

## SECTION 85 – SAMPLE PROBLEMS

### **PROBLEM 1**

Jenny developed a new product that she now sells through a number of retail stores. Over the years, since she started the business, she has grown to 5 stores. Jenny owns the land and building of each of the stores. She also has a distribution center. A few years ago, she acquired a parcel of vacant land next to one of her retail stores that she thinks will appreciate in value. Jenny is a resident of Canada and all of the stores and the distribution center are located in Canada. A recent balance sheet for Jenny’s business includes the following items:

#### Jenny’s Business Balance Sheet

##### Assets

Cash  
Accounts receivable  
Inventory  
Land inventory  
Machinery and equipment  
Computers and office furniture  
Land

##### Liabilities

Accounts Payable  
Line of Credit  
Mortgages  
Other Long Term Liabilities

Jenny has determined that she wants to transfer the business to a new Canadian corporation (“Opco”) on a tax-deferred basis.

### **Question 1**

Jenny has asked whether she can transfer all of the assets to Opco on a rollover basis under subsection 85(1) or whether there are any assets that are not eligible for rollover treatment?

#### **Answer:**

The land inventory is not eligible for rollover treatment by virtue of paragraph 85(1.1)(f).

Trade receivables are generally considered to be capital property of a business and therefore should be eligible property. See the comments below relating to the application of a section 22 election.

### **Question 2**

Jenny has asked whether the fact that the land inventory cannot be transferred on a rollover basis taints the rollover for other assets.

#### **Answer:**

The subsection 85(1) election is made on an asset-by-asset basis. The fact that some assets cannot be transferred on a rollover basis or the fact that a taxpayer chooses not to make an

election in respect of some assets that are eligible for the rollover, does not taint the eligibility of other assets for the rollover.

### **Question 3**

Jenny now understands that she can make an election in respect of the other assets listed above, namely, accounts receivable, inventory, land (other than the land inventory), machinery and equipment and computers and office equipment. She is thinking of getting the subsection 85(1) election form off the internet and preparing it herself and she has asked you whether this list is suitable and complete. Please advise.

#### **Answer:**

The list of assets is not complete. A balance sheet does not always list all of the assets of a business. For example, items that do not have a cost may not be shown on a balance sheet. These may have significant value and an election should be made in respect of these assets (with an elected amount of \$1). Examples may include goodwill (including customer lists), trademarks and patents. If Jenny is running a successful business, it is likely that there is goodwill attached to her business in respect of which she should make an election.

Jenny may also not want to make an election in respect of some assets that are eligible for rollover treatment. Where all or substantially all of the property (including accounts receivable) used in carrying on a business is being sold, it may be preferable to make an election under section 22 rather than under subsection 85(1) in respect of the transfer of the accounts receivable. If an election under section 22 is made, the vendor is entitled to a deduction equal to the discount at which the accounts are sold and the purchaser may be entitled to future allowances for doubtful or bad debts. An election under subsection 85(1) in respect of accounts receivable precludes the use of a section 22 election in respect of the transfer of the receivables.

### **Question 4**

Jenny is proposing to transfer the business to Opco and taking back debt as the sole consideration on the transfer. Please advise.

#### **Answer:**

Jenny needs to receive consideration that includes shares of Opco for the transfer to be eligible for rollover treatment under subsection 85(1). Additionally, as discussed below, Jenny would be required to recognize a gain or income to the extent that the debt received for a particular asset exceeds the cost amount of that asset.

#### **Question 5**

Suppose that one of the properties (the land portion) to be transferred was acquired for \$1m, is encumbered by a mortgage of \$900k and has a current fair market value of \$1.5m. Jenny is proposing to transfer this land (subject to the mortgage) to Opco. In addition to Opco assuming the mortgage of \$900k, suppose the following alternatives as the consideration to be received by Jenny (a) only common shares of Opco, (b) a note of \$100k and common shares of Opco, (c) a note of \$200k and common shares of Opco, (d) a note of \$600k and common shares of Opco and (e) a note of \$700k and common shares of Opco. In each scenario, what is the range of elected amounts? In each scenario, what is the gain realized by Jenny assuming the minimum elected

amount? Which example demonstrates the maximum non-share consideration that Jenny can receive without triggering a gain?

**Answer:**

With respect to the transfer of capital property:

- (i) the elected amount cannot exceed the fair market value of the transferred property at the time of the transfer (paragraph 85(1)(c));
- (ii) subject to (i), the elected amount cannot be less than the fair market value of the non-share consideration received by the transferor (paragraph 85(1)(b));
- (iii) the elected amount cannot be less than the lesser of the fair market value of the transferred property at the time of transfer and the cost amount of the transferred property to the transferor (paragraph 85(1)(c.1)); and
- (iv) subject to (i), where the amount in (ii) and (iii) are different, the lower limit on the elected amount is the greater of the amounts in (ii) and (iii) (paragraph (85(1)(e.3)).

In this case, these amounts are:

- (i) \$1.5m (paragraph 85(1)(c));
- (ii) varies in each scenario, as follows (a) \$900k, (b) \$1m, (c) \$1.1m, (d) \$1.5m, and (e) \$1.6m (paragraph 85(1)(b)); and
- (iii) \$1m (paragraph 85(1)(c.1)).

**(a) Jenny receives only common shares of Opco:** This scenario demonstrates that the lesser of the cost amount and fair market value of the transferred property (paragraph 85(1)(c.1)) will set the lower limit of the elected amount if such amount exceeds the amount of the non-share consideration (paragraphs 85(1)(b) and (e.3)). The permitted elected amounts are between \$1m (paragraph 85(1)(c.1)) and \$1.5m (paragraph 85(1)(c)). If the elected amount is \$1m, Jenny will not realize a gain or loss. This example also demonstrates that a loss cannot be generated on the transfer.

**(b) Jenny receives a note of \$100k and common shares of Opco:** This scenario demonstrates the maximum non-share consideration that Jenny can receive without realizing a gain. The permitted elected amounts are between \$1m (paragraphs 85(1)(b) and (c.1)) and \$1.5m (paragraph 85(1)(c)). If the elected amount is \$1m, Jenny will not realize a gain or loss. The \$100k note and the \$900k assumed mortgage (total of \$1m) is the maximum non-share consideration that Jenny can receive without realizing a gain.

**(c) Jenny receives a note of \$200k and common shares of Opco:** This scenario demonstrates that the amount of the non-share consideration (paragraph 85(1)(b)) will set the lower limit of the elected amount if such amount exceeds the lesser of the cost amount and fair market value of the transferred property (paragraphs 85(1)(c.1) and (e.3)). The permitted elected amounts are between \$1.1m (paragraph 85(1)(b)) and \$1.5m (paragraph 85(1)(c)). If the elected amount is \$1.1m, Jenny will realize a gain of \$100k.

**(d) Jenny receives a note of \$600k and common shares of Opco:** Again, the amount of the non-share consideration (paragraph 85(1)(b)) will set the lower limit of the elected amount if such amount exceeds the lesser of the cost amount and fair market value of the transferred property (paragraphs 85(1)(c.1) and (e.3)). The only permitted elected amount is \$1.5m (paragraphs 85(1)(b) and (c)). Jenny will realize a gain of \$500k.

**(e) Jenny receives a note of \$700k and common shares of Opco:** This scenario demonstrates that the elected amount can never be more than the fair market value of the transferred property (paragraph 85(1)(c)). The only permissible elected amount is \$1.5m. Jenny will realize a gain of \$500k. Jenny may also be considered to have received a shareholder benefit (assuming there are other assets in Opco and the note has a fair market value of \$700k). Consideration should be given to allocating \$100k of the note as the consideration for the transfer of another property.

### Question 6

Suppose that one of the properties to be transferred by Jenny has a cost of \$1m, an outstanding mortgage of \$750k and a fair market value of \$800k. Assuming that the consideration includes shares of Opco and that it is desirable to make a section 85 election, what are the permissible elected amounts?

#### Answer:

The only permitted elected amount is \$800k. This example demonstrates that a property may be transferred at a loss where the fair market value of the property is less than its cost amount. The various stop-loss rules in the Tax Act, such as the superficial loss rule in paragraph 40(2)(g), should apply.

### Question 7

Suppose that Jenny purchased the main trademark that is used in her business for \$1m, that the cumulative eligible capital of the business is \$600k and that the trademark now has a fair market value of \$5m. What is the range of elected amounts for Jenny to transfer the trademark, assuming she receives only common shares from Opco as consideration?

#### Answer:

With respect to the transfer of eligible capital property:

- (i) the elected amount cannot exceed the fair market value of the transferred property at the time of the transfer (paragraph 85(1)(c));
- (ii) subject to (i), the elected amount cannot be less than the fair market value of the non-share consideration received by the transferor (paragraph 85(1)(b));
- (iii) the elected amount cannot be less than the least of the fair market value of the transferred property at the time of the transfer, the cost of the transferred property to the transferor and  $\frac{4}{3}$  of the cumulative eligible capital of the business of the transferor (paragraph 85(1)(d)); and
- (iv) subject to (i), where the amount in (ii) and (iii) are different, the lower limit on the elected amount is the greater of the amounts in (ii) and (iii) (paragraph 85(1)(e.3)).

The permitted elected amounts are between \$800k (paragraph 85(1)(d)) and \$5m (paragraph 85(1)(c)).

### Question 8

Jenny has forklifts that are used in her warehouse. One forklift (FL1) was acquired at a cost of \$1m and has a current fair market value of \$750k and a second forklift (FL2) is older and was acquired at a cost of \$500k and has a current fair market value of \$100k. FL1 and FL2 are depreciable property of the same class and the class has an undepreciated capital cost of \$600k. Suppose that Jenny receives a note of \$600k and common shares of Opco for FL1 and only common shares of Opco for FL2. What are the limits on the elected amount on the transfer of each asset? What are the tax consequences if FL1 was sold by Opco for \$800k?

#### **Answer (Extra – not to be reviewed in small group):**

With respect to the transfer of depreciable capital property:

- (i) the elected amount cannot exceed the fair market value of the transferred property at the time of the transfer (paragraph 85(1)(c));
- (ii) subject to (i), the elected amount cannot be less than the fair market value of the non-share consideration received by the transferor (paragraph 85(1)(b));
- (iii) the elected amount cannot be less than the least of the fair market value of the transferred property at the time of transfer, the cost of the transferred property to the transferor and the undepreciated capital cost of the class to the transferor (paragraph 85(1)(e)); and
- (iv) subject to (i), where the amount in (ii) and (iii) are different, the lower limit on the elected amount is the greater of the amounts in (ii) and (iii) (paragraph 85(1)(e.3)).

Where two or more depreciable properties of the same class are being disposed of at the same time, the first step is to determine the order of disposition of the depreciable properties. Paragraph 85(1)(e.1) allows the transferor to designate the order in which the properties are disposed of.

If Jenny designates that FL1 is transferred prior to FL2, the range of permitted elected amounts for FL1 is between \$600k (paragraphs 85(1)(b) and (e)) and \$750k (paragraph 85(1)(c)). The range of permitted elected amounts for FL2 is between nil (paragraph 85(1)(e) – the elected amount in respect of FL1 is deducted from the undepreciated capital cost of the class for purposes of determining the elected amount for FL2) and \$100k (paragraph 85(1)(c)).

If Jenny designates that FL2 is transferred prior to FL1, the only permitted elected amount for FL2 is \$100k (paragraph 85(1)(c)). The range of permitted elected amounts for FL1 is between \$600k (paragraphs 85(1)(b) and (e.3)) and \$750k (paragraph 85(1)(c)).

No gain or recapture need be realized where FL1 is disposed of first. Recapture of \$100k would be realized where FL2 is disposed of first.

Subsection 85(5) provides that any potential for recapture in the transferor carries forward in the transferee. This provision applies where subsection 85(1) has applied to a transfer of a

depreciable property and the transferor's capital cost of the property exceeds the transferor's proceeds of disposition of the property. The provision provides that, for purposes of sections 13 and 20 and the regulations, the transferee's capital cost of the depreciable property is deemed to be the transferor's capital cost of the property, and the amount by which the transferor's capital cost of the property exceeds the transferor's proceeds of disposition of the property is deemed to have been claimed as capital cost allowance by the transferee.

Assuming the elected amounts in respect of FL1 and FL2 are the least of the amounts set out above, where FL1 is disposed of prior to FL2, subsection 85(5) would provide that the capital cost to Opco of FL1 is \$1m and \$400k would be deemed to have been claimed by Opco as capital cost allowance. The capital cost to Opco of FL2 would be deemed to be \$500k and \$500k would be deemed to have been claimed by Opco as capital cost allowance. If Opco sells FL1 for \$800k, \$200k of recapture would be realized.

Where FL2 is disposed of prior to FL1, subsection 85(5) would provide that the capital cost to Opco of FL2 is \$500k and \$400k would be deemed to have been claimed by Opco as capital cost allowance. The capital cost to Opco of FL1 would be deemed to be \$1m and \$400k would be deemed to have been claimed by Opco as capital cost allowance. If Opco sells FL1 for \$800k, \$100k of recapture would be realized.

## **PROBLEM 2**

Suppose that the fair market value of all of the properties transferred by Jenny to Opco under subsection 85(1) is \$10m and that the aggregate of the elected amounts in respect of all transferred properties is \$6m. Suppose that Jenny receives as consideration for the transfer only shares of Opco and that the shares she receives are made up of two different classes of preferred shares (Class A and Class B) of Opco and a class of common shares of Opco. She envisions that she will receive Class A preferred shares with a value of \$5m, Class B preferred shares with a value of \$3m and common shares with a value of \$2m.

### **Question 1**

What is the cost to Jenny of the Class A preferred shares, the Class B preferred shares and the common shares of Opco?

#### **Answer:**

The cost of property that is non-share consideration is generally the lesser of (a) the fair market value of the particular property, and (b) the proportion of the fair market value of the transferred property that the fair market value of the particular property is of the fair market value of all non-share consideration (paragraph 85(1)(f)).

The cost of preferred shares of a class received as consideration is generally the lesser of (a) the fair market value of the preferred shares of such class, and (b) the proportion of the amount by which the proceeds of disposition (i.e., the aggregate of elected amounts) exceed the fair market value of the non-share consideration, that the fair market value of the preferred shares of such class is of the fair market value of the preferred shares of all classes received as consideration (paragraph 85(1)(g)).

The cost of common shares of a class received as consideration is generally the proportion of the amount by which the proceeds of disposition (i.e., the aggregate of elected amounts) exceed the total of the fair market value of the non-share consideration and the cost of the preferred shares of all classes received as consideration, that the fair market value of the common shares of such class is of the fair market value of the common shares of all classes received as consideration (paragraph 85(1)(h)).

In other words, the cost of preferred and common shares is generally limited to the amount by which the proceeds of disposition (i.e., the aggregate of elected amounts) exceed the amount of any non-share consideration. Cost is allocated first to the preferred shares and next to the common shares. The cost of preferred shares cannot exceed the fair market value of such shares. Cost is allocated amongst preferred shares of various classes received as consideration based on the fair market value of the preferred shares of the various classes. Cost is allocated amongst common shares of various classes received as consideration based on the fair market value of the common shares of the various classes.

The cost of the Class A preferred shares is the lesser of (a) the fair market value of the Class A preferred shares (\$5m), and (b) the proportion of the proceeds of disposition (\$6m) that the fair market value of the Class A preferred shares (\$5m) is of the fair market value of all preferred shares received as consideration (\$8m). (b) computes to \$3.75m. The cost of the Class A preferred shares is accordingly \$3.75m.

The cost of the Class B preferred shares is the lesser of (a) the fair market value of the Class B preferred shares (\$3m), and (b) the proportion of the proceeds of disposition (\$6m) that the fair market value of the Class B preferred shares (\$3m) is of the fair market value of all preferred shares received as consideration (\$8m). (b) computes to \$2.25m. The cost of the Class B preferred shares is accordingly \$2.25m.

The cost of the common shares is nil.

## **Question 2**

Suppose that the full fair market value of the consideration received by Opco is added by it to the stated capital for corporate law purposes of the Class A preferred shares (\$5m), the Class B Preferred shares (\$3m) and the common shares (\$2m). What will the paid-up capital (“PUC”) be of the Class A Preferred shares, the Class B Preferred shares and the common shares of Opco?

### **Answer:**

Where subsection 85(1) has applied to the transfer of property to a corporation, subsection 85(2.1) may reduce the PUC of the classes of shares received as consideration. In general, the total increase in the PUC of all classes of shares received as consideration is limited to the amount by which the transferee corporation’s cost of the transferred property (i.e., the aggregate of elected amounts) exceeds the fair market value of the non-share consideration. The PUC reduction is equal to the amount by which the amount that would otherwise be the increase in the PUC of all classes of shares received as consideration exceeds this maximum permitted increase in PUC. Where there is a PUC reduction in the PUC of the classes of shares received as

consideration, the reduction is to all classes of shares received as consideration, pro rata to what would otherwise be the increase in PUC of the various classes of shares.

In this case, absent subsection 85(2.1), the increase in the PUC of all classes of shares received as consideration would be \$10m. This exceeds the amount by which the cost to Opco of the transferred properties (\$6m) exceeds the fair market value of the non-share consideration (nil). The PUC reduction is the amount by which the amount that would otherwise be the increase in the PUC of all classes of shares received as consideration (\$10m) exceeds this maximum permitted increase in PUC (\$6m). Accordingly, the PUC reduction is \$4m. This PUC reduction is applied pro-rata to the amounts that would otherwise be the increases in PUC of the various classes of shares received as consideration.

The PUC reduction in respect of the Class A Preferred shares is the proportion of the amount of the PUC reduction of all classes of shares received as consideration (\$4m) that the amount that would otherwise be the increase in PUC of the Class A Preferred shares as a result of the transfer (\$5m) is of the amount that would otherwise be the increase in PUC of all classes of shares as a result of the transfer (\$10m). Accordingly, the amount of the PUC reduction in respect of the Class A Preferred shares is \$2m and the net increase in PUC of the Class A Preferred shares as a result of the transfer becomes \$3m.

The PUC reduction in respect of the Class B Preferred shares is the proportion of the amount of the PUC reduction of all classes of shares received as consideration (\$4m) that the amount that would otherwise be the increase in PUC of the Class B Preferred shares as a result of the transfer (\$3m) is of the amount that would otherwise be the increase in PUC of all classes of shares as a result of the transfer (\$10m). Accordingly, the amount of the PUC reduction in respect of the Class B Preferred shares is \$1.2m and the net increase in PUC of the Class B Preferred shares as a result of the transfer becomes \$1.8m.

The PUC reduction in respect of the common shares is the proportion of the amount of the PUC reduction of all classes of shares received as consideration (\$4m) that the amount that would otherwise be the increase in PUC of the common shares as a result of the transfer (\$2m) is of the amount that would otherwise be the increase in PUC of all classes of shares as a result of the transfer (\$10m). Accordingly, the amount of the PUC reduction in respect of the common shares is \$800k and the net increase in PUC of the common shares as a result of the transfer becomes \$1.2m.

### **Question 3**

Suppose that the amount added by Opco to the stated capital for corporate law purposes of the various classes of shares is \$4.5m for the Class A Preferred shares, \$1.5m for the Class B preferred shares and nil for the common shares. What will the PUC be of the Class A Preferred shares, the Class B Preferred shares and the common shares of Opco?

### **Answer:**

There will be no reduction in PUC under subsection 85(2.1). The increase in the PUC of all classes of shares received as consideration (\$6m) does not exceed the maximum permitted increase in PUC (\$6m). The PUC will be equal to the corporate law stated capital (subject to any

subsequent adjustments to PUC). Note that the resulting PUC amounts are different than where there were PUC reductions under subsection 85(2.1).

### **PROBLEM 3**

Jenny has been told that she should transfer her shares of Opco to a holding company (“Holdco”) to crystallize her capital gains exemption (assume that the shares of Opco are qualified small business corporation shares). Suppose that she currently holds only common shares of Opco (and that she holds no debt of Opco) with an adjusted cost base of \$6m, PUC of \$4m and a fair market value of \$10m. Jenny and Holdco intend to pick an elected amount of \$6.5m in respect of the transfer.

#### **Question 1**

Suppose that, as consideration for the transfer of the Opco shares, Holdco issues a promissory note for \$6.5m and common shares with a fair market value of \$3.5m. What are the tax consequences to Jenny?

#### **Answer:**

Subsection 84.1(1) applies where a taxpayer resident in Canada (other than a corporation) transfers shares (held as capital property) of a Canadian corporation (the “subject corporation”) to another Canadian corporation (the “purchaser corporation”), the transferor and the purchaser corporation do not deal at arm’s length and the purchaser corporation and the subject corporation are “connected” immediately after the transfer. The subsection will deem the transferor to have received a dividend to the extent that the amount of the non-share consideration exceeds the greater of the PUC of the transferred shares and the adjusted cost base of the transferred shares (as such adjusted cost base is determined after certain specific adjustments under paragraphs 84.1(2)(a) and (a.1)).

In this case, assuming none of the adjustments in paragraph 84.1(2)(a) or (a.1) applies, the deemed dividend would be \$500k.

#### **Question 2**

Suppose that, as consideration for the transfer of the Opco shares, Holdco issues only common shares to Jenny and adds \$10m to the stated capital for corporate law purposes of the common shares. Is the adjustment to PUC still under subsection 85(2.1)?

#### **Answer:**

Subsection 85(2.1) does not apply to a transaction in respect of which subsection 84.1(1) applies. Subsection 84.1(1) also provides for a PUC adjustment. Under subsection 84.1(1), the maximum permitted PUC increase in respect of a transfer is generally the greater of the PUC of the transferred shares and the adjusted cost base of the transferred shares (as such adjusted cost base is determined after certain specific adjustments under paragraphs 84.1(2)(a) and (a.1)).

### **PROBLEM 4**

Suppose that Jenny currently holds only common shares of Opco (and that she holds no debt of Opco) with an adjusted cost base of \$6m and a fair market value of \$10m. Jenny is considering

exchanging her common shares for a class of preferred shares (Class A) and a new class of common shares. She envisions that she will receive Class A Preferred shares with a value of \$6m and new common shares with a value of \$2m. She also envisions that new common shares will be issued to her spouse. She is planning to have Opco issue to her spouse the same number of new common shares as she will receive.

### **Question 1**

Jenny is planning on electing at \$6m (her cost). Please advise.

#### **Answer:**

Under paragraph 85(1)(e.2), where the fair market value of the transferred property (\$10m) exceeds the fair market value of the consideration received (\$8m) (assuming an elected amount less than the fair market value of the consideration received), the elected amount is deemed to be the elected amount otherwise determined (\$6m) plus the portion of the excess that it is reasonable to regard as a benefit that the taxpayer desired to have conferred on a related person (\$2m).

The elected amount would be deemed to be \$8m. Jenny would realize a gain of \$2m on the transfer.

### ***PROBLEM 5***

Jenny has taken Opco public. Assume that she owns 70% of the shares of Opco and the public owns 30% of the shares. The only outstanding shares of Opco are common shares and each common share has a PUC of \$3 and a fair market value of \$10. Opco is considering purchasing the shares of one of its competitors, Target. Target is a Canadian corporation wholly-owned by an individual (“Vendor”) who is a non-resident of Canada.

### **Question 1**

Suppose that Vendor established Target recently and that the PUC of the shares of Target is roughly the same as the fair market value of the shares. Suppose that Vendor is to receive common shares of Opco as consideration on the transfer of the Target shares and that the shares of Opco to be received by the Vendor will represent 10% of the common shares of Opco. Vendor has asked whether there are any special tax considerations to be aware of. Please advise.

#### **Answer:**

Where shares of an existing class are issued, the recipient should be aware of “PUC averaging”, which may cause the PUC of the shares received to be lower than the amount added to stated capital in respect of the share issuance, since PUC is determined on a class basis.

In this case, the PUC of the common shares of Opco to be received by Vendor will be 10% of the aggregate PUC of all of the common shares of Opco, determined immediately after the issuance of the Opco common shares to Vendor. The PUC of the common shares of Opco held by Vendor will be lower than the PUC of the shares of Target formerly held by Vendor. The PUC of the shares of Opco held by Jenny and the public will be increased. If Opco undertakes a transaction that results in a deemed dividend (such as a redemption of its shares), this reduced

PUC will result in a greater deemed dividend for Vendor. Vendor should consider taking back a separate class of shares of Opco.

## Question 2

Because of the low PUC of the common shares of Opco,<sup>1</sup> Opco has asked Vendor to make a joint election under subsection 85(1) in respect of the transfer to ensure Opco gets full cost (i.e., equal to fair market value) in the shares of Target. Since Vendor is entitled to a treaty exemption for any gain in Canada on the sale of the Target shares, Vendor does not need the election. Nevertheless, Vendor does not see any downside and wants to co-operate. Please advise.

### Answer:

Provided the shares of Target are not “taxable Canadian property” (as defined in subsection 248(1)), there should be no material downside risks. However, if the shares are “taxable Canadian property” and an election is made under subsection 85(1), the shares of Opco held by Vendor would be deemed to be taxable Canadian property. The shares of Opco might not otherwise be taxable Canadian property to the Vendor but for the subsection 85(1) election.

## Question 3

Are there any compliance obligations for Vendor or Opco on the transaction?

### Answer:

Provided the shares of Target are not “taxable Canadian property” (as defined in subsection 248(1)), there should not be any compliance obligations for the Vendor. Further, even if the shares are “taxable Canadian property”, the shares of Target should be “excluded property” (subsection 116(5)), such that there is technically no obligation for the Vendor or Opco to comply with section 116. However, Opco may file a notice pursuant to subsection 116(5.01) in respect of the acquisition of the Target shares to reduce any potential risk of failing to withhold and remit under section 116 (i.e., as a precautionary matter). In this regard, it is common in arm’s length transactions for a purchaser to require a vendor to obtain a section 116 certificate for greater certainty even though it may not be required. The Vendor may not be required to file a Canadian tax return to report the disposition even if the Target shares are “taxable Canadian property” (see subsections 150(1) and 150(5)).

## Question 4

Suppose that Vendor established Target some time ago and that Vendor has little PUC in its shares of Target. Suppose that Target is significantly larger than Opco and that Vendor will receive 51% of the common shares of Opco and a note of Opco as consideration. Vendor has asked whether there are any special tax considerations to be aware of. Please advise.

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<sup>1</sup> *Tuxedo Holdings Co. v Minister of National Revenue* 59 D.T.C. 1102 (Ex. Ct.) stands for the proposition the cost of an asset to a corporation where the corporation issues shares as consideration is the paid-up capital of the shares. *Tuxedo* was decided in respect of a corporation with par value shares. This may no longer be good law with corporations that no longer have par value shares. See *Teleglobe Inc. v. The Queen* 2002 D.T.C. 7517 (F.C.A).

**Answer:**

Subsection 212.1(1) applies where a non-resident person transfers shares of a Canadian corporation (the “subject corporation”) to another Canadian corporation (the “purchaser corporation”), the transferor and the purchaser corporation do not deal at arm’s length and the purchaser corporation and the subject corporation are “connected” immediately after the transfer. The subsection will deem the transferor to have received a dividend to the extent that the amount of the non-share consideration exceeds the PUC of the transferred shares (as such PUC is determined after certain specific adjustments in section 212.1). It may also reduce the PUC of classes of shares received by the transferor as consideration.

**PROBLEM 6**

Opco has performed very well. Jenny has been approached by various parties about selling her shares. She is very interested in continuing in the business through an equity stake in the purchaser. The potential purchasers include an income fund, a non-resident corporation, a pension fund and a public Canadian corporation.

**Question 1**

Jenny understands that she can do a tax-deferred rollover under subsection 85(1) if she receives an equity stake in the purchaser. Please advise.

**Answer:**

Subsection 85(1) applies to a transfer only if it is to a “taxable Canadian corporation”. This is a corporation that is a Canadian corporation not exempt from tax under Part I of the Tax Act. A “Canadian corporation” is a corporation that is resident in Canada and which is either incorporated in Canada or has been resident in Canada from June 18, 1971.

There is no rollover in the Tax Act for transfers of shares of a Canadian corporation to an income fund or pension fund. There is also no rollover in the Tax Act for transfers of shares of a Canadian corporation to a non-resident corporation, but there have been various budget proposals to add such a rollover. A potential rollover exists only on the transfer to a Canadian-resident corporation.