2011 TAX LAW FOR LAWYERS

Rollover Provisions
of
Sections 51, 85.1, 86 and 86.1

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SECTION 51

CONVERTIBLE PROPERTY EXCHANGE

A. Purpose

Section 51 provides for a tax-deferred exchange where shares of, or a convertible debt owing by, a corporation are exchanged by the holder for newly-issued shares of and from the same corporation. It covers what are generally referred to as conversions of shares or convertible debt into treasury shares of the same corporation. The shares or convertible debt must be capital property and are referred to as "convertible property" (although the shares do not need to have conversion rights).

In the absence of section 51 (or some other provision that allows a tax-deferred exchange such as section 85 or 86), the exchange would constitute a disposition of the convertible property (see subparagraphs (b)(i) and (ii) of the definition "disposition" in subsection 248(1)) for proceeds of disposition equal to the value of the shares issued on the exchange, with a resulting capital gain or loss.

B. Summary of Key Attributes

Advantages	Disadvantages
• No need to convert all shares or debt held by holder.	• Shares or debt exchanged must be capital property.
• Generally deemed not to result in a disposition; no reporting or elections required.	• Only shares[1] of issuer can be received—no "boot". If it is desired to issue boot, then split the transaction into 2, no boot on the section 51 part and use section 85 on the other part.
• Issuer corporation can be non-resident.	• Narrow definition of debt.
• Non-arm's length relationships permissible.	• Debt must be convertible under its terms (but CRA may allow adding conversion feature).

[1] Capital property debt-for-debt "rollover" available under section 51.1.

- Cannot recognize loss (consider electing under subsection 85(1))

C. Detailed Analysis

1. Basic Rules—Subsection 51(1)

- The shares or debt of the corporation must be exchanged for treasury shares of the same corporation. The exchange must occur with the issuer; section 51 does not apply to an exchange of issued shares of a corporation between two of its shareholders. It also does not apply to an exchange of shares of one corporation for shares of another corporation.

- There is no difference in treatment in section 51 between common shares and preferred shares.

- There is also no requirement that the corporation be a Canadian corporation. Therefore, the rules can apply to exchanges of shares or debt of non-resident corporations.

- The shares or debt being surrendered in exchange for shares must be held by the taxpayer as capital property. If not held as capital property, then the subsection does not apply and income or losses would be recognized on the exchange (subject to an election under section 85).

- Paragraph 51(1)(a) describes the case in which a share is exchanged for another share of the same corporation. The share that is surrendered must be capital property of the taxpayer, but it is not necessary that it have the conversion feature built into its terms. The section can cause confusion because it uses the term "convertible property" as a defined term. Therefore, any exchange of a share that is capital property for another share of the corporation that is not covered under another section of the Act can potentially qualify under section 51 without regard to whether its terms and conditions provide for the exchange.

- Paragraph 51(1)(b) describes the case in which a debt (referred to as a "bond,

debenture or note") is exchanged for a share of the corporation. The debt must be capital property but, in addition, its terms must confer on the taxpayer the right to make the exchange. That is to say, the conversion feature must be included in the terms of the debt instrument for section 51 to apply.

Paragraph 5 of CRA Interpretation Bulletin IT-448: *Dispositions – Changes in terms of securities* indicates that an optional conversion feature can usually be added to a security without triggering a disposition of the security.[2]

The convertible indebtedness referred to is more restricted than in other provisions of the ITA in that there is no reference to a mortgage, bill, or "similar obligation". See for example the definition of "qualifying debt obligation" in subsection 15.2(3).

- Paragraph 9 of CRA Interpretation Bulletin IT-96R6 clarifies that where a conversion feature is not separable from the security and cannot be traded separately, the rules in section 49 dealing with options do not apply.

- No non-share consideration ("boot") can be received by the taxpayer on the exchange.

Nevertheless, the administrative position of the CRA is that where the taxpayer would otherwise receive a fraction of a share on the exchange, and the taxpayer instead receives cash or other non-share consideration in lieu of the fraction, the taxpayer may obtain a tax-deferred exchange despite the receipt of the boot but is required to reduce the adjusted cost base of the whole shares received on the exchange by the amount of such boot. Alternatively, the taxpayer may choose to report the gain or loss on the amount received in lieu of the fraction. This administrative policy of allowing the taxpayer the ability to ignore the gain or loss does not apply if the value of the boot

[2] See also Income Tax Ruling TR-66; CRA Interpretation Bulletin IT-146R4: *Shares entitling shareholders to choose taxable or capital dividends*, paragraph 2; 1996 CTF Corporate Management Tax Conference Report, Revenue Canada Forum, Question 20; and CRA Income Tax Technical News No. 14, December 9, 1998.

received in lieu of the fraction exceeds $200.[3] This makes the potential to issue boot very limited.

- If all of these requirements are met, then the result of the application of section 51 is as follows:

(a) The taxpayer is deemed by paragraph 51(1)(c) not to have disposed of the shares or debt surrendered on the exchange (except for the purposes of subsection 20(21) relating to overaccrual of interest income and proposed subsections 44.1(6) and paragraph 94(2)(m) relating to non-resident trusts). Therefore, no gain or loss is recognized by the taxpayer.

(b) The cost to the taxpayer of the shares issued to the taxpayer on the exchange is deemed to be equal to the taxpayer's adjusted cost base of the shares or debt surrendered on the exchange.

(c) Where the taxpayer is issued shares of more than one class on the exchange, the taxpayer's adjusted cost base of the shares or debt surrendered on the exchange is allocated to the shares of the various classes issued to the taxpayer based on their relative fair market values.

ACB is allocated based on the formula in paragraph 51(1)(d)

$$A \times \frac{B}{C}$$

A = ACB of the surrendered property

B = FMV, immediately after the exchange, of all shares of the particular class acquired on the exchange by the taxpayer.

C = FMV, immediately after the exchange, of all shares acquired on the exchange by the taxpayer.

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[3] See CRA Interpretation Bulletin IT-115R2: *Fractional Interest in Shares*.

(d) Once the adjusted cost base of the shares issued on the exchange has been determined, there is a subsequent adjustment in paragraphs 51(1)(d.1) and (d.2) that applies if any of the shares or debt surrendered on the exchange have their adjusted cost base reduced as a result of the rules in section 80 dealing with debt forgiveness. The adjusted cost base of the newly-issued shares is reduced by the amount of the cost base reduction under section 80 (which is picked up in paragraph 53(2)(g.1)), and is then increased by exactly the same amount. The purpose of this is to preserve the character of the section 80 reduction, so that on certain subsequent dispositions of the newly issued shares the cost base reduction is taxed as a capital gain. See section 80.03.

- The rules in section 51 are <u>mandatory</u>, not elective. Therefore, a taxpayer in a loss position with respect to the surrendered debt or share cannot realize the loss if the exchange occurs pursuant to section 51 because the adjusted cost base to the taxpayer of the surrendered shares or debt "rolls over" and becomes the cost to the taxpayer of the shares issued on the exchange.

- For the purposes of the corporate attribution rules (i.e., which can create "phantom income") in sections 74.4 and 74.5, the exchange is deemed to be a transfer of the surrendered property by the taxpayer to the corporation. See paragraph 51(1)(e).

- If the surrendered property was taxable Canadian property of the taxpayer, the shares issued to the taxpayer on the exchange are deemed to be taxable Canadian property for the 60 months after the exchange. This change to paragraph 51(1)(f) from the March, 2010 Federal Budget in determining taxable Canadian property status after March 4, 2010 was intended to remedy a problem with previous paragraph 51(1)(f) which permanently deemed the newly issued shares to be taxable Canadian property. Also see the discussion below under the heading "Section 116".

2. Related Person Benefit—Subsection 51(2)

- Where the fair market value of the surrendered debt or shares is greater than the fair market value of the shares issued on the exchange, and it is reasonable to regard any portion of the excess as a benefit that the taxpayer desired to confer on a related person, then the taxpayer is deemed to have disposed of the surrendered property for proceeds of disposition equal to its adjusted cost base plus the amount of the benefit, provided that the proceeds cannot exceed the fair market value of the surrendered property. A capital loss cannot arise. Note that, unlike paragraph 85(1)(e.2), there is no exception to this rule where the related person is a corporation wholly-owned by the taxpayer.

- Where subsection 51(2) applies, the taxpayer's cost of the new shares issued on the exchange is deemed to be equal to the lesser of (i) the adjusted cost base of the surrendered property immediately before the exchange, and (ii) the fair market value of the new shares issued on the exchange plus the amount that would have been the taxpayer's capital loss on the disposition but for the loss denial rule. If more than one class of shares is acquired, the acquisition cost must be allocated among the classes in relation to their fair market values. The amount of the benefit is therefore not recognized in the adjusted cost base of the new shares or the ACB of the related person's shares so a degree of double taxation occurs.

3. Paid-Up Capital—Subsection 51(3)

- The purpose of subsection 51(3) is to prevent a deemed dividend from arising where subsection 51(1) applies to an exchange of a share for a share of a Canadian corporation. If the corporate stated capital of the newly issued shares exceeds the tax paid-up capital of the shares surrendered on the exchange, section 84 would trigger a deemed dividend. For example, assume a share with a corporate stated capital of $100 is issued on a transaction governed by section 85 such that subsection 85(2.1) requires the tax paid-up capital of the share to be reduced to $80. If the share is subsequently

converted into another share of the same corporation, the corporate stated capital of the new share would likely also be $100. In the absence of subsection 51(3), subsection 84(1) would deem the corporation to have paid a dividend of $20 since the paid-up capital of the new share would equal its corporate stated capital, and the effect would have been to increase the paid-up capital of the corporation by $20, something that section 84 penalizes by way of a deemed dividend equal to that increase.

- Paragraph 51(3)(a) reduces, at the time of the exchange, the paid-up capital of the new shares from their corporate stated capital to an amount equal to the paid-up capital of the surrendered shares. This is accomplished by reducing the paid-up capital of a particular class of shares issued on the exchange by

$$(A - B) \times \frac{C}{A}$$

Where:

A = the total of all increases as a result of the exchange in the corporate stated capital of any class of shares of the corporation (the new treasury shares issued);

B = the tax paid-up capital of the surrendered shares, and

C = the increase in the corporate stated capital of the particular class.

Therefore, in the example above, A would be $100, and B would be $80 so that the amount of the reduction in paid-up capital would be $20. If only one class of shares was issued on the exchange, then C/A would be 1, and the paid-up capital of that class of shares would be reduced from the corporate stated capital of $100 down by $20 to $80. Consequently, the exchange would not result in a deemed dividend under subsection 84(1).

If more than one class of shares is issued, the paid-up capital reduction is allocated to the various classes based on their relative amounts of corporate stated capital.

- Where a taxpayer exchanges a class of shares of a corporation for shares of more than one class, the allocation of paid-up capital and adjusted cost base between the classes of shares issued on the exchange may not have the same symmetry as before. This is because the allocation of paid-up capital is based on relative corporate stated capital whereas the allocation of adjusted cost base is based on relative fair market values.

  For example, suppose a taxpayer owns a common share of a corporation with a paid-up capital and adjusted cost base equal to $5,000 and a fair market value of $20,000. If the share was to be repurchased by the corporation, the taxpayer would recognize a deemed dividend of $15,000 and no capital gain or loss.

  Suppose the common share is exchanged for 1 Class "A" Share with a stated capital of $2,500 and a fair market value of $12,000, and 1 Class "B" Share with a stated capital of $2,500 and a fair market value of $8,000. Under paragraph 51(1)(d), the adjusted cost base to the taxpayer of the Class "A" Share would be

$$\$5,000 \times \frac{\$12,000}{\$20,000} = \$3,000.$$

  The paid-up capital of the Class "A" Share under paragraph 51(3)(a) would be

$$\$2,500 - ((\$5,000 - \$5,000) \times \$2,500/\$5,000), \text{ or } \$2,500.$$

  The adjusted cost base of the Class "B" Share would be

$$\$5,000 \times \frac{\$8,000}{\$20,000} = \$2,000.$$

The paid-up capital of the Class “B” Share would also be $2,500.

Therefore, on a future repurchase or redemption of the Class “A” Share for $12,000, there would be a deemed dividend of $12,000-$2,500 = $9,500 and a capital loss of $500 (subject to the stop-loss rule in subsection 112(3)). On a future repurchase of the Class “B” Share for $8,000, there would be a deemed dividend of $8,000-$2,500 = $5,500 and a capital gain of $500.

- If a class of shares has had its paid-up capital reduced under paragraph 51 (3)(a), and subsequently some of the shares of the class are redeemed or repurchased in circumstances described in subsection 84(3), or the paid-up capital of the class is reduced in circumstances described in subsection 84(4) or (4.1), then the amount of any deemed dividend that arises because of the paid-up capital reduction in paragraph 51(3)(a) is added back to the paid-up capital of the remaining shares of the class pursuant to paragraph 51(3)(b). This is to prevent a double counting since the paid-up capital reduction in respect of the whole class in paragraph 51(3)(a) continues to apply even though part of the reduction has already been captured as a deemed dividend. Therefore, the amount of the deemed dividend that is in excess of what the deemed dividend would have been but for the paid-up capital reduction in paragraph 51(3)(a) is added back and restored to the paid-up capital of the class.

4. Overriding Rollovers—Subsection 51(4)

- Section 51 does not apply to an exchange where an election is made under section 85. That is to say, section 51 can be overridden by making an election under section 85. Section 85, if applicable, provides greater flexibility in that:

    (a) proceeds of disposition can be selected within a range thereby allowing for a “partial” rollover if that is desired,

    (b) the surrendered property need not be capital property,

(c) a loss can be created, subject to the application of any stop-loss rules, and

(d) boot can be received tax-free up to adjusted cost base (subject to section 84.1).

- Section 51 also does not apply where section 86 applies.

5. Debt Forgiveness—Paragraph 80(2)(g)

Where the fair market value of a share (except a "distress preferred share" or a share issued pursuant to the terms of certain convertible debt) issued on a conversion of a debt is less than the amount of the debt, paragraph 80(2)(g) will apply to deem the debt to have been settled for an amount equal to the fair market value of the share, thereby triggering the debt forgiveness rules in section 80. This ACB adjustment gets picked up in paragraphs 51(1)(d.1) and 51(1)(d.2).

SECTION 86

REORGANIZATION OF CAPITAL

A. Purpose

Section 86 provides for a tax-deferred exchange where, in the course of a reorganization of the capital of a corporation, a taxpayer has disposed of capital property that was all of the shares of a particular class of a corporation that were owned by the taxpayer, and the taxpayer received property from the corporation that includes other newly issued shares of the same corporation.

This is to be compared with section 51 which also allows for exchanges of shares for shares of the same corporation, except that section 51:

(a) does not allow for non-share consideration to be received;

(b) does not require all shares of a class owned by the taxpayer to be exchanged;

(c) does not require that the exchange of shares for shares occur as part of a reorganization of capital; and

(d) allows exchanges of convertible debt for shares.

In the absence of section 86 (or some other provision that allows a tax-deferred exchange, such as section 51 or 85), the exchange would constitute a disposition of the old shares (see subparagraph (b)(i) of the definition "disposition" in subsection 248(1)) for proceeds of disposition equal to the value of the boot and shares issued on the reorganization, with a resulting capital gain or loss.

Section 86 is often used as a means of effecting an estate freeze. It is also sometimes used as a preliminary step in a "butterfly" transaction involving a corporate reorganization where a class of shares is exchanged for shares of one or more other classes.

B. Summary of Key Attributes

Advantages	**Disadvantages**
• Non-share consideration (i.e. "boot") can be received on exchange.	• Must dispose of all old shares of class held.
• Automatic rollover; no election need be filed.	• Old shares exchanged must be capital property.
• Issuer corporation can be non-resident.	• Cannot recognize loss (consider electing under subsection 85(1)).
• Non-arm's length relationships okay.	
• No difference between common shares and preferred shares.	

C. Detailed Analysis

1. Basic Rules—Subsection 86(1)

- There is no difference in treatment in section 86 between common shares and preferred shares.

- There is no requirement that the corporation be a Canadian corporation. Therefore, the rules can apply to reorganizations of capital of non-resident corporations.

- The exchange must occur in the course of a reorganization of the capital of the corporation.

- The CRA's general position is that a "reorganization of capital" for the purposes of subsection 86(1) will normally require amendments to the articles of incorporation of the corporation that is exchanging shares.[4]

  - Whether or not this is a correct interpretation of the phrase "reorganization" remains a subject of some debate. The CRA's interpretation may accord with a literal interpretation of the phrase, as a modification of the rights of the capital holder *vis-a-vis* the corporation.[5] The modification of rights, privileges, restrictions or conditions attached to shares should be substantial.[6]

  - The CRA has normally accepted that amendments to the articles of incorporation of a corporation will be sufficient to attract the application of subsection 86(1).[7] However, it appears that Document 2010-0373271C6 represents the first time that the CRA has indicated that articles of amendment should be filed.

  - In determining whether there has been a "reorganization", the CRA normally makes reference to *Kennedy v. M.N.R.*,[8] where Cattanach J. held

[4] See Document 2010-0373271C6 dated October 8, 2010.

[5] For a thorough discussion on this point, see John A. Brussa, "Capital Reorganizations," in Report *of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 16:1-38.

[6] Vern Krishna, *The Fundamentals of Canadian Income Tax*, 9th ed., (Toronto: Carswell, 2006) at 28:III.

[7] See, for example, Income Tax Ruling ATR-22R dated April 14, 1989.

[8] *Kennedy v. M.N.R.*, 72 D.T.C. 6357 (Fed. T.D.), affirmed on this point 73 D.T.C. 5359 (F.C.A.).

that the phrase referred to an alteration in the form in which a business was carried on, with substantially the same shareholders after the alteration was complete.

- This case was not decided in the context of subsection 86(1), so it is not clear whether the *Kennedy* test is the appropriate threshold for a "reorganization of capital" or, if this is the appropriate threshold, whether a change in form could be achieved without changes to the articles of incorporation (i.e., changes to issued share capital).

- The conditions of application of subsection 86(1) have been canvassed in other materials, and it may be useful to review these sources if comfort is required.[9]

- The old shares must be held as capital property of the taxpayer. If not held as capital property, then the subsection does not apply and income or loss would be recognized on the exchange (subject to an election under section 85).

- The taxpayer must dispose of all the shares of a particular class of shares owned by the taxpayer. Section 51 is not so restrictive in its application.

- The consideration that the taxpayer receives must include other shares of the corporation ("new shares"). It is possible for the taxpayer also to receive boot. However, the amount of boot should be limited to the paid-up capital of the old shares so that subsections 84(2) or 84(3) do not apply to deem a dividend to have been received.

- If all of these requirements are met, then the result of the application of section 86 is as follows:

[9] See Maureen Tabuchi, "Share Capital Reorganizations for Private Corporations" in "Personal Tax Planning," (2003), vol. 51, no. 3 *Canadian Tax Journal*, 1340-1378 and Darcy D. Moch and Stanley R. Ebel, "Basics of Corporate Reorganizations: Sections 51, 85, 85.1, and 86," *2002 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 2002), 10:1-32.

(a) The cost to the taxpayer of any boot received on the reorganization is deemed to be equal to its fair market value.

(b) The cost to the taxpayer of the new shares of the corporation received on the reorganization is deemed to be equal to the adjusted cost base to the taxpayer of the old shares minus the fair market value of any boot.

(c) Where more than one class of new shares is received by the taxpayer on the reorganization, the adjusted cost base of the new shares is allocated among the classes based on relative fair market values. Contrast this with the different ACB allocation rules in section 85 where the first ACB allocation is to preferred shares.

(d) The taxpayer is deemed to have disposed of the old shares for proceeds of disposition equal to the total of the cost of the new shares and the boot received by the taxpayer. Provided the fair market value of the boot does not exceed the adjusted cost base to the taxpayer of the old shares, no gain or loss will be recognized. If the fair market value of the boot exceeds the adjusted cost base of the old shares, a capital gain will arise and the adjusted cost base of the new shares will be nil. A capital loss can never arise. However, the possible application of subsections 84(2) or 84(3) should be considered in any case where boot is proposed to be received.

- The rules in section 86 are <u>mandatory</u>, not elective. Therefore, a taxpayer in a loss position with respect to the exchanged shares cannot recognize the loss if the exchange occurs pursuant to section 86.

- Unlike sections 51, 85 and 85.1, there is no rule that provides for a continuation of "taxable Canadian property" status. If the old shares of the corporation were taxable Canadian property to the taxpayer, there is no rule that deems the new shares received by the taxpayer on the reorganization to be

taxable Canadian property. See the discussion herein under the heading "Section 116".

2. Related Person Benefit—Subsection 86(2)

- Subsection 86(2) applies where the total fair market value of the new shares and boot received by the taxpayer on the reorganization is less than the fair market value of the old shares and it is reasonable to regard any portion of the excess as a benefit that the taxpayer desired to confer on a related person. Note that unlike paragraph 85(1)(e.2), there is no exception to this rule where the related person is a corporation wholly-owned by the taxpayer.

- The taxpayer is considered to have disposed of the old shares for proceeds of disposition equal to the fair market value of any boot plus the amount of the benefit, provided that the proceeds cannot exceed the fair market value of the old shares. A capital loss cannot arise.

- The cost to the taxpayer of the new shares is deemed to be equal to the adjusted cost base of the old shares less the fair market value of the boot and less the amount of the benefit. If more than one class of new shares is acquired, the acquisition cost is allocated among the classes in relation to fair market values.

3. Paid-Up Capital—Subsection 86(2.1)

- Subsection 86(2.1) operates to prevent, in most circumstances, a deemed dividend from arising where subsection 86(1) applies to an exchange. If the corporate stated capital of the new shares exceeds the tax paid-up capital of the old shares, the application of subsection 84(1) would, but for subsection 86(2.1), result in a deemed dividend.

- Paragraph 86(2.1)(a) operates in a manner similar to that of paragraph 51(3)(a) and keeps the paid-up capital of the new shares at the same amount as the paid-up capital of the old shares less the fair market value of any boot received by the taxpayer. Paragraph 86(2.1)(b) adds back to the paid-up capital of the class the amount of any deemed dividend subsequently arising under subsection 84(3), (4) or (4.1) as a result of the paid-up capital reduction in paragraph 86(2.1)(a).

- Notwithstanding subsection 86(2.1), consider whether subsections 84(2) or 84(3) could still apply if boot exceeds the paid-up capital of the old shares.

4. Preservation of Debt Forgiveness History—Subsection 86(4)

- Subsection 86(4) operates as the character preservation rule for reductions in the adjusted cost base of the old shares arising as a result of section 80. This provision is similar to the provisions in paragraphs 51(1)(d.1) and (d.2).

5. Overriding Rollover—Subsection 86(3)

- Section 86 does not apply where section 85 applies. Therefore, it is possible to override section 86 by making an election under section 85.

- Section 85, if applicable, provides greater flexibility in that:

  (a) proceeds of disposition can be selected within a range thereby allowing for a “partial” rollover,

  (b) the old shares need not be capital property, and

  (c) a loss can be created, subject to any stop-loss rules.

SECTION 85.1

SHARE FOR SHARE EXCHANGE

A. Purpose

Section 85.1 provides for a tax-deferred exchange of shares of a corporation for treasury shares of another corporation. This is to be contrasted with sections 51 and 86 which both deal with exchanges between a corporation and an existing holder of its securities.

In the absence of section 85.1 (or an election under section 85), an exchange of shares of one corporation for shares of another would be a disposition of property for proceeds of disposition equal to the value of the shares received and would be subject to recognition of gain or loss.

B. Acquisition of Domestic Corporation – Subsections 85.1(1) and (2)

Subsection 85.1(1) applies where shares of a particular class of a Canadian corporation, (referred to in the section as the "purchaser") are issued to and received by a taxpayer (referred to as the "vendor") in exchange for shares owned by the vendor of any particular class of another corporation that is a taxable Canadian corporation. Takeover bids, share exchanges that are undertaken pursuant to plans of arrangement, and other acquisitions of shares of a target corporation in exchange for shares of the purchaser may be subject to section 85.1 provided the target corporation is a taxable Canadian corporation and the purchaser is a Canadian corporation.

C. Summary of Key Attributes

Advantages	Disadvantages
• Not all shareholders have to defer gain.	• Shares exchanged must be capital property.
• Other shareholders can use subsection 85(1) if the purchaser is a taxable Canadian corporation.	• Shareholder must be arm's-length with purchaser before, and cannot control purchaser after, the exchange.

- A shareholder of target can dispose of some shares on a taxable basis, others on a "rollover" basis.
- No election required, but must not report any gain or loss.
- No difference between common shares and preferred shares, whether being exchanged by the taxpayer or issued by the purchaser.

- Only shares of purchaser can be received for shares of target—no "boot".
- The cost to the purchaser generally limited to PUC of target shares.

D. Detailed Analysis

1. Basic Rules—Paragraph 85.1(1)(a)

- As long as shares are exchanged for shares, it does not matter if the share of the target or of the purchaser is a share of a class, a series of a class or a fraction of a share. For example, the taxpayer may receive shares of one class of the purchaser in exchange for some shares of the target, and shares of the same class, another class or another series of the same class for other shares of the target. The rules in section 85.1 can be applied separately to each separate exchange set forth in the exchange agreement. Moreover, the taxpayer can treat one such exchange as taxable and another as tax-deferred.

- There is no difference between common shares and preferred shares, whether being exchanged by the taxpayer or issued by the purchaser.

- The shares that are being disposed of by the taxpayer must be held as capital property by the taxpayer. If not held as capital property, then subsection 85.1(1) does not apply and income or loss would be recognized on the exchange (subject to an election under section 85). For inventory of shares, use section 85.

- Section 85.1 is a conceptually interesting tax-deferred exchange. It allows the shareholder to claim a complete tax-deferred exchange by deeming the shareholder to have disposed of the shares of the target corporation for

proceeds of disposition equal to the shareholder's adjusted cost base of the shares, and to have acquired the shares of the purchaser at that same adjusted cost base. The shareholder achieves this tax-deferred exchange by taking no action or by reporting a completely tax-deferred exchange in the shareholder's tax return (i.e. reporting proceeds of disposition equal to adjusted cost base plus outlays and expenses incurred for the purpose of making the disposition).

If the shareholder reports any portion of the gain or loss from the disposition of the shares of the target corporation, then the shareholder has no tax-deferred treatment available in respect of any of the shares subject to that exchange and must realize all of the gain or loss in respect of the shares disposed of on that exchange. Generally, a shareholder will elect for a tax-deferred exchange when the shareholder is in a position of gain, and elect for a taxable exchange when the taxpayer is in a position of loss. Although the subsection refers to portions of a gain or loss, it is actually an all or nothing proposition, however, the exchange could be split into more than 1 transaction to achieve the desired result.

- The fact that some shareholders elect to treat the exchange of their shares as a taxable event does not affect the entitlement of other shareholders to treat the transaction as a tax-deferred exchange. Moreover, where a shareholder exchanges some shares of the target for shares of a particular class of the purchaser, and other shares of the target for shares of another class of the purchaser, the shareholder can treat the exchange of shares of one class as tax-free and the exchange for shares of the other class as taxable.

- Unlike section 85, no election forms need be filed.

- Where the shares of the target corporation were taxable Canadian property of the vendor, the shares of the purchaser corporation acquired by the vendor are deemed to be taxable Canadian property.

2. Cost to Purchaser—Paragraph 85.1(1)(b)

- Paragraph 85.1(1)(b) sets out the tax cost to the purchaser. The purchaser is deemed to have a cost of each share of the target corporation acquired by the purchaser on the exchange equal to the lesser of (i) the fair market value of the acquired share; and (ii) its paid-up capital of the acquired share. Although the purchaser may be giving up real value in the form of shares of its capital stock that could have been issued for cash, and therefore should be considered to have incurred a real cost equal to the fair market value of the shares, the purchaser's cost is limited to the paid-up capital of the acquired shares.

- The loss of cost base to the purchaser may not be important if the target is amalgamated with or wound-up into the purchaser corporation because the shares of the target would disappear on the merger. Similarly, if the target is merged into the purchaser and no step-up in the tax cost of the target's underlying property is available under paragraph 88(l)(c), the cost of the target shares would not be relevant.

- The tax cost to the purchaser is the same whether or not the vendor reported a tax-deferred share-for-share exchange. The purchaser's cost is set out in paragraph 85.1(1) (b) and applies whenever the requirements of application of the subsection are met as set out in the preamble.

3. Conditions Denying Rollover—Subsection 85.1(2)

- Subsection 85.1(2) puts a limitation on the application of subsection 85.1(1) by providing that the subsection does not apply in the following cases:

  (a) The vendor and purchaser were, immediately before the exchange, not dealing with each other at arm's length (otherwise than by reason of a right referred to in paragraph 251(5)(b) that is a right of the purchaser to acquire the exchanged shares). The subsection cannot be used in non-arm's length transactions, such as a transfer

of shares by a parent corporation to a controlled subsidiary. Section 85 would have to be used instead.

(b) Immediately after the exchange, the vendor or persons not at arm's length with the vendor, alone or together, controlled the purchaser or beneficially owned more than 50% of the fair market value of all outstanding shares of the purchaser.

(c) A section 85 election was filed in respect of the transaction to which the particular taxpayer is a party.

(d) Boot was received by the vendor for the target shares.

(e) The vendor is a foreign affiliate of a taxpayer resident in Canada and has included any portion of the gain or loss, otherwise determined, from the disposition of the exchanged shares in computing its foreign accrual property income.

- As discussed above, the vendor may receive shares of the purchaser for some exchanged shares of the target, and may receive boot for other exchanged shares of the target. Section 85.1 can be applied to those shares that are exchanged for shares of the purchaser notwithstanding that the other shares exchanged for boot will not be subject to the tax-deferred exchange under section 85.1. The share exchange provisions must, however, clearly identify which shares are exchanged for boot and which are exchanged for shares of the purchaser.

- The CRA acknowledges that where the transaction involves payment of a package of boot and share consideration, it is possible to structure the exchange so that the consideration is described as being share consideration for a fraction of each share of the target, and boot for the remaining fraction of each share of the target. Provided the documentation makes it clear as to which fraction is exchanged for what, section 85.1 may be used for the fraction of each exchanged share for which only share consideration is

received. The authority for this is presumably subsection 248(1) which defines a “share” to mean a share or fraction of a share.[10]

- In addition, where the shareholder would otherwise receive a fraction of a share of the purchaser on the exchange, and the shareholder instead receives cash or other non-share consideration in lieu of the fraction, the shareholder may obtain a tax-deferred exchange despite the receipt of boot but is required to reduce the adjusted cost base of the whole shares received on the exchange by the amount of such cash or other consideration. Alternatively, the taxpayer may choose to report the gain or loss on the amount received in lieu of the fraction. This administrative policy of allowing the taxpayer the ability to ignore the gain or loss does not apply if the value of the boot received in lieu of the fraction exceeds $200.[11] For boot greater than $200, the exchange agreement will have to be modified to ensure the boot is attributable to a specific share or fraction of a share exchanged, as discussed above.

- The use of section 85 by one shareholder does not preclude the use of section 85.1 by another.

4. Paid-Up Capital—Subsection 85.1(2.1)

- Subsection 85.1(2.1) reduces the paid-up capital of the shares of the purchaser corporation issued on the exchange to an amount equal to the paid-up capital of all the shares of the target acquired.

- Where more than one class of shares of the purchaser has been issued on the exchange, the paid-up capital of all the shares of the target corporation is allocated to the various classes of shares of the purchaser so issued based on the relative amounts of their corporate stated capital. In other words, allocation based on relative paid-up capital not on relative fair market value.

[10] See paragraph 7 of CRA Interpretation Bulletin IT-450R: *Share for share exchange*.

[11] *Ibid*, paragraph 6.

5. When to Use Section 85

- Shareholders of target who are already significant shareholders, directors or officers of purchaser may wish to use subsection 85(1) rather than 85.1 as a precaution against a subsequent finding that they were not dealing at arm's length with the purchaser.

- A purchaser may wish to consider structuring the transaction so that the shareholders, or at least major shareholders, of the target corporation employ section 85 instead of section 85.1 so that the purchaser may obtain a cost of the target shares greater than the paid-up capital of the target shares. For example, if the adjusted cost base to a major shareholder of shares of the target is greater than the paid-up capital of the shares but less than fair market value, consider using an election under subsection 85(1). The major shareholder would achieve a tax-deferred exchange if the section 85 election were set at an amount equal to the shareholder's adjusted cost base, and the purchaser would acquire the shares at a cost equal to the elected amount. If section 85.1 were to apply to the exchange, the cost to the purchaser of the shares would be equal to their paid-up capital.

  If the paid-up capital of the target shares is less than fair market value and a major shareholder is in a loss position because of an even greater adjusted cost base, again consider a section 85 election to set the purchaser's cost at an amount equal to fair market value instead of paid-up capital.

- If the paid-up capital of the target shares exceeds their fair market value, then there is no advantage to the purchaser in employing section 85 as section 85.1 would set the cost of the shares at their fair market value.

- Section 85 also allows greater flexibility because the proceeds of disposition can be set within a range thereby allowing a "partial" rollover to the shareholder.

- Boot can be received under section 85 and can be received on a tax-free basis to the extent of the shareholder's adjusted cost base of the shares (subject to section 84.1).

- Under section 85, the property disposed of need not be capital property as long as it is "eligible property".

- Section 85 can be used to acquire debt or warrants of the shareholder in respect of the target, again subject to the requirements of subsection 85(1).

- The main difference between section 85 and section 85.1 from a mechanical point of view is that section 85 can be employed only by way of election in prescribed form whereas section 85.1 does not require any special form to be filed.

E. Foreign Affiliate Rollover——Subsection 85.1(3)

Subsection 85.1(3) provides for a tax-deferred exchange where shares of a "foreign affiliate" of the taxpayer are disposed of to a purchaser that is, immediately after the disposition, also a foreign affiliate of the taxpayer.

- The shares disposed of must be held by the taxpayer as capital property.

- The consideration received by the taxpayer must include shares of the acquiring foreign affiliate.

- If these requirements are met, the following rules apply:

  (a) The cost to the taxpayer of any boot received by the taxpayer as consideration for the disposition is deemed to be equal to the fair market value of the boot.

  (b) The cost to the taxpayer of any shares of any class of the acquiring foreign affiliate received on the exchange is deemed to be equal to

the adjusted cost base to the taxpayer of the shares disposed of minus the fair market value of any boot received.

Where shares of more than one class of the acquiring affiliate are received on the exchange, the cost is allocated among the shares of the various classes received based on relative fair market values.

(c) The taxpayer is deemed to have proceeds of disposition from the shares disposed of equal to the total of the cost of the shares of the acquiring affiliate received and the boot received by the taxpayer. Provided the fair market value of the boot does not exceed the adjusted cost base to the taxpayer of the shares disposed of, no gain will be recognized.

(d) The cost to the acquiring affiliate of the shares of the target affiliate is deemed to be equal to the taxpayer's proceeds of disposition.

- Subsection 85.1(4) provides that subsection 85.1(3) does not apply where all or substantially all of the property of the foreign affiliate whose shares are exchanged consists of "excluded property" and the exchange is part of a series of transactions designed to dispose of the shares of the first affiliate to an arm's length person (other than another foreign affiliate of the taxpayer). "Excluded property" includes, *inter alia,* property of the foreign affiliate used principally to earn income from an active business or shares of another foreign affiliate all or substantially all of the assets of which consist of excluded property.

  In the absence of this rule in subsection 85.1(4), a taxpayer could dispose of shares of a foreign affiliate, a gain on which would otherwise be taxable, to another foreign affiliate on a tax-deferred basis. The acquiring foreign affiliate could then dispose of the shares of the first affiliate without recognition of

foreign accrual property income since such income does not include a capital gain from the disposition of shares that are excluded property.

F. Exchange of Shares of One Foreign Corporation for Shares of Another Foreign Corporation—Subsections 85.1(5) and (6)

Subsection 85.1(5) provides for a tax-deferred exchange where a corporation that is not resident in Canada issues shares of its capital stock to a taxpayer in exchange for shares that the taxpayer owns in another corporation also not resident in Canada. The two corporations do not have to be resident in the same foreign country.

- The rules are essentially the same as the rules in subsection 85.1(1).

- Provided the taxpayer disposing of the shares of the target foreign corporation (the "vendor") holds the shares as capital property, and provided that the vendor does not include any portion of the gain or loss otherwise determined in the vendor's income tax return for the taxation year in which the exchange occurs, then the vendor will be deemed to have disposed of the shares of the target corporation for proceeds of disposition equal to the vendor's adjusted cost base in the shares, and to have acquired the shares of the purchasing corporation at a cost equal to that same adjusted cost base.

- Where the shares of the target corporation that were disposed of by the vendor were taxable Canadian property of the vendor, the shares of the purchaser corporation acquired by the vendor are deemed to be taxable Canadian property of the vendor.

- Subsection 85.1(6) will deny the application of subsection 85.1(5) in the following cases:

  (a) The vendor and the purchaser were, immediately before the exchange, not dealing with each other at arm's length (otherwise than because of a right referred to in paragraph 251(5)(b) that is a right of the purchaser to acquire the shares of the target).

(b) Immediately after the exchange, the vendor or persons not at arm's length with the vendor, alone or together, controlled the purchaser corporation or beneficially owned more than 50% of the fair market value of all outstanding shares of the purchaser.

(c) Boot was received by the vendor for the target shares.

(d) The vendor is a foreign affiliate of a taxpayer resident in Canada at the end of the taxation year of the vendor in which the exchange occurred and has included any portion of the gain or loss, otherwise determined, from the disposition in computing its foreign accrual property income.

(e) The vendor is a foreign affiliate of a taxpayer resident in Canada at the end of the taxation year of the vendor in which the exchange occurred and the exchanged shares are excluded property (within the meaning assigned by subsection 95(1)) of the vendor.

Note that there is no provision in the Act which allows the tax-free exchange of shares owned by a shareholder in the capital stock of a corporation resident in Canada for shares of a corporation not resident in Canada, or vice-versa. There was, however, a statement in the "Economic Statement and Budget Update" released by the Minister of Finance on October 18, 2000 indicating that the Government intends to develop a rule allowing for a tax-free cross-border share-for-share exchange where a Canadian resident shareholder receives only share consideration on the exchange. The statement indicated that any such rollover rule would not take effect before the release of draft legislation for public discussion. The federal budgets of February 18, 2003 and March 23, 2004 reiterated this plan. The federal budget of February 23, 2005 stated that "a discussion draft of proposed income tax amendments to implement this initiative will be released in the near future".

The purpose of this proposal is to eliminate the need for cross-border exchangeable share transactions. However, in his March 19, 2007 Federal Budget presentations, the Minister of Finance mentioned that these proposals "…are not a priority at this time."

PRICE ADJUSTMENT CLAUSES AND RECTIFICATION REMEDY

- It is standard practice to include a price adjustment clause (“PAC”) to ensure that the FMV of the exchanged shares is equal to the FMV of the issued shares. Where the Minister disputes the FMV assigned by the parties, such a clause would result in the purchase price and/or the consideration being adjusted retroactively (i.e. *nunc pro tunc*) to the amount determined by the Minister or a court.

- Most PACs used on share-for-share exchanges contain a statement setting out the intention of the parties to transact for FMV consideration, and an agreement to adjust the price *nunc pro tunc* as the result of a determination by the Minister or a court that the FMV is something other than the FMV assigned by the agreement.

- An effective PAC can prevent a multitude of potential problems on a share exchange, including:

    - The conferral of indirect benefits under subsection 56(2) or shareholder benefits under subsection 15(1) where new shares are subsequently issued by the corporation, as occurred in *Kieboom v. M.N.R.*;[12] and
    - The application of the anti-benefit rules in subsections 86(2) and 51(2).

- However, it is necessary that the PAC be effective in order to avoid these outcomes. Recent decisions have revealed two primary means by which the Minister or a court can render a PAC ineffective, and care should be taken to draft a PAC which cannot be easily ignored.

- First, it is necessary that the statement of intention in the PAC actually represents the intention of the parties. Otherwise, it will be possible for a court to ignore the PAC as a sham, as occurred in *Elias v. R.*[13] and *Guilder News Co. (1963) Ltd. v. M.N.R.*[14] In both of

[12] *Kieboom v. M.N.R.*, 92 D.T.C. 6382 (F.C.A.).

[13] *Elias v. R.*, 97 D.T.C. 1188 (T.C.C.), aff’d 2001 D.T.C. 5674 (F.C.A.).

these cases, the courts concluded that the parties never actually intended to transact for FMV consideration and refused to apply to PAC on this basis, with the result that the shareholder benefits under subsection 15(1) were properly assessed.

- Second, if the Minister or a court refuses to make a determination of value, then the PAC may not be engaged. This is what happened in the recent decision in *Garron Family Trust (Trustee of) v. R.*,[15] where neither the Minister nor Woods J. made a determination as to the value of the exchanged shares, but simply held that the value of the shares was greater than the value assigned under the agreement.

- To avoid a situation where a PAC is rendered ineffective in situations where a determination that the value was other than the agreed value will suffice, it may be advisable to draft a PAC that is triggered by something other than a "determination":

> ... a triggering event for the PAC should not be based solely on a "determination" but should include a proposed assessment or reassessment on the basis that the FMV of the transferred property was greater or lesser than the FMV of the preferred shares issued in consideration therefor. Each of paragraph 85(1)(e.2), subsection 86(2), subsection 51(2), and paragraph 69(1)(b) involves such a comparison. Another triggering event could be a proposed assessment or reassessment on the basis that a benefit was conferred as part of or as a consequence of the transaction or event or series of transactions or events, including the issuance of such preferred shares. This approach may address possible subsection 15(1) situations. Finally, to answer a *Kieboom*- or *Romkey*-based attack, one might say that the triggering event also refers to a disposition or transfer of property or rights to or for the benefit of another shareholder or prospective shareholder, although this concept is likely inherent in the previous approach. (All of the above assumes taxpayer acquiescence in the proposed assessment or reassessment.)[16]

- It may be possible to avoid this issue by asking the representative of the Minister at examinations for discovery what the Minister believes the FMV of the exchanged shares to be, as the answer may be sufficient to evidence a "determination" having been made.[17]

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[14] *Guilder News Co. (1963) Ltd. v. M.N.R.*, 73 D.T.C. 5048 (F.C.A.).

[15] *Garron Family Trust (Trustee of) v. R.*, 2009 D.T.C. 1287 (T.C.C.), aff'd 2010 D.T.C. 5189 (F.C.A.).

[16] Joan E. Jung, "Price Adjustment Clauses Under Attack?", vol. 11, no. 2 *Tax for the Owner-Manager* (Toronto: Canadian Tax Foundation, April 2011).

[17] See *L.I.U.N.A. Local 527 Members' Training Trust Fund v. Canada*, 92 D.T.C. 2365 (T.C.C.), where Bowman J.T.C.C. (as he then was) held that, for the purposes of determining whether the Minister was of the opinion that an organization was not a charity, a question on discovery would suffice to establish the Minister's opinion.

- Where it becomes apparent that a PAC may be ineffective, or the defect in the share exchange is one that cannot be fixed through the PAC mechanism, it may be possible to have the agreement rectified to eliminate or mitigate the adverse tax consequences.

- For example, this is what happened in the recent decision of the Alberta Court of Queen's Bench in *S&D International Group Inc. v. Attorney General of Canada*,[18] where Graesser J. exercised his equitable jurisdiction to reduce the consideration given under an agreement where the parties had assigned a FMV to the consideration that was significantly less than the FMV assigned by the Minister. In that case, the agreement did not contain a PAC, so the taxpayers were forced to seek equitable relief.

- In the tax context, rectification can also be used to substitute the type of consideration given,[19] or to rescind the agreements such that the transactions are *void ab initio*.[20]

- Although some cases suggest that tax deferral must be a "primary and continuing objective" of the transactions in order to obtain equitable relief, *S&D International* stands for the proposition that no such objective is required. Graesser J. held that the equitable jurisdiction of the Court was engaged by a fundamental mistake as to the tax effect of the transactions, as evidenced by the self-evident fact that the parties would have done "something else" had they been aware of the tax effect of the transactions as documented.

- It is important to note that the purpose of rectification is to amend the documents to accord with the intentions of the parties. Therefore, documents should make reference to the intentions of the parties, whether in the form of recitals or otherwise. In the case of a share-for-share exchange, the agreements should always contain a recital evidencing the intention that a tax-deferred exchange occur, and that a particular provision apply.

- In Quebec, the *Code civil du Québec* represents a complete code, so it not possible for the Cour Supérieure to rely on its inherent jurisdiction under section 96 of the *Constitution*

[18] *S&D International Group Inc. v. Attorney General of Canada*, 2011 A.B.Q.B. 230.

[19] *Juliar v. Canada (Attorney General)* (1999), 46 O.R. (3d) 104 (Ont. S.C.J. [Commercial List]), affirmed (2000), 50 O.R. (3d) 728 (Ont. C.A.), leave to appeal refused (2001), 153 O.A.C. 195n (S.C.C.).

[20] *Stone's Jewellery Ltd. v. Arora* (2009), 314 D.L.R. (4th) 166 (Alta. Q.B.).

Act, 1867 to grant equitable rectification.[21] However, in the recent decision in *Services environnementaux AES inc. c. Canada*,[22] the Cour d'Appel du Québec held that Article 1425 of the *Code* can be relied on to achieve something akin to rectification, provided that the request for relief is legitimate and necessary and no third parties are prejudiced.

SECTION 116

Section 116 contains a regime for the collection of tax that non-residents might be required to pay on a disposition of taxable Canadian property.

A. Purpose and Basic Application

Canada generally does not have the ability to collect tax on income earned in Canada by a non-resident once the money or property of the non-resident person has left Canada, so it is necessary to collect tax at the time the income arises and before any amount can be paid to the non-resident. In the absence of such a regime, non-residents would effectively be liable for tax on income earned in Canada to the extent that assets remained in Canada which could be enforced against to satisfy the tax debt.

Section 116 imposes an obligation on a purchaser of "taxable Canadian property" to ascertain whether the vendor is a resident of Canada. If the vendor is a non-resident, the purchaser is liable to pay an amount on account of the non-resident's tax equal to 25% of the purchase price, unless the non-resident has obtained a clearance certificate under subsection 116(4). The purchaser will ordinarily withhold the amount required under section 116 from the payment to the vendor, and, in accordance with subsection 116(5), remit it to the Receiver General within 30 days of the end of the month of the sale.

B. Cause for Concern with Share Exchanges

[21] Jean-François Dorais, "Rectification in Quebec", vol. 19, no. 5 *Canadian Tax Highlights* (Toronto: Canadian Tax Foundation, May 2011).

[22] *Services environnementaux AES inc. c. Canada*, 2011 CarswellQue 1079 (Q.C.C.A.)

It is important to note that subsection 116(5) requires that the amount paid on account of tax be equal to 25% of the purchase price and not 25% of the vendor's gain on the disposition. As a result, even where an acquisition of taxable Canadian property from a non-resident is completed on a tax-deferred basis, there may be an obligation to withhold and remit 25% of the FMV of the property acquired from the non-resident if a clearance certificate is not obtained.

As discussed above, sections 51, 85 and 86 can apply to a share exchange where the corporation is a resident of Canada but some of the shareholders are not. In some circumstances, this could result in the application of subsection 116(5) to the exchange where there has been an "acquisition" of the share disposed of by the non-resident on the exchange.

The CRA will likely take the position that, where there has been a disposition of shares by a non-resident person without a corresponding acquisition (including on a repurchase, redemption or exchange), the shares have been acquired from the non-resident person by the corporation.[23] Indeed, the CRA has opined in the past that subsection 116(5) would apply to a section 51 exchange, which is deemed not to involve a disposition of the exchanged shares.[24] Notwithstanding the reasonable technical arguments that no acquisition has occurred on many exchanges, it is therefore necessary to consider the potential application of section 116 every time a contemplated share-for-share exchange includes a non-resident shareholder.

C. Detailed Analysis

1. Basic Rules – Subsection 116(5)

- There must be an <u>acquisition of taxable Canadian property</u> from a non-resident person.

- The property is not depreciable property or "excluded property".

[23] See, for example, Technical Interpretation 2010-0387151E5 dated February 10, 2011 and Technical Interpretation 2008-0301701E5 dated June 12, 2009 (share repurchase), Technical Interpretation 2010-0371391E5 dated December 15, 2010 and Technical Interpretation 2006-0184741E5 dated July 10, 2007 (distribution of trust capital), Technical Interpretation 2002-0149955 dated February 24, 2003 (deemed disposition on delisting) and Technical Interpretation 2002-0156945 dated October 11, 2002 (share-for-share exchange).

[24] Technical Interpretation 2001-0070415F dated March 28, 2001.

- Unless an exception discussed below applies, the purchaser must remit an amount equal to 25% of the amount, if any, by which the cost to the purchaser of the acquired property exceeds an amount fixed by the Minister in a certificate issued under subsection 116(2).

- The purchaser is entitled to deduct or withhold from the amount paid to the vendor the amount it is required to remit on account of the vendor's tax.

- There are three main exceptions to subsection 116(5):

    - After reasonable inquiry, the purchaser had no reason to believe that the vendor was not a resident of Canada;
    - The shares are "treaty-protected property"; or
    - A clearance certificate was issued under subsection 116(4).

- As will be seen below, provided that the value of the exchanged shares is principally attributable to something other than real property, and has been for the 60-month period preceding the exchange, it should be possible to rely on one of three significant exceptions to subsection 116(5).

2. Taxable Canadian Property

- As a condition of application of any provision of section 116, the property must be "taxable Canadian property" as defined in subsection 248(1).

- This definition was subject to extensive modifications in Budget 2010, which were made effective March 4, 2010. If the relevant acquisition occurred prior to March 4, 2010, the following comments may not apply.

- For a private corporation, a share is only "taxable Canadian property" if, at any time in the 60-month period prior to disposition, more than 50% of the FMV of the share was derived directly or indirectly from some combination of:

  - Canadian real property;
  - Canadian resource properties;
  - Timber resource properties; or
  - Options or interests in any of these types of property, whether or not the property exists.

- For a public corporation, the shares will be "taxable Canadian property" if the private corporation requirements are met and more than 25% of the shares of the corporation are owned by the particular taxpayer or persons who do not deal at arm's length with the particular taxpayer.

- For public corporations, the "taxable Canadian property" definition can result in shares being "taxable Canadian property" of certain shareholders but not of other shareholders.

- In all circumstances, if more than 50% of the share value was attributable to something other Canadian real property or resource properties at all times during the 60-month period prior to the share exchange, the shares are not "taxable Canadian property" and subsection 116(5) cannot apply to the exchange.

3. Treaty-Protected Property

- If the shares are "taxable Canadian property" of the non-resident shareholder, it may be possible to rely on the subsection 116(5.01) exception for treaty-protected property. This exception requires the filing of forms with the CRA, but does have the benefit of a "due diligence" defence if the purchaser misapplies the exception.

- In order for this exception to apply, the purchaser must conclude after reasonable inquiry that the vendor is resident in a country with which Canada has a tax treaty.

- The property must be "treaty-protected property" as defined in subsection 248(1) under the tax treaty with the country that the vendor is believed to be resident in, if the vendor were actually a resident of that country.

- The purchaser must provide notice in accordance with subsection 116(5.02). This requirement will be satisfied by filing an information return in Form T2062C within 30 days of the acquisition.

- "Treaty-protected property" means property in respect of which a gain on disposition would not be taxed under Part I by virtue of a tax treaty with another country. So, for example, if the value of a share acquired by a corporation on an exchange from a United States-resident shareholder is not principally attributable to real property situated in Canada, the share would be "treaty-protected property" by virtue of Article XIII(4) of the *Canada-United States Tax Convention*.

4. Excluded Property

- If the shares exchanged might be taxable Canadian property and the notice requirements in subsection 116(5.02) were not complied with, it may still be possible to avoid the application of subsection 116(5) on the basis that that shares are "excluded property".

- The shares of public corporations will always be "excluded property" by virtue of paragraph 116(6)(b), so provided that the acquisition is not the result of a deemed disposition on the de-listing of the corporation, subsection 116(5) should never apply on an exchange of public corporation shares.

- Shares of a private corporation will be "excluded property" if they are "treaty-exempt property" pursuant to paragraph 116(6)(i).

    - For corporations that are not related to the non-resident shareholder exchanging shares, the shares will be "treaty-exempt property" under subsection 116(6.1) if they are "treaty-protected property".

- For corporations that are related to the non-resident shareholder exchanging shares, the shares will only be "treaty-exempt property" under subsection 116(6.1) if they are "treaty-protected property" and a Form T2062C was filed within 30 days of the exchange.

SECTION 86.1

FOREIGN SPIN-OFFS

Section 86.1 provides for the distribution by a publicly-traded foreign corporation to its shareholders of shares it owns in another foreign corporation on tax-free basis to shareholders of the distributing corporation who are resident in Canada.

A. Purpose

Section 86.1 provides for a tax-deferred transaction to Canadian resident shareholders where a publicly-traded foreign corporation whose shares are widely held undertakes a "spin-off" transaction whereby it distributes to its common shareholders common shares of another foreign corporation owned by the distributing corporation.

In the absence of section 86.1, a shareholder resident in Canada would generally be subject to taxation on the transaction depending upon how the transaction is characterized. For example, if the effect of the transaction is that the foreign corporation distributes the shares of the other corporation by way of a dividend in kind to its shareholders, then the Canadian resident shareholder would be required to include the dividend in income pursuant to section 90 and paragraph 12(l)(k) of the Act. Subsection 52(2) would give the shareholder a cost in the shares of the other corporation received on the dividend equal to their fair market value.

B. Summary of Key Attributes

Advantages	**Disadvantages**

- Completely tax-free to shareholders resident in Canada.
- One shareholder may elect that the distribution be a tax-free event to that shareholder and another shareholder may elect that the distribution be taxable to that shareholder.

- Applies only where the distribution is made in respect of <u>common</u> shares of the distributing corporation.
- Distributing corporation must be listed on a prescribed foreign stock exchange and its shares must be widely held and actively traded.
- Shares being distributed must be common shares of another foreign corporation.
- Both corporations must be resident in the same foreign country and never have been resident in Canada.
- No “boot” can be received.
- Election must be filed by shareholder in order for section 86.1 to apply.

C. Detailed Analysis

1. Basic Rules—Subsections 86.1(1) and (2)

- If a Canadian resident shareholder of the distributing corporation elects for section 86.1 to apply to the distribution, the transaction is not a taxable event to that shareholder. This is accomplished by subsection 86.1(1) which provides that the amount of an “eligible distribution” received by a taxpayer shall not be included in computing the income of the taxpayer. As a consequence, the cost rule in subsection 52(2) will not apply to the eligible distribution received by the taxpayer.
- The rules in section 86.1 <u>do not require</u> that the shares of the distributing corporation owned by the taxpayer be held as capital property.
- The concept of an “eligible distribution” is defined in subsection 86.1(2):

(a) The distribution to the taxpayer must occur because the taxpayer owns common shares in the stock of the distributing corporation and the distribution must be in respect of all of the common shares of the distributing corporation owned by the taxpayer.

(b) The property received by the taxpayer on the distribution must consist solely of common shares of another corporation owned by the distributing corporation (the "spin-off shares"). No cash or other boot can be distributed to the taxpayer as part of the distribution. The CRA announced in Income Tax Technical News No. 28 (published April 24, 2003) that "poison pill" shareholder rights attached to the spin-off shares will not disqualify the distribution provided that the rights were established for *bona fide* commercial reasons and not to obtain a tax benefit and do not have more than nominal value at the time of the spin-off.

(c) Where the distributing corporation is resident in the United States, the following rules must be met:

   (i) Both the distributing corporation and the distributed subsidiary must be resident in the United States at the time of the distribution and must never have been resident in Canada.

   (ii) The common shares of the distributing corporation (but not the spin-off shares) must be shares of a class that are widely held and actively traded on a U.S. stock exchange that is prescribed in section 3201 of the Regulations. Draft amendments to section 86.1 were included in the July 18, 2005 "technical bill" which provide that common shares of a distributing corporation not actively traded on a prescribed U.S. stock exchange will nonetheless meet the requirements of section 86.1 if they are widely held and

registered with the U.S. Securities and Exchange Commission (the “SEC”).

(iii) the transaction must be a tax-free event under U.S. law to shareholders of the distributing corporation who are resident in the United States.

(d) Where the distributing corporation is not resident in the United States, the distribution must be prescribed by the Regulations for the rules in section 86.1 to apply, and, in addition, the following rules must be met:

(i) Both the distributing corporation and the corporation the shares of which are being distributed must:

A. be resident in the same country, other than the United States, which is a country with which Canada has a tax treaty, and

B. never have been resident in Canada.

(ii) The common shares of the distributing corporation (but not the spin-off shares) must be shares of a class that are <u>widely held</u> and <u>actively traded</u> on a stock exchange that is prescribed in section 3201 of the Regulations.

(iii) The transaction must be a tax-free event under the law of the foreign country in which both corporations are resident to shareholders of the distributing corporation who are resident in that country.

(iv) The transaction must be prescribed in the Regulations subject to such terms and conditions as are considered appropriate in the circumstances. The point to note, then, is

that except where the distributing corporation and the other foreign corporation are both resident in the United States, the transaction has to be prescribed by the Department of Finance.

(e) Regardless of the whether the distributing corporation is a resident in the U.S. or another country, the distributing corporation (not the taxpayer) must provide the CRA, within 6 months after the distribution, with information that establishes the following facts:

(i) At the time of the distribution, the common shares of the distributing corporation in respect of which the distribution was made were widely held and actively traded on a prescribed stock exchange (or further to the pending amendment noted above, they were at that time widely held and registered with the SEC).

(ii) The distributing corporation and the corporation the shares of which were distributed were never resident in Canada.

(iii) The date of the distribution.

(iv) The type and fair market value of each property distributed to residents of Canada.

(v) The name and address of each resident of Canada that received property with respect to the distribution.

(vi) Where the distribution is not prescribed, that the distribution is not taxable under U.S. law to shareholders resident in the United States.

(vii) Where the distribution is prescribed, that the distribution is not taxable under the law of the particular foreign country to shareholders resident in that country.

(viii) Such other matters as may be required, in prescribed form.

(f) The taxpayer must elect in writing in the taxpayer's income tax return for the year in which the distribution occurred to have section 86.1 apply to the distribution. Pursuant to subsection 220(3.2) of the Act and paragraph 600(c) of the Regulations, the CRA has the discretion to accept a late-filed election or the revocation of an election previously filed. The taxpayer must also provide the following information to the CRA:

(i) The number, cost amount and fair market value, immediately before the distribution, of the common shares owned by the taxpayer in the distributing corporation.

(ii) The number and fair market value, immediately after the distribution, of the common shares owned by the taxpayer in the distributing corporation and of the spin-off shares received by the taxpayer.

(iii) Such other information as may be required in prescribed form.

2. Cost Amount of Shares—Subsection 86.1(3)

- Subsection 86.1(3) sets the cost to the taxpayer of the common shares of the distributing corporation and of the spin-off shares received on the distribution:

(a) The taxpayer must reduce the taxpayer's cost of the common shares of the distributing corporation by

$$A \times \frac{B}{C}$$

Where:

A = the cost amount, immediately before the distribution, of the common shares of the distributing corporation;

B = the fair market value, immediately after the distribution, of the spin-off shares received on the distribution; and

C = the total of the fair market value, immediately after the distribution, of the common shares of the distributing corporation and of the spin-off shares received on the distribution.

(b) The cost to the taxpayer of the spin-off shares received on the distribution is equal to the amount that is deducted from the cost to the taxpayer of the shares of the distributing corporation as described in (a).

3. Reassessments—Subsection 86.1(5)

- Subsection 86.1(5) allows the CRA to make whatever reassessments, determinations or redeterminations as are necessary beyond the normal reassessment period where information is subsequently obtained to the effect that under the law of the particular foreign country, the distribution was not a tax-free event to shareholders resident in that country.

- The non-application of section 86.1 has been at issue in a series of recent informal procedure decision, which dealt with the spin-off of the electronics and healthcare businesses of Tyco International Ltd. ("Tyco"), a publicly traded and widely-held Bermuda corporation. In the course of this reorganization, Tyco transferred the assets and undertakings of these businesses to new Bermuda corporations ("Electronics" and "Covidien"), and then distributed the shares of Electronics and Covidien to its shareholders.

- It was admitted in all of the relevant appeals that the information required by paragraph 86.1(2)(e) was never provided to the Minister by Tyco, which was crucial to the non-application of subsection 86.1(2) since Bermuda and Canada do not have a tax treaty.

- The results in the cases varied significantly, as did the rationale for the decisions:

  - In *Hamley v. Canada*,[25] Hershfield J. found as a fact that Tyco was the recipient of the shares in the shares of Electronics and Covidien for the purposes of subsection 86.1(2), with the result that the distribution was a dividend in kind included in income under paragraph 12(1)(k) and section 90.

  - In *Capancini v. R.*,[26] Bowie J. held that the word "dividend" referred to a *pro rata* distribution of profits to the shareholders. Since the shares of Electronics and Covidien distributed to the shareholders were not a portion of earnings or profits of Tyco, there was no dividend received by the taxpayer.

  - In *Yang v. R.*,[27] Sheridan J. made the same findings of fact as in *Hamley*, and dismissed the appeal. Sheridan J. held that the distinction between *Hamley* and *Capancini* was the finding of fact made by Bowie J. that the shares of Electronics and Covidien were never owned by Tyco, but were created in the course of the reorganization and distributed to the shareholders. Based on the documents presented to the shareholders by Tyco, Sheridan J. found as a fact that Tyco did in fact own the shares, and that the *Hamley* analysis should apply.

- Similar issues arose in two similar cases (not involving Tyco), which again yielded conflicting results:

  - In *Morasse v. R.*,[28] the appellant was a shareholder of a Mexican corporation ("Telmex") which spun off a newly created subsidiary ("Movil"). In the course of

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[25] *Hamley v. Canada*, 2010 TCC 459

[26] *Capancini v. R.*, 2010 D.T.C. 1394 (T.C.C.)

[27] *Yang v. R.*, 2011 TCC 187

[28] *Morasse v. R.*, 2004 D.T.C. 2435 (T.C.C.)

the spin-off, which used a process unique to Mexican law, Telmex was essentially split in two, and Movil issued shares directly to the appellant. C.J. Miller T.C.J. held that the amount was not a dividend, on the basis that a corporation with no issued shares could not have paid a dividend on the initial issuance of shares. What had happened amounted to a stock split, and did not result in any Canadian tax consequences.

- In contrast, in *Allen v. R.*,[29] C.J. Miller J. held that the shares received on a spin-off were a dividend, as no evidence was presented as to the spin-off transactions that would have allowed him to conclude otherwise. Since the transactions most likely involved a dividend in kind, the Minister's characterization of the receipt as a dividend was the appropriate result. Unfortunately for the taxpayer, as all of the corporations were United States residents, the dividend in kind would have met the requirements of subsection 86.1(2) had the dividend payer simply filed the required information with the Minister.

- Given the significant number of Canadian taxpayers who hold shares of Tyco, appellate guidance may be necessary to reconcile the conflicting Tax Court jurisprudence.

[29] *Allen v. R.*, 2006 D.T.C. 48 (T.C.C.)