SELECTED PROPOSED AMENDMENTS
(December 20, 2002)

1. TAX ON SPLIT INCOME 2
2. DEFINITION OF COMMON LAW SPOUSE 4
3. TAX ON EXCESSIVE CAPITAL DIVIDEND ACCOUNT ELECTIONS 5
4. REFUND OF INSTALMENTS – HARDSHIP 7
5. STOCK OPTIONS – DEDUCTION 9
6. THE REPLACEMENT PROPERTY RULES 11
7. CAPITAL GAINS RESERVE 12
8. BUSINESS RESERVES 13
9. SECTION 160 AMENDMENTS 14
10. ACQUISITION OF CONTROL 16

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SELECTED PROPOSED AMENDMENTS
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The Department of Finance released draft legislation and explanatory notes on December 20, 2002. This draft legislation was rather detailed and covered a number of different topics. In this paper, I will concentrate on the following parts of the draft legislation:

1. Tax on Split Income (Kiddie Tax)
2. Definition of Common Law Spouse
3. Excessive Capital Dividend Election
4. Refund of Instalments
5. Stock Options – Deduction
6. Replacement Property Rules
7. Capital Gain Reserve
8. Business Reserves
9. Section 160 Amendments
10. Acquisition of Control

For each of the above subjects, I will provide an analysis of what the previous rules were and what the proposed legislation is. I will also attempt to provide a practical analysis of the implication of the new rules. Where applicable, I will provide examples which should make understanding the new proposals much easier.

SELECTED PROPOSED AMENDMENTS
(December 20, 2002)

1. TAX ON SPLIT INCOME

In 2000, the Department of Finance released the "Kiddy Tax Rules" as defined in section 120.4. This section provides that the highest federal tax rate is applicable to certain "split income". The Department of Finance has amended the definition of split income in respect of fiscal periods and taxation years that begin after the announcement date of December 20, 2002. Therefore, these rules would apply for inter-vivos trusts that have a December 2003 taxation year-end. The definition of split income of a specified individual is the total of all amounts which is required to be included in the individual's income in respect of partnership or trust income if the source of the income is the provision of goods or services by the partnership or trust to, or in support of, a **business** carried on by:

i) a person related to the individual at any time in the year;

ii) a corporation of which a person who is related to the individual is a specified shareholder at any time in the year; or

iii) a professional corporation of which a person related to the individual is a shareholder at any time in the year.

A specified individual means:

(a) an individual who has not attained the age of 17 years before the year;

(b) at no time in the year was non-resident; and

(c) has a parent who is resident in Canada at any time in the year.

Subparagraph C in the definition of split income is being amended by replacing the phrase "goods or services" with the phrase "**property** or services".

SELECTED PROPOSED AMENDMENTS (December 20, 2002)

Property is a defined term in section 248(1) which means property of any kind whatever whether real or personal or corporeal or incorporeal and without restricting the generality of the foregoing, includes:

(a) a right of any kind whatever, a share or a chose in action,

(b) unless a contrary intention is evident, money,

(c) a timber resource property, and

(d) the work in progress of a business that is a profession.

The term that was previously used in this section – “goods” is not a defined term. Therefore, there may have been circumstances where taxpayers were successfully able to argue that what was provided by the person or corporation related to the specified individual was not goods. Because of the very broad definition of property, any property or services provided by the related person or corporation will now be subject to the kiddie tax rules.

Property income must be in support of a business carried on by the related person or corporation. This means that if a trust owns a rental property, it will not necessarily be caught under these new rules. Instead, if the property owned by the trust was used for the business of the related individual, then that rental income would now be subject to the kiddie tax rules whereas before it may not have been. In the explanatory notes, the Department of Finance states that these new rules will ensure “that the split income rules will apply to income from property such as rental income”. Even though the technical notes say that the rules will now apply to rental income, the rental income must be in support of a business. Otherwise, the rental income will not be subject to these rules.

In the technical notes, the government has stated that it has made this change because "it would monitor the effectiveness of this targeted measure, and may take appropriate action if new income splitting techniques developed".

This is an area that the government is monitoring closely and there could be additional changes if the government finds other sources of income which it feels should be caught by the Kiddie Tax.

2. DEFINITION OF COMMON LAW SPOUSE

The definition of a spouse and a common law spouse has implications throughout the Income Tax Act. In subsections 73(1) and 73(1.01), there is a rollover on any transactions between spouses or common law partners. The attribution rules in 74.4 deal with transfers to spouses or common law partners. The definition of an affiliated person in subsection 251.1(1) states that spouses and common law partners are affiliated persons. The definition of related person in subsection 251(2) states that individuals are related if they are connected by marriage or common law. The related persons definitions have an effect on the association rules in section 256. One of the other areas where the issue of common law spouse is relevant is in calculating eligibility for various credits (such as GST or Child Tax Benefits) where family income is one of the determining factors.

Based on the above, determining whether or not individuals are considered to be common law spouses is a significant issue. Before the proposed amendments, a common law partner was defined, in section 248(1), as a person who cohabits in a conjugal relationship with the taxpayer and

(a) has cohabited with the taxpayer for a **continuous period** of at least one year, or

(b) would be the parent of a child of whom the taxpayer is a parent.

The definition goes on to state that where the taxpayer and the person cohabit in a conjugal relationship they are, at any particular time after that time, deemed to be cohabiting in a conjugal relationship unless they were not cohabiting at the particular time for a period of 90 days that includes the particular time because of a breakdown of the conjugal relationship.

The proposed amendments are changing the definition in two different areas. Firstly, where the original definition stated that the individual and taxpayer must cohabit for a continuous period of at least one year, the new proposal states "throughout the 12-month period that ends at that time". This change makes a lot of sense in that the previous definition did not say that the one-year period had to include the time that is being analyzed. The current definition states that there must have been cohabitation throughout the 12-month period that ends at the time being looked at.

The other proposed change is that instead of stating that two individuals are considered to be common law partners unless they were "not cohabiting" at the particular time, a proposal has been made to state that they were "living separate and apart" at the particular time. This is a clearer definition of what "not cohabiting" means. These rules are effective as of 2001 and subsequent taxation years.

3. TAX ON EXCESSIVE CAPITAL DIVIDEND ACCOUNT ELECTIONS

Section 83 of the Income Tax Act allows private corporations to pay a capital dividend tax-free to its Canadian shareholders. The capital dividend account includes various components including the non-taxable portion of a capital gain, insurance proceeds and capital dividends received from other corporations.

Before a capital dividend is paid, a Canadian corporation is required to submit to the government form T2054 reflecting the amount of capital dividend to be paid. Attached to this form must also be a summary of the capital dividend account as well as certified copies of directors' resolutions stating that a capital dividend is to be paid. Once the

CCRA receives this form, it often checks to see whether its internal records agree with the calculation of the capital dividend account provided by the taxpayer. If it has been determined that the capital dividend account, as determined by the taxpayer and paid out to its shareholders, is in excess of the capital dividend account determined by the CCRA, then pursuant to subsection 184(2) there is a tax on this excessive election. This subsection currently levies a tax of three-quarters of the excess capital dividend election. There are, however, relieving provisions which allow the corporation to change the excess capital dividend election into a taxable dividend. The result of this is to change the taxation of the excess amount from 75% to the normal dividend tax rate which in Ontario is approximately 31%. The tax on the excessive amount is to be reduced to 60% as per the proposed amendments.

An election to treat the excess capital dividend as a separate taxable dividend is not valid pursuant to subsection 184(4) unless:

(a) it is made with the concurrence of the corporation and all of its shareholders who received or were entitled to receive all or any portion of the dividend in respect of which a tax would be payable and whose addresses were known to the corporation; and

(b) either

- i) it is made on or before 30 months after the day on which the original dividend became payable, or
- ii) each shareholder that was entitled to receive all or a portion of the dividend concurs with the election.

This means that even those shareholders that are not taxable on the receipt of a taxable dividend (such as a pension fund) would have to concur with the election under the current 184(4) in order to avoid the tax on the excess election. In order to deal with this issue, proposed amendment subsection 184(5) has been introduced. This subsection proposes that where a recipient of a dividend is exempt from tax under Part I, then,

(a) there is no need to have concurrence with the election on the excess dividend, and

(b) the election on the excess dividend is valid only if it is made on or before the day that is 30 months after the day on which the original dividend became payable.

These rules apply for corporations after the 1999 taxation year. Any elections made under this subsection will be deemed to have made in a timely manner if they are made within 90 days after the amendments receive Royal Assent.

4. REFUND OF INSTALMENTS – HARDSHIP

Three new subsections have been added with regard to the refund of instalments. Proposed subsection 164(1.52) states that the Minister may refund to the taxpayer all or any part of the excess refund referred to in subsection 164(1.51). Proposed subsection 164(1.51) provides the criteria as to when instalments can be refunded. Proposed subsection 164(1.53) states that in calculating penalties or interest, an instalment is deemed not to have been paid to the extent that all or any part of the instalments can reasonably considered to have been refunded under proposed subsection 164(1.52). The key criteria are listed in proposed subsection 164(1.51), which states that the Minister can refund excessive instalments if the following four conditions are met:

i) The taxpayer has paid instalments of tax under Part 1 or where the taxpayer is a corporation, Part I.3, VI, VI.1 or XIII.

ii) It is reasonable to conclude that the total amount of instalments paid exceeds the total amount of taxes that will be payable by the taxpayer under the part of the Income Tax Act referred to, in i) above for the year.

iii) The Minister is satisfied that the payment of the instalment has caused or will cause undue hardship to the taxpayer.

iv) The Minister must agree to make the refund.

The first condition should be easy to meet in that it is simple to prove that a taxpayer has paid instalments. The second test of proving that the instalments will exceed the taxes payable should also be relatively simple to prove, especially if it is close to the end of the year. If, however, a taxpayer were trying to show that the taxes payable would be significantly less during the first half of the year, the CCRA officials may be reluctant to give the refund since there is still a long period of time for income to be earned. Where there are circumstances that are obviously going to reduce the taxpayer's income, such as the loss of a contract or key customer, it may be possible to meet the second condition at any time during the year.

The third condition may well be the most difficult to prove. The Minister must be satisfied that the payment of instalments will cause an **undue hardship** to the taxpayer. This is a very subjective determination that will be made by the CCRA officials. There are no specific criteria as to what undue hardship means. Therefore, there is the possibility that whether a taxpayer meets this test or not will be dependent on who the taxpayer is dealing with at the CCRA. This is an unfortunate situation in that every taxpayer should be treated equally. The best way for equal treatment to occur is if the CCRA provides guidelines as to what undue hardship means.

The fact that the CCRA is willing to refund instalments, before they otherwise would have, is certainly a step in the right direction. Previously, the CCRA had no mechanism to refund instalments in the year until the year in question had been assessed. In those situations, where a taxpayer anticipated having the same income as in a previous year, and had made the requisite instalments, there was no mechanism for a refund of instalments when it became obvious to the taxpayer that the income levels of a prior year would not be met.

One of the difficulties in this area may be the time at which undue hardship is proven. There may be situations where a taxpayer is not in undue hardship at the time of the request, but if the refund is not provided, then the taxpayer will be in undue hardship and could go bankrupt before any funds are refunded. These cases will be dealt with on a case-by-case basis.

5. STOCK OPTIONS – DEDUCTION

A few years ago, the Department of Finance released a number of significant changes to the way in which stock options were taxed. The main focus of these amendments was to allow the deferral of stock option income for holders of public company options. Those rules were issued at the time when stock options were prevalent and the stock market was appreciating significantly. Unfortunately for many, the stock market situation has changed dramatically since the time that the initial set of rules were issued. In light of the significant changes with the stock market, a number of corporations have tried to re-price stock options at a lower exercise price.

For example, the stock option exercise price may have been $50 originally. The corporation would reduce the exercise price of the same option to $10. The rules in subsection 7(1.4) allow for the exchange of options to be a tax-free transaction. Where subsection 7(1.4) applies, the taxpayer is deemed not to have disposed of the exchanged option and not to have acquired the new option. As well, the new option is deemed to be the same option as, and a continuation of, the exchanged option. This ensures that there is no taxation on the stock option exchange provided the necessary conditions are met. This also has an effect on whether or not a taxpayer is eligible for the stock option deduction of 50% in paragraph 110(1)(d). Subparagraph 110(1)(d)(ii) states that the amount payable by the taxpayer to acquire the security must not be less than the fair market value of the security at the time that the option was issued. With the rules as they currently stand, a taxpayer would not meet this test in a situation where the option price has been reduced by way of reducing the exercise price without exchanging the option.

In order to deal with this situation, the Department of Finance has amended subsection 110(1.7) and added proposed subsection 110(1.8). Proposed subsection 110(1.8) essentially states the conditions that are necessary in order for subsection 110(1.7) to apply. Proposed subsection 110(1.8) sets out two conditions in order for subsection 110(1.7) to apply:

i) The taxpayer cannot qualify for the stock option deduction in 110(1)(d) if the option were exercised immediately after the exercise price reduction and this subsection were disregarded; and

ii) The taxpayer would be entitled to a deduction under paragraph 110(1)(d) if there had in fact been an exchange of options, and the employee exercised the option immediately after the exchange.

The Department of Finance is trying to ensure that the provisions of subsection 110(1.7) would only apply where an otherwise disqualifying reduction in the exercise price could have been effected by way of an exchange of options without disqualifying the stock option.

Subsection 110(1.7) deems there to be an exchange of one option for another even though there was simply a reduction in the exercise price. As long as the new exercise price is the fair market value of the underlying shares at that time, then the taxpayer will still be able to claim the stock option deduction under 110(1)(d). These amendments apply to exercise price reductions that occurred after 1998.

As discussed above, new provisions had been added to the Income Tax Act with regard to the deferral of the stock option benefit with public company shares. If, however, a taxpayer was not able to claim the stock option deduction because of a stock option exercise price being reduced, the taxpayer is eligible to file the election on the deferral of the stock option benefit 60 days after Royal Assent. This is to allow situations where the stock option deferral is now available because of the introduction of 110(1.7) and (1.8) that otherwise was not available.

6. <u>THE REPLACEMENT PROPERTY RULES</u>

There are replacement property rules for depreciable property in subsection 13(4) and for non-depreciable property in section 44. These rules allow the deferral of recapture and capital gains provided that the proceeds from the sale of the assets are used to buy a replacement asset with the proceeds. In order for these replacement property rules to apply, the former property had to be replaced before the end of the second taxation year in the case of appropriations and in any other case before the end of the first taxation year, following the year of disposition. This meant that if there were a short taxation year because of a change of control, the replacement property had to be purchased before that deemed short year-end. In order to remedy this situation, the Department of Finance has proposed that the time period within which properties must be replaced is as follows:

(a) for appropriation situations – **<u>24 months</u>** after the end of the initial year, and

(b) in any other case – **<u>12 months</u>** after the end of the initial year.

This ensures that those taxpayers who have a short taxation year are not penalized by not being able to use the replacement property rules. Instead, the taxpayer now has 12 months to 24 months depending on the situation.

The amendments to the replacement property rules will apply to dispositions that occurred in taxation years that end on or after the date that is 24 months before December 20, 2002 for appropriations and in any other case, in respect of dispositions that occurred in taxation years that end on or after the date that is 12 months before

December 20, 2002. Therefore, for those situations where there was a short taxation year within 12 months or 24 months before December 20, 2002, there could be an extension for the replacement property rules to apply.

7. CAPITAL GAINS RESERVE

Subsection 44(7) deals with those situations where a taxpayer is prohibited from claiming a capital gains reserve.

A capital gain reserve is currently disallowed where:

(a) The taxpayer, at the end of the year or at any time immediately the following year, was not resident in Canada or was exempt from tax under any other provisions of Part 1, or

(b) The person to whom the former property of the taxpayer was disposed of was a corporation that, immediately after the disposition,

- i) was controlled directly or indirectly in any manner whatever by the taxpayer,
- ii) was controlled, directly or indirectly in any manner whatever, by a person or a group of persons by whom the taxpayer was controlled, or
- iii) controls the taxpayer, directly or indirectly were the taxpayer is a corporation.

The Department of Finance has added proposed paragraph (c) which states that the capital gain reserve will be denied where the former property was disposed of to a partnership in which the taxpayer was, immediately after the disposition, a "majority interest partner". A majority interest partner is defined in subsection 248 as a person or partnership

(a) whose share of the partnership's income from all sources for the last fiscal period of the partnership would have exceeded one-half of the partnership's income from all sources for that period if the taxpayer had held each interest in the partnership held by the taxpayer or affiliated persons, or

(b) whose share, together with the shares of every person with whom the taxpayer is affiliated, of the total amount that would be paid to all members of a particular partnership, if it were wound up at that time, exceeds half of that amount.

This means that if 50% of the income is allocated to the individual or an affiliated person or if 50% of the assets on wind-up would be allocated to the individual or affiliated persons, then the taxpayer is a majority interest partner. This eliminates the possibility of selling the asset to a partnership instead of a corporation in order to claim the capital gain reserve. This applies to any dispositions that occur after December 20, 2002.

8. BUSINESS RESERVES

Paragraph 20(1)(n) allows for a reserve on business income in respect of property sold where a portion of the sale proceeds are not due. There are, however, certain conditions under which a reserve cannot be taken. Subsection 20(8) currently provides that a reserve is not available under paragraph 20(1)(n) where

(a) The taxpayer, at the end of the year or at any time immediately following the taxation year,

  i) was exempt from tax under any provision of Part 1, or

  ii) was not resident in Canada and did not carry on a business in Canada; or

(b) The sale occurs more than 36 months before the end of the year.

The Department of Finance has proposed two additional paragraphs. In proposed paragraph (c) of this subsection, a reserve will be denied where the property was sold to a corporation that, immediately after the sale,

i) was controlled by the taxpayer;

ii) was controlled by a person or a group of persons that control the taxpayer; or

iii) controlled the taxpayer.

In proposed paragraph (d) the reserve will be denied where the purchaser of the property sold was a partnership in which the taxpayer was immediately after the sale a majority interest partner.

This applies to dispositions of property that occur after December 20, 2002.

9. <u>SECTION 160 AMENDMENTS</u>

Section 160 contains rules that deal with the situations where a person has transferred property by means of a trust or any other means to:

(a) a person's spouse or common law partner or a person who has since become the person's spouse of common law partner,

(b) a person who was under 18 years of age, or

(c) a person with whom the person was not dealing at arm's length.

The following rules will apply.

1) The transferee and transferor are jointly and severally liable to pay a part of the transferor's tax equal to the tax by which the tax for the year is greater than it would have been without regard to various attribution rules in respect of any income, or gain from the disposition of the property; and

2) The transferee and transferor are jointly and severally liable to pay an amount equal to the lesser of

   a) The amount by which the fair market value of the property transferred exceeds the fair market value of the consideration given for the property, and

   b) The total of all amounts each of which is the amount that the transferor is liable to pay in taxes or in respect of the taxation year in which the property was transferred or any preceding taxation year.

The section concludes by stating that nothing in that subsection shall be deemed to limit the liability of the transferor under any other provision of this Act.

There are various other subsections in section 160 dealing with other situations where joint liability would arise including the following:

160(1.1) – Where subsection 69(11) applies

160(1.2) – Tax on split income

160.2(1) – Amounts received out of or under an RRSP

160.2(2) – Amounts received out of or under an RRIF

160.3(1) – Amounts received out of or under an RCA trust

160.4(1) – Liabilities in respect of transfers by insolvent corporations

In all of the above subsections, there is a proposed amendment that those who are jointly liable with the original taxpayer are also liable for any interest on those taxes.

SELECTED PROPOSED AMENDMENTS (December 20, 2002)

These proposed amendments apply to any assessments made after December 20, 2002.

10. ACQUISITION OF CONTROL

The provisions in subsection 256(7) deal with acquisition of control. More specifically, this subsection attempts to clarify when an acquisition of control has occurred and under which circumstances there has not been acquisition of control. The determination of whether or not there has been an acquisition of control is relevant for a number of other sections within the Income Tax Act. Subsection 249(4) states that where there has been an acquisition of control, then there will be a deemed year-end. The deemed year-end affects many other areas including but not limited to the following:

(a) the proration of the small business deduction,

(b) the proration of capital cost allowance,

(c) the use of non-capital losses carried forward and when they are to expire,

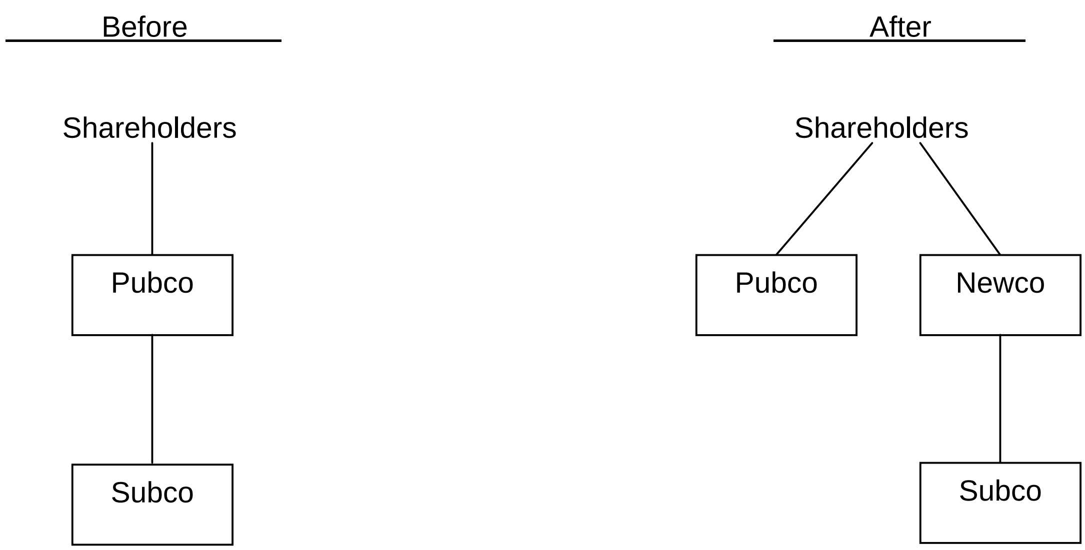
(d) the loss of capital losses carried forward,

(e) the availability of investment tax credits, and

(f) the proration of eligible capital expenditure amounts.

The proposed amendments include the addition of clause 256(7)(a)(i)(E). This clause ensures that there is no acquisition of control of a corporation on a distribution that is discussed in subsection 55(1). These rules are generally known to be the Butterfly Rules. There will be no change of control where there has been a distribution by a specified corporation where a dividend that is received in the course of a spin-off distribution is not treated as a capital gain by the anti-avoidance rules in subsection 55(2) because of the application of paragraph 55(3)(b). The detailed rules of the butterfly transactions dealt with in section 55 are beyond the scope of this paper. However, there are some key situations where these change of control rules will be relevant. Paragraph 55(3)(b) generally deals with public corporations.

Suppose that a public company has shares that are widely owned. There is no one person or group of persons that controls the company. The public company ("Pubco") wishes to transfer the shares of its subsidiary company ("Subco") to a new corporation ("Newco"). In order to effect this transfer, Pubco sets up a Newco and transfers the Subco's shares to Newco. As a consequence of the butterfly reorganization, the Newco shares are held by the same shareholders that were shareholders of Pubco. The Newco will now own the shares of the Subco. Without proposed clause 256(7)(a)(i)(E) as noted above, there would have to be a change of control. This would have resulted in a deemed year-end. Since the exact same shareholders are still in control of Newco, as were the shareholders of Pubco, the proposed rules are now that there won't be a change of control in that situation.



These new rules will apply to the acquisition of any shares after 2000.

SELECTED PROPOSED AMENDMENTS
(December 20, 2002)

The second amendment to subsection 256(7) is the proposed amendment in subparagraph 256(7)(a)(iii). In this subparagraph, it states that there will be no acquisition of control of a corporation by a related group of persons if each member of each group of persons that controls the corporation was related to the corporation immediately before the change of control.

An example of the situation that is contemplated within these rules is as follows:

> Corporation X was previously owned by Dad 51% and Daughter 49%. There are only common shares outstanding which means that Dad has de jure control of the corporation. If Dad disposed of 10 shares of the corporation to an arm's length person, Dad would no longer have de jure control and a group of persons would be considered to acquire de jure control of the corporation. In this case, the group of persons that could have acquired control could be any of the following groups:
>
> a. Dad and Daughter (90% control)
>
> b. Dad and arm's length person (51%)
>
> c. Daughter and arm's length person (59%)

In the Department of Finance technical notes, it states that it is a question of fact as to which group has acquired control of the corporation. If it can be proven that Dad and Daughter are still in control of the corporation, then there would not be an acquisition of control. If, however, it could be shown that the arm's length person and either one of Dad or Daughter have formed a group, then there would be an acquisition of control since there would be a change of control from Dad, originally, to this new group.

The key issue in this situation is trying to determine who the controlling group of persons is. Since this will be a question of fact, there will have to be detailed analysis as to whether or not it could be argued that there are three different groups that control the corporation. If this is the case, then the acquisition of control rules would apply. It will not always be clear whether or not a change of control has occurred given that it is the relationship between the new shareholder and the old shareholders that will be determinative. One of the ways that could prove that Dad and Daughter still control the corporation is possibly through a shareholder agreement or an agreement between just Dad and Daughter stating that they will vote in the same manner. Since this situation is driven by the facts, careful analysis and backup will be required in order to justify the position taken.

Based on the analysis of the proposed amendments, there are some significant changes that practitioners need to be aware of.