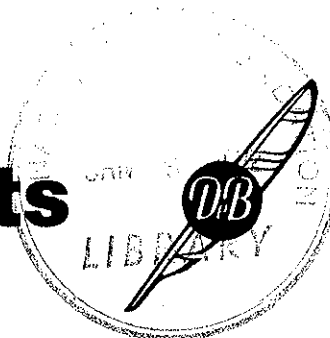


Budget Amendments 1981



SPECIAL RELEASE

DECEMBER 28, 1981

© 1981, Richard De Boo Limited, 81 Curlew Drive, Don Mills, Ontario M3A 3P7

Notes on Transitional Arrangements and Amendments Relating to the November 12th, 1981 Federal Budget

Tabled in the House of Commons by
The Honourable Allan J. MacEachen, Minister of Finance

CONTENTS

Reserves	2
Capital Cost Allowances	2
Soft Costs	3
Work in Progress	4
Restricted Interest Expense	4
Retiring Allowances	6
Accrual of Interest Income	6
Income-Averaging Annuity Contracts	7
Small Business Bonds	7
Reorganizations	8
Loans to Non-Residents	9
Employer Housing Loans	9
Prescribed Rate of Interest	9
Deferred Profit-Sharing Plans	10
Life Insurance RRSPs	10
Life Insurance Policyholders	10
Contractual Commitments	11

RESERVES

Budget Resolution 31 proposed that for all dispositions of property after November 12, 1981 no reserve be permitted to a taxpayer in respect of the profit or capital gain attributable to unpaid instalments. The effect of this was that taxpayers could no longer defer income tax on profits or capital gains by arranging to receive the sale proceeds over a number of years.

Although the principle of this proposed measure is sound, there are a number of circumstances where the measure would impose some hardship and disrupt established business practices. It is therefore proposed that a reserve be provided over a maximum period of three years for dispositions of real property that give rise to ordinary income. For this purpose the proceeds will be treated first as a receipt of the profit. To the extent that the profit has not been reported in the year of sale and the subsequent year, it must be brought into income in the third year.

Modifications will also be made to ease the proposal in respect of taxable gains arising on dispositions of capital property. These taxable gains will also be brought into income as proceeds are received but a five-year reserve mechanism will be provided so as to ensure that the cumulative amount of taxable gain that has been brought into income is not less than one-fifth of the full taxable gain times the number of taxation years that have elapsed since the disposition. For example, where property is sold in 1982 for a taxable gain of \$50,000, the maximum reserve that could be claimed in 1983 would be \$30,000. The reserve would be less than \$30,000 if by the end of 1983 the taxpayer had received proceeds of more than \$20,000. The effect of the rules is to ensure that at least two-fifths of the taxable gain is included in income by the end of the second year.

The budget does not affect the existing rules allowing farmers and small business owners a tax-free rollover on the transfer of a farm property or shares to their children. However, some farmers choose to benefit from the general reserve provisions as an alternative to making a tax-free transfer. For transfers of a family farm by a taxpayer to his child, the five-year period for the reserve will be extended to 10 years. The same 10-year period for reserves will also apply to transfers of a family farm corporation or partnership or a small business corporation in the circumstances covered by the special rules pertaining to inter-generational transfers set out in subsections 73(3), (4) and (5) of the *Income Tax Act*.

The restrictions in the three, five and ten year periods over which reserves may be claimed will not apply where the property is disposed of pursuant to an agreement in writing entered into on or before November 12, 1981. The pre-budget rules will continue to apply to such transactions.

CAPITAL COST ALLOWANCES

The budget proposed that the capital cost allowance in the year an asset is acquired be limited to one-half the normal rate. The budget proposal in most cases applied to property acquired after November 12, 1981. It is desirable to allow an orderly transition to the new rules for taxpayers who were committed to acquire depreciable property before the budget. To achieve this it is proposed that assets acquired before the end of 1982 will continue to receive a full write-off rate in four circumstances. They are:

- (a) where the taxpayer had made a binding written agreement before November 13, 1981 to acquire the property;

- (b) where arrangements with respect to the acquisition or leasing of the property were substantially advanced and evidenced in writing before November 13, 1981, and where the taxpayer enters into a written obligation to acquire the property on or before May 31, 1982;
- (c) where the taxpayer or a person with whom the taxpayer does not deal at arm's length had commenced the construction, manufacture or production of the property on or before the budget day; or
- (d) where arrangements, evidenced in writing, for the construction, manufacture or production of the property were substantially advanced before November 13, 1981 and the construction, manufacture or production commences on or before May 31, 1982.

The half-year rule will apply to the amount by which the cost of any depreciable property of a prescribed class acquired by a taxpayer exceeds the proceeds of disposition of property of the same class in the year.

In addition, for depreciable property owned by a taxpayer before November 13, 1981, the half-year depreciation rule will not apply on its subsequent transfer to a related taxpayer. For depreciable property acquired after November 12, 1981, the half-year rule will not apply on a non-arm's length transfer provided the property had been owned by the transferor for at least 365 days or the property was not subject to the half-year rule on its acquisition. This rule is designed to accommodate most corporate reorganizations.

For those taxpayers who have a fiscal period commencing after 1981 that is less than 12 months, the amount of the capital cost allowance to which a taxpayer is otherwise entitled on each class of depreciable property will be required to be prorated on the basis of the number of days in the period.

Because of the long lead time required by producers of Canadian films to arrange interim financing and bring a film to the production stage, certain arrangements are entered into well in advance of production. In recognition of these arrangements which are peculiar to the film production industry, the half-year depreciation rule will be deferred until 1983 for investments in certified films. This transitional arrangement is in keeping with the government's policy of supporting a stable and viable Canadian film industry and ensures an orderly transition to the new rules which will become effective for film investments made in 1983.

SOFT COSTS

Budget Resolution 15 proposed that soft costs (other than landscaping) incurred after November 12, 1981 should be included in the cost of land and buildings rather than being immediately deductible. This applied both to multiple-unit residential buildings and to other real estate projects. There are a number of circumstances where extensive planning took place before November 12, 1981 for the construction of major building projects the financing of which was dependent on the existing tax treatment for soft costs.

It is proposed that soft costs will be deductible with respect to a building:

- (a) the footings or other base support for which are in place by December 31, 1981, or
 - (b) where arrangements, evidenced in writing, for its construction in Canada were substantially advanced before November 13, 1981, and the footings or other base support are in place by May 31, 1982,
- and provided in either case that construction proceeds without undue delay.

WORK IN PROGRESS

Budget Resolution 27 proposed that for fiscal periods ending after 1981, the work in progress of professional firms at the end of the period be included in computing income for that period. This proposal is to be phased in over a two-year period. As a result, it will not affect fiscal periods ending on or before December 31, 1982 and for the 1983 fiscal period only one-half of the year-end work in progress will be required to be included in professional income. The effect of the budget rule is that, after this transaction, costs of work in progress will not be tax-deductible until revenue from the work is included in income.

There has been some uncertainty concerning the valuation of work in progress for professionals. The cost of work in progress will not include fixed or indirect overheads, such as rental, secretarial and general office expenses. It will generally be restricted to those costs, such as the salaries paid to professional employees, that are expected to be recovered in future billings. No cost is required to be imputed to partners' or proprietors' time.

RESTRICTED INTEREST EXPENSE

Budget Resolution 23 proposed that for the 1982 and subsequent taxation years the interest expense that would otherwise be deductible in a year on money borrowed by an individual or partnership to earn income from property be restricted to such income for the year. The restriction did not apply where the funds were used in a business, to acquire an interest in a partnership carrying on an active business, or to acquire a residential rental building before November 13, 1981.

Transitional relief will be provided to give a period of time for taxpayers to reorganize their financial affairs in light of the new rules, but at the same time ensure that the basic purpose of the restricted interest expense rule is maintained.

Modifications to the rules relating to restricted interest expense are proposed to encourage investment in private small business corporations by investors and employees. In addition, for interest on funds borrowed to acquire shares of taxable Canadian corporations, including public corporations, a special deduction is provided for up to \$10,000 of interest against non-investment income.

The \$10,000 exception is designed to encourage equity investment by Canadians and to address the concern that the measure as proposed would bias equity investment towards those public shares that pay dividends and away from those companies whose earnings are retained in the business for expansion. The special rules for investment in the shares of private companies are described in the next paragraph. These are designed to facilitate investment in small business.

Private company equity investment

It is proposed that interest paid in a year will not fall within the restricted interest rules where it is in respect of loans used by an individual to acquire shares in a qualifying private corporation

- (a) of which a taxpayer is a significant shareholder, or
- (b) of which the taxpayer is an employee to the extent that such interest does not exceed his income, including any remuneration, from the corporation for the year.

For the purpose of this rule a significant shareholding of an *individual* in a corporation is one in which he owns shares representing 10 per cent or more of the value and voting rights of all shares. To qualify as a significant shareholding, a *corporate* shareholder will have to own shares representing 25 per cent of the value and voting rights of all shares.

In addition, a qualifying private corporation means a taxable Canadian private corporation substantially all of whose property consists of

- (a) assets used in an active or non-qualifying business carried on by it, or
- (b) shares or indebtedness of any other qualifying private corporation in which it had a significant shareholding.

In addition, a corporation will not qualify if at any time after November 12, 1981 it has privatized or has become a successor to a non-qualifying corporation. The circumstances in which a private corporation becomes a successor to another corporation include:

- amalgamation with the other corporation,
- winding-up of the other corporation at a time when the private corporation was a significant shareholder of the other corporation, and
- the acquisition by the private corporation of property of the other corporation as a result of which the other corporation becomes a significant shareholder of the private corporation.

The purpose of this rule is to ensure that the incentives for investment in a private corporation do not become an inducement for public corporations to become private.

Pre-Budget Loans

Budget Resolution 20 proposed to eliminate the deduction of interest on loans taken out after November 12, 1981 where the funds were used to contribute to a registered retirement savings plan (RRSP), a registered pension plan (RPP) or to acquire an income-averaging annuity contract (IAAC). However, the treatment with respect to interest incurred on pre-budget loans used for these purposes was not specifically dealt with in the original budget proposals. Many individuals have organized their affairs under the provisions of the present *Income Tax Act* on the basis that interest would be fully deductible. A number of such individuals will not have sufficient other investment income to offset or absorb the interest on such loans. To accommodate this problem and allow these taxpayers whose interests are affected sufficient time to reorganize their affairs, it is proposed to treat as income from property all income received after 1981 from an RRSP, RPP or IAAC to the extent of the amount of any restricted interest expense incurred by the taxpayer on an obligation entered into before the budget to invest in any such plan or annuity.

Pre-Budget Building Loans

The rules relating to restricted interest expense will not apply on funds borrowed before the budget to acquire a residential rental building or on funds borrowed after November 12, 1981 to finance the purchase of any such building after that date in circumstances where the acquisition was pursuant to an agreement in writing entered into on or before the budget date. It has also been announced that the restricted interest rule would be waived for interest on funds borrowed by the first purchaser of a multiple-unit residential building (MURB) or by the first purchaser of an interest in a MURB partnership.

For this purpose the first purchaser will generally be regarded to be the first person who owned and held the investment as capital property after November 12, 1981 provided that it was acquired by him from a person or partnership for whom the property was regarded as inventory and fully taxed on disposition. This first-purchaser test may be evidenced by a certificate or similar affidavit by the vendor to the effect that the property was regarded, for tax purposes, as inventory to him.

Transitional Rule

A two-year transition is to be provided for interest that falls into the category of restricted interest. For 1982, any restricted interest expense may be deductible from up to two-thirds of the amount of the taxpayer's income determined before any deduction of restricted interest. For 1983, one-third of income may be offset by restricted interest. This means that most taxpayers, other than those who had taken what might be regarded as excessive advantage of the interest deduction, will have two years to rearrange their affairs to avoid the restriction on the deductibility of interest expenses.

RETIRING ALLOWANCES

Budget Resolution 42 proposed that tax-free transfers of retiring allowances to a registered pension plan (RPP) or a registered retirement savings plan (RRSP) after November 12 be restricted to \$3,500 for each year of employment during which the employee was not a member of an RPP or deferred profit-sharing plan (DPSP).

Tax-free transfers to RRSPs should also be permitted for employees who have been members of their employers' pension plans in situations where the employers' contributions to those plans have not vested as in the case of plant closings, or where pension entitlements need to be augmented. It is proposed that several changes be made to this proposal.

First, those employees who retired prior to November 13, 1981 will be allowed to transfer, tax free, to an RRSP the total amount of the retiring allowance received in respect of that retirement even if it is received after November 12, 1981.

Second, all employees who retire after November 12, 1981 and before 1982 will be allowed to transfer to an RRSP the full amount of a retiring allowance in respect of such retirement where the allowance was received pursuant to a written agreement to retire that was entered into on or before the budget date.

Third, a tax-free transfer of a retiring allowance will be allowed by a person who was a member of a registered pension plan or a deferred profit-sharing plan. Such transfer will be limited to \$2,000 for each year during which he was employed by the employer who paid the allowance and was a member of the employer's RPP or DPSP. In addition, the budget proposal will be altered to allow the tax-free transfer to an RRSP of a retiring allowance in the amount of \$3,500 for each year during which the employee was a member of an RPP or DPSP of his employer but in respect of which employer contributions to the plan did not vest in him.

ACCRUAL OF INTEREST INCOME

A modification is proposed to the change in Budget Resolutions 8, 9 and 10 concerning the reporting of accrued interest income on annuities

and other debt obligations. On such instruments acquired by individuals prior to the budget, only income attributed to the period following the first anniversary date after November 12, 1981 in the case of annuities — and after December 31, 1981 in the case of debt obligations — will be required to be included in income on the three-year accrual basis. Similarly where a corporation, partnership or trust acquired an annuity before December 20, 1980 or a debt obligation before October 28, 1980, only the income accrued in taxation years beginning after November 12, 1981 will be required to be included in income annually. This modification, which will not apply to financial institutions, should smooth the transition to the new rules for holders of existing financial instruments.

INCOME-AVERAGING ANNUITY CONTRACTS (IAACs)

Budget Resolution 43 proposed that amounts paid after November 12, 1981 to purchase an income-averaging annuity contract (IAAC) would be deductible only if all annuity payments under the contract are to be paid out before 1983.

Representations have been received from a number of individuals who had not technically purchased an IAAC before the budget date, but had arranged in writing to have the funds withheld from their remuneration for transfer into an IAAC. It is proposed that the budget changes on IAACs not apply in such cases where income had been earned and the funds had been withheld before November 12, 1981.

It is also proposed that all qualifying income may be contributed to a one-year annuity contract issued after budget day and not (as required under the present law) the qualifying income less an amount equal to one year's annuity payment. In addition, payments out of such a short-term annuity contract in 1982 will not be subject to deduction of tax at source.

SMALL BUSINESS BONDS

Under the small business bond provision, reduced interest rates for qualifying small business borrowers are made possible under a tax rule treating interest on the loan as a dividend and thus tax-exempt for corporate lenders. Budget Resolution 13 proposed that for small business bonds issued after November 12, 1981, only interest in excess of 6 per cent would be eligible for this tax exemption unless the bond was issued pursuant to an agreement in writing made on or before November 12, 1981. Budget Resolution 160 proposed a similar 6-per-cent threshold for term preferred shares, income bonds or debentures issued in cases of financial difficulty. It is proposed to remove the threshold requirement in all cases. This means that the entire amount of the interest paid on any qualifying small business bond issued after November 12, 1981 will qualify for the exemption, as the whole amount will be treated as a dividend. Similarly, the 6-per-cent threshold will be removed from term preferred shares and income bonds or debentures issued under conditions of financial difficulty.

It is also proposed to extend the deadline to January 31, 1982, for the issue of small business bonds by qualifying small business corporations and for the acquisition of specified property for business expansion.

A separate release providing details of the new rules proposed for small business bonds will be published shortly.

REORGANIZATIONS

The budget proposed that all transfers of property to corporations and all corporate share transfers, exchanges, amalgamations and other corporate reorganizations be treated as currently taxable dispositions except in those cases where the transferor controls the corporation to whom the property is transferred or where the reorganization does not result in any change in control of a corporation. There was also an exception for transfers of property by an individual to a small business corporation. The changes were proposed to be effective for transactions after November 12, 1981.

These proposals have affected the tax consequences of numerous reorganizations that were in process at the date of the budget. While this issue was addressed in a press release on November 18 with respect to reorganizations that were substantially concluded before the budget, the variety and complexity of the transactions in progress are such that uncertainty remains as to the scope of the transitional provisions. In addition, the control test set out in the budget measures may have the effect of imposing the tax on capital gains where shares are disposed of in the course of a reorganization leading to a business combination or pooling of interest. This type of reorganization is not unusual, particularly for smaller corporations wanting to join their business assets and operations.

To remove the uncertainty that would otherwise exist, to allow a reasonable period of transition for those reorganizations that are in progress and to provide additional time to consider modifications to the rules proposed in this complex area of the law, it is proposed that the existing reorganization rules in the *Income Tax Act* be maintained for transactions completed before the end of 1982. This will have the effect of postponing the effective date to January 1, 1983 for those changes to the *Income Tax Act* proposed in Budget Resolutions 33 (Tax-Free Dispositions); 56 (Transfers to a Corporation); 58 (Share for Share Exchange); 60 (Amalgamations); 64(a) and (b) (Foreign Affiliate Reorganizations) and 70 (Transfers to a Partnership).

A number of clarifications of general interest are also being provided with respect to various corporate measures.

The 12.5 per cent corporate distributions tax applies to dividends paid by corporations out of earnings that have enjoyed the benefits of the small business deduction. The tax is necessary in order to ensure that the small business tax matches the ultimate dividend tax credit. In determining whether a dividend is paid out of low-rate earnings, dividends will be considered to be distributed first from investment income, next out of low-rate earnings and then out of other business earnings. In addition, payments on arm's-length small business bonds will not be treated as dividends for purposes of this tax.

Budget Resolution 160(c) deals with after-tax financing and proposes that dividends received by any corporation on shares that are redeemable within five years from the date of issue will no longer be deductible. As indicated in the resolution, this rule will not apply to a dividend received on a "prescribed share". For this purpose, a prescribed share will include a publicly listed share as prescribed under income tax Regulation 6201 for the purpose of the definition "term preferred share". In addition, dividends received by a corporation on shares of a controlled subsidiary and dividends received as part of a transaction or series of transactions to which paragraph 55(3)(b) of the *Income Tax Act* applies will not be subject to this new rule.

Budget Resolution 24 extends the restricted interest expense rules to certain borrowings by corporations. This anti-avoidance rule is designed to apply to incorporated investment portfolios. As such, it will not apply to public corporations nor will it apply to borrowings to finance shares or indebtedness of subsidiary corporations.

LOANS TO NON-RESIDENTS

The existing *Income Tax Act* requires interest to be imputed on certain loans to non-residents. Budget Resolution 14 proposes, effective January 1, 1982, to extend the imputation requirement to other forms of indebtedness and to remove the exemption for loans by a corporation to its foreign subsidiary.

A number of Canadian corporations typically fund the overseas operations they carry on through their foreign subsidiaries by way of a combination of equity capital and interest-free debt. While it is clearly appropriate to require interest to be charged on funds loaned to a foreign subsidiary and, indeed, most other countries require interest to be charged on such loans, for a number of companies it will be unduly disruptive and in some cases impossible to reorganize their affairs before the end of the year when the new rules take effect.

It is therefore proposed that the changes proposed to section 17 not apply to require the imputation of interest for any period before January 1, 1983 except with respect to a loan made to a non-resident after November 12, 1981 by a corporation, partnership or trust. It will not apply to any such loan on which interest is payable at a reasonable rate.

EMPLOYER HOUSING LOANS

Budget Resolution 51 proposed that the existing \$50,000 exclusion for low-interest employee housing loans was to be withdrawn effective January 1, 1982 and a taxable benefit be imputed to the employee at prescribed rates of interest applicable when the loan was made. It is proposed that this change be phased in for existing housing loans to allow employers time to work out new remuneration arrangements for their employees who are affected by this measure. Under this phase-in, no tax will be payable on the benefit to an employee from the first \$40,000 of housing loan outstanding in 1982, and for the first \$20,000 of such loans in 1983. Thereafter the special exclusion for housing loans will no longer apply. These transitional rules will apply only to loans for which arrangements in writing were concluded on or before November 12, 1981.

PRESCRIBED RATE OF INTEREST

The prescribed rate is the rate of interest charged on tax arrears and paid on tax refunds and is also the rate used to determine taxable benefits on interest-free loans to employees, shareholders and non-residents. The budget supplementary information indicated that starting in 1982 the prescribed rate of interest would be established quarterly on the basis of the average interest rate on 90-day treasury bills during the first month of the preceding quarter. It was noted that for the first quarter of 1982 the prescribed rate would therefore, be increased from the existing rate of 12 per cent to 19 per cent, based on October interest rates for treasury bills.

Interest rates have dropped significantly since the budget and the 90-day treasury bill rate for November was about 16 per cent. The prescribed

rate for the first quarter of 1982 will therefore be reduced to 16 per cent. The prescribed interest rate for subsequent quarters will be set in accordance with the formula outlined in the budget.

DEFERRED PROFIT-SHARING PLANS

Budget Resolutions 127 and 130 proposed to deny a deduction for any contribution to a deferred profit-sharing plan (DPSP) in which the owner or significant shareholder is a beneficiary, for taxation years commencing after November 12, 1981. It also proposed to restrict the contribution to a registered retirement savings plan (RRSP) to \$3,500 for a year in which an individual was a member of a DPSP.

The budget proposal would require many companies to reorganize their existing deferred income plans for employees to ensure that the owners or principal shareholders and their relatives were excluded from a DPSP.

It is proposed that rather than deny a deduction for all contributions made to existing DPSPs in which the owner or principal shareholder is a beneficiary, the deduction should be disallowed only for those contributions for taxation years commencing after the budget date made on behalf of a beneficiary referred to in Budget Resolution 130. This includes certain shareholders and others who have a significant interest in the business. It is proposed also to limit the RRSP contribution to \$3,500 in a year only if a contribution has been made to a DPSP either by a taxpayer in the year or on his behalf in the fiscal period of an employer that ends in the year. Registration will be denied for future DPSPs which allow an owner, specified shareholder or any related person to qualify as a beneficiary of the plan.

LIFE INSURANCE RRSPs

Budget Resolution 126 requires that where term life insurance or some other benefit has been used as an inducement for a person to enter into a registered retirement savings plan (RRSP), the plan will not qualify unless any such ancillary benefits are removed before July 1, 1982. This change was made to curtail the growing use of promotional schemes by financial institutions for selling RRSPs since the cost of such benefits would inevitably be borne by the beneficiary in the form of lower retirement income.

Representations have been received by a number of uninsurable individuals who have invested in RRSPs with this insurance feature and who will be unable to replace the coverage if it is cancelled. It is proposed that the life insurance coverage existing at December 31, 1981 not be required to be cancelled on any RRSP in effect on that date.

LIFE INSURANCE POLICYHOLDERS

Budget Resolution 134 proposed that the adjusted cost basis of a life insurance policy exclude that portion of any premium that is not reasonably attributable to the savings element of the policy. In response to concerns expressed by holders of existing policies, the application of the new rule will be confined to policies issued after November 12, 1981. Thus the adjusted cost basis of the policies in force before the budget will not be affected by the budget proposal. Technical discussions will continue with life insurance industry representatives on appropriate taxation of the interest build-up in whole life insurance policies issued after the budget date.

CONTRACTUAL COMMITMENTS

The budget was silent in a number of areas on proposed new rules as they apply to transactions carried out pursuant to contracts and arrangements in writing made before the budget date. The normal practice of accommodating the tax treatment of a purchase or sale transaction concluded after the budget but pursuant to an agreement in writing entered into before the budget will be followed in implementing the changes proposed.

Thus, for example, the budget proposals in Resolutions 22 and 31 relating to terminal losses and reserves will not apply on a disposal by a taxpayer of property after November 12, 1981 pursuant to an agreement in writing concluded on or before that date. Similarly the proposals in Budget Resolutions 62 and 111, referring to the effect of asset disposals on the capital dividend and refundable dividend tax accounts, will not apply with respect to dispositions of property made under agreements in writing entered into on or before November 12, 1981. In addition, the proposals in Budget Resolutions 84 and 85 relating to the treatment of losses will not apply where the change of control is a consequence of a purchase of shares pursuant to an agreement in writing entered into on or before the budget date. These circumstances will be accommodated in the legislation introduced to implement the budget proposals.