TAX LAW FOR LAWYERS

SHARE EXCHANGES

Section 51

- Section 51 provides a tax-free rollover for certain conversions of debt issued by a corporation into shares of that corporation and conversions of shares of a corporation into other shares of that same corporation.

- Section 51 does not apply to a conversion if section 85 or 86 applies: 51(4).

Basic Rules – Paragraphs 51(1)(a) and (b)

> The investor must give up shares or debt of the issuer corporation in exchange for shares of the issuer.

> The shares or debt surrendered must be capital property.

> 39(4) election.

- *R v. Vancouver Art Metal Works Limited* 93 DTC 5116 (FCA): meaning of “trader or dealer in securities”.
- “share” is defined in ITA 248 (1) to include a fraction of a share.
- IT – 115R2: shareholder may receive up to $200 of cash or other non-share consideration.

Subsection 51(1)

- No disposition; therefore no gain or loss: 51(1)(c).
- If gain or loss is desired, use 85(1).
- ACB of convertible security becomes cost of new shares: 51(1)(d).

- *D’Auteuil Lumber Company Limited v. MNR* 70 DTC 6096 (Ex. Ct.).
- It is permissible to add a conversion right to the terms of a debt, so that on conversion of the debt into shares section 51 will apply. Para. 5 of IT-448
- “taxable Canadian property” status flows through: 51(1)(f).
- The CRA states in Doc. # 9631575 and # 2001-0070415 that a section 116 certificate is needed where a non-resident shareholder’s TCP shares are converted under section 51, but see paragraph 116(3)(a).

Subsection 51(2)

> If conversion confers a benefit on a related person, the security holder is deemed to have disposed of the convertible property for proceeds equal to the lesser of:

- (i) the ACB of the convertible property plus the amount of the benefit; and
- (ii) the FMV of the convertible property.

Subsection 51(3)

> On a share conversion, any increase in the PUC of the new shares over the old shares will be deducted in determining the new shares' PUC.

Debt Forgiveness

- On a debt-to-share conversion, if new shares have a value less than the principal of the debt the debt forgiveness rules in section 80 will apply to the issuer: 80(2)(g).

Convertible Debt

- It is not always clear if interest payable on debt convertible into a fixed number of shares is deductible.
- Convertible debt will not qualify for the 212(1)(b)(vii) W/T exemption in some circumstances – although no longer important except NAL interest or participating debt

Section 86

- Like section 51, section 86 provides a tax-free rollover when a shareholder disposes of shares of a corporation in exchange for shares of that same corporation.

- If the conditions for the application of section 86 are satisfied, section 86 will apply rather than section 51: 51(4).

Differences Between 51 and 86

- 86 does not apply to conversions of debt into shares.
- 86 applies only if the exchange occurs “in the course of a reorganization of the capital” of the issuer corporation.

- The shareholder must dispose of all of the shares of the class of the exchanged shares owned by the shareholder.
- The shareholder may receive boot in addition to new shares.

Similarities to Section 51

- Both sections apply only to dispositions of shares that are capital property.
- Both sections apply automatically. No election is required to be filed.

Typical Uses For Section 86

> Freezing value of shares.

> Restructuring capital of private and public corporations.

> Share exchange spin-outs.

Other Requirements for 86(1)

> There must be a disposition of the old shares. This can be achieved by cancelling them.

> There must be a reorganization of the issuer's capital.

Consequences of 86(1)

- If boot received, its cost to the shareholder is FMV: 86(1)(a).
- Cost to the shareholder of new shares equals ACB of old shares minus FMV of any boot received: 86(1)(b).
- Old shares are deemed to be disposed of for proceeds equal to the cost of the new shares and FMV of boot received: 86(1)(c).
- Cannot create a loss
- Not necessary for issuer to be a Cdn. Corp.

Subsection 86(2)

> If exchange confers a benefit on a related person the shareholder is deemed to have disposed of the old shares for proceeds equal to the lesser of:

- (i) the FMV of any boot received plus the amount of the benefit; and
- (ii) the FMV of the old shares.

> Cost of the new shares is reduced by the amount of the benefit.

Subsection 86(2.1)

- The PUC of the new shares is limited to the amount by which the PUC of the old shares exceeds the FMV of any boot.
- If boot received by the shareholder exceeds the PUC of the old shares, there will be a deemed dividend to the shareholder under 84(3).

Section 85 Advantages

> Section 85 may be used in lieu of Section 86:

- A loss can be created (subject to stop-loss rules).
- The old shares need not be capital property.
- The elected amount can be chosen to produce a gain.

Section 85 Disadvantages

- Deemed dividend may be produced by 85(2.1).
- Necessary to file election(s).

SECTION 85.1

- 85.1(1) and (2): exchanges of shares of taxable Canadian corporations.
- 85.1(3) and (4): exchanges of shares of foreign affiliates.
- 85.1(5) and (6): exchanges of shares of non-resident corporations (other than foreign affiliates).

Requirements for Application of 85.1(1)

- Shares must be issued by Purchaser corporation to Vendor in exchange for shares of the target corporation .
- Purchaser must be a Canadian corporation and Target must be a taxable Canadian corporation.
- Shares of Target must be capital property to Vendor.

85.1(2): More Requirements

- Vendor and Purchaser must be at arm's length before exchange (otherwise than because of a 251(5)(b) right).
- After the exchange Vendor cannot control Purchaser.
- Vendor and Purchaser must not elect that 85(1) applies.
- Only consideration received by Vendor is shares of Purchaser.

Consequence of Application of 85.1(1)

> Vendor is deemed to have disposed of Target shares at their ACB (unless gain or loss reported): 85.1(1)(a)(i).

> Vendor is deemed to have acquired Purchaser shares at a cost equal to ACB of Target shares (unless gain or loss reported): 85.1(1)(a)(ii).

> If Target shares were TCP to Vendor, then Purchaser shares will be TCP to Vendor: 85.1(1)(a).

- Cost to Purchaser of Target shares is deemed to be lesser of their PUC and FMV.
- PUC of shares issued by Purchaser corporation will be reduced to equal the PUC of the Target shares: 85.1(2.1).
- It is possible for Vendor to receive a combination of share and non-share consideration by allocating consideration of different types to particular Target shares.

ALTERNATIVES TO 85.1

- 85(1) election.
- “Tainted” exchanges.
- Give Vendor choice of 85.1(1) or 85(1).

85.1(3) and (4)

- 85.1(3) provides a rollover for the disposition by a resident of Canada of foreign affiliate (“FA1”) shares to another foreign affiliate (“FA2”).
- FA1 shares must be capital property to Vendor.
- Consideration received by Vendor must include shares of FA2.

Consequence of 85.1(3)

> Cost to Vendor of FA2 shares is ACB of FA1 shares minus FMV of any boot received.

> Cost to Vendor of any boot received is its FMV.

> Vendor’s proceeds of FA1 shares equal cost of FA2 shares to Vendor plus FMV of boot .

> FA2’s cost of FA1 shares equals Vendor’s proceeds.

Subsection 85.1(4)

- This subsection is an avoidance rule which provides that the rollover under 85.1(3) does not apply if all or substantially all of the property of the foreign affiliate whose shares are transferred is “excluded property” and the transfer is part of a series of transactions the purpose of which is to dispose of the shares to an arm’s length party.
- Excluded Property – generally property used to earn active business income and shares of a foreign affiliate the FMV of which is attributable to property used to earn active business income.
- FAPI not include capital gain from disposition of excluded property.

Subsections 85.1(5) and (6)

- These subsections provide a rollover where a taxpayer disposes of shares of a non-resident corporation for shares of another non-resident corporation.
- 85.1(3) takes precedence over 85.1(5) when both provisions would otherwise apply. Thus 85.1(5) and (6) do not apply to dispositions of the shares of a foreign affiliate to another foreign affiliate.

SECTION 86.1 FOREIGN SPIN-OFFS

- Section 86.1 applies when a publicly-traded foreign corporation distributes shares of a corporation that it owns to its shareholders.
- Must be widely held public co. that is actively traded on a prescribed foreign stock exchange.
- It the requirements of the section 86.1 are met such shares (“spin-off shares”) will be received free of Canadian tax: 86.1(1)(a).
- The cost to the shareholder of the foreign parent shares (the “original shares”) will be allocated between the original shares and the spin-off shares based on FMV: 86.1(3).

ELIGIBLE DISTRIBUTION: 86.1(2)

- There must be a distribution on all of the taxpayer's common shares of the distributing corporation (i.e., the original shares): 86.1(2)(a).
- The distribution must consist only of common shares of another corporation owned by the distributing corporation (i.e., the spin-off shares): 86.1(2)(b).
- S/H cannot receive cash or "boot" of any kind.

- In the case of a U.S. spin-off, both corporations must be resident in the U.S. and never have been resident in Canada. The original shares must be widely –held and actively traded on a prescribed U.S. exchange. Distribution must be non-taxable in the U.S.: 86.1(2)(c).
- For non–U.S. foreign spin-offs, similar requirements apply. Also the distribution must be prescribed in the Regulations: 86.1(2)(d).

  ie. Except for qualifying U.S. spinoffs, the transaction has to be prescribed by the Department of Finance.

Section 86.1(2)(e) &(f)

- 86.1(2)(e) provides that the foreign distributing corporation must file stipulated information with the CRA within six months after the end of the year in which the spin-off takes place.
- 86.1(2)(f) provides that the Canadian shareholder also must file certain information and an election to have Section 86.1 apply.