

# CORPORATE REORGANIZATIONS ITA 85(1) ROLLOVERS

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# Outline

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- introduction
- conditions of application
- elected amount
- results of application
- special cases
- compliance

# Introduction

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- permits transfer of certain assets to a taxable Canadian corporation to occur on a tax-deferred or “rollover” basis
- whether transfer will be taxable or tax deferred will depend on:
  - who is transferor?
  - who is transferee?
  - what is the transferred property and what are its tax attributes?
  - what kind of consideration and what amount of each type of consideration is received?
  - what is the elected amount?

# Introduction

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- uses
  - incorporation of a business or investments
  - estate planning (estate freeze)
  - corporate reorganizations
  - butterflies
  - acquisitions and dispositions
  - loss utilization
- elective
- allows complete or partial rollover
- asset by asset

# Introduction

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- requirement for effective commercial transaction
  - commercial transaction may impact tax deferral but not vice versa (except that desire for tax deferral may influence the structuring of the commercial transaction)
- potential for technical errors and unintended tax consequences
- potential for double taxation
  - when property sold by corporation
  - when shares sold by transferor
- not the only tax issue
  - 20(24), 22 and commodity taxes

# Conditions of Application

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## ➤ 5 conditions

- transferor — taxpayer
- transferee — Taxable Canadian Corporation
- transferred property — eligible property
- consideration received — must include shares of transferee
- election — transferor and transferee must make a joint election

# Conditions of Application — Transferor

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## ➤ Taxpayer

- any person whether or not liable for tax
- individuals
- corporations
- trusts
- partnerships (ITA 85(2))
- non-residents

# Conditions of Application — Transferee

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- Taxable Canadian Corporation
- 89(1)
- two conditions
  - Canadian Corporation
  - not exempt from tax under Part I of ITA
- Canadian Corporation
  - resident in Canada, and
  - either incorporated in Canada or resident in Canada from June 18, 1971



# Conditions of Application — Transferred Property

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- Eligible Property
- 85(1.1)
- capital property (other than real property owned by a non-resident) (ITA 85 (1.1)(a))
- certain real property owned by a non-resident
  - capital property owned by a non-resident insurer in certain circumstances (ITA 85(1.1)(b))
  - capital property used by a non-resident in a Canadian branch (ITA 85(1.1)(h)) where the transfer is part of the incorporation of the Canadian branch

# Conditions of Application — Transferred Property

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- incorporation of a Canadian branch
- 85(1.2)
- three conditions
  - immediately after the disposition the corporation is controlled by the taxpayer or a related person
  - all or substantially all of the property of the branch is transferred to the corporation
  - the transfer is not part of a series of transactions that results in control of the corporation being acquired by a person after the transfer

# Conditions of Application — Transferred Property

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- Eligible Capital Property (ITA 85(1.1)(e))
  - e.g. goodwill
- inventory (other than real property inventory) (ITA 85(1.1)(f))
  - including work in progress of professionals and cash basis inventory
  - exclusion of real property inventory intended to prevent conversion of an inventory gain from the sale of land into a capital gain from the sale of shares
- Canadian and certain foreign resource property (ITA 85(1.1)(c) and (d))
- a security or debt obligation used in an insurance or money-lending business (ITA 85(1.1)(g))

# Conditions of Application — Transferred Property

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- excluded property
  - real property inventory
  - real property that is capital property held by a non-resident (subject to exceptions)
  - deferred financing charges
  - life insurance policies (unless held as inventory)
  - unbilled disbursements
  - holdbacks

# Conditions of Application — Transferred Property

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- income interest in a trust
- cash basis receivables
- prepaid expenses
- tax pools (e.g. R&D) (Doc. No. 9826207)
- rights under fishing licence (Doc. No. 9726477)
- non-principal residence portion of unsevered land (Doc. No. 9725647)

# Conditions of Application — Transferred Property

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- what about a partnership interest
  - *Walchuk v. The Queen*
  - IC – 88-2, paragraph 24
  - *Loyens v. The Queen*
  
- *Membrex Limitée v. The Queen*

# Conditions of Application — Consideration

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- two types of considerations
  - shares in the capital of the transferee
  - everything else
- consideration must include share consideration
- everything else is called “non-share consideration” or “boot”
- amount of boot may result in loss of tax deferral or trigger gain on the transaction

# Conditions of Application — Consideration

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- one or more shares in the capital of the transferee must be received as consideration
- “share” means a share or a fractional share of the capital stock of a corporation (ITA 248(1))
- what if several properties transferred for one share?
  - IT-291R2
- share can include common or preferred share
- *Estate of Louise Barnabe v. M.N.R.*
- *Dale v. The Queen*



# Conditions of Application — Consideration

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- “boot” can include cash, debt, assumed liabilities, shares of other corporations or other property
- boot not exceeding ACB/cost amount of transferred property will not trigger gain
- boot permits recovery of original investment without recognition of gain
- excessive boot will give rise to gain

# Conditions of Application — Consideration

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- beware of 84.1 and 212.1 on share transfers
- Doc. No. 2000-0039335
- provisions of assumption agreement

# Elected Amount

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- amount specified in joint tax election
- ITA sets out prescribed limits
- can elect within range
- allows full rollover, partial rollover or fully taxable transaction
- ITA will adjust if outside range

# Elected Amount

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- elected amount
  - deemed proceeds of property to transferor
  - deemed cost of property to transferee
- accounting and corporate law amounts may be different

# Elected Amount

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- prescribed limits
  - deferral available to the extent of share consideration
  - deferral not available to the extent boot exceeds ACB/cost amount of transferred property
- generally between ACB/cost amount of transferred property and FMV of transferred property

# Elected Amount

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- three general limits (for non-depreciable capital property)
  - (a) cannot elect in excess of FMV of transferred property
  - (b) subject to (a), cannot elect less than FMV of boot
  - (c) cannot elect less than lesser of (i) the ACB/cost amount of the transferred property and (ii) the FMV of the transferred property
- Where (b) and (c) are different amounts, greater of the two is the lower limit of the elected amount
- (a) trumps but may have shareholder benefit if FMV of boot exceeds FMV of transferred property
- forced to recognize losses

# Elected Amount

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- property by property
- cannot elect at nil
- if want full tax deferral
  - ensure boot does not exceed ACB/cost amount of transferred property
  - elect at ACB/cost amount of transferred property
- may want to elect even if want to realize gain on the transaction
  - Tuxedo Holdings
- partnership with negative basis

# Results of Application

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- what do the rules do?
  - proceeds to transferor of transferred property
  - cost to transferee of transferred property
  - basis for determining cost to transferor of consideration received
  - basis for determining PUC of share consideration
- general principle
  - tax attributes should be limited to elected amount
- value of consideration, price adjustment clauses and deemed dividends



# Rules of Application — Cost of Consideration

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- cost of boot
  - FMV
- cost of preferred shares
  - elected amount exceeds boot (but not exceeding FMV of shares)
- cost of common shares
  - elected amount exceeds boot exceeds cost of preferred shares
- if more than one class of preferred or common shares is received, allocation among share classes is based on relative fair market value
- planning
  - isolate bases

# Rules of Application — Cost of Consideration

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## Asset Transferred

Cost	\$100
FMV	200

## Consideration Received

Note	100
Common Shares (FMV)	100

## Tax Results of Election

Elected Amount	100
Cost of asset to corporation	100
Cost of shares to transferor	Nil

# Rules of Application — PUC of Consideration

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- 85(2.1)
- may result in PUC grind
- applies only to 85 rollovers and does not apply if 84.1 applies
- if PUC exceeds (elected amount exceeds boot)
  - PUC reduced to (elected amount exceeds boot)
- reduction is pro-rated over all classes of share consideration based on relative PUC of each class of share consideration
- can sometimes hold down corporate law stated capital to avoid a 85(2.1) PUC grind

# Rules of Application — Value of Consideration

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- FMV of consideration > FMV of transferred property
  - 15(1)
  
- FMV of transferred property > FMV of consideration received
  - 85(1)(e.2)
  - desire to confer benefit on related shareholder
  - adjusts elected amount upward

# Rules of Application — Value of Consideration

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- valuation issues
- share features
  - redeemable at the option of the holder or the issuer?
  - amount of dividends?
  - dividends are discretionary or fixed?
  - dividends are cumulative or non-cumulative?
  - voting rights?
  - any fixed entitlement on a liquidation, dissolution or winding-up?
  - preference as to dividends or distributions on a liquidation, dissolution or winding-up?
  - restrictions on transferability?
  - restrictions on dilution or impairment of value by issuance of and distributions on other shares?

# Rules of Application — Price Adjustment Clauses

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- price adjustment clause
- provides for adjustment of purchase price of property or redemption amount of shares if purchase price or redemption amount greater or less than FMV of transferred property
- in agreement of purchase and sale or terms of preferred shares
- alternative
  - formula purchase price or redemption amount

# Rules of Application — Price Adjustment Clauses

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- what triggers adjustment
  - CRA audit
  - determination by directors
- how is adjustment effected
  - pay more or get refund of boot
    - should interest be payable?
  - issue more shares or donate some shares back to the issuer
    - any adjustment for interim dividends?
  - change in redemption amount or other share attributes

# Rules of Application — Price Adjustment Clauses

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- IT-169
  - bona fide
  - notification
  - excess/shortfall refunded
- 1980 Round Table — donation of excess shares
- TR-82 — terms of preferred shares
- Doc. No. 2002-0162427 — amended election



# Rules of Application — Deemed Dividends

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- 84(1)
- deemed dividend to the extent that the PUC of the issued shares exceeds the FMV of the transferred assets
- contributed surplus arising on a transaction in respect of which an election under subsection 85(1) is made cannot be converted into PUC without triggering a deemed dividend

# Rules of Application — Deemed Dividends

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## ➤ 84.1

### ➤ conditions

- taxpayer other than a corporation
- transfer shares of a “subject corporation”
- to a no-arm’s length transferee corporation
- transferee corporation and subject corporation are connected
  - controlled or over 10% votes and value

# Rules of Application — Deemed Dividends

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## ➤ results

- PUC grind
- PUC of consideration shares
- to the extent PUC of consideration shares exceeds the amount by which (a) greater of PUC and adjusted ACB of transferred shares exceeds (b) boot
- deemed dividend to the extent boot exceeds greater of PUC and adjusted ACB of transferred shares

## ➤ *Juliar v. Canada*

# SPECIAL CASES

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- cost averaging for identical properties held as capital property (ITA-47)
- separate pools for pre-and post- 1971 properties
- consideration received may result in cost averaging
- planning
  - isolate holdings

# SPECIAL CASES

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- non-resident issues
- 116
- Deemed "taxable Canadian property"
  - 85(1)(i)
- 212.1
- treaty protection
- may want to elect even if treaty protection

# COMPLIANCE

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- JOINT ELECTION BY TRANSFEROR AND TRANSFEREE  
PRESCRIBED FORMS
- T2057 — Individuals, Corporations, Trusts
- T2058 — Partnerships
- FILING PROCEDURES
- Filed in duplicate
- By Transferor
- At Transferor's District Taxation Centre
- Separate from any Tax Returns

# COMPLIANCE

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## ➤ DEADLINE FOR FILING

- ITA 86(6) — On or before earliest tax return filing date for parties to transfer

## ➤ LATE FILING PERMITTED — ITA 85(8)

- Within 3 years from time that the election form should have been filed
- Penalty — Lesser of :
  - A 1/4 of 1% (FMV of Assets – Elected Amount)
  - B \$100 x number of months late

## ➤ MAXIMUM PENALTY — \$8,000

# COMPLIANCE

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- SPECIAL CASES — ITA 85(7.1)
  - Election cannot be revoked
  - Minister may permit election to
    - be filed after 3 years
    - be amended