it has not claimed any capital cost allowance because it is unable to use the deduction itself. In March of a particular year, Purchaser Corporation transfers the depreciable property to Target Corporation. In April, Purchaser Corporation acquires control of Target Corporation and a taxation year-end occurs immediately prior to the acquisition of control pursuant to new subsection 249(4). Target Corporation would be able to claim capital cost allowance on the depreciable property in the taxation year deemed to end at the time of the acquisition of control and if a loss resulted, it could use it to shelter income earned in the year and prior to the time of acquisition of control or in any of the three previous taxation years. If the loss was large enough, Target Corporation could obtain a refund of tax previously paid. Subsection 111(5) would not apply because the loss is not being carried back from a post-control taxation year to a pre-control taxation year.



Subsection 13(24) will prevent this from occurring by providing that where control of a corporation has been acquired, and within the 12 month period ending immediately before the acquisition the corporation acquired depreciable property that was not used or acquired for use in a business that was carried on by the corporation immediately before the commencement of the 12 month period, then for the purposes of claiming capital cost allowance (as well as for the purposes of the rules relating to investment tax credits and refundable investment tax credits), the property will be deemed to have been acquired immediately after the time of the acquisition of control and therefore after the end of the taxation year that will be deemed to have ended immediately before the time of the acquisition of control. The capital cost of the property will therefore not be included in computing undepreciated capital cost until just after the commencement of the new taxation year. Accordingly, any loss resulting from the deduction of the capital cost allowance will be realized in the new taxation year and will be subject to the rules in subsection 111(5): the non-capital loss cannot be applied to offset income for taxation years ending prior to the acquisition of control except for income from the same business.

The rule will also apply where the depreciable property is acquired by a partnership of which the corporation was a majority interest partner, as defined in subsection 97(3.1). The rule will not apply, however, if the property was owned by a person or persons related to the corporation (or was owned by the corporation itself or by a partnership of which it was a majority interest partner) throughout the period commencing immediately before the twelve-month period and ending at the time the property was acquired by the corporation (or the partnership). The purpose of this is to make the rule applicable only to acquisitions of depreciable property from unrelated persons. Where the corporation was incorporated during the twelve-month period, new subsection 13(25) deems it, for the purpose of subsection 13(24), to have been in existence up to the time it was incorporated and to have been related to the persons to whom it was related from its incorporation to immediately prior to the acquisition of control.

This rule applies whether or not the acquisition of control or the acquisition of the depreciable property is tax-motivated. For example, a newly incorporated corporation which acquires depreciable property from an unrelated person but undergoes an acquisition of control within 12 months following the acquisition of the property will be subject to the rule. Capital cost allowance attributable to the depreciable property will not be deductible for the period prior to the acquisition of control but instead will be deductible in the new taxation year commencing at the time of the acquisition of control. Accordingly, the deduction may be claimed against income from the period of time prior to the acquisition of control only as a carryback under subsection 111(5), which will be available only if the capital cost allowance qualifies as a deduction in the calculation of income from a business, and therefore is a non-capital loss, and only to the extent of income in the prior taxation year that is earned from the same business.

If the depreciable property acquired by the corporation is disposed of before the acquisition of control, the property will be treated as having been acquired by it immediately before the disposition.

Proposed new subsection 66(11.4) contains a similar rule where a corporation (or a partnership of which it was a majority interest partner) acquires a Canadian or foreign resource property within the 12 month period ending immediately before the time of acquisition of control and, immediately before that 12 month period, the corporation (or the partnership, if it were a corporation) was not a principal-business corporation. For the purpose of the provisions relating to the deduction of foreign exploration and development expenses, cumulative Canadian development expense and cumulative Canadian oil and gas property expense, the corporation will be deemed to have acquired the property at the time of the acquisition of control and therefore after the end of the taxation year that will be deemed to have ended immediately before the time of the acquisition of control. Accordingly, any loss resulting from the deduction of the cost of the particular resource property under those provisions will be realized in the new taxation year and will be subject to the rules in subsection 111(5). The reason for excepting principal-business corporations from the rule is that a principal-business corporation is one that is engaged in some aspect of the resource industry[8] and the assumption

8. See the definition of "principal-business corporation" in ITA, *supra* n. 2 at para. 66(15)(h).

is being made that the person who acquired control of the corporation is the person who transferred the resource property to the corporation and that person is likely a principal-business corporation. If the corporation, control of which is acquired, is also a principal-business corporation, then the rule will not apply on the theory that corporations that carry on the same business will not be subject to this rule or the rule in new subsection 13(24) since a loss could be created following the acquisition of control and then carried back under subsection 111(5).

The rule in subsection 66(11.4) will not apply where the resource property was owned by a person or persons related to the corporation (or was owned by the corporation itself or by a partnership of which it was a majority interest partner) throughout the period of time commencing immediately before the twelve-month period and ending at the time the property was acquired by the corporation (or the partnership). New subsection 66(11.5) contains a rule similar to the rule in subsection 13(25).

D. NEW SUBSECTION 111(4): EFFECT OF ACQUISITION OF CONTROL ON BOTH REALIZED AND ACCRUED CAPITAL LOSSES

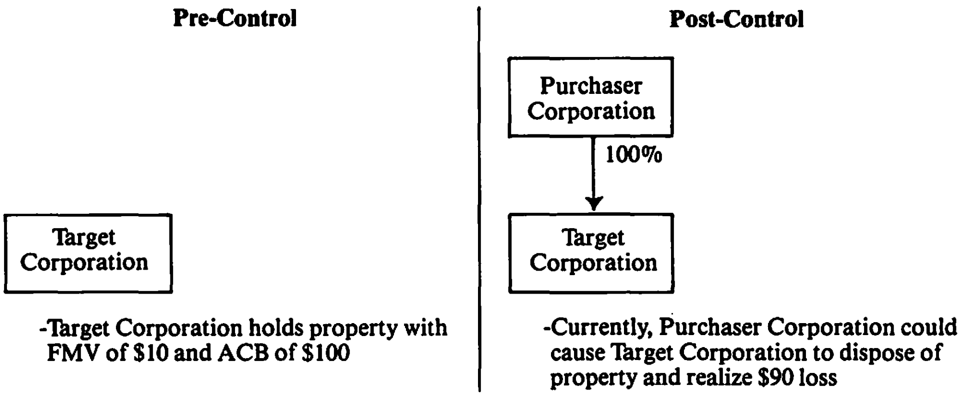
It is proposed that subsection 111(4) be deleted and replaced by a new and revised subsection 111(4).

> 111(4) Notwithstanding subsection (1), where, at any time (in this subsection referred to as "that time"), control of a corporation has been acquired by a person or group of persons
>
> (a) no amount in respect of a net capital loss for a taxation year ending before that time is deductible in computing the corporation's taxable income for a taxation year ending after that time, and
>
> (b) no amount in respect of a net capital loss for a taxation year ending after that time is deductible in computing the corporation's taxable income for a taxation year ending before that time,
>
> and where, at that time, the corporation neither became nor ceased to be exempt from tax under this Part on its taxable income,
>
> (c) in computing the adjusted cost base to the corporation at and after that time of each capital property, other than a depreciable property, owned by the corporation immediately before that time, there shall be deducted the amount, if any, by which the adjusted cost base to the corporation of the property immediately before that time exceeds its fair market value immediately before that time;
>
> (d) each amount required by paragraph (c) to be deducted in computing the adjusted cost base to the corporation of a property shall be deemed to be a capital loss of the corporation for the taxation year that ended immediately before that time from the disposition of the property; and
>
> (e) each capital property owned by the corporation immediately before that time, other than a property in respect of which an amount would, but for this paragraph, be required by paragraph (c) to be deducted in computing its adjusted cost base to the corporation, as is designated by the corporation in its return of income under this Part for the year or in a prescribed form filed with the Minister on or before the day that is 90 days after the day on which a notice of assessment of tax payable for the year or notification that no tax is payable for the year is mailed to the corporation, shall be deemed to have been disposed of by the corporation immediately before the time that is immediately before that time for proceeds of disposition equal to the greater of
>
> (i) the adjusted cost base to the corporation of the property immediately before that time, and
>
> (ii) the lesser of the fair market value of the property immediately before that time and such amount as is designated by the corporation in respect of the property

and shall be deemed to have been reacquired by it at that time at a cost equal to the proceeds of disposition thereof.

Paragraph 111(1)(b) of the Act allows a taxpayer to carry back a capital loss realized in a taxation year for deduction against net capital gains realized during the previous three taxation years and ahead for an indefinite period for deduction against future net capital gains. Subsection 111(4) currently denies the carryover of capital losses realized by a corporation for a taxation year ending prior to or following the taxation year in which control of the corporation has been acquired. Net capital losses realized in the year in which control is acquired are therefore unaffected but capital losses of any taxation year prior to or subsequent to the year in which control is acquired are wiped out. The effect of new subsection 249(4) will be to eliminate net capital losses realized in the year of the acquisition of control since that year will be deemed to end immediately before the acquisition.

In addition, new paragraph 111(4)(c) provides that where a corporation owns non-depreciable capital property at the time of acquisition of control of the corporation, if the adjusted cost base of the capital property exceeds its fair market value, the adjusted cost base must be reduced to that fair market value. Paragraph 111(4)(d) provides that the amount of the reduction is deemed to be a capital loss of the corporation for the taxation year that ended immediately before the time of the acquisition of control. Except to the extent the capital loss can be used to shelter capital gains in the taxation year deemed to have so ended, the capital loss will expire on the acquisition of control. This prevents the purchaser of the Target Corporation from realizing the capital loss following the acquisition of control when the loss accrued while Target was owned by the vendor.



To partially relieve against the elimination of the accrued capital loss, new paragraph 111(4)(e) provides that the corporation may designate certain capital property to have been disposed of by it immediately before the end of the taxation year that is deemed to end immediately prior to the acquisition of control for proceeds of disposition equal to an amount that is selected by the taxpayer. The corporation is then deemed to have reacquired the property at the time of the acquisition of control at a cost equal to the proceeds of disposition. The amount of the notional capital gain is the amount that is the difference between the proceeds of disposition selected by the taxpayer and the adjusted cost base of the particular property. The taxpayer may select as the proceeds of disposition any amount between the adjusted cost base of the particular property and its fair market value. The result is that the corporation is allowed to create a notional capital gain for the purpose of using up the capital loss created through the reduction in the adjusted cost base of other capital properties or other capital losses that have arisen through real dispositions of capital property during that taxation year or have been carried forward from a previous taxation year, in exchange for a stepped-up cost base in the designated capital property. The amount selected cannot be less than the adjusted cost base of the property. Hence, the election cannot result in creation of a capital loss.[9]

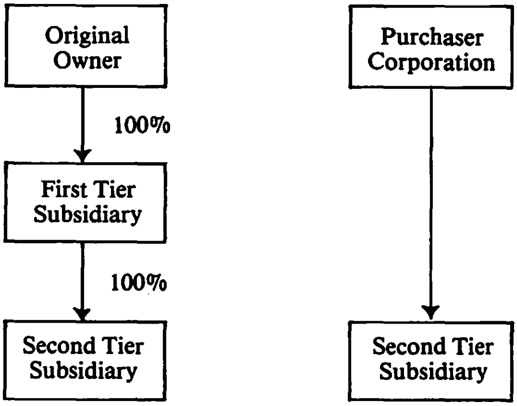
To cross-refer the reduction of the adjusted cost base of non-depreciable capital property in paragraph 111(4)(c) to the rules in section 53 dealing with the calculation of adjusted cost base, new paragraph 53(2)(b.2) will be added to those rules and will require a reduction in the adjusted cost base of a capital property by the amount referred to in paragraph 111(4)(c).

Prior to the January 15, 1987 amendments, transactions were being implemented whereby a corporation which owned a capital property with an adjusted cost base of $100 and a fair market value of $10 but which could not use the $90 capital loss if it were to be realized, would transfer the property by way of gift to a second tier subsidiary all of the shares of which were owned by a first tier subsidiary. Under subsection 69(1), the transferor would be deemed to have realized proceeds of disposition equal to the fair market value of $10 and the transferee would be deemed to have acquired the property at a cost of $10. Because the sale was to a controlled corporation, subsection 85(4) of the Act denied the $90 capital loss that would otherwise have been realized. Instead, because the transferor owned no shares directly in the capital stock of the transferee, paragraph 53(1)(f.1) would add the denied capital loss of $90 to the cost of the property to the transferee resulting in an adjusted cost base of the property to the transferee of $100. Essentially, the provision would put the second tier subsidiary in the same position as the transferor.

The transferor would then be in a position to cause the first tier subsidiary to sell the shares of the second tier subsidiary to a third party purchaser. Following the acquisition, the purchaser could cause the subsidiary to dispose of the property and realize the capital loss and have the loss moved up to the purchaser under subsection 88(1.2) on a winding-up of the subsidiary. Alternatively, the purchaser could move up the property from the subsidiary on the winding-up and realize the loss in the purchaser itself.[10] In either case, the potential $90 capital loss would have been effectively transferred from the original owner to the purchaser to be used to shelter $90 of capital gains of the purchaser and the original owner would have received a fee in the form of proceeds of disposition of the second tier subsidiary.

9. Note that para. 111(4)(c) overrides para. 111(4)(e) to prevent restating the cost at its original adjusted cost base.

10. ITA, *supra* n. 2 at para. 88(1)(c) would set the purchaser's cost in the property at an amount equal to the subsidiary's cost, i.e. $100.



-Transfer by way of gift of property with ACB of $100 and FMV of $10 from Original Owner to Second Tier Subsidiary
-Second Tier acquires property at cost = $100

-Purchaser Corporation causes Second Tier Subsidiary to dispose of property and realize $90 loss

Subsection 111(4), as amended, and paragraph 53(2)(b.2) will prevent this from occurring because on the acquisition of control of the subsidiary, the adjusted cost base of the property will be reduced to $10, the fair market value, and the $90 will become a capital loss to be eliminated on the change of control.

E. AMENDED SUBSECTIONS 111(5.1) AND (5.2): EFFECT OF ACQUISITION OF CONTROL ON DEPRECIABLE PROPERTY AND ELIGIBLE CAPITAL PROPERTY

It is proposed that subsections 111(5.1) and (5.2) be deleted and replaced by new and revised subsections 111(5.1) and (5.2).

> 111(5.1) Where, at any time, control of a corporation (other than a corporation that at that time became or ceased to be exempt from tax under this Part on its taxable income) has been acquired by a person or group of persons and, if this Act were read without reference to subsection 13(24), the undepreciated capital cost to the corporation of depreciable property of a prescribed class immediately before that time would have exceeded the aggregate of
>
> (a) the fair market value of all the property of that class immediately before that time, and
>
> (b) the amount in respect of property of that class otherwise allowed under regulations made under paragraph 20(1)(a) or deductible under subsection 20(16) in computing the corporation's income for the taxation year ending immediately before that time,
>
> the excess shall be deducted in computing the income of the corporation for the taxation year ending immediately before that time and shall be deemed to have been allowed in respect of property of that class under regulations made under paragraph 20(1)(a).
>
> 111(5.2) Where, at any time, control of a corporation (other than a corporation that at that time became or ceased to be exempt from tax under this Part on its taxable income) has been acquired by a person or group of persons and immediately before that time the corporation's cumulative eligible capital in respect of a business exceeded the aggregate of
>
> (a) ½ of the fair market value of the eligible capital property in respect of the business, and
>
> (b) the amount otherwise deducted under paragraph 20(1)(b) in computing the corporation's income from the business for the taxation year ending immediately before that time,

the excess shall be deducted under paragraph 20(1)(b) in computing the corporation's income from the business for the taxation year ending immediately before that time.

The proposed amendments contemplate the revision of subsections 111(5.1) and (5.2) to take into account the deemed taxation year-end that will occur upon an acquisition of control. Currently, subsection 111(5.1) provides that where control of a corporation is acquired in a particular taxation year at a time when the undepreciated capital cost to the corporation of depreciable property of a certain class calculated at the time of the acquisition of control is greater than the fair market value of all the property of that class, the excess is deemed to have been allowed as capital cost allowance in computing the corporation's income for taxation years ending before the particular taxation year in which control is acquired. The excess is deemed to have been a non-capital loss or farm loss, as the case may be, for the taxation year immediately preceding the year in which control is acquired and is regarded as having been realized in the course of carrying on the business in which the property was used at that time.

The amendment to subsection 111(5.1) simply provides that the test of whether or not the undepreciated capital cost of depreciable property of the particular class exceeds the fair market value of the property is to be applied immediately before the time that control is acquired, and the undepreciated capital cost is to take into account the amount claimed as capital cost allowance or as a terminal loss for the taxation year deemed to have ended immediately before the acquisition of control. (Under the current rule, since there is no deemed taxation year-end on the acquisition of control, there is no capital cost allowance claimed in the portion of the taxation year up to the time of the acquisition of control and therefore the undepreciated capital cost balance reflects capital cost allowance claims up to and including the end of the last taxation year. It will, however, include the capital cost of any additions to the class during the portion of the taxation year up to the time of the acquisition of control.) Where the undepreciated capital cost so determined exceeds the fair market value, the excess is deemed to have been claimed as a deduction from income in the form of capital cost allowance for that taxation year. As with the amendment to subsection 111(4), the purpose is to prevent the acquisition of a corporation having a potential but unrealized loss in respect of its assets (commonly referred to as a "pregnant loss").

Similarly, subsection 111(5.2), which applies where the target corporation's cumulative eligible capital in respect of a business calculated at the time of the acquisition of control exceeds one-half of the fair market value at that time of the eligible capital property used in respect of the business, provides that the excess is deemed to have been deducted by the corporation under paragraph 20(1)(b) for taxation years ending before the year in which control was acquired and is deemed to have been a non-capital loss or farm loss, as the case may be, of the corporation for the taxation year immediately preceding the year in which control is acquired and is regarded as having been realized in the course of carrying on that business. The amendment simply changes the point of determination to the time immediately prior to the acquisition of control and applies where the corporation's cumulative eligible capital in respect of a business, reduced by the amount otherwise deducted under paragraph 20(1)(b) in computing the corporation's income from that business for the taxation year deemed to have ended immediately before the acquisition of control, exceeds one-half of the fair market value at that time of the eligible capital property. The excess is deemed to have been deducted under paragraph 20(1)(b) in computing the corporation's income for the taxation year ending immediately before the acquisition of control.

Subsections 111(5.1) and (5.2) do not currently apply to a corporation that was exempt from Part I tax immediately before the acquisition of control and the amendments do not propose to change this. Currently, subsection 111(5.3) provides that where the corporation is in its first taxation year, for the purposes of subsections 111(5.1) and (5.2), it is deemed to have had a taxation year immediately preceding its first taxation year. It is proposed that subsection 111(5.3) be repealed as it is now unnecessary in view of the deemed year-end that will occur immediately prior to the acquisition of control. Instead, a new subsection 111(5.3) is proposed as discussed below under "Miscellaneous Amendments".

F. REPEAL OF SECTION 1801 OF THE INCOME TAX REGULATIONS: AMENDMENT TO METHODS OF VALUING INVENTORY

Subsection 10(1) of the Act provides that in calculating income from a business, amounts included in the taxpayer's inventory must be valued at their cost to the taxpayer or their fair market value, whichever is lower, or in such other manner as may be permitted by regulation. Section 1801 of the Income Tax Regulations currently allows the taxpayer to value all of its inventories at cost or at fair market value, rather than the lower of cost or fair market value, provided, of course, that the method of valuation remains constant. The purpose of the amendment is to prevent trading in what might be called "pregnant" inventory losses. For example, if a corporation's inventory has a fair market value substantially lower than its cost, and that corporation pursuant to section 1801 values its inventory for tax purposes at cost, the corporation could be acquired by a purchaser corporation which would then dispose of the property and realize the loss. By repealing section 1801, taxpayers will be required to value their inventories at the lower of either their cost or fair market value to prevent the postponing of the write-down to fair market value until a disposition has occurred. This will also have the additional consequence of forcing a corporation to claim a write-down prior to the time of disposition thereby resulting in a non-capital loss which will be subject to the loss carryover rules in subsection 111(1). This may have an unfortunate effect if the loss is not used within the seven year carryforward or the three year carryback and therefore expires.

G. NEW SUBSECTIONS 69(11), (12) AND (13) AND 107(6): TRANSFER OF ACCRUED GAINS OR LOSSES TO UNRELATED PURCHASERS

> 69(11) Where, at any time as part of a series of transactions, a person or partnership (in this subsection and subsection (12) referred to as the "vendor") has disposed of property for proceeds of disposition that are less than its fair market value and it may reasonably be considered that one of the main purposes of the series was to obtain the benefit of

(a) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable under this Act, or

(b) any balance of undeducted outlays, expenses or other amounts

available to a specified person in respect of a subsequent disposition of the property or property substituted for the property, notwithstanding any other provision of this Act, the vendor shall be deemed to have disposed of the property at that time for proceeds of disposition equal to its fair market value at that time.

69(12) For the purposes of subsection (11), a "specified person" is

(a) a person that was not (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) related to the vendor immediately before the series of transactions commenced; or

(b) a partnership of which neither the vendor nor a person who was (otherwise than by virtue of a right referred to in paragraph 251(5)(b)) related to the vendor immediately before the series commenced was a majority interest partner (within the meaning assigned by subsection 97(3.1)) immediately before the series commenced.

69(13) Where there has been an amalgamation or merger of a corporation with one or more other corporations to form one corporate entity (in this subsection referred to as the "new corporation"), each property of the corporation that became property of the new corporation as a result of the amalgamation or merger shall be deemed, for the purpose of determining whether subsection (11) is applicable in respect of the amalgamation or merger, to have been disposed of by the corporation immediately before the amalgamation or merger for proceeds of disposition equal to

(a) in the case of a Canadian resource property or a foreign resource property, nil;

(b) in the case of any eligible capital property, an amount equal to twice the cost amount to the corporation of such property immediately before the amalgamation or merger; and

(c) in the case of any other property, the cost amount to the corporation of the property immediately before the amalgamation or merger.

107(6) Notwithstanding any other provision of this Act, where a person or partnership (in this subsection referred to as the "vendor") has disposed of property and would, but for this subsection, have had a loss from the disposition, the vendor's loss otherwise determined in respect of the disposition shall be reduced by such portion thereof as may reasonably be considered to have accrued during a period in which

(a) the property or property for which it was substituted was owned by a trust; and

(b) neither

(i) the vendor, nor

(ii) any person related to the vendor, nor

(iii) any partnership of which the vendor or a person related to the vendor was a majority interest partner (within the meaning assigned by subsection 97(3.1))

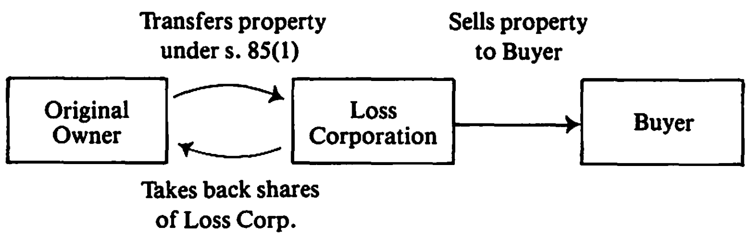
had a capital interest in the trust.

Prior to January 15, 1987, a number of transactions were being structured whereby property would be transferred by a transferor on a rollover basis to a transferee which had accumulated loss carryforwards and the transferee would then resell the property on a taxable basis using its loss carryforwards to shelter the gain and allowing the ultimate purchaser to acquire a stepped-up cost equal to the purchase price paid. The intermediary loss corporation would realize a fee, generally reflected in the difference between the price paid to the transferor and the higher price extracted from the ultimate purchaser, as compensation for using its tax shelter. The original transferor would receive its cash either by a redemption of shares received by it on the rollover or possibly by acquiring the shares of the intermediary loss corporation.

New subsection 69(11) is designed to prevent this type of transaction. It provides that where a person, as part of a series of transactions, has disposed of property for proceeds of disposition that are less than its fair market value (i.e. on a rollover basis) to defer an accrued but unrealized gain on the property, and it may reasonably be considered that one of the main purposes of the series of transactions was to obtain the benefit of any deductions in computing income or taxable income or any tax credits, or the benefit of any undeducted outlays, expenses or other amounts (such as unclaimed capital cost allowance or the balance of undeducted resource expense pools) that are available to a person that is a "specified person", then the vendor is deemed to have disposed of the property for proceeds of disposition equal to its fair market value at that time.

A "specified person" is defined in new subsection 69(12) to be a person that was not related to the vendor immediately before the series of transactions commenced, or a partnership of which neither the vendor, nor a person who was related to the vendor immediately before the series commenced, was a majority interest partner immediately before the series commenced. In other words, the provision is designed to apply only where the purpose of the series of transactions is to obtain the benefit of tax shelter available to an *unrelated* party.

For example, suppose a person owns a property with a fair market value of $100. The property could be an item of inventory, a capital property or a resource property but in any case a disposition of the property at its fair market value would result in a recognition of income by the owner. To avoid (or at least mitigate) this result, the person transfers the property to an unrelated loss corporation in exchange for shares of the loss corporation using the rollover provisions of subsection 85(1) of the Act to defer the recognition of gain. Under subsection 85(1), the cost to the loss corporation of the acquired property would be the amount elected on the rollover which would be selected to prevent the recognition of income on the transfer. The loss corporation then sells the property to a third party for $100 and shelters any income recognized by it with its existing loss carryforwards.



After deducting a fee, the remaining proceeds are distributed to the original owner by way of a redemption or acquisition of the shares of the loss corporation held by the original owner. The original owner may get away with a deemed dividend that will be tax-free under subsection 112(1) or may face a capital gain as a result of the application of subsection 55(2), but the goal is to realize a lower tax cost than what would be realized if the loss corporation had not acted as an intermediary.

Subsection 69(11) will deny the rollover treatment to the original owner and instead require the owner to recognize proceeds of disposition equal to the fair market value of the property. Subsection 69(11) will apply because it may reasonably be considered that one of the main purposes of the series of transactions was to obtain the benefit of the losses available to the loss corporation.

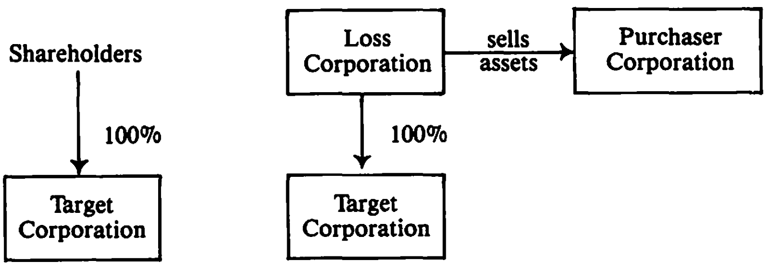
Although subsection 69(11) uses the words "obtain the benefit of" in describing the usage of deductions, credits and tax account balances by the unrelated party, the rule is limited to circumstances where the benefit relates to tax shelter available to the unrelated party in respect of a subsequent disposition of the property or property substituted for the property. It does not apply where the tax shelter of the unrelated party is used to shelter income from the property that is not related to the disposition of the property.[11]

Any transaction where a person disposes of property on a rollover basis to an unrelated intermediary to obtain the benefit of the losses of the intermediary in respect of a subsequent disposition of the property is intended to be subject to subsection 69(11). "Losses" in this context means any deductions in computing income or taxable income or any tax credits that reduce tax payable, and any benefit that can arise through use of the balance of undeducted outlays, expenses or other amounts. This would include the undepreciated capital cost account of a class of depreciable property as well as the cumulative resource accounts such as cumulative Canadian exploration expense, cumulative Canadian development expense and cumulative Canadian oil and gas property expense. Hence, a transaction pursuant to which resource property is rolled over to an unrelated corporation which disposes of the property at fair market value and is able to shelter the proceeds of disposition because it has a sufficient balance in its cumulative Canadian oil and gas property expense account (or its cumulative Canadian development expense account), or otherwise can shelter any resulting income through use of its cumulative Canadian exploration expense or earned depletion accounts will be subject to subsection 69(11). The transferor would, accordingly, be denied the rollover and would instead be deemed to dispose of the resource property at fair market value.

Use of losses of an unrelated third party might also be accomplished where a purchaser seeks to acquire assets of a corporation but the shareholder or shareholders of the target corporation are only prepared to sell shares. The shareholders may consider it preferable for them to recognize a capital gain (all or a portion of which may be subject to the capital gains exemption) rather than have the corporation realize income tax consequences from the sale of its assets, which may include ordinary income from recapture of capital cost allowance on depreciable property or from the disposition of inventories or resource properties. The corporation may also have a lower cost base in its assets than the adjusted cost base to the shareholders of their shares. Presumably a trade-off for the desire of the shareholders to sell their shares would be a reduction in the purchase price from what would be paid if the assets were purchased. To improve its tax position, however, the purchaser finds a loss corporation

11. New sub-s. 112(2.4) may, however, apply where a corporation transfers property to a loss corporation in exchange for "collateralized" dividend paying preferred shares issued by the loss corporation where the purpose of the transaction is to apply the losses of the loss corporation against income from the property and distribute the income to the original owner by way of dividend.

which undertakes the acquisition of the target corporation making it a wholly-owned subsidiary. The loss corporation winds-up the target corporation on a tax-free basis pursuant to subsection 88(1) of the Act and acquires the assets of the target corporation at a cost equal to the same cost of the assets to the target. The loss corporation then sells the assets to the purchaser at their fair market value. Income recognized by the loss corporation is offset through the use of its losses or the balance of its undeducted costs or expenses, as the case may be, and yet the purchaser has acquired assets which, in the case of depreciable property or resource property, it can amortize for tax purposes at an amount based on their fair market value acquisition cost. The loss corporation would realize a fee equal to the difference between the price paid to the shareholders for the shares of the corporation and the price received on the sale of the assets. The purchaser has essentially purchased assets at the same price that it would have paid for the stock, less the fee to the intermediary corporation.



-Shareholders sell shares of Target Corporation to Loss Corporation

-Loss Corporation winds-up Target Corporation under s. 88(1)

This type of transaction will now be subject to the rules in subsection 69(11). The disposition for proceeds less than fair market value occurs at the time of the winding-up pursuant to subsection 88(1) and although the target corporation (the "vendor") will be related to the loss corporation at the time of the winding-up, it will not have been related to the loss corporation immediately before the series of transactions commenced, and therefore the loss corporation will qualify as a specified person.

New subsection 66(13) makes the subsection apply where the property is transferred to the loss corporation by way of an amalgamation of the vendor with the loss corporation. Since subsection 69(11) requires for its application that there be a disposition of the property for proceeds of disposition that are less than fair market value, subsection 69(13) treats the property of the vendor as having been disposed of immediately before the amalgamation for proceeds of disposition that would result in a tax-free disposition.

The rules in subsection 69(11) would not seem to apply where the assets are owned by a partnership rather than a corporation and the partner sells his interest in the partnership to a loss corporation. If, following the acquisition of the partnership interest by the loss corporation, the partnership were to sell the assets to a third party at a price equal to their fair market value, the resulting income would be allocated to the loss corporation to the extent of its share thereof which income would be sheltered by the loss corporation through the use of its loss carryforwards or the balance of its undeducted costs or expenses, as the case may be. Subsection 69(11) would not apply since there has been no disposition of property for proceeds of disposition that are less than fair market value.

While the subsection denies the rollover to the vendor, it does not adjust the acquisition cost to the purchaser. The vendor is deemed to dispose of the property for proceeds of disposition equal to fair market value but the purchaser is nevertheless deemed to acquire the transferred property at a cost determined under the particular rollover rule pursuant to which the transaction was completed.[12]

Subsection 107(6) is designed to prevent a vendor from disposing of property and claiming a loss from the disposition of the property when in fact the loss accrued during a period of time while the property was owned by a trust and neither of the vendor, any person related to the vendor, or a partnership of which the vendor or a related person was a majority interest partner, had a capital interest in the trust. Where only a portion of the loss may be considered to have accrued during that period of time, then only that portion of the loss is denied to the vendor.

For example, suppose Corporation A is a capital beneficiary of a trust and the trust holds capital property with an adjusted cost base of $100 and a fair market value of $10. If the trust disposes of the property, it will realize a $90 capital loss which will be available to shelter current capital gains of the trust or may be carried back three taxation years or forward indefinitely pursuant to the rules in paragraph 111(1)(b). Similarly, the trust could distribute the property to Corporation A which, under subsection 107(2), would take the property at a cost equal to $100. Corporation A would then be able to dispose of the property at its fair market value and claim the $90 capital loss. Both of these results are acceptable. Suppose, however, that Corporation A were to sell its capital interest in the trust to Corporation B, a third party who is unrelated to Corporation A and who was not a beneficiary of the trust during the time the $90 loss was accruing, for $10 and the trust then distributes the property to Corporation B. The distribution to Corporation B would occur on a rollover basis pursuant to subsection 107(2) and Corporation B would take the property at a cost equal to $100, thereby enabling it to realize a $90 capital loss on a subsequent disposition of the property. Because it would be reasonable to consider all of the $90 capital loss to have accrued while the property was owned by the trust and at a time when Corporation B was not a beneficiary nor related to the person who was a beneficiary at that time, subsection 107(6) will reduce Corporation B's loss by the whole $90. The $90 capital loss simply disappears.

Subsection 107(6) does not apply just to capital losses, although it will not have application to inventory losses as a result of the repeal of section

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12. *But see Allfine Bowlerama* v. *MNR* 72 D.T.C. 1502, where the Tax Review Board essentially allowed a purchaser to obtain a fair market value cost on a purchase from a non-arm's length vendor at a price which was less than fair market value because the vendor was deemed to have disposed of the property at fair market value under the predecessor to what is now para. 69(1)(b) and the Board felt that to set the cost to the purchaser at less than fair market value would result in double taxation.

1801 of the Income Tax Regulations. It will have application to losses that have accrued prior to January 15, 1987 even though it applies only to property distributed to a beneficiary from a trust in satisfaction of all or part of a capital interest in the trust that was acquired by the beneficiary after January 15, 1987, except where the beneficiary acquiring the interest was obliged on that date to acquire it pursuant to an agreement in writing entered into on or before that date. That is to say, there is no rule exempting from the provision any portion of the loss that accrued prior to January 15, 1987.

H. AMENDMENTS TO SUCCESSOR CORPORATION RULES

The successor corporation rules apply where one corporation (the "successor corporation") acquires all or substantially all of the Canadian resource properties or all or substantially all of the foreign resource properties of another person (individual or corporation) (the "predecessor") by way of purchase, amalgamation, merger, winding-up or otherwise but excluding an amalgamation of a corporation and one or more of its wholly-owned subsidiary corporations, an amalgamation of one or more corporations each of which is a wholly-owned subsidiary corporation of the same corporation,[13] and a winding-up of a 90% owned subsidiary pursuant to the rules in subsection 88(1) of the Act. The predecessor and the successor corporation also must elect to have the successor rules apply. The rules currently provide that following such an acquisition, the successor corporation can deduct the undeducted balance of the predecessor's unused Canadian exploration and development expense, cumulative Canadian exploration expense, cumulative Canadian development expense and cumulative Canadian oil and gas property expense, in each case determined as at the time immediately following the acquisition but reduced by any amount in respect thereof deducted by the predecessor in the taxation year in which the acquisition occurs. In the case of an acquisition of foreign resource properties, it is the unused foreign exploration and development expenses which flow-over to the successor corporation.

In each case, however, the successor corporation can only deduct the expenses that flow-over to it against qualifying income from the properties acquired. This qualifying income of the successor corporation is income from the disposition of the acquired properties and production income from the acquired properties. Currently, however, the production income of the successor corporation from the acquired properties can include any production income from properties already owned by the successor and in respect of which the predecessor had, immediately before the acquisition by the successor, an interest or a right to take or remove petroleum or natural gas or minerals. Consequently, if the successor already had an interest in a producing property and it acquired another interest in the same property under an acquisition to which the successor rules apply, then the successor would be entitled to deduct the unused resource expenses of the predecessor against not only production income from the interest acquired

13. These are amalgamations of the type referred to in sub-s. 87(1.2) and are specifically excluded from the successor corporation rules.

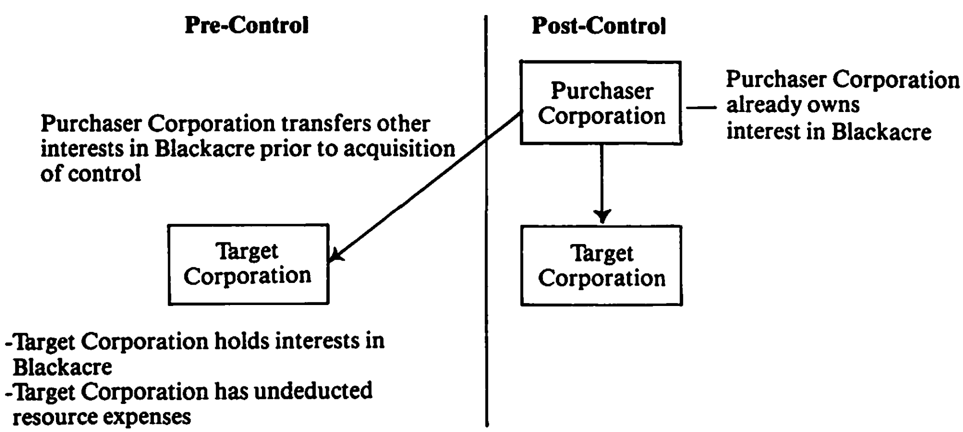
from the predecessor in the producing property but also against its production income from the interests in the property already owned by it. Hence, a corporation which was an industry partner with a particular corporation that was interested in selling all its Canadian resource properties could pay more for the resource deductions which would accompany the sale than a bidder which did not have an interest in the same properties as the particular corporation.

The proposed amendments to the successor corporation rules would restrict the deduction by the successor corporation of the unused resource expenses of the predecessor to production income from the interests acquired from the predecessor. The successor corporation will not be able to highgrade the deductions by using them against interests not owned by the predecessor at the time of the acquisition. The amendments do not change the ability of the successor corporation to deduct the expenses against income realized from a disposition of the acquired properties.

Bill C-64 repeals all of the successor rules and re-enacts them in the form of new section 66.7. As restated, the rules contain the amendment described above.

The successor rules also apply on an acquisition of control. Subsection 66.7(10), as contained in Bill C-64, provides that the target corporation is, after the time of the acquisition of control, deemed to be a successor corporation that jointly elected with a notional predecessor corporation to have the successor rules apply. The target corporation is deemed to have acquired, from the notional predecessor at the time of the acquisition of control, all of the Canadian resource properties and foreign resource properties that were owned by it immediately before the acquisition of control. Accordingly, the target corporation, after the acquisition of control, may deduct its resource expenses that were unused immediately prior to the time of the acquisition of control only against income realized from the disposition of such properties and production income from such properties.

Currently, it is possible for a corporation which proposes to acquire control of a target corporation or to acquire all or substantially all of the Canadian resource properties of the target corporation to have the target corporation agree to acquire, prior to the acquisition of control or the



acquisition of the resource properties, as the case may be, resource properties owned by the purchaser. Upon the acquisition of control or of the properties, the successor rules would currently apply to allow the unused resource expenses of the target corporation to be deducted against the properties owned by the target at the time of the succession, including the properties acquired by it from the purchaser.

Proposed new subsection 66.7(11) is designed to prevent this form of highgrading.

> 66.7(11) Where, at any time,
>
> (a) control of a taxpayer that is a corporation has been acquired by a person or group of persons, or
>
> (b) a taxpayer has disposed of all or substantially all of his Canadian resource properties or foreign resource properties,
>
> and, before that time, the taxpayer or a partnership of which the taxpayer was a member acquired a property that is a Canadian resource property, a foreign resource property or an interest in a partnership and it may reasonably be considered that one of the main purposes of such acquisition was to avoid any limitation provided in subsection 29(25) of the *Income Tax Application Rules, 1971* or any of subsections (1) to (5) on the deduction in respect of any expenses incurred by the taxpayer or a corporation referred to as a transferee in paragraph (10)(g) or (h), the taxpayer or the partnership, as the case may be, shall be deemed, for the purposes of applying those subsections to or in respect of the taxpayer, not to have acquired the property.

Subsection 66.7(11) will prevent a purchaser corporation from avoiding the effect of the successor corporation rules upon acquisition of control of a target corporation by providing that where the target corporation has, before the acquisition of control, acquired any Canadian resource property or any foreign resource property and it may reasonably be considered that one of the main purposes of the acquisition was to avoid any limitation provided in the successor corporation rules on the deductibility of any resource expenses of the target corporation, the target will be deemed for the purposes of those provisions not to have acquired the particular property. That is to say, for purposes of the successor corporation rules, the target corporation will be deemed not to have acquired the property and, not owning it at the time of the acquisition of control, the successor rules will not allow the target to deduct its resource expenditures following the acquisition of control against income from that property.

Similarly, subsection 66.7(11) will also provide that where a taxpayer has disposed of all or substantially all of his Canadian resource properties or foreign resource properties to a purchaser and, before that time, the taxpayer acquired a Canadian resource property or a foreign resource property, and it may reasonably be considered that one of the main purposes of the acquisition was to avoid any limitation provided in the successor rules on the deductibility of any expenses by the purchaser of the resource properties, the taxpayer shall be deemed for the purposes of those provisions not to have acquired the property.

I. MISCELLANEOUS AMENDMENTS

(a) Subsection 111(5.3) is to be repealed for the reasons noted earlier. A new subsection 111(5.3) is proposed which will require a corporation that has a debt owing to it which is required to be included in the income of the corporation for the taxation year in which control is acquired or any previous taxation year and in respect of which the corporation would otherwise be allowed a doubtful debt deduction under paragraph 20(1)(l), to instead claim the debt as a bad debt under paragraph 20(1)(p) for the taxation year deemed to end immediately prior to the acquisition of control. Consequently, the deduction must be claimed prior to the acquisition of control and cannot remain unclaimed for use by the purchaser after the acquisition of control.

(b) Currently, it is arguable that a negative adjusted cost base that a corporation might have in an interest in a partnership can be reset to zero without tax cost by causing the corporation to undergo an amalgamation with another corporation.[14] Proposed new subsection 100(2.1) will require the particular predecessor corporation to recognize the negative adjusted cost base as a capital gain deemed to arise immediately before the amalgamation but only where the predecessor was not related to the amalgamated corporation, within the meaning of subsection 251(3.1). This is accomplished by deeming the predecessor to have disposed of the partnership interest for proceeds of disposition equal to its adjusted cost base immediately before the amalgamation and the amalgamated corporation to have acquired the interest in the partnership at a cost equal to that adjusted cost base. Where the predecessor was related to the amalgamated corporation, new paragraph 87(2)(e.1) will provide that the negative adjusted cost base is simply carried over to the amalgamated corporation on the amalgamation. A similar carryover of the negative adjusted cost base will also occur on a winding-up to which the rules in subsection 88(1) apply. This is accomplished by an amendment to paragraph 88(1)(e.2) which amendment adds a cross-reference to paragraph 87(2)(e.1).

(c) Subsection 37(1) of the Act allows a taxpayer to deduct certain defined expenditures of a current or capital nature that relate to scientific research and experimental development. To the extent not deducted in the year incurred, the expenses may be carried forward for deduction in a subsequent taxation year provided that in the subsequent year the particular business to which the expenditures relate is carried on and the taxpayer continues to incur expenditures in respect of scientific research and experimental development. It is proposed that on an acquisition of control of a corporate taxpayer, the carryforward of undeducted expenses will be deemed to be nil but then in each subsequent year throughout which the particular business is carried on for profit or a reasonable expectation of profit, the pre-control expenses will be available for deduction in an amount equal to the corporation's income for the year of deduction from the particular business.

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14. The argument proceeds on the basis that the adjusted cost base of the partnership interest is nil immediately prior to the amalgamation by virtue of sub-para. 54(a)(iv) (assuming the interest is disposed of on the amalgamation) and the negative adjustments to the adjusted cost base of a partnership interest do not flow through an amalgamation since the amalgamated corporation is a new corporation.

J. EFFECTIVE DATES OF PROPOSED AMENDMENTS

Generally speaking, the proposed amendments announced in the January 15, 1987 press release are effective for acquisitions of property, acquisitions of control or dispositions of property, as the case may be, occurring after January 15, 1987. In many but not all cases, there is a grandfathering provision that will exclude from the new rules a transaction that occurs pursuant to an obligation in existence on January 15, 1987 under an agreement in writing entered into on or before that date, but in many of these cases the transaction must occur during 1987 in order to be grandfathered.

The press release indicates that a person shall be considered not to be obliged to acquire or dispose of property or to acquire control of a corporation, as the case may be, if the person may be excused from performing the obligation as a result of changes to the Act affecting acquisitions or dispositions of property or of control of corporations. This is designed to negate the purported effect of an agreement entered into on or before January 15, 1987 under which a person is obliged to acquire or dispose of property or to acquire control of a corporation but the obligation is conditional on there not being any amendments to the rules in the Act relating to acquisitions or dispositions of property or acquisitions of control.

Other of the amendments apply to taxation years ending after January 15, 1987. In each case, the application rule will have to be examined to determine the time of application of the relevant proposal.

II. FEBRUARY 18, 1987 NOTICE OF WAYS AND MEANS MOTION

On February 18, 1987, the Minister of Finance tabled a Budget in the House of Commons which included a Notice of Ways and Means Motion to amend the Income Tax Act. Two of the proposed amendments are within the scope of this paper and are included in Bill C-64.

A. SUCCESSOR CORPORATION RULES: ELIMINATION OF RESTRICTION TO TWO "SUCCESSIONS"

As described above, the successor corporation rules allow a corporation which acquires all or substantially all of the Canadian resource properties or all or substantially all of the foreign resource properties[15] of a person (individual or corporation) by way of purchase, amalgamation, merger, winding-up or otherwise (other than an amalgamation described in subsection 87(1.2) or a winding-up described in subsection 88(1) of the Act) to deduct the unused resource accounts of the vendor determined immediately following the acquisition to the extent not deducted by the vendor in its taxation year in which the acquisition occurred. The rules apply only if the vendor and purchaser jointly elect to have them apply. As discussed earlier, following the amendment contained in the January 15, 1987 press release, the purchaser can only use the deductions against production

15. The successor rules for acquisitions of foreign resource properties arise from sub-ss. 66(8) and (9) which simply refer to and adopt the rules in sub-ss. 66(6) and (7) relating to the successor rules applicable to Canadian exploration and development expenses.

income from the particular property interests acquired and against income from the disposition of such interests.

The successor rules also apply where the purchaser described in the preceding paragraph disposes of all or substantially all of the resource properties acquired from the original vendor to a second purchaser by way of a transaction of one of the types described in the preceding paragraph. The rules allow, again on an elective basis, the second purchaser to deduct any portion of the resource accounts of the original vendor which was available for deduction by the first purchaser by virtue of the successor rules but was not fully deducted by that first purchaser. Again, the second purchaser can apply the deductions only against income from those properties. The rules that provide for this second flow-over of expenses are sometimes referred to as the "second successor rules".

If the second purchaser disposes of all or substantially all of the resource properties to a third purchaser, any deductions of the original vendor still remaining unused currently do not flow-over to the third purchaser. That is to say, there are presently no "third successor rules". The deductions in fact will remain with the second purchaser but since they can only be deducted against income of the second purchaser from the properties and the second purchaser no longer owns the properties (or any significant portion thereof), the deductions are of little or no value to the second purchaser.

As noted earlier, Bill C-64 essentially repeals and re-enacts all of the successor rules by way of new section 66.7. One of the results is that the successor rules are extended so as to apply to an unlimited number of successions from the person who is the original owner of the property. The new rules retain the restriction of limiting the deduction of the unused expenses of the original owner to production income from, or income resulting from a disposition of, the interests acquired. The new rules apply to acquisitions of resource properties occurring after February 17, 1987.

B. SHARE-FOR-SHARE EXCHANGE: AMENDMENTS TO SECTION 85.1

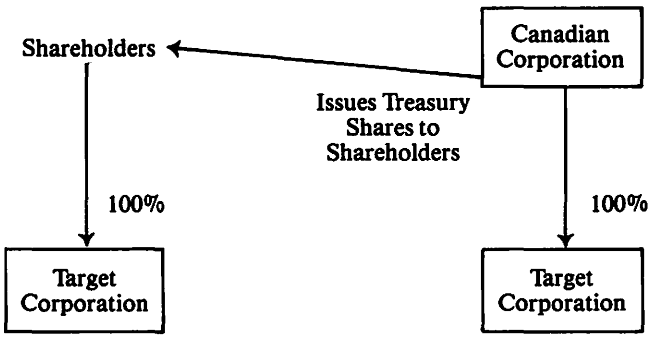
Section 85.1 allows a shareholder of a corporation to elect to receive a tax-free rollover upon the transfer by that shareholder of his shares in the target corporation to a purchaser that is a Canadian corporation in exchange for treasury shares issued by the Canadian corporation provided:

(a) the shareholder held the transferred shares as capital property;
(b) the shareholder and the purchaser were dealing at arm's length immediately before the exchange;
(c) the shareholder, persons with whom he did not deal at arm's length, or the shareholder together with such persons, does not control, directly or indirectly in any manner whatever, the purchaser and does not beneficially own more than 50% of the fair market value of all issued and outstanding shares of the purchaser, in both cases determined immediately after the exchange;
(d) no election is made under section 85 of the Act in respect of the transfer; and

(e) the only consideration received by the shareholder from the Canadian corporation for the transferred shares is shares of the Canadian corporation.

Unlike a section 85 election, no election forms have to be filed; the shareholder simply files his income tax return treating the disposition on a rollover basis. This is one of the main appeals of section 85.1 where there are a large number of shareholders tendering their shares: a massive filing of election forms is not required.

The other advantage is that the Canadian corporation is currently deemed to acquire the transferred shares at a cost equal to their fair market value immediately prior to the exchange provided the Canadian corporation acquires, either at that time or at a subsequent time, at least 10% of the fair market value of all issued and outstanding shares of the target corporation. If the 10% test is not met, the cost of the acquired shares to the Canadian corporation is nil.[16]



Bill C-64 proposes to change this and instead set the cost to the Canadian corporation of the acquired shares at the lesser of their fair market value and their paid-up capital for purposes of the Act. The paid-up capital of a share for purposes of the Act is equal to its stated capital or paid-up capital under corporate law subject to adjustment by the Act. Generally speaking, the paid-up capital of a share of a particular class represents the value of the consideration that has been received by the corporation for the issuance of all outstanding shares of that particular class, divided by the number of issued and outstanding shares of that class, unless the corporation has selected a lower paid-up capital pursuant to the relevant corporate law, or the Act has reduced the paid-up capital for tax purposes. Generally speaking, but not in all cases, if a corporation has been a growth corporation, the fair market value of its outstanding shares will likely exceed their paid-up capital, and in such a case the effect of the proposed amendment would be to limit the cost to the acquiring Canadian corporation of the shares so acquired to their paid-up capital. Note that if

16. Specifically, the rule is that each share of the target corporation is acquired at its fair market value provided that, at any time after the exchange and prior to the disposition of that share, the Canadian corporation meets the 10% test in respect of all issued and outstanding shares of the target corporation. If at the time the share is disposed of, the Canadian corporation has not at any time between the exchange and the disposition met the 10% test, its cost in the share is deemed to be nil.

the paid-up capital were to be less than the adjusted cost base to the shareholder of the transferred shares, consideration may be given to using section 85 to give the shareholder a tax-free exchange since section 85 will set the cost to the Canadian corporation of any shares acquired from the shareholder at an amount equal to the shareholder's adjusted cost base (assuming that the elected amount for purposes of the section 85 election equals the shareholder's adjusted cost base).

The purpose of the amendment is to prevent the shareholder from obtaining a rollover while the acquiring Canadian corporation achieves an acquisition cost equal to fair market value if that fair market value is greater than the paid-up capital of the shares. The Canadian corporation would then be able to sell the shares of the acquired corporation and any gain or loss would be determined by comparing the proceeds of disposition to the fair market value of the shares at the time of their acquisition by the Canadian corporation on the original exchange. In addition, where the Canadian corporation acquires or ultimately owns more than 90% of the issued and outstanding shares of the target corporation and the other rules in subsection 88(1) are met, the target corporation could be wound-up on a tax-free basis and the Canadian corporation would be entitled to carryover part of its fair market value cost base in the shares of the target on to non-depreciable capital property of the target distributed to the Canadian corporation on the liquidation.[17]

The proposed amendment is to be applicable to exchanges occurring after February 17, 1987.

17. This is the "bump" provision contained in ITA, *supra* n. 2 at sub-paras. 88(1)(c) and (d).