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Tax Notes

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Inside

The Capital Gains Exemption: Keeping It Pure

With the passage of Bill C-28 into law on December 24, 2007, it is now official that the lifetime capital gains exemption in section 110.6 of the *Income Tax Act* (Canada) (the "Act")[1] has been increased to $750,000 from $500,000. It is anticipated that this change will cause advisors to re-examine strategies that are intended to help their clients make the most out of the exemption. In this regard, even where no sale is remotely contemplated, ongoing planning may be required to ensure that non-qualifying or offside assets can be systematically removed from Canadian-controlled private corporations carrying on active businesses primarily in Canada to purify them so that personally held shares will be able to qualify for capital gains exemption treatment at the time of an eventual sale.

For example, certain corporations just have a knack for spinning off excess cash. This happy problem will surely be made "worse", due to the new eligible dividend rules that encourage corporations to maintain excess cash that they might otherwise have bonused out to get down to the small business limit. As a result, without proper planning, these corporations may over time have more offside assets than assets used by the corporations in their active businesses carried on in Canada and would fail the 50% test, which must be met for 24 months continuously for the shares to qualify.[2]

In other circumstances, ongoing planning will be necessary, since where even a single holding corporation is added into a corporate structure, the 50% test will generally be upgraded to an "all or substantially all" test, which is often referred to as a 90% test, for the entire 24 month holding period.[3]

Also, where an estate freeze has been implemented to multiply the capital gains exemption among "designated persons",[4] such as spouses and minor children, then in order to be able to rely on the exception to the subsection 74.4(2) corporate attribution rules for corporations that are at all times "small business corporations",[5] the corporation will need to satisfy the 90% test at all times.

For any period of time where the corporation is not a small business corporation, these rules will deem an individual, who has transferred or loaned property to a corporation when one of the main purposes of the transfer or loan can be considered, to have been to benefit a designated person to have a deemed interest inclusion based on the value of the transfer or loan outstanding from time to time, less specified amounts. It is worth noting that the application of the subsection 74.4(2) attribution rules will not necessarily mean that the shares will cease to be qualified small business corporation shares unless the 90% test is met at all times, such as may be the case where an individual holds shares of a holding corporation, rather than directly in the operating corporation.

Crystallization

Another area that will surely get more attention is transactions implemented to crystallize a shareholder's unused capital gains exemption. However, provided that appropriate ongoing purification strategies are put in place, crystallization may not always be advisable, particularly when the shareholders are young and entrepreneurial. For example, if the shareholder crystallizes his or her exemption and then ends up selling shares of another corporation or ends up selling assets instead of shares,[6] the shareholder will not be able to enjoy the benefit until he or she dies. In addition, minimum tax, potential blockage of ABILs, the possibility of additional future increases in the amount of exemption or of accidental redemption or repurchase of purified shares and the inherent section 84.1 issues that will be relevant whenever crystallization transactions are implemented must also be kept in mind.

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On the other hand, although purification strategies sound great. If the appropriate ongoing maintenance is not properly kept up, then shares that currently would qualify for the capital gains exemption might not be able to qualify at a later time when the exemption is to actually be realized on a sale. Worse still, in some situations, failure to keep up maintenance may result in the application of the corporate attribution rules.[7]

Ongoing Purification Strategies

Even though there are a number of ways to implement ongoing purification strategies, throughout the remainder of this article a mere four strategies will be discussed. For purposes of this article the four strategies discussed will be referred to as: the Ongoing Strip Strategy, the Simple Redemption Strategy, the Neuman Strip Strategy, and the Corporate Beneficiary Strategy.

What is common among each strategy is that they all require stripping offside assets of an operating corporation ("Opco") into a holding corporation ("Holdco") on an ongoing basis. Provided such strategies are implemented as long-term strategies, until recently it was generally believed that subsection 55(2) should not be applicable to these strategies.[8] As a result, unlike pre-sale purification strategies, the ability to remove offside assets is generally not limited to safe income attributable to shares held by Holdco.[9] However, due to recent expansive court decisions such as in *Copthorne*,[10] which have given the phrase "series of transactions" an almost unlimited scope, tax advisors should still carefully review and weigh the risks with their clients of implementing even long-term strategies that involve the creation of inter-corporate dividends that exceed safe income.

In addition, each of the strategies can be a bit awkward to maintain, since the strategies all require a significant amount of maintenance to keep the Opco free of offside assets that might otherwise jeopardize the ability of its shareholders to enjoy their capital gains exemptions at the time of an eventual sale. One practical method that can be used to try to ensure that offside assets will not build up in an Opco is to give instructions to the Opco's banker to automatically transfer cash in excess of agreed amounts to the Holdco as loans to the Holdco. At regular intervals throughout the course of each year the Opco would declare and pay dividends to eliminate any loans owing by Holdco. However, where it is intended that the dividends will qualify as eligible dividends, it will be necessary to comply with the CRA's administrative policies regarding the timing and method of paying such dividends.

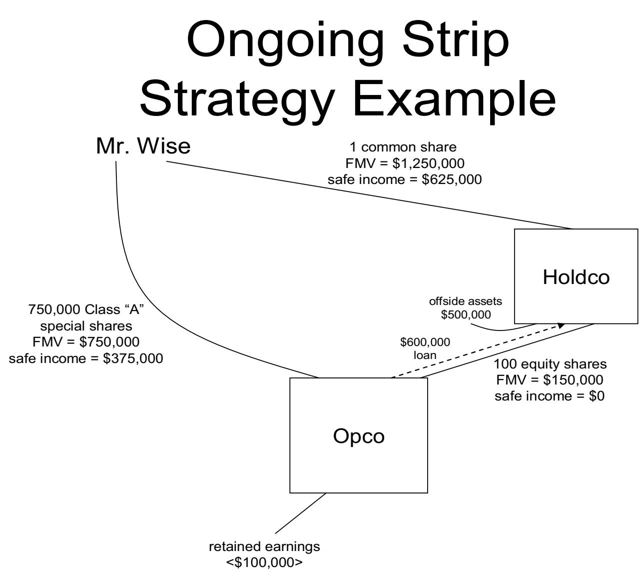
Ongoing Strip Strategy

The Ongoing Strip Strategy is basically a safe-income strip strategy that builds in the flexibility to pay inter-corporate dividends that exceed safe income.

To illustrate the implementation of this strategy, assume that Mr. Wise is the sole shareholder of the 100 issued common shares of Opco worth $2,000,000. Opco has $1,000,000 of retained earnings and $500,000 of offside assets that Mr. Wise wants to strip. Mr. Wise wants to be able to strip additional offside assets from time to time as they build up in Opco.

Mr. Wise will implement a section 86 freeze of his shares, whereby he will exchange his common shares under section 86 for 750,000 Class A special shares of Opco, each of which is an ordinary non-voting preference share redeemable and retractable for $1 and 100 equity shares, which are just a new class of common type shares, having a value equal to the remaining $1,250,000 of value of Opco. Mr. Wise will incorporate Holdco and transfer his 100 equity shares of Opco to Holdco on a tax-deferred basis in exchange for common shares of Holdco. Opco could pay a dividend to Holdco equal to the amount of the offside assets, or alternatively it could pay a dividend or series of dividends that exceeds the amount of the current offside assets.[11] From a business perspective, paying dividends in excess of the offside assets and lending back amounts that are still required to operate Opco's active business on a secured basis could provide considerable asset protection benefits. Business issues, such as financial covenants, might restrict the ability to proceed in this fashion though there may be ways to deal with such issues. For purposes of this example it is assumed that a $1,000,000 dividend will be declared and that the $500,000 of dividends not represented by offside assets will be paid by issuance of demand non-interest bearing promissory notes.

The diagram below illustrates the corporate structure of Mr. Wise's group after the Ongoing Strip Strategy has been fully implemented.



Mr. Wise might use the Ongoing Strip Strategy to keep Opco "pure" on a perpetual basis because it is relatively simple to implement and does not require a valuation. This strategy might also be attractive if he doesn't want to commit to crystallize his exemption on the Opco shares at the present time – for example, because he owns other corporate shares that he might sell first.

On the other hand, there are some issues to keep in mind when implementing the Ongoing Strip Strategy. For example, in addition to the subsection 55(2) issue discussed previously, the usual issues relating to ensuring that Opco will be considered to be "connected"[12] with Holdco must be kept in mind; otherwise, Part IV tax could be levied. If inter-corporate dividends are paid that exceed the safe income in the shares, other issues, including GAAR, may also need to be considered, especially if there is an eventual sale of the shares of Opco. In addition, this strategy would not enable Mr. Wise to utilize his full capital gains exemption if his personally held shares he retains in Opco are not worth $750,000 at the time the strategy is implemented. Finally, without further planning, the strategy will not be useful if Mr. Wise is hoping to multiply his capital gains exemption with a freeze in favour of a typical Canadian discretionary family trust.

Simple Redemption Strategy

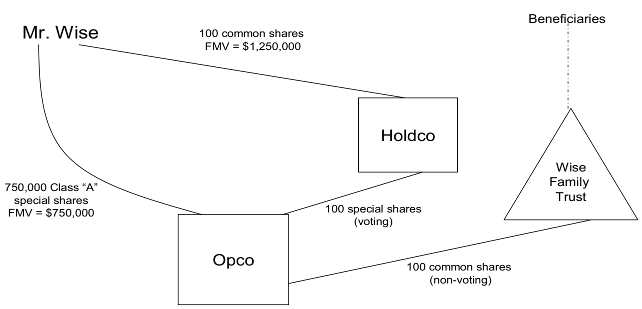
The Simple Redemption Strategy is a variant of the Ongoing Strip Strategy that would involve Mr. Wise completely freezing his common shares of Opco in exchange for ordinary freeze shares, some of which he will transfer to Holdco so that they can be redeemed to remove offside assets from Holdco.

The freeze could be put in place with a family trust acquiring the growth shares of Opco to achieve traditional estate freeze objectives and also enable Mr. Wise to multiply the use of the capital gains exemption among his family members. If the freeze includes his minor children and/or his spouse, care will need to be taken to avoid the application of the corporate attribution rules.[13]

When implementing any type of estate freeze strategy, our practice is generally to ensure that the freeze structure does not impact on corporate control. To maintain control, generally, the freezor will directly or indirectly hold some class of voting control shares and any trusts or individuals that become shareholders will generally be given shares that either have no votes whatsoever or nominal votes where necessary. Among other benefits, proceeding in this fashion will generally eliminate Part IV tax problems and will also avoid having to deal with the CRA's administrative positions dealing with changes of control and trustees of trusts.[14]

The diagram below illustrates the simple redemption strategy. Based on the assumption that Mr. Wise wants to maintain shares having a value equal to his capital gains exemption, he would transfer $1,250,000 of the frozen shares to Holdco on a tax-deferred basis and would continue to hold $750,000 of the frozen shares. From time to time Holdco could request periodic redemptions of its frozen shares of Opco or if Mr. Wise is more aggressive, he might even cause Holdco to have all of the frozen shares redeemed at once. To keep the diagrams illustrating this and the remaining strategies relatively uncluttered, the diagrams will be prepared on the assumption that all of the Class A special shares have been redeemed and all references to the loan back of assets, offside assets and retained earnings amounts will be ignored.

Simple Redemption Strategy Example



In general, the tax advantages, risks, and issues associated with this strategy are similar to those described in connection with the Ongoing Strip Strategy. However, the subsection 55(2) risks associated with the Simple Redemption Strategy would be heightened since each redemption would normally give rise to a deemed dividend that is at least partially unprotected by safe income and where redemptions are used, the subsection 55(2) risks are greater than where simple dividends are paid.

The main non-tax related problem with this strategy is that once all of the Class A special shares are redeemed additional planning will need to be put in place to strip additional offside assets.

Neuman Strategy

In the context of purification, the Neuman Strategy is any strategy whereby a Holdco is introduced as a shareholder of a class of shares that permit dividend sprinkling to Holdco in accordance with the *Neuman* case[15] so that a corporation such as Opco can remove offside assets on an ongoing basis in a tax-effective manner through inter-corporate dividends.[16]

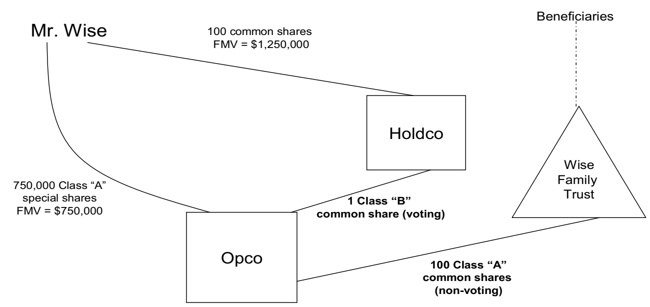
When this strategy is used, our practice would usually be to have the Holdco acquire a nominal number of one class of common shares and, in a freeze situation, for the family trust to own a large number of another class of common shares of the operating corporation so that the lion-share of the growth will accrue to the common shares of the operating corporation owned by the trust.[17]

We understand that rather than use common shares some practitioners would have Holdco own shares that are entitled to unlimited dividend rights but no equity participation. To date we have not generally used such shares.

Although some practitioners' approaches might differ, we would generally recommend that steps similar to the simple redemption strategy be used to remove pre-existing offside assets. This is also true for the Corporate Beneficiary Strategy, discussed below.

An example of this strategy is set out in the diagram below.

Neuman Strategy Example



Corporate Beneficiary Strategy

The Corporate Beneficiary Strategy employs a trust with a corporate beneficiary and relies on subsection 104(19) for the ability to strip assets by paying dividends to the trust which are then distributed to the corporate beneficiary without the dividends losing their character as ordinary tax neutral inter-corporate dividends.[18]

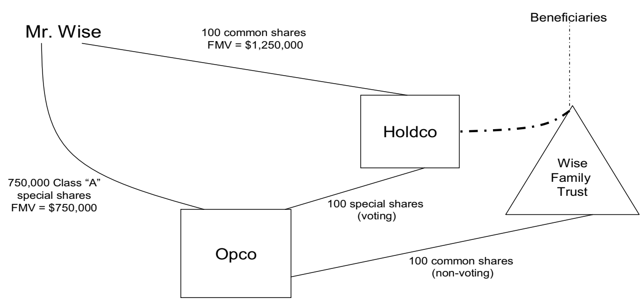
This strategy is an alternative to Neuman Strategies but is arguably less artificial since it relies on the clear provisions of the Act rather than the *Neuman* decision for its ability to effectively pay disproportionate dividends.

Though tax issues involving subsection 55(2) are similar to the risks referred to previously, in more complex corporate structures, the Part IV tax issues might require additional analysis and might effectively preclude the use of this strategy.

Since it has been assumed that Holdco will be frozen in favour of the trust and since Holdco will be a corporate beneficiary of the trust, an additional risk of this type of planning is that arguably subsection 75(2) could be applicable.[19] In a recent technical interpretation, the CRA indicated that where a trust has paid FMV for its shares in a corporate beneficiary it would not apply subsection 75(2). This technical interpretation reversed prior positions taken by the CRA.[20]

An example of this strategy is set out below.

Corporate Beneficiary Strategy Example



– *Michael Goldberg, tax partner, Minden Gross, a member of MERITAS Law Firms Worldwide.*[21] This article is based on a presentation by the author in Taxation of Private Businesses, a webinar presented by CCH on February 5, 2008.

Notes:

[1] RSC. 1985, c.1 (5th Supp.), as amended. Unless otherwise indicated, all statutory references are to the Act.

[2] See subparagraph 110.6(1)(*c*)(i) of the "qualified small business share" definition.

[3] See paragraph 110.6(1)(*d*) of the "qualified small business share" definition. Although there are cases that have applied a lower standard than 90% to the meaning of "all or substantially all", to the extent possible, the 90% standard should be adhered to when planning to take advantage of the capital gains exemption.

[4] As those terms are defined in subsections 74.4(1) and 74.5(5).

[5] As that term is defined is subsection 248(1).

[6] In the case of an asset sale, purification will also not be beneficial for capital gains exemption purposes, though due to the asset protection benefits offered by entering into purification strategies it is likely that there will continue to be other benefits of pursuing such strategies.

[7] In the past, some practitioners also expressed the concern that the exemption might be eliminated without grandfathering or lead time. This risk seems somewhat unlikely at the present time but remains a concern.

[8] If timing is a concern, it would be advisable to try and time the dividend payment towards the end of the dividend paying corporation's fiscal period and to ensure that that corporation's corporate tax return is filed as soon as possible thereafter to attempt to start the limitation period running or that year.

[9] Similarly, the ability to implement other types of planning such as butterfly and spin-out transactions should also not be impeded by safe income concerns.

[10] *Copthorne Holdings Ltd. v. The Queen*, 2007 DTC 1230 (TCC).

[11] Although in the examples used in this article we have limited the amount of the dividends to the amount of retained earnings in Opco to avoid creating a deficit, subject to corporate law concerns, it might be possible to pay additional dividends.

[12] As that term is defined in subsection 186(4). In particular, the operating corporation must either be controlled by Holdco or Holdco together with other non-arm's length persons (see subsection 186(2)) or Holdco must own greater than 10% of the shares of the operating company having full votes and value of the operating company at all times.

[13] As discussed earlier in this article, provided that Opco is always a small business corporation, the corporate attribution rules in subsection 74.4(2) should not apply where transfers are made for the benefit of designated persons, such as is typical when implementing estate freezes. The introduction of Holdco, a corporation that will not be a small business corporation, as described in this strategy would appear to require a separate analysis of the corporate attribution rules. Fortunately, it appears that the corporate attribution rules would not be applicable as a result of the transfer to Holdco since, per paragraph 74.4(2)(*a*), the only corporation in which a designated person is a "specified shareholder" (within the meaning of paragraph 74.4(2)(*a*)) is a small business corporation.

[14] See Technical Interpretation 2004-0087761E5, May 24, 2005.

[15] *Neuman v. M.N.R.*, 98 DTC 6297 (SCC). Very briefly, the case is generally considered to have validated dividend splitting using different classes of shares on which discretionary dividends could be declared to the exclusion of other classes.

[16] For more on the Neuman Strategy, see Len Vandenberg, "The Capital Gains Deduction – A Checklist Approach", 2000 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2000), 8:22-23.

[17] Some practitioners are bothered by the artificiality of the Neuman Strategy and strategies similar to the Neuman Strategy. In particular, very large dividends can be paid on a small number of shares with nominal values; also, unless a non-impairment clause is in place, subject to applicable corporate law, there is the potential of using dividends paid on such shares to strip pre-existing equity value.

[18] For more on the Corporate Beneficiary Strategy, see Todd M. Rosenberg, CA., LL.B., "Inter-Vivos Trusts", 2004 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2004), 15:21-24, and the Vandenberg article, *Ibid.* pages 8:23-24.

[19] It might be possible to avoid this problem by having a different corporation act as the corporate beneficiary. Of course, this will add additional complexity and cost to the strategy.

[20] See Technical Interpretation 2006-0218501E5, March 9, 2007 (French).

[21] Thanks to David Louis, also of Minden Gross. Any errors or omissions are strictly my own.

Understanding the New Pension Income Splitting Options

Might Kenneth Carter roll over in his grave? As Chair of the Royal Commission on Taxation (the "Commission") in the sixties, he might remind us today that the Commission's report recommended that the family ought to be the unit of taxation. The view of the Commission members recognized that family income is a joint product which acknowledges the holding of a job and the care of home and children. They further acknowledged the propensity to divide income artificially thanks to our progressive tax system. However, the Commission's recommendation was not codified into our tax law.

But now we fast forward four decades to last fall, when, out of the blue, the government floated a miniature version of taxing the family unit . . . pension income splitting. Commencing in 2007, married and common-law pensioners may see a drop in their tax bills, thanks to these new rules. Our last taste of this came in the 1980s when couples became able to pool and split their CPP entitlements. However, these provisions are quite different. First, the new splitting rule is a year-by-year election, whereas CPP splitting is a one-time permanent decision. Second, the splitting only goes one way, whereas the CPP is pooled and divided equally. Third, the annual amount of split income is totally discretionary, subject to a maximum of one-half of the qualifying income. Fourth, the type of income that qualifies for splitting is much broader – essentially income that qualifies for the pension credit for the transferor. This means income from work pensions, RRIFs, and annuitized RRSPs.

It is the transferor who determines the qualification to split. The transferee requires no qualification other than to be a spouse or common-law partner as defined under tax law. The main benefit, of course, should derive from a difference in the marginal tax brackets of the two parties. However, the age and circumstance of the transferee may contribute further to the value of making the transfer. If the transferee qualifies for the pension credit but otherwise has no other pension income to enjoy it, the transferred-in income will now qualify. A third bonus might include reduced OAS clawback burden for the transferor.

A surprising extra from the mandarins in Finance is that the corresponding proportion of tax withheld on the sources must also transfer. Typically, this would bear more commonly on transfers of work pensions, not RRIFs or annuities, which usually have no tax withheld.

There will be some complexities and confusion with the quarterly instalment strategies for each of the parties. To avoid over and under instalments by the parties, it may be prudent to do a little *pro forma* tax planning, wherein each would estimate his or her income and pension splitting strategy during the year, and modify his or her instalment payments accordingly.

Whether splitting strategy is addressed during the year or when the tax returns are prepared in the following spring, ultimately, the determination must be made as to how much to split to achieve an optimal result. The fact patterns for some couples may give an obvious answer – the full one-half allowable may be the wisest. Other fact patterns may be less obvious, particularly when both spouses have significant incomes. And remember, this decision must be made every year!

We were sitting around the office one day thinking about this when somebody postulated that the range of choices must be parabolic, meaning that there is one optimum split for every couple's fact pattern, and further, that computer power should be able to do the heavy lifting for the optimizing search, thus saving endless trial-and-error iterations. Excel spreadsheet technology saved the day with the "solver" add-in plus a few other enhancements to our in-house tax planning application. Armed with this new tool, we ran 30 trials with real client data to test this new tax-saving opportunity.

Now for the surprising results. Every tax practitioner I have spoken with about this new provision expressed amazement at the revenue give away by the folks at Finance. I guess some wily veteran practitioners may have been more taciturn, and rightly so. After 30 documented "clinical" trials [using rates applicable to residents of British Columbia], we have observed that the average win for our clients is typically very small. Why? First, many taxpayers retired today took planning steps during their working years to improve their tax burdens in retirement, e.g., spousal RRSPs, directed savings to the lower-income spouse, etc. Second, the tax bracket structure cuts a broad sweep across middle-range income. Incomes from $37,000 to almost $69,000, while vastly different, are in the same marginal tax bracket. Therefore, splitting within this range may yield zero gain. Third, the increase between two marginal brackets at higher income levels is typically 2%. Thus, splitting, say $10,000, across two brackets only yields approximately $400. Fourth, some splits gain on tax brackets, but trigger extra clawback to the transferee.

Ironically, the very first test case yielded a family tax saving of $6,000, and that was by far the best one. In that case, the transferee spouse had no other income at all and the transferor spouse's income was quite large.

The solver optimizer turned out to be a lot smarter than we are, when it identified a beneficial "reverse" split from a *lower*-income spouse to the *significantly higher*-income spouse, which would seem counterintuitive at first. The reason was the OAS clawback. The lower-income transferor crawled down out of clawback territory, while the higher-income transferee was already fully clawed back anyway, and thus bore no extra clawback cost from the extra income. The transferor's gain from reduced clawback was greater than the extra marginal tax rate of the transferee.

It is reasonable to infer that this new Carter-like provision "threw a bone" to Canadian retirees, who last fall felt their retirement incomes were dealt a blow from the trust unit saga. The Finance Minister probably recalled when a previous government felt the brunt of "Grey Power" when it proposed to remove indexation from universal government pensions. However, single retirees suffering from the trust unit legislation were not thrown the bone, nor were non-retirees, who will instead only have something to look forward to in their retirement years.

As another tax preparation season comes upon us this spring, it will be interesting to see if the tax preparation software developers crank it up a notch and program this solver optimization feature into their product offerings. If they don't, we will be turning to our in-house tax planning application for help. We think that we have only scratched the surface of understanding the complex tax planning ramifications of pension splitting. We may have to learn the rest with our feet in the fire this spring.

In closing, remember that finance ministers have a habit of coming and going, and policy leanings may depend upon the political stripe currently in power. The lesson is to not depend on this new pension splitting too heavily, at the expense of historical tried-and-true financial planning strategies that have served us over the ages.

– Don Nilson, FCMA, CFP, TEP, Principal – Nilson & Company/AFT Trivest Management

Child Fitness Tax Credit

The Child Fitness Tax Credit, as implemented by section 118.03, is applicable to the 2007 and subsequent taxation years. Bill C-28 (Royal Assent on December 14, 2007) enacted new section 9400 of the Income Tax Regulations, applicable after 2006, which sets out details regarding prescribed programs of physical activity, as referenced in section 118.03.

In a letter dated October 31, 2007 (Document No. 2007-0248341M4), the CRA confirmed that receipts issued by qualifying entities for the purpose of claiming a child fitness tax credit do not have to be prepared in any specific format to be considered as official, but must contain the following information: name and address of organization; name of qualifying program/activity; amount/date received and portion eligible for credit; full name of payer; child's name and year of birth; and authorized signature. If a child is registered in more than one program of prescribed physical activity with the same qualifying entity, only one receipt is required, provided it contains a description of each eligible program and all the other information required on the receipt. For future taxation years, qualifying entities must continue to indicate the total amount received from an individual that is attributable to the registration or membership of a qualifying child, and the amount eligible for the credit.

Portions of the Department of Finance Explanatory Notes for Regulation 9400 are reproduced below:

Prescribed programs of physical activity

New Part XCIV of the Regulations defines, for the purpose of the definition "eligible fitness expense" in section 118.03 of the Act (the Child Fitness Tax Credit), the activities that qualify as a prescribed program of physical activity.

Subsection 9400(1) – Definitions

New subsection 9400(1) of the Regulations defines terms for the purpose of subsection 9400(2) which prescribes certain types of programs of physical activity that qualify under section 118.03 of the Act for the Child Fitness Tax Credit.

"physical activity"

"Physical activity" means a supervised activity suitable for children that contributes to cardio-respiratory endurance and to one or more of the following: muscular strength, muscular endurance, flexibility and balance; for example, hockey, karate, football, swimming and hiking. The physical activity cannot consist of an activity where a child rides on or in a motorized vehicle as an essential component of the activity. This would, for example, exclude from the definition riding a snowmobile but would include waterskiing.

* * *

Subsection 9400(2) – Prescribed program of physical activity

New subsection 9400(2) of the Regulations prescribes programs of physical activity for the purposes of the definition "eligible fitness expense" in subsection 118.03(1) of the Act.

A prescribed program of physical activity is

- a weekly program of a duration of 8 or more consecutive weeks in which all or substantially all of the activities include a significant amount of physical activity,
- a program of a duration of 5 or more consecutive days of which more than 50 per cent of the daily activities include a significant amount of physical activity – for example, this would apply to summer and day camp programs,
- a program offered to children by a club association or similar organization (the "organization") in circumstances where a participant in the program may select amongst a variety of activities if
  - more than 50 per cent of those activities offered to children by the organization are activities that include a significant amount of physical activity, or
  - more than 50 per cent of the time scheduled for activities offered to children in the program is scheduled for activities that include a significant amount of physical activity; or
- a membership in an organization of a duration of 8 or more consecutive weeks if more than 50 per cent of all the activities offered to children by the organization include a significant amount of physical activity.

Note that, to qualify as a prescribed program of physical activity, these programs cannot be part of a school's curriculum.

Example:

Sabrina just joined the Girl Guides of Canada. Her mother paid $100 in registration fees for 2 hours of activities per week for 10 weeks. The Girl Guides program provides that 1 hour and 15 minutes of the 2 hours of activities will be devoted to physical activity. Therefore, the program will be considered a prescribed program of physical activity and Sabrina's mother may claim a child fitness tax credit of $15 ($100 × 15%).

Subsection 9400(3) – Mixed-use facility

New subsection 9400(3) of the Regulations applies in cases where a program is not a prescribed program of physical activity because it does not meet the 50 per cent requirement set out in paragraph 9400(2)(*c*). In such cases, subsection 9400(3) allows a taxpayer to claim a portion of the amount that is paid for the program as an eligible fitness expense. In such circumstances, a "portion of the program" is considered a prescribed program of physical activity and that portion is either

- the percentage of activities offered to children by the organization that are activities that include a significant amount of physical activity, or
- the percentage of the time scheduled for activities in the program that is scheduled for activities that include a significant amount of physical activity.

Example:

Sabrina's mother pays $200 for the registration of her daughter at a community center. The portion of the activity offered to children by the center that qualifies as physical activities for the purpose of the credit is 40 per cent. Therefore, only 40 per cent of the program will be considered a prescribed program of physical activity and Sabrina's mother may claim a child fitness tax credit of $12 (($200 × 40 per cent) × 15%).

Subsection 9400(4) – Membership

New subsection 9400(4) of the Regulations provides for cases where a membership in an organization does not meet the 50 per cent activities requirement set out in paragraph 9400(2)(*d*). Assuming the activity is not part of a school's curriculum, the portion of the expense that will be eligible for the purpose of the definition "eligible fitness expense" in subsection 118.03(1) of the Act is the portion of the activities offered to children by the organization that are activities that include a significant amount of physical activity.

Subsection 9400(5) – Horseback riding

For the purpose of the definition "physical activity", new subsection 9400(5) of the Regulations deems horseback riding to be an activity that contributes to cardio-respiratory endurance and to one or more of the following: muscular strength, muscular endurance, flexibility and balance.

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