Editorial Comment on Budget Resolutions

That it is expedient to amend the *Income Tax Act* and other tax legislation as follows:

Resolution 1: Adoption Expense Tax Credit

1. (1) Paragraph (*a*) of the description of B in subsection 118.01(2) of the *Income Tax Act* is replaced by the following:

(*a*) $15,000, and

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

(3) Subsection 117.1(1) of the Act does not apply in respect of subsection 118.01(2) of the Act for the 2014 taxation year.

Editorial Comment: The adoption expense credit, in section 118.01 of the Act, provides a federal non-refundable credit to taxpayers who adopt a child under the age of 18 years. The credit is provided for "eligible adoption expenses" incurred by taxpayers during the "adoption period" as defined in subsection 118.01(1) of the Act. In the past, the maximum amount claimed per child was 15% of the lowest income tax rate. For example, the maximum claim for each child in 2014 was originally set to be $11,774.

The Budget will increase the maximum claim for eligible adoption expenses in 2014 to $15,000 per child, in recognition of the increased costs individuals incur in the adoption process. The credit may be claimed in the taxation year in which an adoption is completed. This maximum amount will be indexed for inflation in subsequent taxation years after 2014.

Resolution 2: Medical Expense Tax Credit

2. (1) The portion of paragraph 118.2(2)(*l*) of the Act before subparagraph (i) is replaced by the following:

(*l*) on behalf of the patient who is blind or profoundly deaf or has severe autism, severe diabetes, severe epilepsy or a severe and prolonged impairment that markedly restricts the use of the patient's arms or legs,

(2) Subsection 118.2(2) of the Act is amended by adding the following after paragraph (*l.91*):

(*l.92*) as remuneration for the design of an individualized therapy plan for the patient because of the patient's severe and prolonged impairment, if

(i) because of the patient's impairment, an amount would be, if this Act were read without reference to paragraph 118.3(1)(*c*), deductible under section 118.3 in computing a taxpayer's tax payable under this Part for the taxation year in which the remuneration is paid,

(ii) the plan is required to access public funding for specialized therapy or is prescribed by

(A) a medical doctor or a psychologist, in the case of mental impairment, or

(B) a medical doctor or an occupational therapist, in the case of a physical impairment,

(iii) the therapy set out in the plan is prescribed by, and, if undertaken, administered under the general supervision of,

(A) a medical doctor or a psychologist, in the case of mental impairment, or

(B) a medical doctor or an occupational therapist, in the case of a physical impairment, and

(iv) the payment is made to a person ordinarily engaged in a business that includes the design of such plans for individuals who are not related to the payee;

(3) Subsections (1) and (2) apply in respect of expenses incurred after 2013.

Editorial Comment: The Medical Expense Tax Credit ("METC") is provided in subsection 118.2(1) of the Act. Subsection 118.2(2) provides a list of expenditures that qualify as medical expenses for the purpose of the METC.

Taxpayers who qualify for the METC are eligible for a credit equal to 15% of eligible medical and disability-related expenses above a specific threshold. The relevant threshold is the lesser of either 3% of the taxpayer's net income or the indexed dollar amount, which was $2171 in 2014.

The Budget proposes that the costs of an individual therapy plan will qualify for the METC if certain criteria are met:

- The cost of therapy itself qualifies under the METC;
- The therapy is under the general supervision of a medical doctor, occupational therapist or psychologist;
- The plan is designed for an individual with a severe and prolonged physical or mental impairment, and as a result of his or her impairment, the individual is eligible for the Disability Tax credit;
- The individual therapy plan is required to access the services of a medical doctor, therapist or psychologist that is administering the plan; and
- The plan is prepared by a professional who is not related to the individual.

As stated in the Explanatory Notes, the Budget proposes to add costs associated with training service animals for taxpayers with severe diabetes to the list of expenditures in subsection 118.2(2). Eligible expenses would include the cost of the service animal, care and maintenance required for the animal and any reasonable travel expenses incurred to train service animals.

These measures apply to expenses incurred after the 2013 taxation year.

Resolutions 3 to 6: Search and Rescue Volunteers Tax Credit

3. (1) Subsection 81(4) of the Act is amended by replacing the portion after subparagraph (*b*)(ii) with the following:

there shall not be included in computing the individual's income derived from the performance of those duties the lesser of $1,000 and the total of those amounts, unless the individual makes a claim under section 118.06 or 118.07 for the year.

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

4. (1) Subsections 118.06(1) and (2) of the Act are replaced by the following:

118.06 (1) In this section and section 118.07, "eligible volunteer firefighting services" means services provided by an individual in the individual's capacity as a volunteer firefighter to a fire department that consist primarily of responding to and being on call for firefighting and related emergency calls, attending meetings held by the fire department and participating in required training related to the prevention or suppression of fires, but does not include services provided to a particular fire department if the individual provides firefighting services to the department otherwise than as a volunteer.

(2) For the purpose of computing the tax payable under this Part for a taxation year by an individual, there may be deducted the amount determined by multiplying $3,000 by the appropriate percentage for the taxation year if the individual

(*a*) performs in the year not less than 200 hours of service each of which is an hour of

(i) eligible volunteer firefighting service for a fire department, or

(ii) eligible search and rescue volunteer service for an eligible search and rescue organization; and

(*b*) provides the certificates referred to in subsections (3) and 118.07(3) as and when requested by the Minister.

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

5. (1) The Act is amended by adding the following after section 118.06:

118.07 (1) The following definitions apply in this section and section 118.06.

"eligible search and rescue organization" means a search and rescue organization

(*a*) that is a member of the Search and Rescue Volunteer Association of Canada, the Civil Air Search and Rescue Association, or the Canadian Coast Guard Auxiliary; or

(*b*) whose status as a search and rescue organization is recognized by a provincial, municipal or public authority.

"eligible search and rescue volunteer services" means services, other than eligible volunteer firefighting services, provided by an individual in the individual's capacity as a volunteer to an eligible search and rescue organization that consist primarily of responding to and being on call for search and rescue and related emergency calls, attending meetings held by the organization and participating in required training related to search and rescue services, but does not include services provided to an organization if the individual provides search and rescue services to the organization otherwise than as a volunteer.

(2) For the purpose of computing the tax payable under this Part for a taxation year by an individual, there may be deducted the amount determined by multiplying $3,000 by the appropriate percentage for the taxation year if the individual

(*a*) performs in the year not less than 200 hours of service each of which is an hour of

(i) eligible search and rescue volunteer service for an eligible search and rescue organization, or

(ii) eligible volunteer firefighting services for a fire department;

(*b*) provides the certificates referred to in subsections (3) and 118.06(3) as and when requested by the Minister; and

(*c*) has not deducted an amount under section 118.06 for the year.

(3) If the Minister so demands, an individual making a claim under this section in respect of a taxation year shall provide to the Minister a written certificate from the team president, or other individual who fulfils a similar role, of each eligible search and rescue organization to which the individual provided eligible search and rescue volunteer services for the year, attesting to the number of hours of eligible search and rescue volunteer services performed in the year by the individual for the particular organization.

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

6. (1) Paragraph 118.3(2)(*d*), the description of C in subsection 118.61(1), paragraph 118.61(2)(*b*), paragraph (*a*) and subparagraph (*b*)(ii) of the description of C in section 118.8, the description of B in paragraph 118.81(*a*), sections 118.92 and 118.94, paragraph 127.531(*a*) and clause 128(2)(*e*)(iii)(A) of the Act are amended to add references to section 118.07.

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

Editorial Comment: These resolutions introduce a Search and Rescue Volunteers Tax Credit for individual volunteers who provide eligible search and rescue services. This is similar to the Volunteer Firefighters Tax Credit permitted for individual volunteers who provide firefighting services in 2011 and subsequent taxation years.

From 2014 onwards, an individual who volunteers to provide search and rescue services on the ground, in the air, or in water, will be eligible to claim a non-refundable credit of 15% on an amount of $3000.

The individual must volunteer at least 200 hours for search and rescue activities in a taxation year. Eligible and rescue activities include:

- responding to and being on call for search and rescue and related emergencies;
- attending meetings held by the search and rescue organization; and
- participating in training sessions related to search and rescue.

If an individual performs services that are eligible for both the Search and Rescue and the Volunteer Firefighters credits, then the individual can claim either credit but not both. An individual claiming either of these two credits is ineligible for a tax exemption under subsection 81(4) for honoraria paid by a government, municipality or public authority.

Eligible search and rescue organizations include:

- Search and Rescue Volunteer Association of Canada;
- Civil Air Search and Rescue Association;
- The Canadian Coast Guard Auxiliary; or
- Any other search and rescue organization that is recognized by a provincial, municipal or public authority.

The individual claiming this tax credit may have to obtain a written certificate from a team president, or an individual with equivalent authority, to certify the number of hours of service completed.

This credit is not available to an individual who provides search and rescue services in another capacity and not as a volunteer.

Various provisions in the Act are amended to recognize the new search and rescue tax credit, which applies to 2014 and subsequent taxation years.

Resolution 7: Extension of the Mineral Exploration Tax Credit for Flow-Through Share Investors

7. (1) Paragraph (*a*) of the definition "flow-through mining expenditure" in subsection 127(9) of the Act is replaced by the following:

(*a*) that is a Canadian exploration expense incurred by a corporation after March 2014 and before 2016 (including, for greater certainty, an expense that is deemed by subsection 66(12.66) to be incurred before 2016) in conducting mining exploration activity from or above the surface of the earth for the purpose of determining the existence, location, extent or quality of a mineral resource described in paragraph (*a*) or (*d*) of the definition "mineral resource" in subsection 248(1),

(2) Paragraphs (*c*) and (*d*) of the definition "flow-through mining expenditure" in subsection 127(9) of the Act are replaced by the following:

(*c*) an amount in respect of which is renounced in accordance with subsection 66(12.6) by the corporation to the taxpayer (or a partnership of which the taxpayer is a member) under an agreement described in that subsection and made after March 2014 and before April 2015, and

(*d*) that is not an expense that was renounced under subsection 66(12.6) to the corporation (or a partnership of which the corporation is a member), unless that renunciation was under an agreement described in that subsection and made after March 2014 and before April 2015;

(3) Subsections (1) and (2) apply to expenses renounced under a flow-through share agreement entered into after March 2014.

Editorial Comment: By issuing flow-through shares, which are generally common shares, resource corporations may raise capital and, as exploration and development expenses are incurred, renounce those expenses to the holders of flow-through shares. The holders may deduct the renounced expenses in computing their taxable income. As an additional benefit, the mineral exploration tax credit ("METC" — not to be confused with the medical expense tax credit referred to elsewhere in the Budget papers), which is available to individuals who acquire flow-through shares, provides a credit equal to 15% of specified mineral exploration expenses incurred in Canada and renounced to flow-through share investors. The METC, which was first enacted in 2000, was initially scheduled to expire at the end of 2003. However, in 2003 the government extended the METC for a further year, and thereafter has continued to enact annual one-year extensions of the METC. Resolution 7 will amend the definition of "flow-through mining expenditure" in subsection 127(9) of the *Income Tax Act* so as to extend the METC for a further year, to flow-through share agreements entered into on or before March 31, 2015.

By reason of a "look-back" rule, funds raised in one calendar year with the benefit of the METC may be spent on eligible exploration up to the end of the following calendar year. Thus, funds raised by a corporation with the METC during the first three months of 2015 may be spent by the corporation on eligible exploration until the end of 2016.

Resolution 8: Farming and Fishing Businesses

8. (1) Section 248 of the Act is amended by adding the following after subsection (28):

(29) For the purposes of this Act, if at any time a person or partnership carries on a farming business and a fishing business,

(*a*) a property used at that time principally in a combination of the activities of the farming business and the fishing business is deemed to be used at that time

(i) principally in the course of carrying on the farming business, and

(ii) principally in the course of carrying on the fishing business; and

(*b*) in the case of a corporation or partnership,

(i) a property used at that time principally in the course of carrying on the farming business is deemed to also be used at that time principally in the course of carrying on the fishing business, and

(ii) a property used at that time principally in the course of carrying on the fishing business is deemed to also be used at that time principally in the course of carrying on the farming business.

(2) Subsection (1) applies to dispositions and transfers of property that occur after 2013.

Editorial Comment: Under subsections 70(9) to (9.8) of the Act, a tax-deferred rollover is allowed under the Act if qualified farm or fishing property is bequeathed by a deceased taxpayer to his or her child. For these purposes, a "child" is defined in subsection 70(10) to include a grandchild and great-grandchild, and a person who, at any time before the person attained the age of 19 years, was wholly dependent on the deceased taxpayer for support was in legal or factual custody of the person. The treatment is elective and can be a full rollover (no gain realized) or a partial rollover (partial gain realized).

Under the current rules, if the deceased individual carried on the farming or fishing business, the property must have been "used principally" in the farming or fishing business, as the case may be (see s. 70(9)). "Principally" generally means 50% or more. If the property was a share in a family farm or fishing corporation or an interest in a family farm or fishing partnership, all or substantially all of the fair market value of the property owned by the corporation or partnership must have been attributable to assets used principally in a farming or fishing business, as the case may be (see s. 70(9.2)). "All or substantially all" is interpreted by the CRA to mean 90% or more.

The Budget proposes to add new subsection 248(29) to the Act, which would clarify these rules such that property used principally in a combination of farming and fishing will be deemed to be used principally in a farming business and a fishing business. Accordingly, if a property is used 40% of the time for farming and 35% of the time for fishing, the new rules will provide that the property qualifies for the "used principally" requirement and thus can be eligible for the tax-deferred rollover.

A similar concern arises in respect of the $800,000 life capital gains exemption (CGE) that currently applies to individuals disposing of qualified farming or fishing property (see ss. 110.6(2) and (2.2)), including shares and interests in family farm or fishing corporations or partnerships (all defined in s. 110.6(1)). Under current rules, a "principally used" test is applied independently for property used in a farming or fishing business, but a combination of farming or fishing use cannot be applied together. As with the amendment to the rollover rules, proposed subsection 248(29) effectively clarifies that property used principally in a combination of farming and fishing will be deemed to be used principally in a farming and a fishing business for the purposes of the CGE rules.

The new rules will apply to dispositions and transfers that occur in 2014 and subsequent tax years.

Resolution 9: Tax Deferral for Farmers

9. (1) The definition "breeding animals" in subsection 80.3(1) of the Act is replaced by the following:

"breeding animals" means deer, elk and other similar grazing ungulates, bovine cattle, bison, goats, sheep, and horses, that are over 12 months of age and are kept for breeding;

(2) Subsection 80.3(1) of the Act is amended by adding the following in alphabetical order:

"breeding bees" means bees that are not used principally to pollinate plants in greenhouses and larvae of such bees;

"breeding bee stock", of a taxpayer at any time, means a reasonable estimate of the quantity of a taxpayer's breeding bees held at that time in the course of carrying on a farming business using a unit of measurement that is accepted as an industry standard;

(3) Section 80.3 of the Act is amended by adding the following after subsection (4):

(4.1) If in a taxation year a taxpayer carries on a farming business in a region that is at any time in the year a prescribed drought region or a prescribed region of flood or excessive moisture and the taxpayer's breeding bee stock at the end of the year in respect of the business does not exceed 85% of the taxpayer's breeding bee stock at the beginning of the year in respect of the business, there may be deducted in computing the taxpayer's income from the business for the year the amount that the taxpayer claims, not exceeding the amount, if any, determined by the formula

$$(A - B) \times C$$

where

A is the amount by which

(*a*) the total of all amounts included in computing the taxpayer's income for the year from the business in respect of the sale of breeding bees in the year

exceeds

(*b*) the total of all amounts deducted under paragraph 20(1)(*n*) in computing the taxpayer's income from the business for the year in respect of an amount referred to in paragraph (*a*) of this description;

B is the total of all amounts deducted in computing the taxpayer's income from the business for the year in respect of the acquisition of breeding bees; and

C is

(*a*) 30% where the taxpayer's breeding bee stock in respect of the business at the end of the year exceeds 70% of the taxpayer's breeding bee stock in respect of the business at the beginning of the year, and

(*b*) 90% where the taxpayer's breeding bee stock in respect of the business at the end of the year does not exceed 70% of the taxpayer's breeding bee stock in respect of the business at the beginning of the year.

(4) The portion of subsection 80.3(5) of the Act before paragraph (*b*) is replaced by the following:

(5) An amount deducted under subsection (4) or (4.1) in computing the income of a taxpayer for a particular taxation year from a farming business carried on in a region prescribed under those subsections may, to the extent that the taxpayer so elects, be included in computing the taxpayer's income from the business for a taxation year ending after the particular taxation year, and is, except to the extent that the amount has been included under this subsection in computing the taxpayer's income from the business for a preceding taxation year after the particular year, deemed to be income of the taxpayer from the business for the taxation year of the taxpayer that is the earliest of

(*a*) the first taxation year beginning after the end of the period or series of continuous periods, as the case may be, for which the region is prescribed under those subsections,

(5) The portion of subsection 80.3(6) of the Act before paragraph (*a*) is replaced by the following:

(6) Subsections (2), (4) and (4.1) do not apply to a taxpayer in respect of a farming business for a taxation year

(6) Section 80.3 of the Act is amended by adding the following after subsection (6):

(7) In applying subsection (4.1) in respect of a taxation year, the unit of measurement used for estimating the quantity of a taxpayer's breeding bee stock held in the course of carrying on a farming business at the end of the year is to be the same as that used for the beginning of the year.

(7) Subsections (1) to (6) apply to the 2014 and subsequent taxation years.

Editorial Comment: Under section 80.3 of the Act, farmers who dispose of breeding livestock due to drought, flood or excess moisture conditions existing in prescribed regions (see ss. 7305, 7305.01 and 7305.02 of the *Income Tax Regulations*) in a given year are permitted to defer a portion of the sale proceeds from inclusion in their income until the year following the sale (or a later year if the undesirable conditions persist). In order to obtain a deferral, the taxpayer's breeding herd at the end of the year in respect of the business cannot exceed 85% of the taxpayer's breeding herd at the beginning of the year.

The deferred amount is 90% of the sale proceeds if the farmer's breeding herd at the end of the year is equal to or less than 70% of the taxpayer's breeding herd at the beginning of the year. A lower 30% deferral applies if the taxpayer's breeding herd at the end of the year is greater than 70% of the taxpayer's breeding herd at the beginning of the year.

The Budget proposes to amend the definition of "breeding animals" to add horses that are over 12 months of age and kept for breeding (the existing definition includes deer, elk and other similar grazing ungulates, bovine cattle, bison, goats, and sheep, that are over 12 months of age and kept for breeding, but includes only horses that are over 12 months of age and are kept for breeding in the commercial production of pregnant mares' urine). Additionally, the Budget proposes to extend the deferral under section 80.3 to "breeding bees" (i.e., bees that are not used principally to pollinate plants in greenhouses and larvae of such bees).

The new provisions in section 80.3 would apply to the 2014 and subsequent tax years.

Resolution 10: Amateur Athlete Trusts

10. The Act is modified in accordance with the proposals relating to Amateur Athlete Trusts described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Section 143.1 of the Act allows an amateur athlete to enter into an arrangement with a registered Canadian amateur athletic association. The arrangement, deemed to be a trust and referred to as an "amateur athlete trust", allows the athlete to contribute his or her "qualifying performance income" (see definition in s. 143.1(1)) for a taxation year to the trust. Such income includes endorsement income, prize money, or income from public appearances or speeches received during a period in which the athlete was amateur in connection with the athlete's participation in international sporting events. The contributed income is excluded from the athlete's income and is instead deemed to be income of the trust for the year. That contributed income, along with any investment income earned on the contributed income, is not taxable in the trust. It is included in the athlete's income upon distribution from the trust.

Since the qualifying performance income is not included in the athlete's income, it cannot qualify as "earned income" for RRSP contribution purposes (see the definitions of "earned income" and "RRSP deduction limit" in s. 146(1) of the Act). As such, it does not currently add to the athlete's RRSP contribution room. The Budget proposes to allow income that is contributed to an amateur athlete trust to qualify as earned income for the purpose of determining the RRSP contribution limit of the trust's beneficiary.

The proposed amendments would apply in respect of contributions made to amateur athlete trusts after 2013. Additionally, the Budget papers indicate that individuals who contributed to an amateur athlete trust before 2014 will be permitted to make an election to have income that was contributed to the trust in 2011, 2012 and 2013 also qualify as earned income. An individual will be required to make such an election in writing and submit it to the CRA on or before March 2, 2015.

It is interesting to note that this amendment may provide a direct benefit to our Olympic athletes in Sochi who are competing for medals while our Minister of Finance presents his 2014 Budget. Also, the CRA has stated in the past that it considers Olympic medals and Canadian Olympic Committee prize money to be taxable to successful athletes (see, for example, s. 7700 of the *Income Tax Regulations* and CRA Document No. 2012-0458181M4 "Olympic performance awards" (September 18, 2012) and CRA Document No. 2013-0477251M4 "Prescribed prizes, lottery winnings, insurance" (March 14, 2013)).

Resolutions 11 to 12: GST/HST Credit Administration

11. (1) The portion of subsection 122.5(3) of the Act before the formula is replaced by the following:

(3) An eligible individual in relation to a month specified for a taxation year who files a return of income for the taxation year is deemed to have paid during the specified month on account of their tax payable under this Part for the taxation year an amount equal to $1/4$ of the amount, if any, determined by the formula

(2) Subsection 122.5(5) of the Act is replaced by the following:

(5) If an individual is a qualified relation of another individual in relation to a month specified for a taxation year and both those individuals would be, but for this subsection, eligible individuals in relation to the specified month, only the individual that the Minister designates is the eligible individual in relation to the specified month.

(3) Subsections (1) and (2) apply to the 2014 and subsequent taxation years.

12. (1) Subsection 152(1.2) of the Act is amended by striking out "and" at the end of paragraph (*b*), by adding "and" at the end of paragraph (*c*) and by adding the following after paragraph (*c*):

(*d*) where the Minister determines the amount deemed by subsection 122.5(3) to have been paid by an individual for a taxation year to be nil, subsection (2) does not apply to the determination unless the individual requests a notice of determination from the Minister.

(2) Subsection (1) applies to the 2014 and subsequent taxation years.

Editorial Comment: The Goods and Services Tax/Harmonized Sales Tax (GST/HST) credit is a refundable tax credit that is available to low-income eligible individuals, based on their adjusted family net income. For 2014, the credit is phased out when the adjusted family income reaches $34,872.

Under current rules, an eligible individual is required to apply for the credit by checking a box on their income tax return. Resolution 11 proposes to eliminate that requirement, and instead the CRA will automatically determine if the individual qualifies. In the case of eligible couples, the resolution proposes that the Minister will designate the eligible individual; the Budget papers indicate that this will be the eligible individual whose tax return is assessed first. The measures will apply to tax returns filed for the 2014 year and subsequent years.

A notice of determination will not be sent to ineligible individuals (those who do not qualify for the credit). However, an ineligible individual can request a notice of determination from the CRA. Once the determination is made, the individual will have the opportunity to object to the determination.

Resolution 13: Tax on Split Income

13. (1) Subparagraph (*b*)(ii) of the definition "split income" in section 120.4 of the Act is replaced by the following:

(ii) can reasonably be considered to be income derived

(A) from the provision of property or services by a partnership or trust to, or in support of, a business carried on by

(I) a person who is 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, or

(B) from a source that is a business or from the rental of property, if a person who is related to the individual at any time in the year

(I) is actively engaged on a regular basis in the activity of the partnership, in respect of which paragraph 96(1)(*f*) applies, of earning income from a business or the rental of property, or

(II) has an interest in the partnership directly or indirectly through another partnership, or

(2) Subparagraph (*c*)(ii) of the definition "split income" in section 120.4 of the Act is amended by striking out "or" at the end of clause (B), by adding "or" at the end of clause (C) and by adding the following after clause (C):

(D) to be income derived from a source that is a business or from the rental of property, if a person who is related to the individual at any time in the year is actively engaged on a regular basis in the activity of the trust of earning income from a business or the rental of property.

(3) Subsections (1) and (2) apply to the 2014 and subsequent taxation years.

Editorial Comment: The Canadian income tax system applies a progressive marginal rate structure to the taxation of personal income. The *Income Tax Act* contains a number of rules intended to reduce the ability of a high-income taxpayer to split taxable income with lower-income individuals. One of these rules, which imposes a tax on "split income," limits income-splitting techniques that seek to shift certain types of income from a high-income individual to a lower-income minor. The highest marginal tax rate (currently 29 per cent) applies to "split income" paid or payable to a minor, which generally comprises:

- taxable dividends (and shareholder benefits) received directly, or indirectly through a partnership or trust, in respect of unlisted shares of Canadian and foreign corporations (other than shares of a mutual fund corporation);
- capital gains from dispositions of those types of shares to persons who do not deal at arm's length with the minor; and
- income from a partnership or trust that is derived from providing property or services to, or in support of, a business carried on by a person related to the minor or in which the related person participates.

The tax on split income does not currently apply to situations where a minor is allocated income from a partnership or trust that is derived from business or rental activities conducted with third parties. As a result, certain taxpayers who engage in those activities are using trust and partnership structures to split business and rental income with minors. For example, an adult might provide services to clients of a partnership of which the adult's minor child is a member (either directly or through a trust of which the child is a beneficiary). The child is then allocated a share of the partnership's income–in essence, income that was earned as a result of the services provided by the adult.

Resolution 13 proposes to amend the definition of "split income" in subsection 120.4(1) of the *Income Tax Act* so as to preclude the use of a partnership or a trust to split income in the above manner. In particular, it is proposed that the definition "split income" be amended to include income that is, directly or indirectly, paid or allocated to a minor from a trust or partnership if:

- the income is derived from a source that is a business or a rental property; and
- a person related to the minor
  - – is actively engaged on a regular basis in the activities of the trust or partnership to earn income from any business or rental property, or
  - – has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership).

The proposed amendment will apply to the 2014 and subsequent taxation years.

Resolutions 14 to 27: Graduated Rate Taxation of Trusts and Estates

14. (1) Clause 80.04(6)(*a*)(ii)(B) of the Act is replaced by the following:

(B) if the debtor is an individual (other than a trust) or a graduated rate estate, the day that is one year after the taxpayer's filing-due date for the year;

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Following an announcement made in the 2013 Federal Budget that the Government would "consult on possible measures to eliminate the tax benefits that arise from taxing at graduated rates grandfathered *inter vivos* trusts, trusts created by will, and estates (after a reasonable period of estate administration)", and the subsequent consultation paper released June 3, 2013, Budget 2014 includes measures which largely eliminate such benefits.

Trusts meeting the definition of "testamentary trust", which currently benefit from several tax preferences (including graduated rates and off-calendar year ends), will cease having access to such benefits, unless such trusts are "graduated rate estates", a new concept introduced in the Budget. Graduated rates will also continue to apply to testamentary trusts for the benefit of disabled individuals. Details regarding this exception will be released in the coming months

Generally, the measures announced in Budget 2014 will eliminate the ability of many trusts to use graduated rates of taxation and will instead put those trusts on equal footing with non-grandfathered *inter vivos* trusts which are subject to tax on all income at the top rate applicable to individuals pursuant to section 122 of the Act. Interestingly, the measures are not proposed to take effect until 2016 and later taxation years. This "phasing in" period should give taxpayers ample opportunity to "unwind" complex testamentary trust planning that was undertaken under the existing rules; there is no grandfathering for trusts or estates established on or before Budget Day.

As noted, the new provisions will apply to the 2016 and subsequent taxation years.

Resolution 14

The time for filing an agreement to transfer a forgiven amount under the debt forgiveness rules is to be amended. As a result of the amendment, the time to file the agreement is extended to one year for individuals and graduated rate estates only; previously, testamentary trusts were entitled to the same filing period.

15. (1) Subsection 104(23) of the Act is amended by adding "and" at the end of paragraph (*c*), by striking out "and" at the end of paragraph (*d*) and by repealing paragraph (*e*).

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Paragraph 104(23)(*e*) is to be repealed. The provision exempted testamentary trusts from the general requirement to pay income tax instalments, as mandated by the rules in sections 155, 156 and 156.1. Under current legislation, testamentary trusts are simply required to pay tax within 90 days after the end of each taxation year. Interestingly, the relief from instalments was not retained for testamentary trusts that meet the definition of graduated rate estate. As a consequence, these trusts will be required to pay instalments in accordance with the rules of the Act and CRA policy.

16. (1) The portion of subsection 122(1) of the Act before paragraph (*a*) is replaced by the following:

122. (1) Notwithstanding section 117, the tax payable under this Part for a taxation year by a trust (other than a graduated rate estate) is the total of

(2) Subsection 122(2) of the Act is repealed.

(3) Subsections (1) and (2) apply to the 2016 and subsequent taxation years.

Editorial Comment: Resolution 16 proposes to amend section 122 of the Act in two ways. First, an exception to the general rule that trusts are to pay tax at the top rate applicable to individuals (currently 29%) in subsection 122(1) is introduced in respect of a trust that is a "graduated rate estate". As discussed below, the term "graduated rate estate" is a proposed definition to be added to subsection 248(1) to allow for a 36-month administration period for estates that are testamentary trusts.

The second amendment to section 122 is the proposed repeal of subsection 122(2). This provision exempts "grandfathered" *inter vivos* trusts from the general rule providing for flat rate taxation in subsection 122(1). This exemption applies to certain trusts that were established before June 18, 1971 and that meet a number of other criteria. Generally, in order to maintain grandfathered status, a trust cannot have:

(i) lost its status as a trust resident in Canada at any time since June 18, 1971;

(ii) carried on an active business during the year in question;

(iii) received property by way of gift after June 18, 1971;

(iv) received a contribution (defined in section 94) after June 22, 2000;

(v) incurred, after June 18, 1971, any debt or other obligation to pay an amount to, or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length; or

(vi) received property after December 17, 1999 from another trust, where the other trust was subject to subsection 122(1) and no beneficial change in ownership of the property resulted on the transfer.

These "tainting" provisions, which are relevant to determining grandfathered trust status, will be irrelevant beginning in 2016 as the entire concept of a grandfathered *inter vivos* trust is to be eliminated.

17. (1) Subsection 127(7) of the Act is replaced by the following:

(7) If, in a particular taxation year of a taxpayer who is a beneficiary under a trust that is a graduated rate estate or that is deemed to be in existence by section 143, an amount is determined in respect of the trust under paragraph (*a*), (*a.1*), (*a.4*), (*a.5*), (*b*) or (*e.1*) of the definition "investment tax credit" in subsection (9) for its taxation year that ends in that particular taxation year, the trust may, in its return of income for its taxation year that ends in that particular taxation year, designate the portion of that amount that can, having regard to all the circumstances including the terms and conditions of the trust, reasonably be considered to be attributable to the taxpayer and was not designated by the trust in respect of any other beneficiary of the trust, and that portion is to be added in computing the investment tax credit of the taxpayer at the end of that particular taxation year and is to be deducted in computing the investment tax credit of the trust at the end of its taxation year that ends in that particular taxation year.

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Subsection 127(7), as it currently exists, enables a testamentary trust (or an *inter vivos* trust for a communal organization which is deemed to be in existence by section 143) to allocate any or all of its investment tax credits arising in respect of certain acquisitions and expenditures in a particular taxation year to its beneficiaries, provided that it does so in a reasonable manner "having regard to all of the circumstances including the terms and conditions of the trust". Resolution 17 proposes to limit the availability of this provision to graduated rate estates (and the trusts subject to section 143).

18. (1) The description of C in section 127.51 of the Act is replaced by the following:

C is

(*a*) $40,000, in the case of an individual (other than a trust) or a graduated rate estate; and

(*b*) nil, in any other case; and

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

19. (1) Section 127.53 of the Act is repealed.

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Resolutions 18 and 19 propose to amend certain provisions related to the computation of alternative minimum tax (AMT) under Division E.1 of Part 1 of the Act to reflect the elimination of graduated rate taxation for testamentary trusts other than graduated rate estates. Generally, the alternative minimum tax requires a revised computation of income, which adds back a number of deductions allowed to individuals under other sections of the Act. The amounts added back are normally in respect of certain so-called "tax-preference" items (for example, income tax deductions related to some tax shelters, and capital gains). Certain deductions are permitted in arriving at AMT payable (for example, personal exemptions). A basic exemption of $40,000 is allowed in computing the AMT of certain individuals.

The proposed amendments in Resolutions 18 and 19 are related to the basic exemption. Under Resolution 19, section 127.53 will be repealed. This eliminates the definition of basic exemption currently found in that section and also the ability of certain trusts to "share" the basic exemption by filing an agreement with the CRA.

The $40,000 basic exemption will now be contained in section 127.51 itself, which is the provision by which an individual's minimum amount is computed. As a result of this proposed amendment, the $40,000 exemption will only be available to individuals (other than trusts) and graduated rate estates. Testamentary trusts that are not graduated rate estates will not be entitled to the basic exemption. The amount of the exemption will not be adjusted.

20. (1) The portion of subsection 152(4.2) of the Act before paragraph (*a*) is replaced by the following:

(4.2) Notwithstanding subsections (4), (4.1) and (5), for the purpose of determining, at any time after the end of the normal reassessment period of a taxpayer who is an individual (other than a trust) or a graduated rate estate in respect of a taxation year, the amount of any refund to which the taxpayer is entitled at that time for the year, or a reduction of an amount payable under this Part by the taxpayer for the year, the Minister may, if the taxpayer makes an application for that determination on or before the day that is ten calendar years after the end of that taxation year,

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

21. (1) Paragraph 164(1.5)(*a*) of the Act is replaced by the following:

(*a*) if the taxpayer is an individual (other than a trust) or a graduated rate estate for the year and the taxpayer's return of income under this Part for the year was filed on or before the day that is ten calendar years after the end of the taxation year;

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Under subsection 152(4.2), the Minister of National Revenue has the discretion to reassess or redetermine the tax liabilities of a taxpayer beyond the normal reassessment period in order to give the taxpayer a refund or to reduce taxes payable for the taxation year in question upon the taxpayer's request. This rule currently applies to individuals (other than trusts) and testamentary trusts. Resolution 20 will eliminate the ability of testamentary trusts to grant the Minister this authority. Instead, only individuals (other than trusts) and graduated rate estates will be so entitled.

Resolution 21 provides for a related amendment to paragraph 164(1.5)(a) in respect of the Minister's authority to refund overpayments to certain taxpayers where the relevant tax return was filed more than three but less than ten calendar years after the end of the taxation year.

22. (1) The portion of paragraph 165(1)(*a*) of the Act before subparagraph (i) is replaced by the following:

(*a*) where the assessment is in respect of the taxpayer for a taxation year and the taxpayer is an individual (other than a trust) or a graduated rate estate for the year, on or before the later of

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Subsection 165(1) sets out the limitation period for filing a notice of objection under the Act. Generally, the limitation period is 90 days after the date of sending the notice of assessment to which the objection pertains. This is extended for individuals (other than trusts) and testamentary trusts under paragraph 165(1)(*a*) to the later of the 90 day period and the day that is one year after the filing due date of the individual for the year in question. Resolution 22 eliminates the extension for testamentary trusts and limits its application to individuals (other than trusts) and graduated rate estates.

23. (1) The portion of paragraph (*d*) of the definition "designated beneficiary" in subsection 210(1) of the Act before subparagraph (i) is replaced by the following:

(*d*) another trust (referred to in this paragraph as the "other trust") that is not a graduated rate estate, a mutual fund trust or a trust that is exempt because of subsection 149(1) from tax under Part I on all or part of its taxable income, if any beneficiary under the other trust is at that time

(2) Clause (*d*)(iii)(A) of the definition "designated beneficiary" in subsection 210(1) of the Act is replaced by the following:

(A) a graduated rate estate,

(3) Paragraph 210(2)(*a*) of the Act is replaced by the following:

(*a*) a graduated rate estate;

(4) Subsections (1) to (3) apply to the 2016 and subsequent taxation years.

Editorial Comment: Resolution 23 proposes to eliminate the preferential treatment for testamentary trusts under Part XII.2 of the Act and provide the preference instead to graduated rate estates. Part XII.2 was enacted to prevent a non-resident from avoiding tax through the use of a trust to earn income from a business carried on in Canada or from a disposition of taxable Canadian property. It applies where, among other requirements, there is a "designated beneficiary" as defined in subsection 210(1). Under current legislation, a testamentary trust is excluded from being a designated beneficiary. Resolution 23 will limit this exemption to graduated rate estates. The other exemptions to the definition of designated beneficiary are not being amended.

Testamentary trusts are also currently exempt from Part XII.2 tax under paragraph 210(2)(*a*). This exemption is being amended and will only be available to graduated rate estates.

24. (1) Paragraph (*a*) of the definition "personal trust" in subsection 248(1) of the Act is replaced by the following:

(*a*) a graduated rate estate, or

(2) The portion of paragraph (*b*) of the definition "personal trust" in subsection 248(1) of the Act before subparagraph (i) is replaced by the following:

(*b*) a trust in which no capital interest or income interest was acquired for consideration payable directly or indirectly to

(3) Subsection 248(1) of the Act is amended by adding the following in alphabetical order:

"graduated rate estate", at any time, means an estate that arose on and as a consequence of a death, if that time is no more than 36 months after the death and at that time the estate is a testamentary trust;

(4) The portion of subsection 248(25.1) of the Act before paragraph (*a*) is replaced by the following:

(25.1) If, at any time, a particular trust transfers property to another trust (other than a trust governed by a registered retirement savings plan or by a registered retirement income fund) in circumstances to which paragraph (*f*) of the definition "disposition" in subsection (1) applies, without affecting the personal liabilities under this Act of the trustees of either trust or the application of subsection 104(5.8),

(5) Subsections (1), (2) and (4) apply to the 2016 and subsequent taxation years.

(6) Subsection (3) comes into force on December 31, 2015.

Editorial Comment: Resolution 24 contains a number of proposed amendments to section 248 consequential on the elimination of graduated rate taxation for testamentary trusts and estates (and grandfathered *inter vivos* trusts).

First, an amendment to the definition of "personal trust" in subsection 248(1) is proposed to eliminate the reference to a "testamentary trust" in paragraph (*a*) and to replace it with a reference to a "graduated rate estate". Second, an amendment to paragraph (*b*) of the definition of "personal trust" is proposed to eliminate references to *inter vivos* trusts and "beneficial interest" and will instead apply now to any trust provided that no capital interest or income interest in the trust was acquired for consideration payable directly or indirectly to the trust, or to any person who has made a contribution to the trust by way of transfer, assignment or other disposition of property. This eliminates the preference previously afforded to testamentary trusts that qualified as personal trusts irrespective of the circumstances in which beneficial interests in the estate were acquired.

The most significant amendment to subsection 248(1) as regards these rules is the introduction of the concept of a "graduated rate estate". In order to qualify as a graduated rate estate (which pursuant to the proposed amendment contained in Resolution 16 is exempt from flat top-rate taxation and can therefore enjoy the benefits of graduated rates), an estate must meet three tests simultaneously:

i. The estate must have arisen on or as a consequence of a death,

ii. The time must be no more than 36 months after the death, and

iii. The estate must be, at that time, a testamentary trust.

There are two notable elements of this requirement. The 36-month limitation is effectively a concession by the government to allow a limited amount of time under which a new estate can be administered without being subject to flat rate tax. That is, graduated rate estates are effectively being treated as an extension of the recently deceased taxpayer so that his or her assets can be dealt with in a reasonable amount of time without unduly subjecting the income of those assets to more tax than the individual would have paid had they lived. Upon the expiration of the 36 month period, proposed amendments to subsection 249(1) of the Act in Resolution 25 will have the effect of "converting" the estate's taxation year to a calendar year.

The other notable element of the graduated rate estate definition is that in order for an estate to qualify as such it must at all times be a "testamentary trust" as defined in subsection 108(1) of the Act.

Generally, a trust is a testamentary trust if it arose on the death of an individual and as a consequence of that death, with certain exceptions, which typically apply where there have been additional transfers to the trust after the original contribution that arose on the death of the individual. This definition is unchanged by Budget 2014.

Essentially, the preferences previously afforded to testamentary trusts and estates (and grandfathered *inter vivos* trusts) are being limited in their application solely to graduated rate estates, which by definition cannot exceed 36 months in duration.

The fourth amendment to section 248 in Resolution 24 is the elimination of the reference to paragraph 122(2)(*f*) in subsection 248(25.1) (which deals with certain trust-to-trust transfers). This repeal is consequential to the proposed elimination of subsection 122(2) in Resolution 16, which previously provided the rules allowing for grandfathered *inter vivos* trusts.

25. (1) Paragraphs 249(1)(*b*) and (*c*) of the Act are replaced by the following:

(*b*) in the case of a graduated rate estate, the period for which the accounts of the estate are made up for purposes of assessment under this Act; and

(*c*) in any other case, a calendar year.

(2) Section 249 of the Act is amended by adding the following after subsection (4):

(4.1) For a particular trust that is created by will or that is an estate that arose on and as a consequence of a death,

(*a*) its taxation year that otherwise includes a particular time is deemed to end immediately before the particular time if

(i) in the case of a trust created by will, the particular time is the first time after 2015, or

(ii) in the case of an estate, the particular time is the first time after 2015 at which the estate is not a graduated rate estate;

(*b*) a new taxation year of the particular trust is deemed to begin at the particular time; and

(*c*) for the purpose of determining the particular trust's fiscal period after the particular time, it is deemed not to have established a fiscal period before that time.

(3) Subsection (1) applies to the 2016 and subsequent taxation years.

(4) Subsection (2) comes into force on December 31, 2015.

26. (1) The portion of paragraph 249.1(1)(*b*) of the Act before clause (ii)(B) is replaced by the following:

(*b*) in the case of

(i) an individual (other than an individual to whom section 149 or 149.1 applies or a trust),

(i.1) a trust (other than a mutual fund trust if the fiscal period is one to which paragraph 132.11(1)(*c*) applies or a graduated rate estate),

(ii) a partnership of which

(A) an individual (other than an individual to whom section 149 or 149.1 applies or a graduated rate estate),

(2) Subsection (1) applies to the 2016 and subsequent taxation years.

Editorial Comment: Resolution 25 proposes to amend the Act to require that all trusts, other than graduated rate estates, use a calendar year end for tax purposes. Under subsection 249(1) of the Act, certain limitations are imposed on the definition of a taxation year. For individuals, generally, a calendar year is required. One exception to that rule under current legislation is for testamentary trusts, which are generally entitled under paragraph 249(1)(*c*) to use an off-calendar year end (subject to the limitation in paragraph 249.1(1)(*d*) that the period not be longer than 12 months). Resolution 25 proposes to limit this entitlement to graduated rate estates only.

Resolution 25 also proposes to introduce new subsection 249(4.1). Proposed 249(4.1) generally has two implications. First, all trusts that are trusts created by will or estates that arose on and as a consequence of the death of an individual will be deemed to have a taxation year end at the end of the day December 31, 2015 (unless the trust or estate is a graduated rate estate, which are subject to a special rule, as discussed below). This rule relates to the coming-into-force provisions of these new rules, which generally apply for 2016 and subsequent taxation years. Any testamentary trusts (other than graduated rate estates) that are using off-calendar year ends at that time will have a deemed year end and will thereafter be required to compute their obligations under the Act on the basis that they have a calendar year end.

The second implication of proposed subsection 249(4.1) is to deem a graduated rate estate to have a year end upon the loss of graduated rate estate status. Following that deemed year end, which will occur generally on the date that is 36 months after the death of the testator (or some earlier period if the graduated rate estate is "tainted") the trust will by definition no longer be a graduated rate estate and therefore will be required to use a December 31 year end going forward.

Resolution 26 proposes a consequential amendment to paragraph 249.1(1)(*b*) to give effect to the elimination of off-calendar year ends for testamentary trusts and the ability of a graduated rate estate to use an off-calendar year end.

27. The Act and the *Income Tax Regulations* are further modified to make such amendments as are necessary to give effect to the proposals relating to Graduated Rate Taxation of Trusts and Estates described in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Resolution 27 provides the ability to make additional modifications to the Act and the *Income Tax Regulations* to give effect to the proposals regarding graduated rate taxation of trusts. It appears that this resolution is being included in the absence of a specific legislative amendment to preserve graduated rate taxation of testamentary trusts beyond the 36 month period in which the trust is a graduated rate estate for testamentary trusts that benefit disabled individuals. In the Supplementary Information accompanying the Notice of Ways and Means Motion, this policy objective was identified as arising during the consultation period and the Government pledged that graduated rates will continue to apply to such trusts. It is expected that such an exemption will be provided prior to 2016 when these rules come fully into force.

Resolutions 28 to 29: Non-Resident Trusts

28. (1) The definition "connected contributor" in subsection 94(1) of the Act is replaced by the following:

"connected contributor", to a trust at a particular time, means a contributor to the trust at the particular time, other than a person all of whose contributions to the trust made at or before the particular time were made at a non-resident time of the person.

(2) The definition "resident contributor" in subsection 94(1) of the Act is replaced by the following:

"resident contributor", to a trust at any time, means a person that is, at that time, resident in Canada and a contributor to the trust, but — if the trust is an *inter vivos* trust that was created before 1960 by a person who was non-resident when the trust was created — does not include an individual (other than a trust) who has not, after 1959, made a contribution to the trust.

(3) Subparagraph 94(11)(*b*)(ii) of the Act is replaced by the following:

(ii) would be deemed to be resident in Canada immediately before that time because of paragraph (3)(*a*) if this section, as it read in its application to 2013 taxation years, were read without reference to paragraph (*a*) of the definition "connected contributor" in subsection (1) and paragraph (*a*) of the definition "resident contributor" in that subsection,

(4) Subsections (1) to (3) apply to taxation years that end on or after Budget Day, except that those subsections do not apply in respect of a trust to taxation years that end before 2015 if the following conditions are satisfied:

(*a*) no contributions are made to the trust on or after Budget Day and before 2015; and

(*b*) if the trust were to have a particular taxation year that ended after 2013 and before Budget Day,

(i) the trust would be non-resident for the purpose of computing its income for the particular year, and

(ii) if the definitions "resident contributor" and "connected contributor" in subsection 94(1) of the Act were read for the particular year without reference to their paragraphs (*a*), the trust would be resident in Canada for the purpose of computing its income for the particular year.

29. (1) The portion of subsection 94.2(1) of the Act before paragraph (*a*) is replaced by the following:

94.2 (1) Subsection (2) applies to a beneficiary under a trust, and to any particular person of which any such beneficiary is a controlled foreign affiliate, at any time if

(2) Subsection (1) applies to taxation years that end on or after Budget Day, except that it does not apply in respect of a trust to taxation years that end before 2015 if the following conditions are satisfied:

(*a*) no contributions are made to the trust on or after Budget Day and before 2015; and

(*b*) if the trust were to have a particular taxation year that ended after 2013 and before Budget Day,

(i) the trust would be non-resident for the purpose of computing its income for the particular year, and

(ii) if the definitions "resident contributor" and "connected contributor" in subsection 94(1) of the Act were read for the particular year without reference to their paragraphs (*a*), the trust would be resident in Canada for the purpose of computing its income for the particular year.

Editorial Comment: Canada has complex rules in section 94 of the Act that seek to prevent the deferral or avoidance of tax by residents of Canada through the use of non-resident trusts. These rules have been in place for many years, and were recently the subject of a significant overhaul that began with announced changes in 1999 that finally became legislation in 2013. Generally, the non-resident trust rules seek to tax the income and gains of a non-resident trust as though the trust was a resident of Canada where there has been a contribution by a resident of Canada and certain other criteria are present. The new rules apply to 2007 and later taxation years. Under both the pre-2007 rules and the post-2006 rules, however, there was a notable exemption for trusts where the Canadian-resident contributor to the trust has been a resident of Canada for less than 60 months in the aggregate in his or her lifetime. This 60 month tax holiday is informally known as the "immigration trust" exemption, and has been among the cornerstones of Canada's policy of attracting high net worth individuals to immigrate to Canada. It is worthwhile noting that the new, post-2006 rules, were altered many times after their initial introduction; however, the immigration trust concept was always preserved.

Resolution 28

Resolution 28 proposes to amend the definitions of "connected contributor" and "resident contributor" in order to eliminate the use of immigration trusts.

A connected contributor is relevant in determining whether there is a "resident beneficiary" under the trust. The "resident beneficiary" test is two-fold. Firstly, there must be a "beneficiary" who is resident in Canada, and secondly, there must be a connected contributor. Under existing legislation, a "connected contributor" to a trust is any person who has made a contribution to the trust, other than an individual (excluding trusts) who has not resided in Canada for more than 60 months or a person whose contributions to the trust were made during that person's "non-resident time". The reference to a person who has not resided in Canada for more than 60 months is being eliminated. As a result, in cases where there is a beneficiary resident in Canada, a trust will be deemed to be resident in Canada where there has been a contribution by a person otherwise than at a non-resident time of that person.

The resident contributor definition is also proposed to be amended. Generally, a "resident contributor" is a person who is a resident of Canada who has made a contribution to the trust. Under the existing rules, there will be no resident contributor during the first 60 months in aggregate of the contributor's lifetime that the contributor is a resident of Canada. This 60 month window under the resident contributor test is also being eliminated. The ability to settle so-called "granny trusts" (settled by a non-resident of Canada for the benefit of a resident of Canada, provided that the settlor never becomes a resident of Canada) will be maintained. In addition, the existing limited exemption for trusts settled before 1960 will also be preserved. As a result of this amendment, a non-resident trust (settled after 1959) will be deemed to be a resident of Canada under subsection 94(3) of the Act as soon as the settlor becomes a resident of Canada, regardless of whether the settlor has previously been a resident of Canada or is a new immigrant.

Resolution 28 also proposes to amend paragraph 94(11)(*b*), consequential on the elimination of immigration trusts. Existing subsection 94(11) is part of a package of anti-avoidance rules that seek to prevent the avoidance of section 94 through the transfer of property between trusts. Under existing paragraph 94(11)(*b*), these rules will apply where transferee trust (referred to as the "original trust") would have been deemed to be resident in Canada under subsection 94(3) were it not for the immigration trust exemption in the resident contributor and connected contributor definitions. The proposed amendment is to read those definitions as they applied to the 2013 taxation year, since the restructuring of those definitions to eliminate the 60 month immigration trust tax holiday eliminated the paragraphs to which 94(11)(*b*) refers.

As noted above, Resolution 28 provides only very limited grandfathering to existing immigration trusts. Generally, the rules apply to all taxation years of non-resident trusts that end on or after Budget Day. However, there is a limited exception for existing immigration trusts that applies for taxation years ending in 2014 only.

First, there must have been no contributions made to the trust on or after Budget Day and before 2015. Second, the only reason that subsection 94(3) did not deem the trust to be resident of Canada for any notional taxation year that would have occurred between January 1, 2014 and Budget Day is by reason of the existing immigration trust exemption. If these tests are met, the trust will not be deemed to be resident in Canada until January 1, 2015. Given the very broad meaning of "contribution" in section 94 (due to the application of subsection 94(2), which deems many transactions or events to be a transfer of property and therefore possibly a contribution to a trust), it is possible in many cases that the grandfathering will be lost without the intent (or even the knowledge) of the immigrant.

Accordingly, there will be no immigration trusts beginning on January 1, 2015. Those in existence prior to Budget Day will be able to take advantage of the existing rules until December 31, 2014, provided that no contributions are made to the trust in the interim. Note that the residence of the contributor is irrelevant for purposes of this grandfathering provision; any contribution made on or after Budget Day — whether or not made by a resident of Canada — will be sufficient for the trust to lose its grandfathered status. Presumably the grandfathering provisions were inserted to enable existing immigration trust structures to be unwound in light of the elimination of this tax holiday. It is notable that some immigrants would have benefited from all or most of the 60 month holiday depending on when they became a resident of Canada, whereas new immigrants are having their 60 month window reduced, in many cases significantly. It is not clear how the stated objective of tax fairness is met by eliminating the immigration trust concept in this manner.

Resolution 29

Resolution 29 proposes to amend section 94.2 to reflect the elimination of immigration trusts. Generally, section 94.2 provides a set of rules for taxing certain investments by Canadians in non-resident commercial trusts. Under existing legislation, these rules apply to any beneficiary under a non-resident commercial trust, or a "particular person" of which any such beneficiary is a controlled foreign affiliate, subject to an exclusion for a person who has been resident in Canada in aggregate for less than 60 months in his or her lifetime. Resolution 29 proposes to eliminate the exception for beneficiaries who have been resident in Canada for less than 60 months. As with the elimination of immigration trust there is limited grandfathering that will apply where: (i) no contributions have been made to the trust on or after Budget Day and before 2015, and (ii) the only reason that subsection 94(3) did not deem the trust to be resident of Canada for any notional taxation year that would have occurred between January 1, 2014 and Budget Day is by reason of the existing immigration trust exemption. This limited grandfathering seems particularly harsh in the context of non-resident commercial trusts as contributions may have been made to them throughout the year and without the Canadian resident having any knowledge that the trust has received additional property.

Resolutions 30 to 31: Donations of Ecologically Sensitive Land

30. (1) The portion of subparagraph 110.1(1)*(d)*(iii) of the Act before clause (A) is replaced by the following:

(iii) the gift was made by the corporation in the year or in any of the ten preceding taxation years to

(2) Subsection (1) applies to gifts made on or after Budget Day.

31. (1) The portion of paragraph *(c)* of the definition "total ecological gifts" in subsection 118.1(1) of the Act before subparagraph (i) is replaced by the following:

(c) the gift was made by the individual in the year or in any of the ten preceding taxation years to

(2) Subsection (1) applies to gifts made on or after Budget Day.

Editorial Comment: Donations of ecologically sensitive land (forming part of a donor's "total ecological gifts") qualify for the donations tax credit (individuals) or deduction (corporations). The eligible amount of the land — generally, its fair market value less any advantage received back from the donor — qualifies for the credit or deduction. However, any accrued gain in respect of the property is subject to a zero taxable capital gain rate (paragraph 38(*a.2*)) and is therefore not subject to tax.

As with other charitable donations, unused donations can be carried forward for up to five years. The Budget extended the carryforward period for ecological gifts to ten years, applicable to gifts made on or after February 11, 2014.

Resolution 32: Estate Donations

32. Subparagraphs 38(*a.1*)(ii) and (*a.2*)(ii) and 39(1)(*a*)(i.1) and section 118.1 of the Act are modified in accordance with the proposals relating to Estate Donations described

in the budget documents tabled by the Minister of Finance in the House of Commons on Budget Day.

Editorial Comment: Under subsection 118.1(5) of the Act, a donation or gift to a qualified donee that is made by an individual's will is deemed to be made by the individual immediately before the individual's death. Similarly, certain designations of life insurance proceeds or the deceased's RRSP, RRIF or TFSA to a qualified donee are also deemed to be gifts made immediately before the individual's death ("designation donations") (see ss. 118.1(5.1)–(5.3)). Under either scenario, the donation tax credit may be applied only against the individual's income tax otherwise payable. Charitable donations made by an individual's estate may be applied only against the estate's income tax otherwise payable.

Corresponding with the introduction of flat rate taxation of testamentary trusts at the highest marginal rate in 2016, the Budget proposes more flexible rules for the tax treatment of charitable donations made as a consequence of an individual's death.

Donations made by will and designation donations will no longer be deemed to be made immediately before the individual's death. Instead, these donations will be deemed to have been made by the estate in the year in which the property is transferred to the qualified donee. The trustee of the estate may allocate the available donation among any of: the taxation year of the estate in which the donation is made; an earlier taxation year of the estate; or the last two taxation years of the individual. The current limits that apply in determining the total donations that are creditable in a year will continue to apply (i.e., the 100% income limitation for the deceased individual for donations made in the year of death or the preceding year, and the 75% income limit that otherwise applies to individuals (including estates)).

In order to access this new flexible treatment, property donated by the will must be transferred to the qualified donee within 36 months after the individual's death. The donated property will be required to have been acquired by the estate on and as a consequence of the individual's death (or to have been substituted for such property). A similar 36-month rule currently exists and will continue to exist for transfers from an RRSP, RRIF, TFSA or insurer.

The Budget refers to amendments that will be made to ss. 38(*a*.1)(ii) and (*a*.2)(ii) and 39(1)(*a*)(i.1) (that is, the non-taxation of capital gains on gifts of publicly-listed securities, ecological gifts, and certified cultural property). Currently, these rules apply to the person making the gift — including a deceased individual making a gift under his or her will who is then eligible for the donation credit. Presumably, these provisions will be modified to apply to an estate that is deemed to make the donation under the new rules discussed above, such that there will be no taxation of the gains, if any, arising on the donation by the estate.

These changes will apply to the 2016 and subsequent taxation years.

Resolution 33: Donations of Certified Cultural Property

33. (1) Paragraph 248(37)(*c*) of the Act is replaced by the following:

(*c*) of an object referred to in subparagraph 39(1)(*a*)(i.1), other than an object acquired under a gifting arrangement (as defined in subsection 237.1(1)) that is a tax shelter;

(2) Subsection (1) applies to gifts made on or after Budget Day.

Editorial Comment: Under section 110.1 (for corporations) and section 118.1 (for individuals), the fair market value of a donated property forms the basis for the amount of the charitable tax deduction or credit (more particularly, the fair market value forms the starting point of the "eligible amount" of the gift). However, an anti-avoidance rule in subsection 248(35) of the Act provides that, among other things, where the donor acquired the property under a gifting arrangement that is a "tax shelter" (see definition in s. 237.1(1)), the fair market value of the property is deemed to be the lesser of (i) the fair market value of the property otherwise determined and (ii) the cost of the property. Currently, this anti-avoidance rule does not apply to gifts of certified cultural property (see ss. 118.1(10) and 248(37)). The Budget provides that subsection 248(37) will be amended to provide that the anti-avoidance rule in subsection 248(35) applies to cultural property acquired under a tax shelter. The new rule will apply to gifts made on or after February 11, 2014.

Resolution 34: State Supporters of Terrorism

34. (1) Subsection 149.1(4.1) of the Act is amended by striking out "and" at the end of paragraph (*d*), by adding "and" at the end of paragraph (*e*) and by adding the following after paragraph (*e*):

(*f*) of a registered charity, if it accepts a gift from a foreign state, as defined in section 2 of the State Immunity Act, that is set out on the list referred to in subsection 6.1(2) of that Act.

(2) Subsection 149.1(4.2) of the Act is amended by striking out "or" at the end of paragraph (*b*), by adding "or" at the end of paragraph (*c*) and by adding the following after paragraph (*c*):

(*d*) if the association accepts a gift from a foreign state, as defined in section 2 of the State Immunity Act, that is set out on the list referred to in subsection 6.1(2) of that Act.

(3) Subsection 149.1(25) of the Act is amended by striking out "or" at the end of paragraph (*a*), by adding "or" at the end of paragraph (*b*) and by adding the following after paragraph (*b*):

(*c*) the charity or association has accepted a gift from a foreign state, as defined in section 2 of the State Immunity Act, that is set out on the list referred to in subsection 6.1(2) of that Act.

(4) Subsections (1) to (3) apply in respect of gifts accepted on or after Budget Day.

Editorial Comment: There are special revocation rules in the act that allow the Minister of National Revenue to refuse to register or to revoke the registration of a charity or amateur athletic association in specific circumstances (see ss. 149.1(2), 149.1(3), 149.1(4), 149.1(4.1), 149.1(4.2), 149.1(4.3), 149.1(25), 168, 188, 188.1 and 188.2 of the Act).

The Budget proposes to add to the special revocation rules set out in subsections 149.1(4.1), (4.2) and (25) to prevent potential abuse by terrorist organizations or states.

The Budget proposes that where a charity (or Canadian amateur athletic association) accepts a gift from a foreign state (or an agency of such a state) listed as a supporter of terrorism for the purposes of the *State Immunity Act* the Minister may refuse to register, or revoke the charitable status, of the organization.

These new provisions apply in respect of gifts accepted on or after February 11, 2014. The Budget papers state that the Minister of National Revenue will take into consideration the specific facts of each case and will assist charities by providing information about preventing terrorist abuse of the registration system for charities.

Resolution 35: Captive Insurance

35. (1) Subsection 95(2) of the Act is amended by adding the following after paragraph (*a.2*):

(*a.21*) for the purposes of paragraph (*a.2*), one or more risks insured by a foreign affiliate of a taxpayer (in this paragraph referred to as the "foreign policy pool") that, if this Act were read without reference to this paragraph, would not be risks in respect of a person, property or business described in any of subparagraphs (*a.2*)(i) to (iii) are deemed to be risks in respect of a person resident in Canada if

(i) the affiliate, or a person or partnership that does not deal at arm's length with the affiliate, enters into one or more agreements or arrangements in respect of the foreign policy pool,

(ii) as a result of those agreements or arrangements, the affiliate's risk of loss or opportunity for gain or profit in respect of the foreign policy pool, in combination with its risk of loss or opportunity for gain in respect of the agreements or arrangements, can reasonably be considered to be — or could reasonably be considered to be if the affiliate had entered into the agreements or arrangements entered into by the person or partnership — determined, in whole or in part, by reference to one or more criteria in respect of one or more risks insured by another person or partnership (in this paragraph referred to as the "tracked policy pool"), which criteria are:

(A) the fair market value of the tracked policy pool,

(B) the revenue, income, loss or cash flow from the tracked policy pool, or

(C) any other similar criteria, and

(iii) 10% or more of the tracked policy pool is comprised of risks in respect of a person, property or business described in any of subparagraphs (*a.2*)(i) to (iii);

(*a.22*) if the conditions in paragraph (*a.21*) are satisfied in respect of a foreign affiliate of a taxpayer, or a foreign affiliate of another taxpayer with which the taxpayer does not deal at arm's length, and a particular foreign affiliate of the taxpayer, or a partnership of which the particular affiliate is a member, has entered into one or more agreements or arrangements described in that paragraph,

(i) activities performed in connection with those agreements or arrangements are deemed to be a separate business, other than an active business, carried on by the particular affiliate to the extent that those activities can reasonably be considered to be performed for the purpose of obtaining the result described in subparagraph (*a.21*)(ii), and

(ii) any income of the particular affiliate from the business (including income that pertains to or is incident to the business) is deemed to be income from a business other than an active business;

(2) Subsection (1) applies to taxation years of a taxpayer that begin on or after Budget Day.

Editorial Comment: The Canadian foreign affiliate system is designed to preclude taxpayers from shifting certain Canadian-source income to no- or low-tax jurisdictions. Under these rules, certain passive or similar income earned by a controlled foreign affiliate of a taxpayer resident in Canada constitutes foreign accrual property income ("FAPI") and is taxable in the hands of the Canadian taxpayer on an accrual basis.

A specific rule in paragraph 95(2)(*a.2*) of the *Income Tax Act* is intended to prevent Canadian taxpayers, such as financial institutions, from shifting income from the insurance of Canadian risks (i.e., risks in respect of persons resident in Canada, property situated in Canada or businesses carried on in Canada) to a foreign jurisdiction. This rule provides that income from the insurance of Canadian risks constitutes FAPI where 10% or more of the gross premium income (net of reinsurance ceded) of a foreign affiliate of the Canadian taxpayer, in respect of all risks insured by the affiliate, is premium income from Canadian risks. In some situations, an arrangement (sometimes referred to as an insurance swap) may be used to avoid the above rule. An insurance swap generally involves transferring Canadian risks, originally insured in Canada, to a wholly owned foreign affiliate of the taxpayer. The Canadian risks are then exchanged with a third party for foreign risks that were originally insured outside of Canada, while at the same time ensuring that the affiliate's overall risk profile and economic returns are essentially the same as they would have been had the affiliate not entered into the exchange.

Although the Canada Revenue Agency is challenging some of these arrangements under the existing provisions of the *Income Tax Act*, including under the general anti-avoidance rule, the government has decided to undertake specific legislative action to provide that these arrangements give rise to FAPI.

Resolution 35 proposes to extend the rule in paragraph 95(2)(*a.2*). In particular, new paragraph 95(2)(*a.21*) will target situations where:

- taking into consideration one or more agreements or arrangements entered into by the foreign affiliate, or by a person or partnership that does not deal at arm's length with the affiliate, the affiliate's risk of loss or opportunity for gain or profit in respect of one or more foreign risks can — or could if the affiliate had entered into the agreements or arrangements directly — reasonably be considered to be determined by reference to the returns from one or more other risks (the tracked risks) that are insured by other parties; and
- at least 10 per cent of the tracked risks are Canadian risks.

Where the conditions in new paragraph 95(2)(*a.21*) are satisfied, the affiliate's income from the insurance of the foreign risks and any income from a connected agreement or arrangement will be included in computing its FAPI.

The proposed amendment will apply to taxation years of taxpayers that begin on or after February 11, 2014.

Resolution 36: Offshore Regulated Banks

36. (1) Section 95 of the Act is amended by adding the following after subsection (2.1):

(2.11) For the purposes of the definition "investment business" in subsection (1), a taxpayer or a foreign affiliate of the taxpayer, as the case may be, is deemed not to have established that the conditions in subparagraph (*a*)(i) of that definition have been satisfied unless

(*a*) the taxpayer is

(i) a particular corporation that is a bank listed in Schedule I to the *Bank Act*, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities resident in Canada, the business activities of which are subject by law to the supervision of a regulating authority such as the Superintendent of Financial Institutions or a similar authority of a province,

(ii) a subsidiary wholly-owned corporation of a particular corporation described in subparagraph (i), or

(iii) a corporation of which a particular corporation described in subparagraph (i) is a subsidiary wholly-owned corporation and that is subject by law to the supervision of the same regulating authority as the particular corporation; and

(*b*) either

(i) the particular corporation described in subparagraph (*a*)(i) is a bank, trust company or insurance corporation that has, or is deemed for certain purposes to have, $2 billion or more of equity

(A) in the case of a bank, under the *Bank Act*,

(B) in the case of a trust company, under the *Trust and Loan Companies Act*, or

(C) in the case of an insurance corporation, under the *Insurance Companies Act*, or

(ii) more than 50% of the total of all amounts each of which is an amount of taxable capital employed in Canada (within the meaning assigned by Part I.3) of the taxpayer — or a corporation resident in Canada that is related to the taxpayer — for the year is attributable to a business carried on in Canada, the activities of which are subject to the supervision of a regulating authority such as the Superintendent of Financial Institutions or a similar authority of a province.

(2) Subsection (1) applies to taxation years of a taxpayer that begin after 2014.

Editorial Comment: The foreign accrual property income ("FAPI") regime generally requires that income from property earned by, and income from certain businesses carried on by, a controlled foreign affiliate of a taxpayer resident in Canada is to be included in computing the taxpayer's income on an accrual basis. In particular, income from an investment business carried on by a foreign affiliate of a taxpayer is included in FAPI. An investment business is generally defined as a business the principal purpose of which is to derive income from property. Most financial services businesses would be considered investment businesses but for certain exceptions in the definition of investment business.

One of the exceptions (often referred to as the regulated foreign financial institution exception) relates to a business carried on by a foreign affiliate as a foreign bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities, the activities of which are regulated under the laws of the country in which the business is principally carried on or another relevant foreign jurisdiction. The purpose of the regulated foreign financial institution exception is to treat certain *bona fide* financial services businesses carried on by foreign affiliates as active businesses rather than as investment businesses.

Certain Canadian taxpayers that are not financial institutions have structured their offshore affairs so as to qualify for the regulated foreign financial institution exception by establishing foreign affiliates which are subject to regulation under foreign banking and financial laws. In some situations, one of the purposes of these affiliates is to engage in proprietary activities — that is, to invest or trade in securities on their own account — and not to facilitate financial transactions for customers. It is the government's view that the exception should not apply in these circumstances.

Although the Government is of the view that some of these arrangements may be challenged on the basis that they do not qualify for the regulated foreign financial institution exception, the Government has decided to add new statutory conditions that must be met to qualify for the regulated foreign financial institution exception. Under the amendment proposed by Resolution 36, the exception will be available where the following conditions, to be set out in new subsection 95(2.11) of the *Income Tax Act*, are satisfied:

- The relevant taxpayer (i.e., the Canadian taxpayer of which the foreign corporation is a foreign affiliate) is a regulated Canadian financial institution (i.e., a Schedule I bank, a trust company, a credit union, an insurance corporation or a trader or dealer in securities or commodities that is resident in Canada, and that carries on a business the activities of which are supervised by the Superintendent of Financial Institutions or a similar provincial regulator) or a subsidiary wholly-owned corporation of such an institution or a corporation that wholly owns such an institution (and is also subject to regulation).

- More than 50% of the total taxable capital employed in Canada (as defined in Part I.3 of the *Income Tax Act*) of the taxpayer and all related Canadian corporations is attributable to taxable capital employed in Canada of regulated Canadian financial institutions. Alternatively, certain regulated Canadian financial institutions that have (or that are deemed under an applicable federal statute to have) equity of at least $2 billion will be deemed to satisfy this second condition. Subsidiary wholly-owned corporations of such institutions or corporations that wholly own such institutions will also be deemed to satisfy this condition.

Thus, the status of a Canadian taxpayer will, determine whether a foreign affiliate of the taxpayer may be considered to carry on an acceptable regulated financial services business. In addition, the affiliate must carry on a regulated foreign financial services business and the proprietary activities must comprise part of that business.

In the Supplementary Information accompanying the Notice of Ways and Means Motions, the government stated that it will continue to monitor developments in this area to determine whether any further action is required to ensure that the regulated foreign financial institution exception, as modified by the proposed amendment, is not used by taxpayers to obtain tax advantages that are not intended by the government.

The proposed amendment will apply to taxation years of taxpayers that begin after 2014. The Department of Finance has invited stakeholders to submit comments regarding the proposed amendment within 60 days after February 11, 2014 (i.e., the date of the 2014 Budget).

Resolutions 37 and 38: Back-to-Back Loans

37. (1) The portion of subsection 18(5) of the Act before the definition "beneficiary" is replaced by the following:

(5) Notwithstanding any other provision of this Act (other than subsection (5.1)), in this subsection and subsections (4) to (6.1)

(2) Subsection 18(6) of the Act is replaced by the following:

(6) Subsection (6.1) applies at any time in respect of a taxpayer if at that time

(*a*) the taxpayer has a particular amount outstanding as or on account of a particular debt or other obligation to pay an amount to a person or partnership (in this subsection and subsection (6.1) referred to as the "intermediary");

(*b*) as part of a transaction, or series of transactions or events, that includes the taxpayer becoming obligated to pay the particular amount, the intermediary, or a person or partnership that does not deal at arm's length with the intermediary,

(i) has an interest in, or for civil law any right in, property that secures payment of the particular amount which interest or right was provided directly or indirectly by a non-resident person described in subparagraph (*a*)(i) of the definition "outstanding debts to specified non-residents" in subsection (5), or

(ii) has an amount outstanding as or on account of a debt or other obligation to pay an amount to a non-resident person described in subparagraph (*a*)(i) of the definition "outstanding debts to specified non-residents" in subsection (5)

(A) for which recourse is limited, either immediately or in the future and either absolutely or contingently, to the particular debt or other obligation, or

(B) that was entered into on condition that the particular debt or other obligation also be entered into; and (*c*) the intermediary is not a person described in subparagraph (*a*)(i) of the definition "outstanding debts to specified non-residents" in subsection (5).

(6.1) If this subsection applies at any time in respect of a taxpayer, then for the purposes of applying subsections (4) and (5),

(*a*) the portion of the particular amount, at that time, referred to in paragraph (6)(*a*) that is equal to the lesser of the following amounts is deemed to be an amount outstanding as or on account of a debt or other obligation to pay an amount to a specified non-resident shareholder or a specified non-resident beneficiary, as the case may be, of the taxpayer and not to the intermediary:

(i) the total of all amounts each of which is at that time

(A) if the condition described in subparagraph (6)(*b*)(i) is satisfied, the fair market value of a property described in that subparagraph, and

(B) if either of the conditions described in subparagraph (6)(*b*)(ii) are satisfied, an amount outstanding described in that subparagraph, and

(ii) the particular amount; and

(*b*) the proportion of the interest paid or payable by the taxpayer, in respect of a period throughout which paragraph (*a*) applies, on the particular debt or obligation referred to in paragraph (6)(*a*) that the average of all amounts, each of which is an amount that is deemed by paragraph (*a*) to be outstanding at a time during the period is of the average of all amounts each of which is the particular amount outstanding at a time during the period is deemed to be paid or payable by the taxpayer for the period on the amount that is deemed by paragraph (*a*) to be outstanding.

(3) The portion of subsection 18(7) of the Act before paragraph (*a*) is replaced by the following:

(7) For the purposes of this subsection, paragraph (4)(*a*), subsections (5) to (6.1), and paragraph 12(1)(*l.1*), each member of a partnership at any time is deemed at that time

(4) Subsections (1) to (3) apply to taxation years that begin after 2014.

38. (1) Section 212 of the Act is amended by adding the following after subsection (3):

(3.1) Subsections (3.2) and (3.3) apply at any time in respect of a taxpayer if

(*a*) the taxpayer pays or credits a particular amount at that time on account or in lieu of payment of, or in satisfaction of, interest in respect of a particular debt or other obligation to pay an amount to a person or partnership (in this subsection referred to as the "intermediary");

(*b*) at any time in the period during which the interest accrued (in subsections (3.2) and (3.3) referred to as the "relevant period"), as part of a transaction, or series of transactions or events, that includes the taxpayer becoming obligated to pay an amount in respect of the particular debt or other obligation, the intermediary, or any person or partnership that does not deal at arm's length with the intermediary,

(i) has an interest in, or for civil law any right in, property that secures payment of the particular debt or other obligation which interest or right was provided directly or indirectly by a non-resident person, or

(ii) has an amount outstanding as or on account of a debt or other obligation to pay an amount to a non-resident person

(A) for which recourse is limited, either immediately or in the future and either absolutely or contingently, to the particular debt or other obligation, or

(B) that was entered into on condition that the particular debt or other obligation also be entered into; and

(*c*) if the particular amount were paid or credited to the non-resident person rather than the intermediary, the tax that would be payable under this Part is greater than the tax payable under this Part (determined without reference to this subsection and subsection (3.2)) in respect of the particular amount.

(3.2) If this subsection applies at any time in respect of a taxpayer, for the purposes of paragraph (1)(*b*), the taxpayer is deemed, at that time, to pay interest to a non-resident person referred to in paragraph (3.1)(*b*) the amount of which is determined by the formula

$$A \times B/C \times (D - E)/D$$

where

A is the particular amount referred to in paragraph (3.1)(*a*);

B is the average of all amounts each of which is the lesser of

(i) the amount of the particular debt or other obligation referred to in paragraph (3.1)(*a*) outstanding at a particular time in the relevant period; and

(ii) the total of all amounts each of which is at that particular time

(A) if, in respect of the non-resident person, the condition in subparagraph (3.1)(*b*)(i) is satisfied at that particular time, the fair market value of the property described in that subparagraph,

(B) if, in respect of the non-resident person, the condition in clause (3.1)(*b*)(ii)(A) or (B) is satisfied at that particular time, the amount outstanding described in sub-paragraph (3.1)(*b*)(ii), and

(C) if neither clause (A) nor (B) applies at that particular time, nil;

C is the average of all amounts each of which is the amount of the particular debt or other obligation outstanding at a time in the relevant period;

D is the rate of tax that would be imposed under this Part on the particular amount if the particular amount were paid by the taxpayer to the non-resident person; and

E is the rate of tax imposed under this Part on the particular amount.

(3.3) If subsection (3.2) applies to deem a taxpayer to pay interest to more than one non-resident person referred to in paragraph (3.1)(*b*) in respect of a particular debt or other obligation and the total of all amounts determined (without reference to this subsection) for B in the formula in subsection (3.2) in respect of the particular debt or other obligation exceeds the average of all amounts each of which is the amount of the particular debt or other obligation outstanding at a time in the relevant period, then the taxpayer may reduce the amount determined for B in respect of one or more non-resident persons by one or more amounts designated by the taxpayer, as is reasonable in the circumstances, provided that the total of all the designated amounts is not more than that excess.

(2) Subsection (1) applies to amounts paid or credited after 2014.

Editorial Comment: The thin capitalization rules in subsections 18(4) to (7) of the *Income Tax Act* and the non-resident tax and withholding rules in Part XIII of the *Income Tax Act* pertain to the tax treatment of certain interest payments made by taxpayers to non-resident persons.

In this regard, the thin capitalization rules, which were amended in Budget 2012 and Budget 2013 in response to certain recommendations made by the Advisory Panel on

Canada's System of International Taxation, limit the deductibility of interest expense of corporations, partnerships of which a Canadian-resident corporation is a member, and trusts in circumstances where the amount of debt owing to certain non-residents exceeds a 1.5-to-1 debt-to-equity ratio. These rules apply, in the case of a corporation, to debts owing to a specified shareholder (i.e. a person that, either alone or together with persons with which the person is not dealing at arm's length, owns shares representing at least 25% of the votes or value of the corporation) that is not resident in Canada and to debts owing to any other non-resident that does not deal at arm's length with a specified shareholder. In the case of a trust, the rules apply to debts owing to a specified beneficiary that is not resident in Canada and to debts owing to any other non-resident that does not deal at arm's length with a specified beneficiary. In the case of a partnership, the rules apply to debts of partnerships of which a Canadian-resident corporation is a member either directly or indirectly through multiple tiers of partnerships.

Part XIII generally imposes a 25% withholding tax, subject to reduction under an applicable tax treaty, on interest paid or credited by a Canadian resident person (or a non-resident person if the interest is deductible in computing the non-resident person's taxable income earned in Canada) to a non-arm's-length non-resident person.

In some situations, a taxpayer might, depending on the circumstances, be able to avoid either or both the thin capitalization rules (including an existing rule in subsection 18(6) of the *Income Tax Act*) and Part XIII withholding tax through the use of a "back-to-back loan" arrangement that is not caught by subsection 18(6). Such an arrangement generally involves interposing a third party (such as a foreign bank) between two related taxpayers (for instance, a foreign parent corporation and its Canadian subsidiary) in an attempt to avoid the application of rules that would apply if a loan were made, and interest paid on the loan, directly between the two taxpayers.

Although the Canada Revenue Agency is of the view that such transactions may be challenged under existing anti-avoidance rules, the government has decided to preclude the use of back-to-back loan arrangements more forcefully by adding a specific anti-avoidance rule in respect of withholding tax on interest payments, and by replacing the existing anti-avoidance rule in subsection 18(6) with an enhanced anti-avoidance rule. As set out in Resolutions 37 and 38, new subsections 18(6) and 212(3.1) will provide that an unacceptable back-to-back loan arrangement will exist where, as a result of a transaction or series of transactions, the following conditions are met:

- a taxpayer has an outstanding interest-bearing obligation owing to a lender (the intermediary); and
- the intermediary or any person that does not deal at arm's length with the intermediary
  - has a property, or receives a pledge of a property by a non-resident person, as security in respect of the obligation (according to the Budget papers, for this purpose, a guarantee, in and of itself, will not be considered a pledge of property),
  - is indebted to a non-resident person under a debt for which recourse is limited, or
  - receives a loan from a non-resident person on condition that a loan be made to the taxpayer.

Where an unacceptable back-to-back loan arrangement exists, new paragraph 18(6.1)(*a*) will provide that specified amounts in respect of the obligation, and interest paid or payable thereon, will be deemed to be owing by the taxpayer to the non-resident person for the purposes of the thin capitalization rules. The taxpayer will, in general terms, be deemed to owe an amount to the non-resident person (the deemed amount owing) that is equal to the lesser of:

- the outstanding amount of the obligation owing to the intermediary; and
- the fair market value of the pledged property or the outstanding amount of the debt for which recourse is limited or the loan made on condition, as the case may be.

New paragraph 18(6.1)(*b*) will provide that the taxpayer will, in general terms, also be deemed to have an amount of interest paid or payable to the non-resident person that is equal to the proportion of the interest paid or payable by the taxpayer on the obligation owing to the intermediary that the deemed amount owing is of that obligation.

New subsections 212(3.2) and (3.3) will provide that Part XIII withholding tax will generally apply in respect of a back-to-back loan arrangement, to the extent that it would otherwise be avoided by reason of the arrangement. The non-resident person and the taxpayer will be jointly and severally (or solidarily) liable for the additional Part XIII withholding tax.

The proposed amendments will apply:

- in respect of the thin capitalization rules, to taxation years that begin after 2014, and
- in respect of Part XIII withholding tax, to amounts paid or credited after 2014.