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Quick Update – Corporate Tax

Report on Finance Release
Draft Legislation September 13, 2013

Introduction

On September 13, 2013 the Department of Finance (Finance) released significant draft legislative proposals. The following report outlines the corporate tax-related items in the release, which

- target derivative transactions whose purpose is to convert ordinary income into a capital gain (see Character Conversion Rules immediately below);
- target transactions that economically dispose of property without changing ownership (see Synthetic Disposition Rules at page 4 below);
- phase out accelerated deductions for the mining industry (see CEE/CDE and A-CCA Rules at page 9 below);
- restructure and expand corporate loss-trading restrictions (see Non-Acquisition of Control Rules at page 11 below); and
- expand existing thin capitalization rules to restrict interest expense for Canadian branches of non-resident corporations (see Branch Tax Rules – Thin Cap at page 13 below).

Character Conversion Rules

Income Inclusion. These rules are centered on the definition of a "derivative forward agreement" in s. 248(1) (DFA). Any profit from a DFA must be included in ordinary income (s. 12(1)(z.7)). The structure of this provision contemplates either the purchase of a capital property (s. 12(1)(z.7)(i)) or the sale of a capital property (s. 12(1)(z.7)(ii)). In the case of a purchase, the amount included in income is difference between the property's FMV (FMV) at the time acquired under the DFA and the property's cost. In the case of a sale, the amount included in income is the difference between the property's sale price at the time of sale and the property's FMV at the time the DFA was entered into. The income inclusion is added to the property's adjusted cost base (ACB) (s. 53(1)(s) and (t)).

Deduction. A deduction is available where the purchase or sale of the capital property under a DFA instead results in a loss (s. 20(1)(xx)). Such loss decreases the property's ACB (s. 53(2)(w) and (x)).

DFA. A DFA in s. 248(1) involves the purchase or sale of a capital property over a specified time frame.

1. Paragraph (a) of the definition requires that the term of the DFA exceed 180 days or be part of a series of agreements with a term that exceeds 180 days.
2. Paragraph (b) of the definition deals with the *purchase* a capital property, where the economic return is the difference between the price paid for the property and its FMV when delivered. The DFA must have a "derivative component", i.e., the economic return must be attributable, in whole or part, to particular "an underlying interest". The latter is intended to have a broad meaning and includes a

value, price, rate, variable, index, event, probability or thing. For example, the return could be based on the value of a reference fund, 1.5 times the return on the TSX over a period of time, LIBOR, an express or implied fixed interest rate or the price of a commodity.

3. Subparagraphs (b)(i) and (ii) of the definition exclude certain underlying interests. Subparagraph (b)(i) provides that, where the economic return on the purchase of a property is based on the economic performance of the actual property being purchased, the purchase agreement will not be a DFA. In addition, subparagraph (b)(ii) ensures that, where the purchase price of the property is denominated in a foreign currency, changes in the value of the Canadian currency relative to the foreign currency will not cause the purchase agreement to be a DFA.

4. Paragraph (c) of the definition deals with the *sale* of a capital property. The economic return is the difference between the property's FMV at the time the DFA is entered into and the property's sale price. As with purchase DFAs, a sale agreement will not be a DFA where the economic return is attributable to the economic return on the actual property being sold. Further, where the sale price of the property is denominated in a foreign currency, changes in the value of the Canadian currency relative to the foreign currency will not cause the sale agreement to be a DFA (see subparagraphs (c)(i) and (c)(ii)).

5. Subparagraph (c)(ii) provides an additional exclusion. An agreement is not be a DFA where the taxpayer retains a substantial level of economic exposure to the property being sold. Specifically, the agreement must is part of an arrangement that has the effect of eliminating a majority of the taxpayer's opportunity for profit and risk of loss in respect of the property for a period of more than 180 days. This ensures that the DFA rules will not apply where the taxpayer's economic exposure is still based primarily on the property being sold, even if there is a "derivative component" to the agreement.

Examples. These are difficult rules in the abstract. Accordingly, Finance provided some examples.

1. Put/Call Option A. A taxpayer owns a property worth $100. If the taxpayer writes a "covered call option" that allows the option holder to acquire the property for $105, the taxpayer would "retain an economic exposure to $5 of upside and all of the downside" in respect of the property. Where the property is sold on the exercise of the call option, the agreement would not be a derivative forward agreement.

2. Put/Call Option B. On the other hand, if the taxpayer writes the same covered call option and acquires a put option that allows it to sell the property in a year for $105, the taxpayer has eliminated the economic exposure to the property. In other words, if the actual value of the property exceeds $105 in a year, the call option holder would be expected to exercise the call option. If the value of the property is less than $105 in a year, the taxpayer would exercise the put option. Where the property is sold on the exercise of either the put option or the call option, the relevant agreement would be a DFA.

3. Exchangeable Shares – Call Right. A taxpayer owns 100 shares of Yco, a Canadian corporation. The terms of the Yco shares contain a right to redeem the shares (along with a limited right for Yco to retract) at any time in exchange for shares of Zco, a publicly traded foreign corporation (or an amount of cash determined by reference to the value of the Zco shares). The value of the Yco shares therefore

tracks the value of the Zco shares. The taxpayer provides Callco, a Canadian corporation, with a call right that entitles it to purchase the taxpayer's Yco shares for a price determined by reference to the value of a corresponding number of Zco shares. In this situation, the taxpayer would retain a sufficient economic exposure to the Yco shares such that agreement to sell its Yco shares would not be a DFA.

4. Forward Sale A. Conversely, if the Yco shares (in the above example) do not have an embedded exchange right and instead, the taxpayer enters into an agreement to sell the Yco shares more than 180 days in the future for a price determined by reference to the value of the Zco shares, the agreement *would be* a DFA.

5. Forward Sale B. A mutual fund trust purchases a portfolio of non-dividend paying Canadian securities worth $100 million. These are capital properties to the trust. The trust then enters into an agreement to sell the portfolio of Canadian securities to a counterparty in five years for a price determined by reference to the performance of a bond fund (i.e., the price is equivalent to what a $100 million investment in the bond fund would be worth after five years). Assume at the end of the five-year term of the forward sale agreement, the portfolio of Canadian securities is worth $110 million and the notional investment in the bond fund is worth $125 million. The portfolio of Canadian securities would therefore be sold for $125 million (regardless of the FMV of the Canadian securities portfolio at the end of the five-year term). The sale agreement here would be a DFA.

    a. It has a term in excess of 180 days.

    b. The difference between the FMV of the property sold at the time of entering into the agreement ($100 million) and the sale price ($125 million) is determined by reference to an underlying interest (i.e., the notional investment in the bond fund) that is unrelated to the property sold.

    c. Lastly, the sale agreement has the effect of eliminating a majority of the trust's opportunity for gain or profit and risk of loss in respect of the Canadian securities portfolio.

    d. The mutual fund trust would be required to include $25 million in computing its income for the year of the sale under s. 12(1)(z.7), being the difference between the FMV of the property at the time the agreement is entered into ($100 million) and its sale price ($125 million). The ACB of the Canadian securities would be increased by $25 million (under s. 53(1)(t)), such that the trust would have no capital gain or loss on the disposition.

6. Forward Purchase. A corporation enters into an agreement to purchase a portfolio of Canadian securities in five years. It prepays $100 million upon entering into the agreement. The value of the Canadian securities to be delivered on settlement of the agreement is to be determined by reference to the performance of an equity fund that invests primarily in dividend-paying foreign equities. In other words, the value of Canadian securities to be delivered is equivalent to what a notional $100 million investment in the equity fund would be worth after five years. The securities actually purchased are capital properties to the corporation. At the end of five years, the notional investment in the equity fund is worth $125 million. The counterparty therefore delivers a portfolio of Canadian securities to the corporation with a value of $125 million. Assume this portfolio is then immediately sold by the corporation for cash proceeds of $125 million. The purchase agreement here would be a DFA.

a. It has a term in excess of 180 days. The difference between the value of the property delivered and the price paid for the property is unrelated to the economic performance of the property. Rather, it is based on the performance of the unrelated equity fund (i.e., the underlying interest).

b. The corporation would be required to include $25 million in its income (under s. 12(1)(z.7)), being the difference between the FMV of the Canadian securities portfolio when the agreement is settled ($125 million) and the price paid for the Canadian securities ($100 million). The corporation's ACB of the Canadian securities would be increased by $25 million (under s. 53(1)(s)). The corporation would therefore have no capital gain or loss on the disposition of the Canadian securities for $125 million cash.

Transition. The income inclusion in s. 12(1)(z.7) applies to acquisitions and dispositions of property that occur after March 20, 2013, unless transitional relief is available. Transitional relief is not available for acquisitions and dispositions of property that occur after March 21, 2018. The coming-into-force rules (i.e., the transitional rules) applicable to an acquisition or disposition of property under a DFA depend upon whether the agreement was entered into before March 21, 2013 or after March 20, 2013. Paragraph (3)(a) of the transitional rules applies to agreements entered into after March 20, 2013. Paragraph (3)(b) applies to agreements entered into before March 21, 2013. Agreements entered into after March 20, 2013 will only be eligible for transitional relief if they are part of a series of DFAs, and a predecessor agreement was entered into before March 21, 2013. As a result, agreements entered into before March 21, 2013 can be extended or renewed to the end of 2014 without s. 12(1)(z.7) applying, provided certain conditions relating to the size of the agreement are met. These size restrictions are intended to limit new investments in an existing DFA.

Synthetic Disposition Rules

Deemed Disposition. A new rule is introduced (s. 80.6) which provides that a taxpayer who owns a property and who enters into a "synthetic disposition arrangement" in respect of it is deemed to have disposed of the property for proceeds equal to its FMA and to have immediately reacquired the property at that FMV. The rule ensures that taxpayers cannot defer tax by economically disposing of a property without legally disposing of it. The deemed disposition occurs at the beginning of the "synthetic disposition period". Both "synthetic disposition arrangement" (SYDA) and "synthetic disposition period" (SYDP) are defined in s. 248(1).

Definition of SYDA. A SYDA is generally any agreement, series of agreements or other arrangement that allows a taxpayer to eliminate all or substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property for a definite or indefinite period of time. A SYDA would not include an arrangement that eliminates *only* the taxpayer's risk of loss or *only* the taxpayer's opportunity for gain or profit.

1. A taxpayer's opportunity for gain or profit in respect of a property would include the taxpayer's rights (whether contingent or absolute) to earn income (e.g., dividends) or to obtain other benefits in respect of the property and the taxpayer's right to economically participate in any increase in the value of the property. Likewise, a taxpayer's risk of loss would include any liabilities (whether contingent or absolute) or obligations to provide benefits in respect of the property and the taxpayer's economic exposure to any decreases in the value of the property.

2. A taxpayer will not be considered to retain opportunity for gain or profit in respect of a property if the arrangement provides for an offsetting liability. This could occur, for example, where a taxpayer has a right to receive dividends on shares it owns, but has a corresponding obligation to pay the amount of any dividends it receives to a third party. Similarly, a taxpayer will not be considered to retain risk of loss where the arrangement provides for an offsetting benefit.

3. The determination of whether "all or substantially all of a taxpayer's risk of loss and opportunity for gain or profit" in respect of a property has been eliminated is highly factual. Depending on the circumstances, a taxpayer might be considered to have eliminated their risk of loss even if, for example, any or all of the following are retained: the risk that a dividend or other return may not be paid or provided in relation to the property; the risk as to a worsening of the creditworthiness of any party to the arrangement; the risk as to changes in interest rates; or the risk as to fluctuations in foreign currency exchange rates.

4. Similarly, depending on the circumstances, a taxpayer might be considered to have eliminated their opportunity for gain or profit even if, for example, any or all of the following are retained: the opportunity to benefit from a dividend or other return being paid or provided in relation to the property; the opportunity to benefit from an improvement in the creditworthiness of any party to the arrangement; the opportunity to benefit from changes in interest rates; or the opportunity to benefit from fluctuations in foreign currency exchange rates.

5. Although the definition SYDA applies in respect of a property, there is no requirement that the agreement or arrangement or series of agreements be *legally* related to the property. For example, a SYDA in respect of a property could involve a "cash-settled derivative" that offsets the taxpayer's economic interest in the property but does not require that the taxpayer own the underlying property.

6. These new rules look to the economic effects of an arrangement. Since different components of a SYDA can be entered into by different parties, the definition contains a deeming rule that applies to arrangements that are entered into by non-arm's length persons or partnerships. These arrangements are deemed to have been entered into by the taxpayer. It must be reasonable to conclude that these arrangements were entered into, in whole or in part, with the purpose of achieving the deferred disposition. This ensures that the new rules will not apply when a non-arm's length person "inadvertently" enters into a transaction that economically offsets another transaction entered into by the taxpayer.

<u>Examples of SYDA</u>. Similar to the Character Conversion rules, these new rules can be difficult to fully understand from a purely conceptual level. Accordingly, the Department of Finance provided "simplified examples" that illustrate the considerations that are relevant. Again, these new rules are highly dependent on the facts.

1. <u>Classic Example</u>. John owns shares of ABC Co. that have an adjusted cost base of $1 million and a FMV of $10 million. If John sold the shares outright, he would realize a $9 million capital gain. John, however, wants to sell the shares without any immediate tax consequences. In order to effectively sell the shares while deferring tax on the accrued capital gain, John enters into a SYDA.

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a. John receives a five-year loan for $10 million from a purchaser (with interest of $2 million payable in five years). Under the arrangement, John obtains a right to settle the loan (including accrued interest) in five years by transferring the ABC Co. shares to the purchaser. The purchaser obtains a right to acquire the shares from John in five years for $12 million.

b. As a result, John has eliminated his risk of loss and opportunity for gain or profit in respect of the ABC Co. shares. If the value of the shares is less than $12 million in five years, John would be expected to settle the loan by transferring ownership of the shares to the purchaser. If the value of the shares is greater than $12 million in five years, the purchaser would be expected exercise the right to acquire the shares for $12 million.

c. Under s. 80.6, John is deemed to have disposed of the ABC Co. shares at their FMV of $10 million when he enters into the arrangement. He is deemed to have immediately reacquired the shares at a cost of $10 million. As a result, John has an immediate capital gain of $9 million.

d. In five years, John disposes of the shares for proceeds of $12 million (either to settle the $12 million debt or to settle the purchaser's right to acquire the shares for $12 million), which will exceed the $10 million ACB of the ABC Co. shares to John at that time. As a result of the new Character Conversion rules (above), John has a $2 million income inclusion at the time of actual sale, and no additional capital gain result from the actual disposition.

2. Put-Call Arrangement A. A taxpayer owns a non-income producing property with a value of $85. The taxpayer acquires a right to sell the property for $100 in five years (a put) and grants a right to buy the property for $100 in five years (a call). The taxpayer has eliminated all or substantially all of *both* the taxpayer's risk of loss and opportunity for gain or profit in respect of the property. At the end of five years, if the property is worth $115, the call option holder would be expected to exercise the right and purchase the property for $100. If, instead, the property is worth $85 at the end of five years, the taxpayer would be expected to exercise the put right and sell the property for $100.

3. Put-Call Arrangement B. A taxpayer owns shares of a publicly traded company with a value of $100 and the company is not expected to pay dividends in the foreseeable future. The taxpayer buys (for $4) a right to sell the property for $100 in two years, and sells (for $4) a right to buy the property for $102 in two years. The taxpayer would have entered into a SYDA because the taxpayer has eliminated substantially all their risk of loss and opportunity for gain or profit in respect of the property. The taxpayer would also be considered to have entered into a SYDA if the taxpayer sold (for $99) a right to buy the property for $2 in two years, as it would be reasonable to expect the option holder to exercise the option.

4. Put-Call Arrangement C. A taxpayer owns a property with a value of $100. The taxpayer buys (for $1) a right to sell the property for $50 in five years and sells (for $1) a right to buy the property for $150 in five years. In this example, the taxpayer would *retain* a significant economic exposure to the property. Accordingly, the taxpayer would generally not be considered to have eliminated all or substantially all of either of the taxpayer's risk of loss or opportunity for gain or profit.

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5. Secured Loan A. A taxpayer owns a property with a value of $100. As part of an arrangement, the taxpayer receives a loan of $100 and receives a right to settle the loan by transferring the property to the lender. Also as part of the arrangement, the lender obtains the right to acquire the property for $100. The taxpayer has eliminated substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property. If the property's value exceeds $100 at the end of the term of the loan, the lender would be expected to exercise its right to acquire the property for $100. If the property's value is less than $100 at the end of the term of the loan, the taxpayer would be expected to use the property to settle the loan.

6. Secured Loan B. A taxpayer owns a property with a value of $100. A taxpayer receives a loan of $100 that is secured by the property. The taxpayer would generally not be considered to have eliminated substantially all of either of the taxpayer's risk of loss or opportunity for gain or profit. Even if the taxpayer received a right to settle the debt with the property, the taxpayer would not generally be considered to have entered into a SYDA since the taxpayer would not have eliminated all or substantially all of the taxpayer's opportunity for gain or profit in respect of the property.

7. Future Sale A. A taxpayer enters into an agreement to sell a non-income producing property with a current FMV of $100 in five years for $120. Upon entering into the agreement, the taxpayer is obligated to sell the property at the future date for the specified price. The taxpayer has eliminated all or substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property because the taxpayer's return is determined without regard to the economic performance of the property.

8. Future Sale B. A taxpayer enters into an agreement to sell 100 shares of ABC Co. with a current FMV of $100 in five years for $120. The $120 sale price will be decreased based upon dividends paid on the ABC Co. shares. Alternatively, the taxpayer is required to pass on the dividends it receives to the purchaser. The taxpayer has eliminated all or substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property because the taxpayer's return is determined without regard to the economic performance of the property.

9. Future Sale C. A taxpayer enters into an agreement to sell a property at a future date at a price determined by the value of the property at that future date. The taxpayer would not be considered to have eliminated substantially all of either their risk of loss or opportunity for gain or profit.

10. Contingent Sale. A taxpayer enters into an agreement to sell 100 shares of ABC Co. to a purchaser for $100, but only if the purchaser obtains regulatory approval for the sale. When the agreement was entered into, there was a real risk that regulatory approval would not be obtained. The taxpayer has not eliminated all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the shares while this bona fide condition precedent remains outstanding.

11. Short Sale A. A taxpayer borrows 100 ABC Co. shares and immediately sells the shares for their FMV. The taxpayer then buys 100 ABC Co. shares. The taxpayer would have entered into a SYDA in respect of the 100 ABC Co. shares that were purchased because the arrangement has eliminated substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property.

12. Short Sale B. A subsidiary of a large corporation makes a portfolio investment in 100 ABC Co. shares because its investment manager has a bullish outlook on ABC Co. Another subsidiary sells 100 ABC Co. shares short because its investment manager has a bearish outlook on ABC Co. The short investment position is taken without actual knowledge of the long investment. While, taken together, the long and short positions economically offset each other, it cannot be said that the short position was entered into for the purpose of eliminating all or substantially all of the risk of loss and opportunity for gain or profit of the long position.

13. Swap A. A taxpayer owns ABC Co. shares with a cost of $10 and a FMV of $100. The taxpayer enters into a five-year total return swap with a counterparty under which the taxpayer will pay the counterparty the amount of any dividends plus any increases in value in the ABC Co. shares at the end of five years. In return, the taxpayer receives swap payments based on LIBOR as well as an amount equal to any decrease in the value of the ABC Co. shares at the end of five years. This is a SYDA because the taxpayer has eliminated substantially all of both the taxpayer's risk of loss and opportunity for gain or profit in respect of the property over the five-year term of the total return swap, even if the taxpayer retains ownership of the property at the end of the term of the agreement.

14. Swap B. A taxpayer owns ABC Co. shares with a cost of $10 and a FMV of $100. The taxpayer enters into a five-year swap with a counterparty under which the taxpayer will pay the counterparty the amount of any dividends received on the ABC Co. shares (but no amount based on any increase in the value of the ABC Co. shares). In return, the taxpayer receives swap payments based on the dividends received on XYZ Co. shares (but no amount based on any decrease in the value of the ABC Co. shares). The price of the ABC Co. shares is volatile and most of the taxpayer's opportunity for gain or profit (and risk of loss) in respect of the shares is based on the potential appreciation (or depreciation) in the value of the ABC Co. shares. Since the taxpayer retains a significant economic exposure to the ABC Co. shares, the arrangement would not be a SYDA.

Definition of SYDP. The SYDP of a SYDA is the definite or indefinite period of time during which the one or more agreements or other arrangements have the effect, or would have the effect if entered into by the taxpayer, of eliminating all or substantially all the taxpayer's risk of loss and opportunity for gain or profit in respect of a property.

Exceptions. A number of exceptions to the new deemed disposition rule in s. 80.6 are available.

1. Must be an Economic Gain. The rule does not apply unless the deemed disposition would result in a capital gain or income (s. 80.6(2)(a)). This reflects the mischief of the rule, which is the deferral of tax.

2. Mark-to-Market Property. Such property is subject to an annual realization event, making a deemed disposition under this rule unnecessary (s. 80.6(2)(b)).

3. Lease of Tangible Property. It is not intended that this rule displace the existing tax rules with respect to these leases (s. 80.6(2)(c)).

4. Certain Share and Debt Exchanges. The rule does not apply to an exchange of property to which s. 51(1) applies. The latter provision generally permits a tax-deferred exchange of property where a taxpayer exchanges capital property that is a share, bond, debenture or note of a corporation for other capital property that is a share of the capital stock of the corporation.

5. Sold within One Year. The rule does not apply if the property is otherwise disposed of, as part of the arrangement, within one year after the day on which the SYDP begins (s. 80.6(2)(e)). Several provisions allow for a tax-deferred transfer of property. These include s. 85(1), s. 85.1(1) and s. 86(1). In such cases, the exclusion s. 80.6(2)(e) should apply.

Transition. The new rule in s. 80.6 applies to agreements and arrangements entered into after March 20, 2013. It also applies to an agreement or arrangement entered into before March 21, 2013, the term of which is extended after March 20, 2013, and it applies to the agreement or arrangement as if the agreement or arrangement were entered into at the time of the extension.

CEE/CDE and A-CCA Rules

Intangible Pre-Production Mine Development Expenses. The 2013 federal budget announced changes to the tax deductions available for these expenses. The changes are intended to "better align the deductions available for expenses in the mining sector with those available in the oil and gas sector". The following is a brief summary of the applicable changes.

1. New paragraph (c.2) of the definition of "Canadian development expense" in s. 66.2(5) (CDE) captures any expense incurred in bringing a new mine in a mineral resource in Canada (other than an oil sands mine) into production in reasonable commercial quantities, including an expense for clearing the land, removing overburden and stripping, sinking a mine shaft or constructing an adit or other underground entry. Such expenses are therefore deductible at 30% per annum declining balance.

2. The expenses in paragraph (c.2) of the definition of CDE were formerly contained in paragraph (g) of the definition of "Canadian development expense" in s. 66.1(6) (CEE). Such expenses used to qualify for a 100% deduction in the year incurred (to shelter income).

3. Paragraph (c.2) of the definition of CDE does not include an expense or any portion of an expense described in new paragraphs (g.3) or (g.4) of the definition of CEE, which provide transitional relief related to the above change.

4. Paragraph (g.3) of the definition of CEE provides for grandfathering of CEE treatment for two types of eligible pre-production mine development expenses that are incurred before 2017. Subparagraph (g.3)(i) ensures that eligible pre-production mine development expenses that are incurred before 2017 under a written agreement entered into by a taxpayer before March 21, 2013 are treated as CEE. In addition, subparagraph (g.3)(ii) provides that eligible pre-production mine development expenses incurred before 2017 for the development of a new mine are treated as CEE, if either the construction, or the engineering and design work for the construction, of the new mine was started by, or on behalf of, the taxpayer before March 21, 2013.

5. The evidence of the commencement before March 21, 2013 of the engineering and design work for the construction of the new mine must be in writing. For these purposes, the following activities are not considered construction or the engineering and design work for the construction of the mine: obtaining permits or regulatory approvals; conducting environmental assessments, community consultations or impact benefit studies; and any other similar activities.

6. Paragraph (g.4) of the definition of CEE contains a phase-in period in respect of the transition from CEE to CDE for eligible pre-production mine development expenses incurred after March 20, 2013. A portion of the eligible pre-production mine development expenses, if incurred by a taxpayer before 2018, continue to qualify as a CEE of the taxpayer based on the following rates: 100% of the expense in 2013 and 2014, 80% of the expense in 2015, 60% of the expense in 2016, and 30% of the expense in 2017. The remainder of the expense will qualify as a CDE of the taxpayer – see 3.4.1. In light of the above, a taxpayer may allocate eligible pre-production mine development expenses proportionally between two resource expense categories – CEE and CDE – based on the year in which the expense is incurred.

Tangible Pre-Production Mine Development Expenses. Before March 21, 3013 most machinery, equipment and structures used to produce income from a mine were eligible for a base-level capital cost allowance (CCA) rate of 25% on a declining-balance basis. The 25% base-level rate also applied to assets that were used in the initial processing of ore from a mineral resource. In addition to this base-level 25% CCA deduction, “accelerated”, “additional”, or “enhanced” CCA (A-CCA) was provided for certain assets acquired for use in new mines or eligible mine expansions. This A-CCA took the form of an additional allowance that supplemented the base-level CCA deduction.

1. The additional allowance allowed the taxpayer to deduct in computing income for a taxation year up to 100% of the remaining cost of eligible assets acquired for use in a new mine or an eligible mine expansion, not exceeding the taxpayer's income for the year from the particular mining project (calculated after deducting regular CCA). This A-CCA effectively deferred taxation of income from the mining project until the full cost of eligible assets had been recovered by the taxpayer in the form of CCA deductions (shelter).

2. The 2013 federal budget (March 21, 2013) phased-out the A-CCA available for mining projects; the phase-out will be complete by 2020. For the phase-out period, a taxpayer is allowed to claim a percentage of the amount of the A-CCA allowance otherwise permitted (under the pre-March 21, 2013 rules) according to the following schedule:

Transition Schedule for A-CCA Deductions

Year	2013–2016	2017	2018	2019	2020	After-2020
Percentage	100%	90%	80%	60%	30%	Nil

3. Where a taxpayer's taxation year includes more than one calendar year, the A-CCA is prorated based on the number of days in each calendar year.

4. This transition period generally applies to expenses incurred on or after March 21, 2013. However, in recognition of the long time-frames involved in developing mining projects, the existing A-CCA remains available for eligible assets acquired before March 21, 2013. Further, the A-CCA is also available for such assets acquired before 2018 for a new mine or a mine expansion either: (1) under a written agreement entered into by the taxpayer before March 21, 2013; or (2) as part of the development of a new mine or as part of a mine expansion where (i) the construction was started by, or on behalf of, the taxpayer before March 21, 2013, or (ii) the engineering and design work for the construction, as evidenced in writing, was started by, or on behalf of, the taxpayer before March 21, 2013.

5. Activities such as obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities do not qualify as construction or engineering and design work for purposes of (2)(ii) above.

6. The foregoing rules are being implemented through the new definition of "eligible mine development property" in s. 1104(2) of the Regulations and the addition of new Class 41.2 in Schedule II of the Regulations. In addition, several consequential amendments are made to the rules in Part XI of the Regulations.

Non-Acquisition of Control Rules

Policy. Existing rules are intended to restrict the trading of corporate tax attributes among arm's length persons. Nevertheless, Finance is concerned that alternate transactions which circumvent these provisions continue to be undertaken. Depending on the particular facts, these transactions are challenged by the Canada Revenue Agency (CRA) based on existing rules. However, as any such challenge could be time-consuming and costly, Finance is introducing new s. 256.1 to ensure that the appropriate tax consequences apply to these alternate transactions.

Triggering Conditions. The conditions for the new rules (in s. 256.1(3)) to apply are found in s. 256.1(2), which test whether at a particular time

1. shares of the capital stock of the corporation held by a person, or the total of all shares of the capital stock of the corporation held by members of a group of persons, have at the particular time a FMV that exceeds 75% of the FMV of all the shares of the capital stock of the corporation;

2. shares of the capital stock of the corporation held by the person, or the total of all shares of the capital stock of the corporation held by members of the group, have immediately before the particular time a FMV that does not exceed 75% of the FMV of all the shares of the capital stock of the corporation (this condition ensures that s. 256.1(3) does not apply more than once solely because the fair market value of the shares owned by the person or group, which is already above 75%, increases in value);

3. the person or group does not control the corporation at the particular time; and

4. it is reasonable to conclude that one of the main reasons that the person or group does not control the corporation is to avoid the application of one or more of the existing corporate attribute-trading provisions (each a Specified Provision, defined below).

Specified Provision. A "specified provision" is defined in s. 256.1(1) to be any of provisions that restrict the deductible amount of a corporate tax attribute on an acquisition of control of the corporation. These restrictions apply, among other tax attributes, to limit the deductibility of a corporation's loss carryover pools, investment tax credit carryover pools, resource expense pools and scientific research and experimental development expenditure pools.

Partnerships. For the purpose of these rules, a "person" is defined to include a partnership (see s. 256.1(1)).

Deemed Acquisition of Control. Under new 256.1(3)(a) the person or group of persons referred to in s. 256.1(2) is deemed to "acquire" control of the corporation, and each corporation controlled by that corporation, at the particular time for purposes of the existing corporate attribute-trading restrictions.

1. Accordingly, by deeming an acquisition of control of the corporation, and each corporation controlled by it, s. 256.1(3)(a) causes the existing corporate attribute-trading restrictions to apply to all these corporations. The existing rules are also restructured slightly. New s. 251.2(a) provides that a corporation is at any time "subject to a loss restriction event" if at that time control of the corporation is acquired by a person or group of persons. Corporate attribute-trading provisions that formerly referred an acquisition of control (e.g., s. 111(5)) now refer to a taxpayer that is "subject to a loss restriction event" (such taxpayers now include certain trusts, which are beyond the scope of this update).

2. Notwithstanding the above, the person or group of persons is not deemed to "have" control of the corporation, and each corporation controlled by the corporation, at any time after the particular time solely because of the application of this provision. As a consequence, the person, or group of persons, referred to in s. 256.1(2) will not have control of the affected corporations for other provisions solely because the attribute-trading restrictions apply to these corporations.

3. *De jure* control would continue to rest with the person, or group of persons, that actually has such control despite the application of the attribute-trading restrictions to these corporations. In addition, the affected corporations would, in general, continue to be associated with the corporations they were associated with before the application of s. 256.1(3). For example, the affected corporations would remain part of the *de jure* controller's group for the purpose of deducting the small business deduction and investments tax credits, including refundable scientific research and experimental development tax credits.

Not Related or Affiliated. Under s. 256.1(3)(b), during the period that the 75% FMV threshold above is satisfied, each corporation referred to in s. 256.1(3)(a) – and any corporation incorporated or otherwise formed subsequent to that time and controlled by that corporation – is deemed not to be related to, or affiliated with, any person to which it was related to, or affiliated with immediately before s. 256.1(3)(a) applied. Accordingly, these corporations cannot undertake "loss consolidations" within an affiliated, or related, group.

Special Rules. New s. 256.1(4) provides two rules that apply for the purpose of applying the 75% FMV threshold in respect of a person or group of persons under s. 256.1(2)(a).

1. Under s. 256.1(4)(a), if it is reasonable to conclude that one of the reasons that one or more transactions or events occur is to cause a person, or a group of persons, not to hold shares having a FMV that exceeds 75% of the FMV of all the shares of the capital stock of a corporation, s. 256.1(2)(a)

is to be applied without reference to those transactions or events. This rule provides that such transactions or events are to be ignored in determining whether the shareholdings of the person or group of persons exceeds 75% of the FMV of all the shares of the corporation.

2. Under s. 256.1(4)(b), for the purpose of applying the condition in s. 256.1(2)(a) the person, or each member of the group, is deemed to have exercised each right (to acquire shares) that is held by the person or a member of the group and that is referred to in s. 251(5)(b). Accordingly, whether the 75% FMV threshold in s. 256.1(2)(a) has been exceeded by a person, or a group, is to be determined on the basis that the person, and each member of a group, has exercised these rights.

If Share Value Nil. New s. 256.1(5) provides deeming rules that apply in certain circumstances for the purposes of s. 256.1(2) and (4). If the FMV of the shares of the capital stock of a corporation is nil at any time, then for the purpose of determining the FMV of those shares, the corporation is deemed, at that time, to have assets net of liabilities equal to $100,000 and to have $100,000 of income for the taxation year that includes that time.

Acquisition of Profitable Corporations. New s. 256.1(6) contains an anti-avoidance rule that deems the attribute-trading restrictions to apply in specified circumstances.

1. If, at any time as part of a transaction or event or series of transactions or events, control of a particular corporation is acquired by a person, or a group of persons, and it can reasonably be concluded that one of the main reasons for the acquisition of control is so that a specified provision does not apply to one or more corporations, the attribute-trading restrictions are deemed to apply to each of those corporations as if control of each of those corporations is acquired at that time.

2. In general terms, s. 256.1(6) counters tax avoidance structures under which corporate tax attributes were traded by arm's length persons in circumstances where a *loss* corporation that has undeducted tax attributes acquires control of a *profitable* corporation.

3. Because the loss corporation (or a person related to or affiliated with it) acquires control of the profitable corporation (or a corporation related to or affiliated with it), the owners of the corporations avoid (subject to the general anti-avoidance rule in s. 245) an acquisition of control of the loss corporation and the existing corporate attribute-trading rules.

Transition. These rules come into force on March 21, 2013, except they do not apply to an event or transaction that occurs before March 21, 2013 or after March 20, 2013 pursuant to an obligation created by the terms of an agreement in writing entered into between parties before March 21, 2013. For this purpose, parties will be considered not to be obligated if one or more of those parties may be excused from fulfilling the obligation as a result of legislative changes.

Branch Tax Rules - Thin Cap

General Limitation on Interest Expense. The thin capitalization rules in s. 18(4) to 18(8) prevent a corporation resident in Canada from deducting interest on debts owing to certain specified non-residents, to the extent such debts exceed a 1.5-to-1 debt-to-equity ratio.

Non-Resident Corporations – Policy. These rules are extended to non-resident corporations operate in Canada, whether directly or as members of a partnership. In other words, the thin capitalization rules are extended to non-resident corporations that carry on business in Canada, or that, in accordance with s. 216 of the Act, are taxable in Canada under Part I (rather than Part XIII) on certain types of income. In this way, the Canadian operations of these non-resident corporations are effectively treated in the same way as if they were carried out through a wholly-owned Canadian subsidiary. The rules are also extended to certain trusts, which are beyond the scope of this note. The amendments apply to taxation years that begin after 2013. The rules will not apply to a Canadian banking business of an authorized foreign bank (these businesses are addressed in s. 20.2).

Equity. The rules are also amended to replace the description of a corporation's equity for the purposes of the thin capitalization rules in s. 18(4)(a)(ii)(A) to (C) with the new defined term "equity amount". This definition incorporates the current description of a corporation's equity for thin capitalization purposes along with defining the "equity" of non-resident corporations.

1. New s. 18(5) adds the definition "equity amount". Paragraph (a) contains the description of a Canadian-resident corporation's equity previously found in s. 18(4)(a)(ii)(A) to (C). Paragraph (c) contains a description of a non-resident corporation equity for thin capitalization purposes.

2. Since a Canadian branch of a non-resident corporation is not a separate legal person from the non-resident entity, it does not have equity as determined for thin capitalization purposes. Therefore, a 3-to-5 (or 60%) debt-to-assets ratio is used to provide a *notional* amount of equity against which the debts of the non-resident entity are tested. This parallels the 1.5-to-1 debt-to-equity ratio used for Canadian-resident corporations. The debt-to-assets ratio is based on the cost of the assets used or held by the non-resident entity in respect of its Canadian activities.

3. Based on the 3-to-5 debt-to-assets ratio, the permitted equity amount threshold for a non-resident corporation, for thin capitalization purposes, is computed as being 40% of the cost, on an averaged basis, of the assets or property used or held by the non-resident corporation in respect of its Canadian activities less the outstanding debts of the non-resident entity that relate to its Canadian activities and that are not included in its outstanding debts to specified non-residents.

Example. NR Finco and NR Opco are wholly-owned subsidiaries of NR Parent, all of which are corporations and none of which are resident in Canada. NR Opco carries on a business in Canada through a branch. The properties of NR Opco used in its Canadian branch have a total cost of $350,000. NR Finco has made a loan of $150,000 to NR Opco, the proceeds of which are used by NR Opco in its Canadian business. An arm's length financial institution has made a loan of $100,000 to NR Opco, the proceeds of which are also used by NR Opco in its Canadian business. NR Opco's "equity amount" would equal 40% of the amount, if any, by which the total cost of the Canadian branch's assets ($350,000) exceeds the amount of its debts used in the Canadian branch that are not owing to specified non-residents ($100,000). This is multiplied by 1.5 to arrive at NR Opco's thin capitalization limit. The limit is 1.5 x 40% ($350,000 - $100,000) = $150,000. NR Opco would therefore be entitled to deduct interest on up to $150,000 of non-arm's length debts. This corresponds to a 3-to-5 (or 60%) debt-to-assets ratio.

Deemed Specified Shareholder. A Canadian branch is not a separate legal person from the non-resident corporation that it is a part of and as a consequence, a Canadian branch does not have specified shareholders and a non-resident cannot make a loan directly to it. Therefore, for the purpose of applying the thin capitalization rules to non-resident

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corporations, new s. 18(5.2) is added to deem a non-resident corporation to be a specified shareholder of itself. The effect of this deeming rule and clause (a)(i)(B) of the definition "outstanding debts to specified non-residents" in s. 18(5) is that a loan to a non-resident corporation from a non-resident person who does not deal at arm's length with the non-resident corporation will be included in outstanding debts to specified non-residents for the non-resident corporation. This result is consistent with that where a loan is made to a Canadian subsidiary from a non-resident person that does not deal at arm's length with the foreign parent of the Canadian subsidiary.

<u>Property Used in Business</u>. As noted above, since a branch does not have equity in the same sense as a wholly-owned subsidiary, a 3-to-5 debt-to-assets ratio is used for Canadian branches for thin capitalization purposes. The asset portion of this debt-to-assets ratio uses the cost of the property used or held by the non-resident entity in respect of its Canadian activities. As well, amended s. 18(7)(a) allocates to a non-resident partner its share of the property of the partnership, which is included with the non-resident's properties for the purpose of determining the non-resident's equity amount (as defined in s. 18(5)).

1. New s. 18(5.3) is introduced to provide rules that determine, in certain circumstances and for the purpose of determining the non-resident's equity amount, what the cost and use of a particular property is in relation to the Canadian activities of a non-resident corporation or trust.

2. New s. 18(5.3)(a) provides a deeming rule that determines the cost of a property for thin capitalization purposes if the property is only *partly* used in Canada. This cost is based on the proportionate use of property in Canada compared to its total use.

3. New s. 18(5.3)(b)(i) and (ii) deal with partnerships. They allow the thin capitalization rules to apply in respect of property held by a partnership in which a non-resident corporation is a member in the same way the rules would apply if the partner's share of the property were held directly. New s. 18(5.3)(b)(i) allocates the cost of properties of a partnership to its partners in the same proportion as the debts of the partnership are allocated. New s. 18(5.3)(b)(ii) deems the property to be used or held by the partner in the course of carrying on business in Canada if the partnership used or held it in the course of carrying on business in Canada.

<u>Partnership Debts</u>. Existing s. 18(7) provides that, for the purposes of the thin capitalization rules, a partner's share of the debts of a partnership is included with the partner's directly owed debts in determining whether it has exceeded the debt-to-equity threshold under the thin capitalization rules. This rule is amended to allocate to a non-resident partner its share of the property, in addition to allocating its share of the debts, of the partnership.

*** END OF REPORT***