READING 2-1

Objectives of using section 85

LEVEL 1

The provisions of section 85 are used principally to transfer property from the business carried on by an individual or a partnership to a corporation, or from a corporation to another corporation. In most cases, the goal is to transfer property without realizing an accrued gain or recapture of capital cost allowance (CCA) at the time of transfer. This entails deferral but not avoidance of tax on the gain and/or recapture of CCA.

A **rollover** always refers to a transfer with no immediate tax consequences or with reduced tax consequences.

Generally, property is transferred at fair market value (FMV) between unrelated persons, since this is a business transaction from which both parties want to gain. Section 69 requires property to be transferred at FMV between persons not dealing at arm's length. Section 85 does not permit a sale of assets by a person to the corporation of which he is a shareholder at a value other than FMV. For tax purposes, however, it deems POD different from FMV for purposes of computing the capital gain or loss or the recapture of CCA.

A transaction which often requires the use of the section 85 provisions is the incorporation of a sole proprietorship. Here, you will study the limits regarding this type of transfer. The deemed POD or agreed amount are not arbitrary values, and the non-share consideration (NSC) cannot exceed the deemed POD or agreed amount without there being immediate tax consequences.

There are a number of occasions when section 85 may be used, including

- the deferral of tax on the disposition of property to a corporation
- the incorporation of a business by an individual in order to take advantage of tax benefits associated with the use of a corporation
- the implementation of an estate freeze
- the transfer of assets between affiliated corporations
- the possibility for the sole proprietor of a business to take advantage of the capital gains deduction (CGD) of $375,000 ($250,000 if the disposition took place before March 19, 2007) on the sale of a business
- the possibility of crystallizing a capital gain on shares qualifying as small business corporation shares
- the possibility of transferring property to a corporation in order to produce income against which the purchaser's non-capital losses may be used

There are disadvantages in using section 85, which include the possibility of double taxation on the sale of the shares received in consideration for the transfer and on the sale of the assets acquired by the corporation.

READING 2-2

Conditions

LEVEL 1

Eligible persons

Under subsection 85(1), the transferor must be a taxpayer, as defined in subsection 248(1). The taxpayer may be an individual, a trust, or a corporation, even if this person is not required to pay tax. An exempt corporation, for example, is a "transferor" taxpayer which may use the provisions of section 85. Under subsection 85(2), the transferor may also be a partnership. Whether or not the transferor is resident in Canada is not a condition of this subsection.

However, the transferee (or purchaser) must be a corporation that is both Canadian and taxable. These two definitions are contained in subsection 89(1). An exempt corporation, such as a Crown corporation, which is exempt under paragraph 149(1)(d), is therefore not eligible as a purchaser under the provisions of section 85.

This exception for exempt corporations is intended to prevent assets on which there is an unrealized gain from being transferred to an exempt corporation and then disposed of without any tax being payable.

Assets eligible for transfer

Under subsection 85(1), the taxpayer must have disposed of an eligible property to a taxable Canadian corporation in a taxation year in order for the rollover provisions to apply.

Subsection 85(1.1) contains a list of eligible property. Any property not included in this list may not be rolled over under section 85. This list includes:

- a capital property, as defined in subsection 248(1) and section 54, other than real property (land or buildings), or an interest in real property or an option in respect thereof, owned by a non-resident person. Capital property includes the shares of a taxable Canadian corporation, and the shares of such a corporation may be transferred to the corporation itself. This type of transaction is generally referred to as an "internal rollover" and is often used in the crystallization of a capital gain or in an estate freeze.
- a capital property that is a real property, or an interest therein or an option in respect thereof, owned by a non-resident insurer where such property and the property received as consideration for such property are designated insurance property
- a Canadian resource property, unless it is excluded
- a foreign resource property
- an eligible capital property (ECP) such as goodwill
- an inventory, other than **real** property. Inventory which is an interest in real property or an option with respect thereto is also excluded.
- a property, other than capital property or an inventory, that is a security or debt obligation used or held in the year in the course of carrying on the business of insurance or lending money
- a capital property that is a real property, or an interest therein or an option in respect thereof, owned by a non-resident other than a non-resident insurer and used in a business actively carried on in Canada, if certain conditions are met

Some types of property, generally included among the assets of a business, are ineligible for a rollover. These include **cash**, accounts receivable (if an election was made under section 22), prepaid expenses, real property owned by a non-resident (except as described above), and real property held as inventory. The latter exception is especially intended for real estate speculators who would be tempted to convert business income into a capital gain on the dispositions of shares that they received as consideration in a rollover.

With respect to accounts receivable, the taxpayer must therefore decide whether to use the election under section 22 or section 85.

Tax consequences of a section 22 election:

- The transferor must add to his income in the year of transfer, the amount of the reserve for doubtful accounts claimed in the preceding year. Any loss resulting from the disposition of the accounts receivable is deductible in computing income in the year of transfer.
- The purchaser must add to his income in the year of transfer an amount equal to the deduction claimed by the transferor. The accounts receivable are deemed to have been included in the purchaser's income and the purchaser may claim a reserve for doubtful accounts or a deduction for bad debts with respect to them.

Tax consequences of a section 85 election:

- In the year of transfer, the transferor must add to his income the amount of the provision for doubtful accounts that he claimed in the preceding year. With certain exceptions, any loss resulting from the disposition is a capital loss for the year of transfer. This loss can be denied if subsection 40(3.3) or subparagraph 40(2)(g)(ii) applies.
- For the purchaser, any gain or loss realized on the accounts receivable is a capital gain or loss. Because in this case the accounts receivable are not deemed to have been included in income, the purchaser may not, as is the case with section 22, claim a reserve for doubtful accounts or deduction for bad debts with respect to the accounts receivable.

In light of these consequences, it is usually more advantageous to make the election under section 22.

Consideration received

The consideration received by the transferor will usually equal the FMV of the property transferred. As you will see below, paragraph 85(1)(e.2) sets out rules to prevent transactions where the consideration is less than the FMV of the property transferred from conferring a benefit on another related shareholder. A necessary condition that cannot be avoided, however, is that subsection 85(1) requires that the consideration include treasury shares of the corporation to whom the property is transferred.

Shares issued as consideration may be from any class, that is, they may be common or preferred shares. *At least one share must be issued for each asset transferred* because, as you will see below, the rollover rules apply asset by asset. However, paragraph 8 of IC 76-19R3 states that it is sufficient that one share of the capital stock of the corporation be received by the transferor for the provisions of section 85 to apply, even if more than one property is transferred under the same rollover. From a practical standpoint, at least one share per group of assets transferred is often issued. In addition, subsection 248(1) defines "share" as a share or fraction thereof of the capital stock of a corporation. *If a single share is issued for several assets transferred, it would be prudent to indicate in the sale agreement that the consideration (one share) is the total for all property transferred.*

Agreed amount

Under paragraph 85(1)(a), the amount that the transferor and the corporation have agreed upon in their election is deemed to be the transferor's POD of the property disposed of and the corporation's cost of the property acquired, as shown in Example 2-1.

EXAMPLE 2-1

Pascal Roy, sole shareholder of Citrus Computers Ltd., transfers a non-depreciable capital property to Citrus Computers Ltd. under section 85 and receives only shares in return.

ACB of the property transferred	$ 100
FMV of the property transferred	$ 150
FMV of the shares received	$ 150
Agreed amount	$ 100

Under paragraph 85(1)(a):	
POD for Pascal (agreed amount)	$ 100
Cost for tax purposes (ACB) for Citrus Computers Ltd. (agreed amount)	$ 100
Capital gain deferred ($150 – $100)	$ 50

The capital gain is deferred until disposition of the property received by Citrus Computers Ltd.

When determining the agreed amount, the tax status of the transferor must also be taken into account. A transferor who has, say, a capital loss carryforward balance might find it advantageous to realize a capital gain on a rollover. He would then choose an agreed amount enabling him to realize a capital gain that would be eliminated by the full or partial use of the capital loss carryforward balance. It might even be unnecessary to use the provisions of section 85 if the capital loss balance is sufficient to eliminate all of the capital gain.

An agreed amount, within certain limits, must now be determined. There is a lower [paragraph 85(1)(b)] and an upper limit [paragraph 85(1)(c)] that must be respected and within which the amount agreed upon by the parties must fall. Furthermore, the rules for determining the agreed amount fall into two categories: rules applicable to all property regardless of its nature, and rules applicable to specific types of property.

Lower limit

Paragraph 85(1)(b) states that the agreed amount may not be less than the FMV of the non-share consideration (NSC) received by the transferor as consideration for the assets transferred. However, it may be equal to the non-share consideration.

EXAMPLE 2-2

Use the information in Example 2-1 with the following changes:

Consideration received:	
Cash	$ 110
Shares having a FMV of	$ 40
Agreed amount elected in order to avoid a capital gain	$ 100

In this case, the agreed amount of $100 is not acceptable; it cannot be less than $110 (FMV of the non-share consideration or cash).

POD for Pascal [85(1)(b)]	$110
ACB	(100)
Capital gain	$ 10

Cost for tax purposes (ACB) for Citrus Computers Ltd. [85(1)(a)]	$110
Deferred capital gain ($150 – $110)	$ 40

Pascal could have received cash and deferred the entire capital gain ($50) without immediate tax consequences if he had better planned the consideration he received. Because the agreed amount cannot be less than the non-share consideration, Pascal could have received up to $100 in cash (the ACB of the transferred property) without incurring any tax consequences.

EXAMPLE 2-3

Consideration received:	
Cash	$ 100
Shares having a FMV of	$ 50
Agreed amount	$ 100

The agreed amount is acceptable since it is equal to the NSC and is therefore not less than the FMV of the non-share consideration of $100.

Therefore, Pascal does not have a capital gain.

The cost of the property for tax purposes (ACB) for Citrus Computers Ltd. is $100.

In effect, the gain may be deferred, provided it is received in the form of shares issued by the purchaser.

Upper limit

Paragraph 85(1)(c) specifies the upper limit of the agreed amount. It states that the agreed amount may not be greater than the FMV of the property transferred. This rule applies even if the cost amount of the property transferred is greater than its FMV. A taxpayer cannot artificially create a capital gain by transferring property to a corporation. In addition, paragraph 85(1)(c) takes precedence over paragraph 85(1)(b) so that the agreed amount will never be greater than the FMV of the transferred property. The following two examples show how paragraph 85(1)(c) applies.

EXAMPLE 2-4

Using the data from Example 2-1, assume that Pascal receives $160 plus one common share without par value as consideration for the property transferred. Under paragraph 85(1)(c), the agreed amount may not be greater than the FMV of the property transferred of $150. The excess of the amount received over the FMV of the property transferred will be taxed under subsection 15(1) as a taxable benefit conferred on a shareholder (IC 76-19R3, paragraph 25).

Agreed amount [85(1)(c)]	$ 150
For Pascal:	
Agreed amount or POD [85(1)(a)]	$ 150
ACB	(100)
Capital gain	$ 50
Benefit conferred on a shareholder [15(1)]	$ 10
For Citrus Computers Ltd.:	
Cost of the property for tax purposes (ACB) [85(1)(a)]	$ 150

The corporation's cost of the property may not exceed the FMV of the property transferred. This is to prevent the corporation from realizing a loss on the subsequent disposition of property acquired in a rollover. In addition, remember that the purpose of section 85 is to defer a real accrued gain and not to artificially create a gain for the transferor. This may be the goal where the transferor has loss carryforwards and the transferee is earning income.

Paragraph 85(1)(c) takes precedence over paragraph 85(1)(b) if the FMV of the non-share consideration is greater than the FMV of the property transferred, as shown in Example 2-5.

EXAMPLE 2-5

Cost amount of property transferred	$ 100
FMV of property transferred	$ 50
Cash received in consideration, in addition to one share	$ 100
Agreed amount	$ 70

Under paragraph 85(1)(b), the agreed amount, since it cannot be less than the non-share consideration, should be $100. The corporation would then have an acquisition cost of $100, and the transferor would have no gain or loss.

However, under paragraph 85(1)(c), the agreed amount cannot be greater than the FMV of the property transferred. The agreed amount must therefore be equal to $50, and the $50 excess of the amount received over the FMV of the property transferred is taxed under subsection 15(1) as a benefit conferred on a shareholder.

Specific limits

There are also specific limits depending on the type of property transferred.

Under paragraph 85(1)(c.1), where the property is

- inventory,
- capital property (other than depreciable property of a prescribed class),

or

- property that is a security or debt obligation used or held in the course of carrying on the business of insurance or lending money,

the agreed amount cannot be less than the lesser of

(i) the FMV of property transferred, at the time of disposition
(ii) the cost amount of the property transferred at the time of disposition

EXAMPLE 2-6

Cost amount (ACB) of the capital property	$ 5,000
FMV of the capital property	$ 10,000
Amount agreed to by the parties	$ 3,000

The agreed amount cannot be less than the lesser of the following amounts:

(i)	FMV of the property transferred	$ 10,000
(ii)	cost amount of the property transferred	$ 5,000

Amount deemed to be the agreed amount [85(1)(c.1)]	$ 5,000

No gain or loss on disposition of the capital property.

If this limit did not exist, the transferor would be able to incur an artificial loss on the transfer of the property.

Under paragraph 85(1)(d), where the property transferred is an ECP in respect of the business of the taxpayer, the agreed amount cannot be less than the least of

(i) 4/3 of the taxpayer's cumulative eligible capital (CEC) in respect of the business immediately before the disposition
(ii) the cost of the ECP
(iii) the FMV of the ECP at the time of disposition

EXAMPLE 2-7

Cost of the ECP	$ 100
CEC	$ 25
FMV of the ECP	$ 70
Agreed amount	$ 30

The agreed amount cannot be less than the least of the following amounts:

(i)	4/3 of CEC: 4/3 × $25	$ 33
(ii)	cost of the ECP	$ 100
(iii)	FMV of the ECP	$ 70

Amount deemed to be agreed [85(1)(d)]	$ 33
POD (3/4 × $33) [14(1)]	$ 25
CEC	(25)
Income	$ —

Under paragraph 85(1)(e), where the property transferred is depreciable property, the agreed amount cannot be less than the least of

(i) the undepreciated capital cost (UCC) of all property *of that class* immediately before the disposition
(ii) the capital cost (CC) of the property transferred
(iii) the FMV of the property transferred, at the time of disposition

Example 2-8 illustrates how paragraph 85(1)(e) applies.

EXAMPLE 2-8

CC of the property transferred	$ 100
UCC of the class	$ 40
FMV of the property transferred	$ 70
Agreed amount	$ 35
Terminal loss (possible if the agreed amount is $35)	$ 5

The agreed amount cannot be less than the least of the following amounts:

(i)	UCC of the class	$ 40
(ii)	CC of the property transferred	$ 100
(iii)	FMV of the property transferred	$ 70

Amount deemed to be agreed under 85(1)(e)	$ 40

Therefore, a terminal loss is not realized.

These limits prevent a terminal loss from being created artificially. However, if there is an actual terminal loss, because the FMV of the property is less than the UCC of the class and there is no other property in the class, it will be deductible provided the provisions of subsection 13(21.2) do not apply. These provisions will be analyzed below.

Under subsection 85(5), upon the transfer of a depreciable property, if the agreed amount is less than the CC of the transferor, the transferee is deemed to have the same CC that the transferor had. The difference between that CC and the agreed amount is deemed to have been CCA taken in prior years by the transferee. In this way, the corporation is subject to recapture of any CCA that was deferred by the transferor on the rollover when the depreciable property is subsequently disposed of.

The application of subsection 85(5) is illustrated in Example 2-9.

EXAMPLE 2-9

Class 1 building

1. Transferor:

CC	$ 100,000
FMV	$ 200,000
UCC	$ 40,000
Agreed amount	$ 40,000

The building is transferred at $40,000 to defer income taxes. The recapture of CCA that would be $60,000 is deferred. The capital gain of $100,000 is also deferred.

2. Transferee (corporation):

Deemed CC	$ 100,000
CCA deemed to have been claimed	(60,000)
UCC	$ 40,000

If the corporation subsequently sold the building for $200,000, the tax consequences would be as follows:

POD		$ 200,000
CC		(100,000)
Capital gain		$ 100,000
Taxable capital gain (1/2)		$ 50,000
UCC		$ 40,000
Less the lesser of:		
• CC	$ 100,000	
• POD	$ 200,000	(100,000)
Recapture of CCA		$ (60,000)

Order of priority of the limits

Paragraph 85(1)(e.3) specifies general limits to the agreed amount which override the specific limits previously listed.

Thus, for the agreed amount

- the upper limit is the FMV of the property transferred
- the lower limit is the greater of:
  - the FMV of the non-share consideration received [limit under paragraph 85(1)(b)]
  - the amount deemed to be agreed under paragraphs 85(1)(c.1), (d), or (e)

EXAMPLE 2-10

A building is transferred by one corporation to another corporation. The land continues to be owned by the transferor.

CC	$ 100,000
UCC of the class	$ 50,000
FMV of the building	$ 80,000
FMV of the non-share consideration	$ 60,000
Agreed amount	$ 40,000

Under paragraph 85(1)(e), the agreed amount would be equal to the UCC of $50,000. However, under the limits contained in paragraph 85(1)(b), which take precedence, the agreed amount would be equal to $60,000, being the FMV of the non-share consideration received by the transferor. This would give rise to a recapture of CCA amounting to $10,000 ($60,000 – $50,000). Thus if all immediate tax consequences are to be avoided, the FMV of the non-share consideration should not exceed $50,000.

Paragraph 85(1)(e.1) states that where two or more properties described in paragraphs (d) or (e) are disposed of at the same time, the taxpayer must designate the order of transfer of the properties. Since the rules apply on an asset-by-asset basis, the designation will avoid recapture of CCA where non-share consideration is received on the transfer. If the taxpayer has not designated the order, it will be designated by the Minister of Revenue.

Example 2-11 shows the importance of designating an order of transfer.

EXAMPLE 2-11

	Property 1	**Property 2**
	(same class)	
CC	$ 5,000	$ 6,000
FMV	$ 7,000	$ 5,500
Mortgage payable assumed by the transferor (non-share consideration)	$ 4,000	$ 1,000
UCC of the class	$ 8,500	

Tax consequences

To avoid recapture of CCA, the total agreed amount for both properties must not be higher than the UCC of $8,500.

1. Designation by the taxpayer:

	Property 1
CC	$ 5,000
FMV	$ 7,000
UCC of the class	$ 8,500
Mortgage	$ 4,000
Agreed amount	$ 5,000
Recapture of CCA	$ —

	Property 2
CC	$ 6,000
FMV	$ 5,500
UCC ($8,500 – $5,000)	$ 3,500
Mortgage	$ 1,000
Agreed amount	$ 3,500
Recapture of CCA	$ —

2. If the taxpayer does not designate the order, the Minister could designate the following order, an order which would not be advantageous for the transferor:

	Property 2
CC	$ 6,000
FMV	$ 5,500
UCC of the class	$ 8,500
Mortgage	$ 1,000
Agreed amount	$ 5,500
Recapture of CCA	$ —

	Property 1
CC	$ 5,000
FMV	$ 7,000
UCC ($8,500 – $5,500)	$ 3,000
Mortgage	$ 4,000
Agreed amount	$ 4,000
Recapture of CCA ($3,000 – $4,000)	$ 1,000

The order of disposition of property does not have to be indicated when filing the election forms, especially when several depreciable properties are being transferred. However, it should be available if the Minister so requests (see IC 76-19R3, paragraph 3).

LEVEL 2

Benefits conferred on other shareholders

Under section 85, when property is transferred, taxation may be deferred on the accumulated increase in value that is transferred to the shares received as consideration. If the FMV of the shares received were insufficient given the FMV of the property transferred, another related shareholder would benefit.

The anti-avoidance rule provided for in paragraph 85(1)(e.2) prevents a taxpayer (shareholder) from carrying out a transaction with a corporation for the purpose of transferring the accrued value of a property to another related shareholder. In this way, the ITA prevents an indirect benefit from being conferred on other shareholders.

Where the FMV of the property transferred exceeds the greater of

(i) the consideration received (including shares)

and

(ii) the agreed amount

and it is reasonable to regard any portion of such excess as a benefit conferred on a related person, the amount of the **benefit conferred on others** must be added to the agreed amount. However, if the related person is a corporation wholly owned by the transferor immediately after the disposition, paragraph 85(1)(e.2) does not apply, since he is the sole shareholder.

A wholly-owned corporation, as defined in subsection 85(1.3), is a corporation in which all the outstanding shares (except directors' qualifying shares) belong to

(a) the taxpayer (transferor)
(b) a corporation wholly owned by the taxpayer
or
(c) any combination of persons described in (a) or (b)

Where paragraph 85(1)(e.2) applies, the agreed amount is deemed to be adjusted with the effect that the POD for the transferor and the acquisition cost for the corporation are increased by the value of the benefit conferred. However, this deemed increase does not affect the ACB of the consideration received on the transfer. The transferor is thus penalized, since double taxation could result on the disposition of the property received as consideration. Computation of the benefit is not covered by the ITA, but it could be done as illustrated in Example 2-12.

EXAMPLE 2-12

The holders of the common shares of Zilco Ltd. are:

Danny Charles:	10%	10 shares
Cindy Chouinard (Danny's wife):	50%	50 shares
Children of Cindy and Danny:	40%	40 shares

Each common share is worth $1,000 immediately prior to the transfer below.

Danny transfers a non-depreciable capital property to Zilco Ltd.:

ACB	$ 10,000
FMV of the property transferred	$ 60,000
Agreed amount	$ 10,000

As consideration, Danny receives 10 common shares, thereby increasing the number of outstanding shares to 110.

Tax consequences

1. For Danny:

FMV of the property transferred		$ 60,000
Less: the greater of:		
• FMV of shares received (10 × $1,455*)	$ 14,550	
• agreed amount	$ 10,000	(14,550)
Excess		$ 45,450

* FMV of 100 common shares prior to transfer (100 × $1,000)	$100,000
Plus: FMV of property transferred	60,000
FMV of 110 common shares after the transfer	$160,000
FMV of 1 common share after the transfer ($160,000 ÷ 110 shares)	$ 1,455

Benefit conferred

FMV of 90 shares after the transfer (90 × $1,455)	$130,950
Less: FMV of 90 shares before the transfer (90 × $1,000)	(90,000)
Benefit conferred on related persons	$ 40,950

Amount deemed to be agreed or POD ($10,000 + $40,950)	$ 50,950
ACB	(10,000)
Capital gain	$ 40,950
Taxable capital gain (1/2)	$ 20,475
Cost of the shares received by Danny	$ 10,000

This cost must be averaged with 10 shares previously owned because they are identical properties. However, according to paragraph 85(1)(e.2), the amount of the benefit conferred on related persons, namely $40,950, is not added to the ACB of the shares received by Danny in spite of the effect on the agreed amount.

2. For Zilco Ltd.:

Cost of the property	$ 50,950

Note that the amount of the benefit conferred on related persons does not correspond to the $45,450 excess. This is because Danny partially benefits from the transaction, since the value of the 10 shares that he held before the transaction has also increased to $1,455 each.

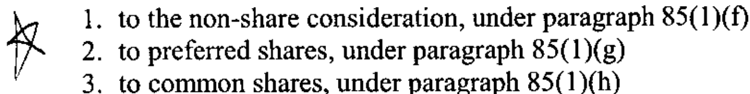
To avoid paragraph 85(1)(e.2) application, ensure that the FMV of the consideration received by the transferor equals the FMV of the property transferred.

LEVEL 1

ACB of the consideration received by the transferor

After determining the amounts at which property may be transferred to a corporation, the cost for the transferor of the property received in payment for the transfer must be determined. Under paragraphs 85(1)(f), (g), and (h), the agreed amount for the property transferred is allocated among the properties received in exchange by the transferor.

The agreed amount must be allocated in the following order:



1. to the non-share consideration, under paragraph 85(1)(f)
2. to preferred shares, under paragraph 85(1)(g)
3. to common shares, under paragraph 85(1)(h)

For non-share consideration, if any, the portion of the agreed amount that is allocated to the transferor is equal to the lesser of

- the FMV of the property received by the transferor
- the FMV of the property transferred to the corporation

For preferred share consideration, if any, the allocated amount is equal to the lesser of

- the FMV of the preferred shares after the disposition
- the excess of the agreed amount over the FMV of the non-share consideration received by the transferor

With respect to common share consideration, if any, the allocated amount is equal to the excess of the agreed amount over the FMV of the non-share consideration and the amount allocated to the preferred shares.

If more than one class of preferred shares is issued as consideration, the cost must be allocated among the classes of preferred shares according to their FMV. This principle also applies if more than one class of common shares is issued as consideration.

EXAMPLE 2-13

A non-depreciable capital property is transferred by an individual to a corporation under section 85.

ACB of the property transferred	$ 10,000	
FMV of the property transferred	$ 20,000	
Agreed amount	$ 10,000	

Consideration received:

Note issued by the corporation	$ 8,000	
Preferred shares — FMV	$ 10,000	
Common shares — FMV	$ 2,000	

ACB of property received by the individual:

1. Note [85(1)(f)]		
The lesser of:		
• the FMV of the property received (note)	$ 8,000	
• the FMV of the property transferred	$ 20,000	
ACB of the note		$ 8,000
2. Preferred shares [85(1)(g)]		
The lesser of:		
• the FMV of the preferred shares	$ 10,000	
• the excess of the agreed amount over the FMV of the NSC received ($10,000 – $8,000)	$ 2,000	
ACB of the preferred shares		$ 2,000
3. Common shares [85(1)(h)]		
The excess of the agreed amount over the FMV of the NSC and the ACB allocated to the preferred shares ($10,000 – $8,000 – $2,000)	$ —	
ACB of the common shares		$ —

Therefore, when computing the capital gain or loss on the disposition of the shares by the individual, it is necessary to take into consideration an ACB of $2,000 for the preferred shares and a nil ACB for the common shares.

The non-share consideration, namely the note, could have been for $10,000 without there being immediate tax consequences for the transferor, since the agreed amount is $10,000. In such a case, the ACB of the preferred shares would have been nil.

Allocation of non-share consideration

Where property is transferred under the provisions of section 85, the NSC received by the transferor must be allocated between the different properties transferred. The following example illustrates such a situation.

EXAMPLE 2-14

Taking advantage of the provisions of section 85, Claudio Romano transfers the following assets to Mozzarello Ltd. at the minimum allowed agreed amounts. Claudio wants to avoid all the immediate tax consequences of the transfer of the property.

	Equipment	**Building**	**Land**
CC	$ 50,000	$ 100,000	$ 20,000
FMV	$ 30,000	$ 120,000	$ 30,000
UCC	$ 18,000	$ 60,000	—
Mortgage		$ 70,000	

At the time the assets are transferred, it is agreed that Mozzarello Ltd. will assume the mortgage on the building. Since this is a debt related to the building, it would be logical for the mortgage to be considered as a portion of the consideration for the building. If such were the case, the agreed amount ($60,000) would be less than the non-share consideration (mortgage of $70,000), which is not allowed under paragraph 85(1)(b). The agreed amount would then be equal to the mortgage, resulting in an unwanted recapture of CCA. This is why it is permissible to allocate a debt among a number of assets in a rollover.

Asset transferred	**Agreed amount**	**Consideration received**			
		Non-share		**Preferred shares**	**Total**
Equipment	$ 18,000	Note:	$ 18,000	$ 12,000	$ 30,000
Building	$ 60,000	Mtge:	$ 60,000	$ 60,000	$120,000
Land	$ 20,000	Mtge:	$ 10,000	$ 10,000	$ 30,000
		Note:	$ 10,000		

Under paragraph 85(1)(g), the ACB of the preferred shares received in consideration of the transfer of the assets is nil, since for each asset, the agreed amount has already been wholly attributed to the non-share consideration under paragraph 85(1)(f).

Valuation

As you have seen, the concept of FMV is often used on a rollover. In a non-arm's length transaction, the POD must be equal to the FMV. On a transfer of assets under section 85, FMV must be determined for each asset transferred in accordance with generally accepted valuation principles. The FMV of the property received as consideration must also be determined.

The FMV attributed to preferred shares issued as consideration will generally not be disputed by CRA if the shares:

- are retractable
- entitle the shareholder to a dividend based on a reasonable rate
- have priority over the other shares in the event of liquidation or dissolution

Given the difficulties that may occur on a valuation, a price adjustment clause is generally recommended in the agreement to roll over property to a corporation. A price adjustment clause should also be included in the agreement when property is sold to a person with whom

the vendor does not deal at arm's length, so as to avoid the negative consequences of the application of section 69.

CRA's policy is clearly outlined in IT-169. CRA will accept a price adjustment clause in computing the income of the parties to the transaction, provided all of the following conditions are met:

- the agreement reflects a bona fide intention of the parties to transfer the property at FMV and arrive at the value by a fair and reasonable method
- the excess or shortfall in price is actually refunded or paid, or a legal liability therefore is adjusted

There will be more detailed comments on the importance of the valuation in Reading 3-2.

Double taxation

Using the provisions of section 85 could create a double taxation problem. Transferring a property at its cost amount, and receiving share consideration having an ACB equal to the cost amount of the property transferred, may result in double taxation on the subsequent sale of the property at FMV.

EXAMPLE 2-15

Rosaria Blanchette, the sole shareholder of Solar Centres Ltd., wishes to transfer a non-depreciable capital property to Solar Centres Ltd. under the provisions of section 85.

Cost amount	$ 3,000
FMV	$ 24,000

Without section 85

POD	$ 24,000
Cost amount	(3,000)
Capital gain	$ 21,000
Taxable capital gain (1/2)	$ 10,500

Using section 85

POD (agreed amount)	$ 3,000
Cost amount	(3,000)
Capital gain	$ —

Consideration received

Common shares having an FMV of $24,000 and an ACB and a PUC for tax purposes of $3,000.

Immediately after the transfer to Solar Centres Ltd., the corporation sells the capital property and Rosaria sells the common shares she received as consideration.

Tax consequences

1. For Rosaria:

POD	$ 24,000
ACB	(3,000)
Capital gain	$ 21,000

	Taxable capital gain (1/2)	$ 10,500
2.	For Solar Centres Ltd.:	
	POD	$ 24,000
	ACB	(3,000)
	Capital gain	$ 21,000
	Taxable capital gain (1/2)	$ 10,500

Total taxable capital gain:

• Rosaria	$ 10,500
• Solar Centres Ltd.	10,500
	$ 21,000

This potential double taxation should not prevent the provisions of section 85 from being used. Its goal, which is to defer tax on an accrued gain and/or recapture of CCA, is generally achieved without immediate double taxation. The property transferred and the shares will probably be sold only after several years, thereby reducing the effect of double taxation, which is deferred over a long period. The two events rarely arise simultaneously. Furthermore, the CGD allowed under subsection 110.6(2.1) on the disposition of the qualified small business corporation shares may erase or at least reduce this double taxation.

If a transferred property is a corporation's only asset, it is also possible, following the sale of the property, to wind up the corporation. Given the CDA created on the sale of the property, the refundable dividend tax on hand (RDTOH) acquired on the income tax paid by the corporation and the income tax credit for dividends that the shareholder is entitled to claim on the winding-up dividend (eligible or non-eligible), it is possible to reduce or even erase the double taxation that arises as a consequence of the rollover.

To review the provisions relating to rollovers, you should read IT-291R3 inclusive of paragraph 28.

READING 2-3

Transfer of property to an affiliated corporation

LEVEL 1

There are a number of rules intended to restrict the recognition of losses in transactions between affiliated persons. These rules, which may also apply outside a transaction by rollover under section 85, are studied here because they often apply in this context.

The tax treatment of the loss incurred in the disposition of property to an affiliated person varies according to the nature of the property (depreciable, non-depreciable, or eligible capital) and the type of taxpayer the transferor is.

The definition of affiliated persons is provided in section 251.1. Under subsection 251.1(4), persons are deemed to be affiliated with themselves, and a person includes a partnership. Among the definitions in subsection 251.1(3) that apply for the purposes of the present section only, the following should be noted:

- controlled: means controlled, directly or indirectly in any manner whatever; thus, both de facto control and de jure control are covered.
- affiliated group of persons: means a group of persons each member of which is affiliated with every other member.

For the purposes of the ITA, subsection 251.1(1) provides that the following persons are affiliated:

(a) an individual and the spouse of the individual;

(b) a corporation and
  - (i) a person by whom the corporation is controlled,
  - (ii) each member of an affiliated group of persons by which the corporation is controlled, and
  - (iii) a spouse of a person described in (i) or (ii);

(c) two corporations, if
  - (i) each corporation is controlled by a person, and these two persons are affiliated,
  - (ii) one corporation is controlled by a person and the other corporation is controlled by a group of persons, and each member of that group is affiliated with that person, or
  - (iii) each corporation is controlled by a group of persons, and each member of each group is affiliated with at least one member of the other group.

Paragraphs 251.1(1)(d) to (f) apply to partnerships.

Non-depreciable capital property (land)

In the case of non-depreciable property, the rules on losses in transactions involving affiliated persons differ, depending on whether the transferor is a corporation or an individual.

Corporation

If a corporation disposes of a non-depreciable capital property and an affiliated person, or an affiliated corporation in the case of a rollover under section 85, acquires or has a right to acquire the transferred capital property or an identical property (substituted property) in the period of 30 days before or after the disposition, the loss resulting from the transaction is

deemed nil under paragraph 40(3.4)(a). The property must be owned by the transferor or an affiliated person at the end of this period. However, under paragraph 40(3.4)(b), the denied loss may be claimed by the corporation that suffered the loss (the transferor) when any of the following events occurs:

- the capital property is disposed to a person other than the transferor or a person affiliated with the transferor. However, neither the transferor nor a person affiliated with the transferor may acquire the property or an identical property within 30 days after the disposition;
- the transferor's taxable status changes (becomes non-resident or exempt from tax);
- the control of the transferor is acquired by a person or group of persons;
- if the substituted property is a debt or a share, a deemed disposition occurs under section 50;
- the winding-up of the transferor, unless it is a winding-up under subsection 88(1).

The denied loss is also referred to as a "suspended loss" because its realization is in effect kept suspended until the property is no longer within the affiliated group.

Individual

If the person who disposes of a non-depreciable capital property is an individual other than a trust, the provisions of section 54 and subparagraph 40(2)(g)(i) apply rather than those of subsection 40(3.4). Under subparagraph 40(2)(g)(i), a taxpayer's loss, if any, is deemed nil if it is considered a superficial loss as defined in section 54. A loss resulting from the disposition of a particular property is considered a superficial loss if:

(a) within 30 days before or after the disposition, the taxpayer or a person affiliated with the taxpayer acquired or had a right to acquire a property that is the same as, or identical (substituted property) to, the particular property;

(b) at the end of that period, the taxpayer or a person affiliated with the taxpayer owned or had a right to acquire the substituted property.

However, the loss is not considered a superficial loss if the individual's taxable status changes (that is, the individual becomes exempt from tax or becomes a non-resident) within 30 days after the disposition.

Under paragraph 53(1)(f), the amount of the superficial loss that the individual may not deduct is added to the ACB of the property or the identical property (substituted property) of the purchaser.

Individual or corporation — purchase or redemption of shares by issuing corporation

When a corporation purchases or redeems any of its shares and the shareholder (individual or corporation) suffers a capital loss, that loss is not a superficial loss, since the shares are then cancelled. The loss will then be deemed to be nil, under subsection 40(3.6), if the corporation is affiliated with the shareholder immediately after the purchase or redemption. Under paragraphs 40(3.6)(b) and 53(1)(f.2), the denied loss is then added to the ACB of all other shares held in the corporation by the shareholder immediately after the redemption. The ACB of each of these shares is adjusted in proportion to their FMV relative to the FMV of all the shares held. Note that the latter rule applies when the shareholder is either a corporation or an individual. Example 1-15, seen in Reading 1-5, illustrates a situation where subsection 40(3.6) applies.

Example 2-16 illustrates how the rules on superficial losses apply when an individual transfers property at a loss to an affiliated person. Example 2-17 illustrates how subsection 40(3.4) applies when the transferor is a corporation.

EXAMPLE 2-16

Dolores Savard incorporates Savory Ltd. and is the sole shareholder. She transfers a non-depreciable capital property, namely a parcel of land, to Savory Ltd.

ACB of the land transferred	$ 20,000
FMV of the land transferred	$ 10,000
Agreed amount	$ 10,000
Consideration received: common shares — FMV	$ 10,000

Tax consequences

1. For Dolores:

Deemed POD (agreed amount)	$ 10,000
Less: ACB	(20,000)
Capital loss	$ (10,000)

Under section 54, the capital loss of $10,000 is a superficial loss, since the land was acquired by a person affiliated with Dolores under subparagraph 251.1(1)(b)(i). Under subparagraph 40(2)(g)(i), the loss is deemed to be nil.

ACB of the common shares [85(1)(h)] (agreed amount)	$ 10,000

2. For Savory Ltd.:

ACB of the land acquired [53(1)(f)] (agreed amount + Dolores's capital loss) ($10,000 + $10,000)	$ 20,000

EXAMPLE 2-17

Use the information in Example 2-16, but assume that the transferor is the corporation Hardy Ltd. instead of an individual.

Tax consequences

1. For Hardy Ltd.:

Deemed POD (agreed amount)	$ 10,000
Less: ACB	(20,000)
Capital loss	$ (10,000)

The capital loss is deemed nil under paragraph 40(3.4)(a) if Hardy Ltd. and Savory Ltd. are affiliated corporations under subparagraph 251.1(1)(b)(i). This loss will be deductible by Hardy Ltd. only when one of the events provided for in paragraph 40(3.4)(b) occurs.

ACB of the common shares [85(1)(h)] (agreed amount)	$ 10,000

2. For Savory Ltd.:

ACB of the acquired property (agreed amount)	$ 10,000

Depreciable property

Subsection 13(21.2) applies on the transfer by a person or partnership (the transferor) of a depreciable property whose "tax cost" is greater than the amount that would otherwise be the transferor's POD, where the transferor or a person affiliated with the transferor holds or has a right to acquire the property 30 days after the disposition. When all these conditions are met, the terminal loss resulting from the transaction is not recognized at that point but is instead "amortized" until certain subsequent events occur. In addition, subsections 85(1) and 85(2) and section 97 do not apply; in other words, the provisions allowing a rollover are denied.

For the purposes of this rule, the "tax cost" is equal to the lesser of

- $\text{UCC of the class immediately before the dispostion} \times \dfrac{\text{FMV of the property disposed of}}{\text{FMV of all the property of the class}}$

or

- CC of the property disposed of

Under subparagraph 13(21.2)(e)(i), the tax cost thus determined becomes the POD for the transferor. If the tax cost of the property is higher than the FMV of the property at the time of its disposition, no loss is recognized. However, the transferor is deemed to have acquired a property whose CC is equal to this excess amount. That property, included in the same class as the transferred property, is deemed to have been acquired by the transferor before the taxation year during which the transfer took place, and the transferor is deemed to hold it until one of the following events listed in subparagraph 13 (21.2)(e)(iii) occurs:

- a disposition of the depreciable property to a person other than the transferor or a person affiliated with the transferor occurs. However, the transferor or a person affiliated with the transferor must not acquire the capital property or a property identical to it within 30 days after the disposition;
- there is a change in the property's use from an income-earning to a non-income-earning purpose;
- there is a change in the transferor's taxable status (becomes non-resident or exempt from tax);
- the control of the transferor is acquired by a person or group of persons;
- the winding-up of the transferor, unless it is a winding-up under subsection 88(1).

The transferor is entitled to claim CCA, at a rate equal to that applying to the transferred property, with respect to the property deemed to have been acquired so long as the transferor is deemed to hold that property. When any of the events listed above occurs, the undepreciated balance becomes a terminal loss deductible under subsection 20(16).

In addition, under paragraph 13(21.2)(g), the purchaser is in the same position as the transferor with respect to the provisions of section 20, as in the case of a rollover; that is, the CC of the property for the purchaser is deemed to be the transferor's CC, and the purchaser is deemed to have deducted as CCA the amount by which the CC of the property for the transferor exceeds the property's FMV at the time of acquisition.

Subsection 13(21.2) does not apply if the disposition of the property is covered by paragraphs (c) to (g) of the definition of superficial loss in section 54, such as on the expiry of an option.

EXAMPLE 2-18

In 2008, Poulos Inc. transfers two antique desks to Alias Ltd., a wholly-owned corporation. Thus, they are affiliated with each other. The desks are the only property in the class.

	Desk 1	Desk 2
CC	$ 2,000	$ 2,500
FMV at the time of transfer	$ 800	$ 3,500
UCC of the class	$ 4,000	

As consideration, Poulos Inc. receives preferred shares with a FMV of $4,300, equal to the FMV of the desks. Desk 2 is sold first.

1. Disposition — Desk 2

   The tax cost is equal to the lesser of:

   - $\$4,000 \times \frac{\$3,500}{\$4,300} = \$3,256$

   or

   - $2,500

   Subsection 13(21.2) does not apply, since the tax cost ($2,500) is less than the FMV ($3,500).

   Under paragraph 85(1)(e), an agreed amount is set at $2,500, since this is the lesser of:

   - UCC for all property in the class immediately before the disposition — $ 4,000

   or
   - CC of Desk 2 — $ 2,500

   or
   - FMV of Desk 2 — $ 3,500

   Thus, there is no immediate tax consequence. The ACB of the preferred shares received in consideration is $2,500, which is the agreed amount, although the shares have a FMV of $3,500. Since there is no NSC, the entire agreed amount is attributed to the preferred shares issued on the rollover, as stipulated in paragraph 85(1)(g).

2. Disposition — Desk 1

   The tax cost is equal to the lesser of:

   - ($4,000 – $2,500) or $\$1,500 \times \frac{\$800}{\$800} = \$1,500$

   or

   - $2,000

   Subsection 13(21.2) applies, since the tax cost ($1,500) is greater than the FMV ($800).

   The deemed POD for Poulos Inc. become $1,500 under subparagraph 13(21.2)(e)(i). There is no tax consequence for Poulos Inc. since the UCC is also $1,500. Thus, no terminal loss is recognized. However, the amount by which the tax cost ($1,500) exceeds the FMV ($800), namely $700, is deemed to be the CC of a property acquired before 2008 and included in class 8. Instead of being entitled to a terminal loss of $700 in 2008, Poulos Inc. will be entitled to a CCA deduction of $140

($700 × 20%). Poulos Inc. may continue to amortize this excess amount until any of the events contemplated in subparagraph 13(21.2)(e)(iii) occurs.

Eligible capital property

If a corporation, trust, or partnership (the transferor) disposes of an ECP and an affiliated person holds or is entitled to acquire that property, or a property identical to it, 30 days after the disposition and that person would be entitled to a deduction under paragraph 24(1)(a), the rules set out in subsection 14(12) will apply. Paragraph 24(1)(a) generally allows for the deduction of the balance of the CEC where a taxpayer has ceased to carry on a business and no longer has any ECP with respect to that business. Under subsection 14(12), this otherwise-allowed deduction is deferred until one of the following events occurs:

- the capital property is disposed of to a person other than the transferor or a person affiliated with the transferor. However, neither the transferor nor a person affiliated with the transferor may acquire the property or an identical property within 30 days after the disposition;
- the transferor's taxable status changes (becomes non-resident or exempt from tax);
- the control of the transferor is acquired by a person or group of persons;
- a change whereby the ECP no longer constitutes ECP of a business of the transferor or an affiliated person;
- the winding-up of the transferor, unless it is a winding-up under subsection 88(1).

During the period between the disposition of the ECP and any of the above-mentioned events as set out in paragraphs 14(12)(c) to (g), the transferor is still considered to be the owner of the ECP and not to have ceased to carry on the business. During this period, the transferor is therefore entitled to the deduction provided for in paragraph 20(1)(b).

The application of subsection 14(12) is shown in Example 2-19.

EXAMPLE 2-19

During its fiscal period ended in 2008, in the process of ceasing to carry on its business, McKeogh Ltd. disposed of a customer list to Hétu Inc. The customer list is the only ECP that McKeogh Ltd. owned. No deduction was claimed under paragraph 20(1)(b) in a previous fiscal period.

POD and FMV	$ 40,000
CEC immediately before the disposition	$ 47,500

In 2009, Hétu Inc. disposes of the customer list to Mackenzie Gardens Ltd.

Tax consequences for McKeogh Ltd.

1. If Hétu Inc. is not affiliated with McKeogh Ltd.

2008

POD ($40,000 × 3/4)	$ 30,000
Less: CEC	(47,500)
Allowed deduction [24(1)(a)]	$ (17,500)

2. If Hétu Inc. is a corporation affiliated with McKeogh Ltd.

2008

POD ($40,000 × 3/4)	$ 30,000
Less: CEC	(47,500)
Deferred loss [14(12)]	$ (17,500)

Allowed deduction [14(12) and 20(1)(b)]
($17,500 × 7%) $ 1,225

2009

a. If Mackenzie Gardens Ltd. is not a corporation affiliated with McKeogh Ltd.

Allowed deduction [14(12) and 24(1)(a)]
($17,500 – $1,225) $ 16,275

b. If Mackenzie Gardens Ltd. is a corporation affiliated with McKeogh Ltd.

Allowed deduction [14(12) and 20(1)(b)]
($17,500 – $1,225) × 7% $ 1,139

READING 2-4

Adjustments to paid-up capital

LEVEL 1

PUC adjustments

In certain cases, the legal PUC of the shares received on a rollover may be adjusted by the provisions of subsection 85(2.1). Subsection 85(2.1) does not apply if section 84.1 applies, even if the application of section 84.1 yields a nil result.

Subsection 85(2.1) provides for

- a possible reduction in the legal PUC of the class of shares received on a rollover under subsection 85(1) or 85(2)
- an increase in the PUC of that class of shares for tax purposes if a deemed dividend computed subsequently is due to a reduction in the legal PUC under subsection 85(2.1)

Reduction of PUC

If all the following conditions are met, subsection 85(2.1) is applicable:

- a taxpayer (person or partnership) transfers property to a corporation
- an election is made under subsection 85(1) or 85(2)
- section 84.1 (or section 212.1) does not apply to the disposition on the transfer of shares to a corporation with which the transferor does not deal at arm's length

Under paragraph 85(2.1)(a), the PUC reduction is equal to

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

where

A = the increase in the legal PUC of all the shares of the capital stock of the corporation issued as a result of the acquisition by the corporation of the property

B = the agreed amount in excess of the FMV of the non-share consideration

C = the increase in the legal PUC of the particular class of shares received in consideration of the rollover

This reduction is provided for in order to prevent the transferor from being able to receive, in a share redemption, an amount that would be taxed as a capital gain eligible for the CGD, rather than as a dividend.

The application of paragraph 85(2.1)(a) is illustrated in Example 2-20.

EXAMPLE 2-20

Sajjad Diaz sells a parcel of land, which is a capital property, to Caviar Ltd. using the provisions of subsection 85(1).

Land

FMV	$ 500,000
ACB	$ 100,000

Consideration received

Note	$ 100,000
Preferred shares — FMV and legal PUC	$ 400,000
Agreed amount	$ 100,000

For the note, the portion of the agreed amount that is attributed to the note is equal to the lesser of the following amounts:

• FMV of the note received	$ 100,000
or	
• FMV of the transferred land	$ 500,000

The cost of the note for Sajjad is therefore $100,000.

For the preferred share consideration, the amount attributed is equal to the lesser of the following amounts:

• FMV of the preferred shares	$ 400,000
or	
• Excess of the agreed amount over the FMV of the note ($100,000 – $100,000)	$ —

The ACB of the preferred shares for Sajjad is therefore nil.

Tax consequences

Reduction of the legal PUC [85(2.1)]

Legal PUC of the preferred shares	$ 400,000
Less: $(A - B) \times \frac{C}{A}$	
$(\$400{,}000 - \$0) \times \frac{\$400{,}000}{\$400{,}000}$	(400,000)
PUC for tax purposes	$ —

If the non-share consideration exceeded $100,000, Sajjad would realize a capital gain on the excess amount. He therefore obtained, exempt from tax, the maximum consideration to which he was entitled, namely the ACB of the land. However, since the PUC of the preferred shares for legal purposes is set at $400,000, had there not been this reduction, Sajjad could have received an amount of $400,000 taxed as a capital gain on the redemption of the shares and perhaps be entitled to the CGD if the shares qualified as small business corporation shares at the time of redemption, as follows:

Amount received		$ 400,000
PUC of the redeemed shares		(400,000)
Deemed dividend [84(3)]		$ —

POD [54]		
Amount received		$ 400,000
Dividend [84(3)]		—
Capital gain		$ 400,000
Taxable capital gain (1/2)		$ 200,000

This gain might be eligible for the CGD. — over

The tax consequences on the redemption of the preferred shares will instead be as follows:

Redemption

Deemed dividend [84(3)]

Amount received		$ 400,000
PUC of the redeemed shares		—
Deemed dividend		$ 400,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when it is included in Sajjad's income, depending on whether the dividend is non-eligible or eligible. The dividend tax credit granted is equal to 13.33% or 18.97% of the grossed-up dividend at the federal level, and the provincial tax credit may vary depending on the individual's province of residence.

Capital gain

POD [54]		
Amount received	$ 400,000	
Deemed dividend [84(3)]	(400,000)	$ 0
ACB		(0)
Capital gain		$ 0

Increase of PUC

Paragraph 85(2.1)(b) provides for a PUC increase equal to the lesser of

(i) the excess of

(A) the total dividends deemed by subsections 84(3), 84(4), or 84(4.1) to have been paid after November 21, 1985, on shares of that class

(A)-(B) over

(B) the amount of the deemed dividend that would have been determined if there had not been a PUC reduction under paragraph 85(2.1)(a) in computing the PUC of the shares of that class

(ii) the PUC reduction under paragraph 85(2.1)(a) for that class of shares

An increase in the PUC of a class of shares is required if, on the redemption of shares of this class, the deemed dividend computed on the redeemed shares is due to a PUC reduction under paragraph 85(2.1)(a). The PUC increase is required because this reduction applies to the entire class as long as there are shares issued from this class still outstanding. On a partial redemption of the shares of the class, the PUC of the remaining shares must be affected only by their share of the PUC reduction as explained in Example 2-21.

EXAMPLE 2-21

Using the information in Example 2-20, assume that Caviar Ltd. redeems 25% of the preferred shares for $100,000.

Tax consequences

<u>Deemed dividend [84(3)]</u>

Amount received by Sajjad	$ 100,000
PUC of the redeemed shares	—
Deemed dividend [84(3)]	$ 100,000

POD [54]	
Amount received	$ 100,000
Dividend [84(3)]	(100,000)
Less: ACB	—
Capital gain	$ —

If there had not been a PUC reduction, the deemed dividend would have been equal to

Amount received	$ 100,000
PUC without reduction under 85(2.1)	(100,000)
Deemed dividend without 85(2.1)	$ —

POD [54]	
Amount received	$ 100,000
Dividend [84(3)]	—
Less: ACB	—
Capital gain	$ 100,000

<u>PUC increase [85(2.1)(b)]</u>

The lesser of:	
• $100,000 – $0 [deemed dividend under 84(3) less deemed dividend without 85(2.1)]	
• $400,000 [PUC reduction]	$ 100,000
PUC increase	$ 100,000

Following the redemption of the preferred shares, the PUC of the preferred shares still held by Sajjad is:

PUC of the remaining shares	$ 300,000
Less: reduction [85(2.1)(a)]	(400,000)
Plus: increase [85(2.1)(b)]	100,000
	$ —

In this example, where 25% of the shares have been redeemed, you can see that the PUC increase under paragraph 85(2.1)(b) has the effect of eliminating a corresponding 25% of the PUC reduction under paragraph 85(2.1)(a)

READING 2-5

Election forms

LEVEL 1

Requirements of the election

Under subsection 85(1), the election to use the rollover provisions is accepted provided Form T2057 is filed. It must be filed with CRA within the required time limit and must be completed in a professional manner, that is, without any error that would adversely affect the validity of the election.

The time limit for filing the joint election by the transferor and the corporation is specified in subsection 85(6). Form T2057 must be filed no later than the earliest of the days on which one of the two taxpayers is required to file an income tax return for the taxation year in which the transfer occurred:

If the transferor is

- an individual: April 30 or June 15 of the following year
- a corporation: six months after the end of its taxation year
- a trust or estate: 90 days after the end of its taxation year

For the purchaser, which is always a corporation: six months after the end of its taxation year

---

EXAMPLE 2-22

Kumar Ltd.'s year end is December 31.
Caravelle Ltd.'s year end is November 30.

On March 1, 2008, Kumar Ltd. transfers assets to Caravelle Ltd. under subsection 85(1). Form T2057 must be filed no later than May 31, 2009, being six months after the end of Caravelle Ltd.'s taxation year.

Subsection 85(7) allows late elections to be filed with respect to section 85. The election is accepted if

- within three years following the deadline for filing the election, the taxpayer makes an election using Form T2057

and

- the taxpayer pays the penalty for late filing provided for in subsection 85(8)

This penalty is equal to the lesser of

- 1/4 of 1% of the excess of the FMV of the property at the time of the disposition over the amount agreed upon in the election for each month or part of a month for which the election is late

or

- $100 per month or part of a month not exceeding $8,000

EXAMPLE 2-23

Gibson Ltd. and Luong Ltd. have fiscal periods ending on June 30. Taking advantage of the provisions of section 85, Gibson Ltd. transfers to Luong Ltd. a parcel of land that is a capital property.

Date of transfer: June 1, 2007

ACB of parcel of land	$ 20,000
FMV of parcel of land	$ 50,000
Agreed amount	$ 20,000

Form T2057 is filed on December 15, 2008, whereas it should have been filed no later than December 31, 2007.

The penalty to be paid in order for the election to be valid is equal to the lesser of the following amounts:

• 1/4 of 1% (FMV of the parcel of land – agreed amount) × number of months or part of a month late, that is, 1/4 of 1% ($50,000 – $20,000) × 12	$ 900
• $100 × 12 months (not exceeding $8,000)	$ 1,200

A penalty of $900 is therefore payable.

In Example 2-23 you studied how to calculate the penalty for the late filing of Form T2057. The example raises an issue as to the reasons for the late filing. Sometimes this is due to a delay on the part of the taxpayer in calling the transaction to the attention of his or her accountant. Unfortunately, there are also cases where the delay is the fault of the accountant, for example, too much work, inattention, or inefficiency in the accountant's office.

Not only will clients be unhappy with having to pay penalties for the failure of their accountant to file the prescribed form on time, but an ethical question also arises as to the lack of professional diligence. Example 2-24 illustrates these ethical points.

EXAMPLE 2-24

Amanda Fife and Marcel Tambour are both CGAs and work together as Fife and Tambour, Partners. Until recently, Marcel has done most of the tax planning and related work, including the filing of prescribed forms where required. But because of a sizable increase in client demand for tax planning, Amanda has taken over some of Marcel's former clients. One of these clients is Gur Singh.

In 2006, on Marcel's advice, Gur formed a corporation to which he transferred the business that he was carrying on as sole proprietor. Gur and his spouse are the sole shareholders of the new corporation. The first fiscal period of the corporation ended on December 31, 2006. In reviewing the file for her first meeting with Gur, Amanda notices that Form T2057 was filed on December 12, 2007, whereas it should have been filed on June 15, 2007. When she mentions this fact to her partner Marcel, he explains to her that he was very busy at that time and that in any case Gur is not aware that a penalty was imposed for late filing.

What should Amanda do?

Suggested solution

1. Amanda should discuss with Marcel the importance of filing prescribed forms within the time limits stipulated in the ITA. That the client failed to notice the late filing is beside the point.

2. Amanda should suggest that they develop appropriate procedures in the firm to ensure timely filing of forms.

3. Gur should be told the reason for the late filing. The firm of Fife and Tambour should offer to pay any excess penalty caused by Marcel's negligence.

In addition, under subsection 85(7.1), a taxpayer may

- file an election after the expiry of the three-year limit after deadline

or

- amend an election previously filed

if, in the opinion of the Minister, the circumstances are such that it would be just and equitable to allow the election. However, the penalty under subsection 85(8) remains applicable.

Subsection 85(7.1) raises another ethical issue for CGAs engaged in tax planning. By either failing to file the form within the three years allowed by the ITA or failing to file an amended form, a CGA could cause serious problems for the taxpayer who is his or her client. At a minimum the taxpayer will have the anxiety of waiting for the Minister's decision on the application to have the form accepted after the three-year time limit. Even if the response is favourable, substantial penalties will have to be paid. In a worst-case scenario, the election will not be allowed and the client will potentially forego substantial tax advantages or end up with an unexpected tax burden.

Filing the election

The form should be filed

- on or before the deadline
- at the CRA taxation centre where the transferor's income tax return is filed
- if there is more than one transferor, such as in the case of co-owners, at the taxation centre where the transferee files his income tax return
- separately from any income tax return

The original must be sent at the earliest date upon which any one of the parties to the election must file an income tax return for the taxation year in which the transfer occurred. If a property transferred was omitted from the rollover, another election for that property will be accepted, provided it is filed within the time limit and the appropriate penalty, if any, is paid.

Read IC76-19R3, paragraphs 9 to 22, regarding filing requirements and late or amended elections.

Comments on the form

Certain points should be noted when completing the form:

- Each property transferred should be described in a summary but precise manner. In the case of depreciable property, the documents indicating the designated order should be retained.
- Goodwill should not be omitted; if the value cannot be determined, a value of $1 should be used.

- The transfer of depreciable property for which the UCC of the class is nil, such as may be the case for classes 12 and 29, should not be omitted. A value of $1 should be used.
- The description of the consideration should indicate that shares have been allocated to each property and the non-share consideration should be accurately described.
- The terms of each class of shares should be described.
- The agreed amount should be exact because it represents the vendor's POD and the purchaser's cost of acquisition. Ensure that the agreed amount is not less than the non-share consideration.
- The form contains a list of questions that must be answered meticulously. It will include information on whether the property transfer agreement signed by the transferor and the purchaser contains a price adjustment clause.
- If the shares are the object of a rollover under section 85, the PUC of these shares must be indicated.

Example of a transfer of property

LEVEL 1

Example 2-25 provides a comprehensive illustration of the transfer of property and the corresponding tax consequences.

EXAMPLE 2-25

In 1983, Mark Benson acquired 1,000 common shares of Cornet Ltd., a public corporation, for $150,000. The PUC of these shares is $1,000. Mark's share ownership in Cornet Ltd. constitutes less than 1% of Cornet's outstanding shares.

Mark's two children are the only shareholders of Quality Ltd. and each of them holds 50 common shares of Quality Ltd. The total PUC of these shares is $15,000, and the FMV is $1,000,000.

Mark wants to transfer his 1,000 common shares of Cornet Ltd. to Quality Ltd. They have a FMV of $500,000. On May 1, 2008, an election is made under subsection 85(1).

Agreed amount	$150,000
Consideration received: 50 common shares — FMV	$500,000
— PUC	$500,000

Mark also owns land and a building that are rental properties. He decides to take the opportunity to transfer them to Quality Ltd., so that his children can participate in the future appreciation. The following data relate to this transfer, for purposes of subsection 85(1):

	Cost	FMV	Agreed amount	Consideration	FMV and PUC
Land	$ 40,000	$120,000	$90,000	100 A pref.	$120,000
Building	$100,000	$230,000	$50,000	$30,000 note	
(UCC $50,000)				100 A pref.	$120,000
				100 B pref.	$ 80,000

On December 1, 2008, all the common shares held by Mark and the Class A preferred shares of Quality Ltd. are redeemed for $740,000, namely, $500,000 for the common shares and $240,000 for the Class A preferred shares.

Tax consequences

A. **At the time of the transfers**

1. For Mark:

<u>Shares of Cornet Ltd.</u>

Deemed POD (agreed amount)	$150,000
Less: ACB	(150,000)
Capital gain	$ —

ACB of the 50 common shares received as consideration [85(1)(h)]	$150,000

Land

Deemed POD (agreed amount)		$ 90,000
Less: ACB		(40,000)
Capital gain		$ 50,000
Taxable capital gain (1/2)		$ 25,000
ACB of the 100 Class A preferred shares received as consideration [85(1)(g)]		$ 90,000

Building

Deemed POD (agreed amount)		$ 50,000
Less: CC		(100,000)
Capital gain (no capital loss on the disposition of a depreciable property)		$ —
UCC		$ 50,000
Less the lesser of:		
• CC	$100,000	
• POD	$ 50,000	$ 50,000
Recapture of CCA		$ —

ACB of the note [85(1)(f)]

The lesser of:	
• FMV of the note received	$ 30,000
• FMV of the transferred building	$230,000

ACB of the 100 Class A preferred shares [85(1)(g)]

The lesser of:	
• FMV of the A and B preferred shares	$200,000
• Excess of the agreed amount over the FMV of the note ($50,000 – $30,000)	$ 20,000

Since there are two classes of preferred shares that are issued in consideration of the transfer of the building, a distribution must be made between the two classes.

ACB of Class A preferred shares

$\$20,000 \times \frac{\$120,000}{\$200,000}$ $ 12,000

ACB of the Class B preferred shares

$\$20,000 \times \frac{\$80,000}{\$200,000}$ $ 8,000

2. For Quality Ltd.:

1,000 common shares of Cornet Ltd. having an ACB of $150,000 and a PUC of $1,000

The ACB of the land is $90,000.

Cost of the building [85(5)]	$100,000
Deemed CCA deducted	(50,000)
UCC	$ 50,000

3. PUC of the shares of Quality Ltd.:

Subsection 85(2.1) provides that there is a reduction of the PUC if:

- a taxpayer transfers property to a corporation
- an election is made under subsection 85(1)
- section 84.1 does not apply to the disposition

Common shares

Reduction of the legal PUC under subsection 85(2.1) as a result of the transfer of the shares of Cornet Ltd.

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

where

A	=	increase in the PUC of all the shares	$ 500,000
B	=	agreed amount	$ 150,000
		Less: FMV of the non-share consideration	—
			$ 150,000
C	=	increase in the PUC of the common shares	$ 500,000

$$(\$500{,}000 - \$150{,}000) \times \frac{\$500{,}000}{\$500{,}000}$$ $350,000

PUC before reduction ($15,000 + $500,000)	$515,000
Less: Reduction [85(2.1)]	(350,000)
PUC of the 150 common shares for tax purposes	$165,000

Class A preferred shares

Reduction of the legal PUC under subsection 85(2.1) as a result of the transfer of land

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

where

A	=	increase in the PUC of all the shares	$120,000
B	=	agreed amount	$ 90,000
		Less: FMV of the non-share consideration	—
			$ 90,000
C	=	increase in the PUC of the Class A preferred shares	$120,000

$$(\$120{,}000 - \$90{,}000) \times \frac{\$120{,}000}{\$120{,}000}$$ $\underline{\$\ 30{,}000}$

Reduction of the legal PUC under subsection 85(2.1) as a result of the transfer of the building

A = $120,000 + $80,000 = $200,000
B = $50,000 – $30,000 = $20,000
C = $120,000

$$(\$200{,}000 - \$20{,}000) \times \frac{\$120{,}000}{\$200{,}000}$$ $\underline{\$108{,}000}$

PUC before reduction	$240,000
Less: Reduction due to transfer of:	
• land	(30,000)
• building	(108,000)
PUC of the 200 Class A preferred shares for tax purposes	$102,000

Class B preferred shares

Reduction of the legal PUC under subsection 85(2.1) as a result of the transfer of the building

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

A = $200,000
B = $20,000
C = $80,000

$$(\$200{,}000 - \$20{,}000) \times \frac{\$80{,}000}{\$200{,}000}$$ $\underline{\$\ 72{,}000}$

PUC before reduction	$ 80,000
Less: Reduction	(72,000)
PUC of the 100 Class B preferred shares for tax purposes	$ 8,000

B. **Redemption of the common shares and Class A preferred shares**

1. Redemption of the 50 common shares

Amount received	$500,000
Less: PUC of the 50 common shares	
$\frac{50}{150} \times \$165{,}000$	(55,000)
Deemed dividend [84(3)]	$445,000

POD [54]		
Amount received	$500,000	
Dividend [84(3)]	(445,000)	$ 55,000
Less: ACB		(150,000)
Capital loss		$ (95,000)

Deductible capital loss (1/2)		$ (47,500)

2. Redemption of the 200 Class A preferred shares

Amount received		$240,000
Less: PUC		(102,000)
Deemed dividend [84(3)]		$138,000
POD [54]		
Amount received	$240,000	
Dividend [84(3)]	(138,000)	$102,000
Less: ACB ($90,000 + $12,000)		(102,000)
Capital gain		$ —

C. **Increase of PUC of common shares**

Deemed dividend without 85(2.1)

Amount received	$500,000
PUC without reduction under 85(2.1) [$515,000 × 50 ÷ 150]	(171,667)
	$328,333

PUC increase [85(2.1)(b)]

The lesser of:
- $445,000 – $328,333 [deemed dividend under 84(3) less deemed dividend without 85(2.1)]
- $350,000 [PUC reduction] $116,667

PUC of remaining 100 common shares

Stated PUC of remaining shares [$515,000 × 100 ÷ 150]	$343,333
Less: reduction [85(2.1)(a)]	(350,000)
Plus: increase [85(2.1)(b)]	116,667
	$110,000