Non-arm's length sale of shares

LEVEL 1

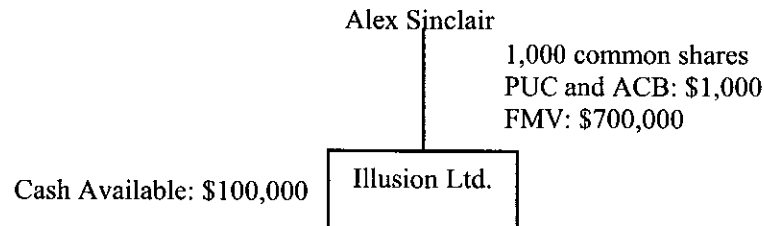
The disposition of shares of a corporation resident in Canada in favour of a corporation with which the person disposing of them does not deal at arm's length is subject to the special rules contained in section 84.1, in the case of a resident of Canada, and in section 212.1, in the case of a non-resident. These rules are designed to prevent **surplus stripping**.

Sale of shares by a resident

The rules set out in section 84.1 were introduced at the same time as the capital gains deduction (CGD). These are anti-avoidance rules which prevent a taxpayer (other than a corporation) from receiving, as a capital gain, funds that would otherwise have been received as taxable dividends from a corporation. Without this rule, it would have been possible, for example, for an individual owning qualified small business corporation shares to take advantage of the $375,000 ($250,000 before March 19, 2007) CGD and withdraw up to $750,000 ($500,000 before March 19, 2007) tax-free by transferring the shares to another corporation that the individual controls, as illustrated in Example 3-1.

EXAMPLE 3-1

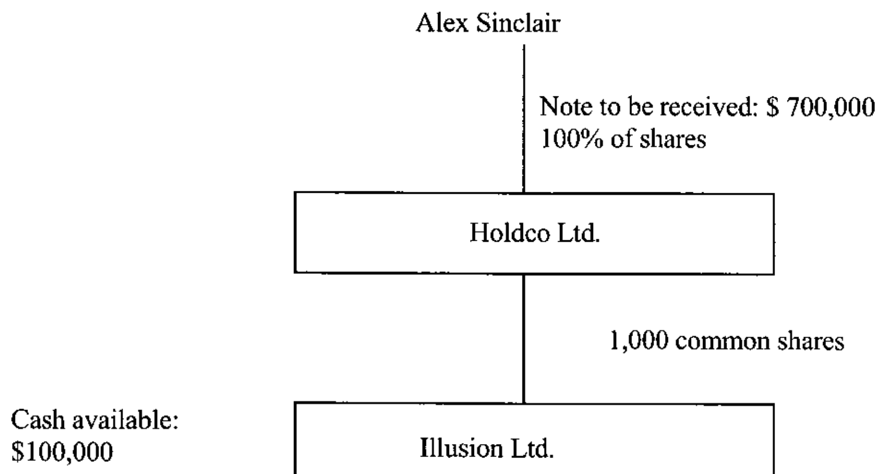
Alex Sinclair holds all the issued and outstanding shares of Illusion Ltd., namely 1,000 common shares. These shares have an FMV of $700,000 and an ACB of $1,000. The PUC of the shares is $1,000. Illusion Ltd. has $100,000 available in cash that it could pay as a dividend to Alex.



Alex has never used his CGD, and the shares of Illusion Ltd. are qualified small business corporation shares.

Planning

In order to take advantage of the CGD and withdraw from Illusion Ltd. an amount equal to the FMV of the shares free of tax, Alex could establish a new corporation, Holdco Ltd., and sell to it the 1,000 common shares of Illusion Ltd. at their FMV of $700,000. The consideration received from Holdco Ltd. would be a note for $700,000.



Were it not for section 84.1, the sale of the shares of Illusion Ltd. to Holdco Ltd. would result in Alex having a taxable capital gain of $349,500 [($700,000 – $1,000) × 1/2], which would qualify for the CGD, and thus Alex would not pay any tax on this gain.

Illusion Ltd. would pay Holdco Ltd. a dividend of $100,000 that would not be subject to Part I tax, since it is deductible under section 112. Nor would this dividend be subject to Part IV tax, except insofar as Illusion Ltd. was entitled to a dividend refund, since Holdco Ltd. and Illusion Ltd. are connected corporations.

Lastly, Holdco Ltd. would repay Alex $100,000 on the $700,000 note. This repayment would have no tax consequences. In the future, the balance of $600,000 on the note could be repaid in the same way as funds became available to Illusion Ltd. Thus, Alex could, with no tax consequences, withdraw $700,000 from Illusion Ltd. whereas that amount should have been paid to him as a dividend, since it comes from the retained earnings of Illusion Ltd. This is what is called "surplus stripping."

In order to prevent this type of transaction, section 84.1 provides for an immediate deemed dividend, if there is non-share consideration, and for a reduction of PUC if shares are received in consideration. The purpose of the PUC reduction is to preclude surplus stripping at the time the shares are redeemed.

Section 84.1 applies both when the shares are disposed of at FMV and when the transfer is carried out at a lesser amount, as when making the election provided for in subsection 85(1). Furthermore, for purposes of the PUC reduction, section 84.1 takes precedence over subsection 85(2.1), as stipulated at the beginning of subsection 85(2.1).

In the case of a rollover of shares using the provisions of subsection 85(1), special attention must be paid to the NSC. Although the NSC may be acceptable for the purposes of subsection 85(1), the effect of subsection 84.1(1) may be such that there is a deemed dividend. Examples 3-5 and 3-6 illustrate this point and should be studied carefully.

Conditions

Section 84.1 applies when all the following conditions are met:

- the shares transferred are capital property of the person disposing of them (the vendor)
- the vendor is not a corporation
- the vendor is resident in Canada
- the purchaser is a corporation
- the vendor and the purchaser do not deal at arm's length

- the corporation whose shares are sold is resident in Canada

and

- the corporation whose shares are sold is connected, within the meaning of subsection 186(4), with the purchaser corporation immediately after the transaction, that is,
  - (a) the corporation whose shares are sold is controlled by the purchaser corporation, within the meaning of subsection 186(2)

  or

  - (b) the purchaser corporation owns more than 10% of the issued voting shares and more than 10% of the FMV of all the shares issued by the corporation whose shares are transferred

LEVEL 2

When determining whether the vendor and the purchaser are dealing at arm's length, it is necessary not only to consider the usual concept set out in section 251, but also the provisions of paragraphs 84.1(2)(b) and (d), which serve to extend that concept.

Paragraph 84.1(2)(b) extends the concept of not dealing at arm's length with the purchaser corporation to the following situation:

(i) the vendor was, immediately before the disposition, one of a group of less than six persons that controlled the corporation whose shares are transferred

and

(ii) the vendor was, immediately after the disposition, one of a group of less than six persons that controlled the purchaser corporation, each member of which was a member of the group referred to in (i)

Under paragraph 84.1(2.2)(a), for purposes of determining whether or not the vendor was a member of a group of less than six persons that controlled a corporation, any shares owned by

(i) the vendor's spouse or the vendor's child who is under 18 years of age (the vendor's child, as defined in subsection 70(10), includes a child of his child, a child of his child's child, and a person who prior to reaching 19 years of age was wholly dependent on the vendor for support and of whom the vendor then had custody and control),

(ii) a trust of which the vendor, his spouse, his child who is under 18 years of age or a corporation described in (iii) is a beneficiary,

or

(iii) a corporation controlled by the vendor, his spouse or his child who is under 18 years of age, a trust described in (ii) or any combination thereof

are deemed to be owned at that time by the vendor and not by the person who actually owned the shares at that time.

In addition, paragraphs 84.1(2.2)(b) to (d) stipulate that

- a group that controls a corporation consists of two or more persons each of whom owns shares of the corporation; the shares need not necessarily be voting shares;
- even if a corporation is controlled by only one member of a group, it is considered to be controlled by that group;
- a corporation may be considered to be controlled by a person or a particular group of persons notwithstanding that it is also controlled by another person or group of persons; a corporation may thus be considered to be controlled by two or more persons or groups of persons at the same time.

Example 3-2 illustrates a situation in which subsection 84.1(1) applies because a taxpayer is considered as not dealing at arm's length owing to the application of paragraph 84.1(2)(b).

EXAMPLE 3-2

The shares of Black Inc., a Canadian corporation, are held in the following proportions by three Canadian residents dealing with each other at arm's length:

Jean Leblanc 51%
Margot Kelly 24%
Paul Cherez 25%

The shares are held by each as capital property.

Margot and Jean decide to transfer the shares that they hold in Black Inc. to another Canadian corporation, LK Management Inc. Immediately after the transfer of the shares, Jean holds 50% of the shares of LK Management Inc. and Margot holds the other 50%.

Tax consequences

1. For Jean:

   Subsection 84.1(1) applies to the transfer by Jean of his shares of Black Inc. to LK Management Inc., since

   - the shares of Black Inc. are capital property for Jean;
   - Jean is not a corporation;
   - Jean resides in Canada;
   - LK Management Inc. is a corporation;
   - Black Inc. resides in Canada;
   - immediately after the transfer of the shares of Black Inc. to LK Management Inc., these two corporations are connected within the meaning of subsection 186(4), since LK Management Inc. holds more than 10% of the shares of Black Inc., in terms of both voting rights and value;
   - Jean does not deal at arm's length with LK Management Inc. under paragraph 84.1(2)(b), since before the transfer of the shares of Black Inc. to LK Management Inc., he was one of a group of fewer than six persons that controlled Black Inc. and immediately after the transfer he is one of a group of fewer than six persons that control LK Management Inc., each of whom was a member of a group that controlled Black Inc., namely him and Margot. While Jean controlled Black Inc. on his own prior to the transfer, under paragraph 84.1(2.2)(c) he is considered to be one of a group that controls it.

2. For Margot:

   Subsection 84.1(1) applies to the transfer of her shares to LK Management Inc. for the same reasons.

Paragraph 84.1(2)(d) extends the concept of arm's length as defined in section 251, stipulating that a trust and its beneficiaries or persons related to the beneficiaries are deemed not to deal with each other at arm's length.

LEVEL 1

Paid-up capital reduction

As noted above, the tax consequences of section 84.1 depend on the nature of the consideration received on the transfer: shares or non-share consideration.

Under paragraph 84.1(1)(a), where the consideration received on the transfer includes shares, the PUC of each class of shares affected by the share issue may be reduced. The reduction of the PUC of a particular class is computed using the following formula:

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

where

A = the increase in the PUC of *all* classes of shares of the share capital of the purchaser corporation following the issue of new shares in consideration of the transfer

B = the greater of:
(i) PUC, immediately before the disposition, of the shares sold;
(ii) the ACB to the vendor, immediately before the disposition
less:
the FMV, immediately after the disposition, of the NSC received by the vendor

C = the increase in the PUC of the particular class of shares following the issue of share of this class in consideration of the transfer

Note that the second part of the operation, expressed by the fraction C/A, has effect only when shares of more than one class are issued in the transfer. If shares of only one class are issued, the result of the fraction C/A is 1.

If the vendor receives shares of more than one class as consideration, the reduction is applied to the different classes of shares received in proportion to the increase in the PUC before the reduction.

Examples 3-3 and 3-4 illustrate how the PUC reduction is calculated under paragraph 84.1(1)(a).

EXAMPLE 3-3

Rita Gagné resides in Canada. She is the sole shareholder of Xiang Ltd. and Pelican Ltd. She transfers to Pelican Ltd., at their FMV, shares of Xiang Ltd. acquired when issued after 1971 and receives in consideration only Class C shares issued by Pelican Ltd. No Class C shares were issued before this transaction. Xiang Ltd. is resident in Canada.

Shares of Xiang Ltd.

FMV	$ 50,000
ACB	$ 100
PUC	$ 100

Class C shares of Pelican Ltd. issued as consideration

FMV	$ 50,000
Legal PUC	$ 50,000

Tax consequences

Subsection 84.1(1) applies to the transfer of shares since all the conditions set out in it are met:

- The shares of Xiang Ltd. are a capital property for Rita.
- The vendor, Rita, is not a corporation.
- Rita and Xiang Ltd. are resident in Canada.
- The purchaser, Pelican Ltd., is a corporation.
- Rita and Pelican Ltd. do not deal at arm's length, since Rita is the sole shareholder of Pelican Ltd.
- After the purchase, Pelican Ltd. holds all the shares of Xiang Ltd., and the corporations are therefore connected within the meaning of subsection 186(4).

Since Rita has received only Class C shares in exchange for the shares of Xiang Ltd., paragraph 84.1(1)(a) applies, reducing the PUC of the Class C shares.

The following is a breakdown of the tax consequences of the transaction for the parties involved.

1. Reduction of the PUC of the Class C shares of Pelican Ltd. [84.1(1)(a)]:

Computation of the reduction

A = Increase in the PUC of all classes of shares of the capital stock of Pelican Ltd. as a result of the issue of new shares as consideration for the transfer		$ 50,000	
B = The greater of the following amounts relating to the transferred shares: (i) PUC: $100 (ii) ACB: $100	$ 100		
Less: FMV of the NSC	—	$ 100	
C = Increase in the PUC of the Class C shares		$50,000	

$$(A - B) \times \frac{C}{A} = (\$50{,}000 - \$100) \times \frac{\$50{,}000}{\$50{,}000}$$ $49,900

Computation of the paid-up capital of the Class C shares

PUC before the reduction	$ 50,000
Less: Reduction under 84.1(1)(a)	(49,900)
PUC for tax purposes	$ 100
Legal PUC	$ 50,000

2. For Rita:

Capital gain on disposition of the shares of Xiang Ltd.

POD	$50,000
ACB	(100)
Capital gain	$49,900
Taxable capital gain (1/2)	$24,950

Note that Rita will be able to claim the CGD with respect to this gain if the shares of Xiang Ltd. are qualified small business corporation shares.

ACB of Class C shares of Pelican Ltd.	$50,000
PUC of the Class C shares of Pelican Ltd.	
Since Rita holds all the Class C shares: 100% × $100	$ 100

3. For Pelican Ltd.:

ACB of the shares of Xiang Ltd.	$50,000

EXAMPLE 3-4

Using the same information as in Example 3-3, now assume that the ACB of the shares transferred is not $100 but $20,000. This could be the case, for example, if Rita Gagné purchased the shares from a previous shareholder.

Tax consequences

The tax consequences are the same except with respect to the reduction of the PUC of the Class C shares of Pelican Ltd.

Reduction of the PUC of the Class C shares of Pelican Ltd. [84.1(1)(a)]:

Computation of the reduction

A = Increase in the PUC of all classes of shares of the capital stock of Pelican Ltd. as a result of the issue of new shares in consideration of the transfer		$ 50,000	
B = The greater of the following amounts relating to transferred shares: (i) PUC: $100 (ii) ACB: $20,000	$ 20,000		
Less: FMV of the NSC	—	$ 20,000	
C = Increase in the PUC of the Class C shares		$50,000	
$(A - B) \times \frac{C}{A} = (\$50{,}000 - \$20{,}000) \times \frac{\$50{,}000}{\$50{,}000}$			$30,000

Computation of the paid-up capital of the Class C shares

PUC before the reduction	$ 50,000
Less: Reduction under 84.1(1)(a)	(30,000)
PUC for tax purposes	$ 20,000
Legal PUC	$ 50,000

The PUC of the shares received in consideration therefore cannot be reduced for tax purposes to an amount less than the ACB of the transferred shares, since there is no non-share consideration. If there was NSC of $20,000, the PUC of the shares received as consideration

would be reduced to nil for tax purposes, since element B of the formula would then have been equal to zero.

Immediate dividend

Under paragraph 84.1(1)(b), a dividend may result from a non-arm's length sale of shares, if the consideration includes non-share property.

Thus, the vendor may receive tax-free, NSC for an amount equal to the greater of the following amounts:

- PUC of the shares transferred
- ACB of the shares transferred

When the non-share consideration exceeds this amount, the excess is taxed as a dividend.

The deemed dividend is computed using the following formula:

$(A + D) - (E + F)$

where

A = the increase in the PUC of all classes of shares of the purchaser corporation following the issue of new shares in consideration of the transfer

D = the FMV, immediately after the disposition, of the NSC received by the transferor

E = the greater of:
  (i) PUC, immediately before the disposition, of the shares transferred
  (ii) the ACB to the vendor, immediately before the disposition, of the shares transferred

F = the PUC reduction computed in paragraph 84.1(1)(a) for all classes of shares concerned

However, to prevent double taxation, paragraph (k) of the definition of POD in section 54 provides that, if a deemed dividend is taxed under paragraph 84.1(1)(b), the POD of the shares disposed of are reduced, as illustrated in Example 3-5.

EXAMPLE 3-5

Pat Moore holds 25% of the issued and outstanding shares of Glory Ltd. He transfers to Beau Ltd., a corporation related to him, the shares of Glory Ltd. that he acquired after 1971. The transfer is carried out under subsection 85(1), and the agreed amount is $40,000.

Shares of Glory Ltd.

FMV	$ 50,000
ACB	$ 100
PUC	$ 100

Consideration paid by Beau Ltd.

Note	$ 40,000
Class A shares — FMV	$ 10,000
— Legal PUC	$ 100

No other Class A shares of Beau Ltd. were issued before the transaction.

Tax consequences

Subsection 84.1(1) applies to the transfer of the shares since all the conditions set out in it are met:

- The shares of Glory Ltd. are a capital property for Pat.
- The vendor, Pat, is not a corporation.
- Pat and Glory Ltd. are resident in Canada.
- The purchaser, Beau Ltd., is a corporation.
- Pat and Beau Ltd. do not deal with each other at arm's length.
- After the purchase, Beau Ltd. holds 25% of the voting shares and the FMV of the shares of Glory Ltd., and the corporations are therefore connected within the meaning of subsection 186(4).

The fact that the transfer is carried under the provisions of section 85 does not prevent subsection 84.1(1) from applying.

Since Pat receives both a share consideration and a non-share consideration, paragraphs 84.1(1)(a) and (b) apply.

The following is a breakdown of the tax consequences of the transaction for the parties involved.

1. Reduction of the PUC of the Class A shares of Beau Ltd. [84.1(1)(a)]:

Computation of the reduction

A = Increase in the PUC of all classes of shares of the capital stock of Beau Ltd. as a result of the issue of new shares in consideration of the transfer	$ 100	
B = The greater of the following amounts relating to the transferred shares:		
(i) PUC: $ 100		
(ii) ACB: $ 100	$ 100	
Less: FMV of the NSC	(40,000)	
(Cannot be negative)		$ —
C = Increase in the PUC of the Class A shares	$ 100	
$(A - B) \times \frac{C}{A} = (\$100 - \$0) \times \frac{\$100}{\$100}$		$ 100

Computation of the paid-up capital of the Class A shares

PUC before reduction	$ 100
Less: Reduction under 84.1(1)(a)	(100)
PUC for tax purposes	$ —

2. For Pat:

Deemed dividend [84.1(1)(b)]

A = Increase in the PUC of all classes of shares of the capital stock of Beau Ltd. as a result of the issue of new shares in consideration of the transfer	$ 100	
D = FMV of the NSC	$ 40,000	
E = The greater of the following amounts relating to the transferred shares: (i) PUC: $ 100 (ii) ACB: $ 100	$ 100	
F = Reduction of the PUC under paragraph 84.1(1)(a)	$ 100	

Deemed dividend:

(A + D) – (E + F) ($100 + $40,000) – ($100 + $100)		$ 39,900

Under paragraph 82(1)(b), this deemed dividend must be grossed up by 25% or 45% when included in Pat'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 varies depending on Pat's province of residence.

Capital gain on disposition of the shares of Glory Ltd. [39(1)(a)]

POD [54]		
Deemed POD [85(1)(a)]	$ 40,000	
Less: Deemed dividend [84.1(1)(b)]	(39,900)	$ 100
ACB of the shares transferred		(100)
Capital gain		$ —
ACB of the Class A shares of Beau Ltd. [85(1)(g)]		$ —

PUC of the Class A shares of Beau Ltd.

Since Pat holds all the Class A shares: 100% × $0		$ —

3. For Beau Ltd.

ACB of the shares of Glory Ltd. [85(1)(a)]		$ 40,000

Example 3-5 clearly illustrates the need to have a good grasp of how subsections 85(1) and 84.1(1) interrelate when there is a transfer of shares to a corporation which is being dealt with at arm's length. In this example, assuming that the agreed amount was set at $40,000 in order to create a capital gain eligible for the CGD or to use net capital losses, the objective is not achieved. The NSC, set at $40,000, is greater than the PUC and the ACB of the transferred shares, and this results in a deemed dividend under paragraph 84.1(1)(b). Also note that under paragraph 84.1(1)(a), there is a reduction of the PUC of the shares received, and this takes precedence over subsection 85(2.1).

ACB adjusted for purposes of section 84.1

For purposes of the computation of the PUC reduction [84.1(1)(a)] and the deemed dividend [84.1(1)(b)], the ACB of the shares sold may be modified if the shares sold were acquired before January 1, 1972, or if they were acquired after 1971 from a person with whom the taxpayer was not dealing at arm's length.

Under paragraph 84.1(2)(a), the ACB of a share acquired before 1972 is determined without reference to ITAR 26(3) and 26(7), meaning that the gain accrued to December 31, 1971, is not included. In addition, any dividend received after 1971 in respect of which an election was made under subsection 83(1) before 1979 is added to the ACB. The latter adjustment is required because the amount of the dividend reduces the ACB under paragraph 53(2)(a). It therefore cancels the effect of the dividend on the ACB, because the increase in value accrued to December 31, 1971, is not taken into consideration.

Under paragraph 84.1(2)(a.1), the ACB of a share acquired after 1971 from a person who does not deal at arm's length with the vendor is deemed to be equal to:

ACB for the vendor
Less:

(i) Where the share was owned before 1972 by a person not dealing at arm's length with the vendor:

FMV on V-day
Less:

- actual cost on January 1, 1972, for the person not dealing at arm's length with the vendor

and

- any dividend received after 1971 in respect of which an election was made under subsection 83(1)

The result cannot be a negative amount.

(ii) In any other case, including shares owned in 1971:

Capital gains which were reported on the share by the taxpayer or an individual with whom the taxpayer did not deal at arm's length after 1984, to the extent the CGD under section 110.6 was claimed against them.

In both cases, such information is not always easy to obtain, since the income tax and benefit return of the person with whom the taxpayer does not deal at arm's length is not necessarily accessible.

Subparagraph (ii) above prevents two related persons from planning a transaction to take advantage of the CGD and withdraw funds from a corporation owned by them. For example, an individual could sell his shares to his spouse and take advantage of the CGD. His spouse would then sell the shares to a related corporation and would thus receive tax-free POD, since her ACB for the shares would be equal to the FMV. Paragraph 84.1(2)(a.1) prevents such planning, *since for the purposes of section 84.1 only* the CGD claimed by the individual reduces the ACB of the spouse's shares by an equivalent amount.

Subsection 84.1(2.1) also takes into account the fact that a capital gains reserve may have been claimed and the portion of the CGD accordingly claimed in a subsequent year for purposes of subparagraph 84.1(2)(a.1)(ii).

Example 3-6 illustrates how paragraph 84.1(2)(a.1) applies and shows a transaction that gives rise to both a PUC reduction and a deemed dividend.

EXAMPLE 3-6

Lea Blake transfers the shares of Dolly Ltd. to Balcon Ltd., a corporation of which she already owns 100% of the common shares. Lea had acquired all the issued and outstanding shares of Dolly Ltd. from her sister in 1990 for $100,000. Her sister had then realized a capital gain of $30,000 ($22,500 taxable), for which she had taken advantage of the CGD. Lea makes the election provided for in subsection 85(1) to transfer the shares of Dolly Ltd. to Balcon Ltd. The agreed amount is set at $100,000. Lea Blake, Dolly Ltd. and Balcon Ltd. are resident in Canada.

Shares of Dolly Ltd.

FMV	$300,000
ACB	$100,000
PUC	$ 70,000

Consideration paid by Balcon Ltd.

Cash		$100,000
20,000 Class A preferred shares	— FMV	$200,000
	— Legal PUC	$200,000

Before the transaction, there were 5,000 Class A preferred shares of Balcon Ltd. issued to a person other than Lea, having a FMV of $50,000 and a PUC of $10,000. The Class A preferred shares are non-voting shares.

Tax consequences

Subsection 84.1(1) applies to the transfer of the shares, since all the conditions set out in it are met:

- The shares of Dolly Ltd. are a capital property for Lea.
- The vendor, Lea, is not a corporation.
- Lea and Dolly Ltd. are resident in Canada.
- The purchaser, Balcon Ltd., is a corporation.
- Lea and Balcon Ltd. do not deal with each other at arm's length, since Lea controls Balcon Ltd. as she holds 100% of the common shares of Balcon Ltd.
- After the purchase, Balcon Ltd. holds 100% of the shares of Dolly Ltd., and the corporations are therefore connected within the meaning of subsection 186(4).

The fact that the transfer is carried out under the provisions of section 85 does not prevent subsection 84.1(1) from applying.

Since Lea receives both a share consideration and a non-share consideration, paragraphs 84.1(1)(a) and (b) apply.

Lea acquired the shares from her sister, a person with whom she does not deal at arm's length. Thus, the ACB of the shares of Dolly Ltd. held by Lea, for the purposes of subsection 84.1(1) only, must be reduced to take account of the amount of the CGD claimed by the sister on the gain that she realizes on the sale of the shares.

The following is a breakdown of the tax consequences of the transaction for the parties involved:

1. ACB of Dolly Ltd. shares for purposes of 84.1(1) [84.1(2)(a.1)]:

ACB for Lea (to sell to Balcon)	$100,000
Less: Capital gain reported by her sister in respect of which the CGD was claimed	(30,000)
ACB for purposes of 84.1(1) → adjustment	$ 70,000

2. Reduction of PUC of Class A shares of Balcon Ltd. [84.1(1)(a)]:

Computation of the reduction

A = Increase in the PUC of all classes of shares of the capital stock of Balcon Ltd. as a result of the issue of new shares in consideration of the transfer	$ 200,000	
B = The greater of the following amounts relating to the transferred shares: (i) PUC $70,000 (ii) **Amended ACB** $70,000	$ 70,000	
Less: FMV of the NSC	(100,000)	
(cannot be negative)	$ —	
C = Increase in the PUC of the Class A shares	$ 200,000	
$(A - B) \times \frac{C}{A} = (\$200{,}000 - \$0) \times \frac{\$200{,}000}{\$200{,}000}$		$ 200,000

Computation of the paid-up capital

PUC of the Class A shares of Balcon Ltd. without reference to 84.1(1)(a) ($200,000 + $10,000)	$ 210,000
Less: PUC reduction	(200,000)
PUC for tax purposes	$ 10,000

3. For Lea:

Deemed dividend [84.1(1)(b)]

A = Increase in the PUC of all classes of shares of the capital stock of Beau Ltd. as a result of the issue of new shares in consideration of the transfer	$ 200,000
D = FMV of the NSC	$ 100,000
E = The greater of: (i) PUC $70,000 (ii) **Amended ACB** $70,000	$ 70,000
F = Reduction in the PUC under paragraph 84.1(1)(a)	$ 200,000

Deemed dividend:		
(A + D) – (E + F)		
($200,000 + $100,000) – ($70,000 + $200,000)		$ 30,000

Under paragraph 82(1)(b), this deemed dividend must be grossed up by 25% or 45% when included in Lea'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 varies depending on Lea's province of residence.

Capital gain on the disposition of shares of Dolly Ltd. [39(1)(a)]

POD [54]		
Deemed POD [85(1)(a)]	$ 100,000	
Less: Deemed dividend [84.1(1)(b)]	(30,000)	$ 70,000
ACB of the shares transferred		(100,000)
Capital loss		$ (30,000)

The $30,000 loss is a superficial loss deemed to be nil under subparagraph 40(2)(g)(i), since Lea and Balcon Ltd. are affiliated immediately before the transfer.

Note that the ACB for purposes of computing the capital loss is not the amended ACB used in computing the reduction in the paid-up capital and the deemed dividend under paragraphs 84.1(1)(a) and (b).

ACB of the 20,000 Class A preferred shares of Balcon Ltd. [85(1)(g)]	$ —

PUC of the 20,000 Class A preferred shares of Balcon Ltd.

$\$10{,}000 \times \frac{20{,}000 \text{ shares}}{25{,}000 \text{ shares}}$ $ 8,000

4. For Balcon Ltd.:

ACB of the shares of Dolly Ltd.

Cost [85(1)(a)]	$100,000
Adjustment for Lea's superficial loss [53(1)(f)]	30,000
	$130,000

5. For the person holding 5,000 preferred Class A shares:

PUC of the 5,000 Class A preferred shares of Balcon Ltd.

$\$10{,}000 \times \frac{5{,}000 \text{ shares}}{25{,}000 \text{ shares}}$ $ 2,000

Note that the PUC of the 5,000 preferred shares, which was $10,000 before the transaction, is now $2,000.

ACB of the 5,000 Class A preferred shares of Balcon Ltd.

The ACB of the shares for this person is not affected.

PUC increase

However, subsection 84.1(3) provides for an increase in the PUC of a class of shares if, on the redemption of shares of this class, the deemed dividend computed on the redeemed shares is due to a PUC reduction under subsection 84.1(1). The PUC increase is required because the reduction under paragraph 84.1(1)(a) applies to the entire class as long as there are shares issued from this class. On a partial redemption of the shares of the class, the effect of the PUC reduction on the redeemed shares must be removed so that the PUC of the remaining shares is affected only by their share of the PUC reduction.

Similarly, if instead of a share redemption, the capital is reduced, resulting in a deemed dividend under subsection 84(4) because of the reduction provided for in paragraph 84.1(1)(a), it is necessary to provide for an increase in the PUC of the class in order to prevent double taxation in the future.

The PUC increase is equal to the lesser of:

(a) the excess of:
   (i) the total of all dividends deemed by subsections 84(3), 84(4), or 84(4.1) to have been paid after May 22, 1985, on shares of that class

   over

   (ii) the amount of the deemed dividend that would have been determined if there had not been a PUC reduction under paragraph 84.1(1)(a), in computing the PUC of shares of that class

(b) the PUC reduction under paragraph 84.1(1)(a) for that class of shares

Example 3-7 illustrates a PUC increase under subsection 84.1(3).

EXAMPLE 3-7

Using the information in Example 3-5, assume that Beau Ltd. redeems one-half of the shares for $5,000.

Tax consequences

1. For Pat:

   Deemed dividend [84(3)]

Amount received	$ 5,000
PUC of the redeemed shares	(—)
Deemed dividend	$ 5,000

   Under paragraph 82(1)(b), this deemed dividend must be grossed up by 25% or 45% when included in Pat'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 varies depending on Pat's province of residence.

Capital gain

Redemption value	$ 5,000
Deemed dividend [84(3)]	(5,000)
POD [54]	—
ACB	—
Capital gain	$ —

2. Increase in the PUC of Class A shares of Beau Ltd. [84.1(3)]

Deemed dividend if there had not been a PUC reduction under paragraph 84.1(1)(a):

Amount received	$ 5,000
PUC without the PUC reduction under 84.1(1)(a) (50% × $100)	(50)
Deemed dividend without 84.1(1)(a)	$ 4,950

Computation of the increase

The lesser of the following amounts:

a. The excess of the real deemed dividend over the deemed dividend if there had not been a PUC reduction $5,000 – $4,950 = $50
b. The reduction of the PUC of the class: $100 — $ 50

PUC of the outstanding Class A shares after the redemption

Legal PUC of the remaining shares	$ 50
Less: PUC reduction [84.1(1)(a)]	(100)
Plus: PUC increase [84.1(3)]	50
	$ —

Difference in application between section 84.1 and subsection 85(2.1)

Up to now you have studied two ITA provisions that affect the PUC of shares issued in consideration of a transfer of property, namely section 84.1 and subsection 85(2.1). Exhibit 3-1 should help you distinguish between these provisions as to the conditions under which they apply and their consequences. As this is a *summary*, aspects previously studied are not repeated.

EXHIBIT 3-1

84.1	85(2.1)
Conditions	
• Transferor: any taxpayer residing in Canada, except for a corporation • Purchaser: corporation not dealing at arm's length with the transferor • Property transferred: a share of a corporation resident in Canada • Any share transfer transaction: at FMV or rollover under section 85 or other provision of the ITA • Immediately after the share transfer, the corporation whose shares are transferred is connected to the purchaser	• Transferor: any taxpayer or any partnership • Purchaser: any taxable Canadian corporation • Property transferred: any eligible property under 85(1.1) • Subsections 85(1) or 85(2) must apply on the transfer of the property • **Does not apply where section 84.1 applies**
Consequences	
• Reduction of the PUC of the shares issued as consideration • Immediate taxable dividend if the consideration includes non-share property	• Reduction of the PUC of the shares issued as consideration

For other comments and illustrations relating to section 84.1, read paragraphs 1 to 12 of IT-489R.

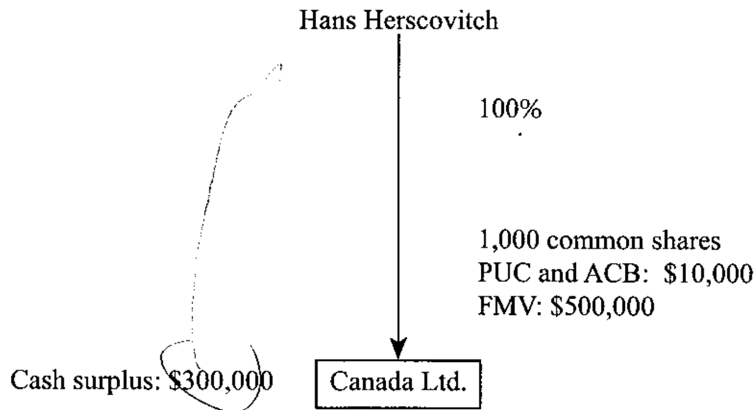
Sale of shares by a non-resident to a corporation resident in Canada

In the absence of section 212.1, a non-resident holding shares in a Canadian corporation could have sold his shares to another corporation resident in Canada with which he was not dealing at arm's length, and thus convert a dividend that he may have received from the first corporation into a capital gain. This planning technique would have been very advantageous because a number of tax conventions entered into by Canada provide that capital gains realized on the sale of shares are not taxable in Canada.

Example 3-8 illustrates a situation contemplated by section 212.1.

EXAMPLE 3-8

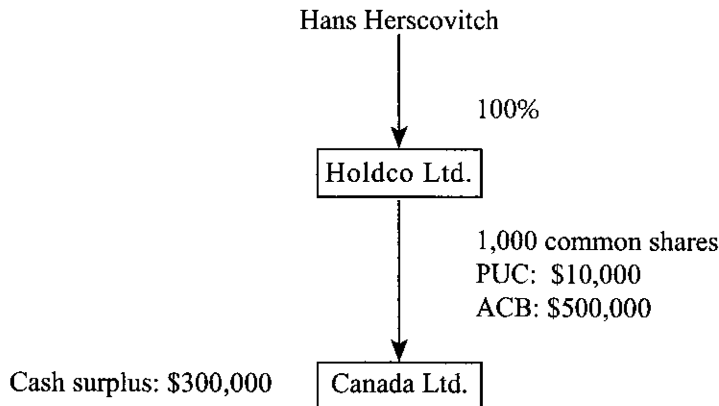
Hans Herscovitch is a resident of a country with which Canada has signed a tax convention, which provides that the capital gain on the sale of shares of a Canadian corporation is not taxable in Canada for Hans. This tax convention also provides that the withholding tax rate on dividends is 15%. Hans is the sole shareholder of Canada Ltd., a Canadian corporation. He holds 1,000 common shares. The PUC and ACB of the shares is $10,000, and their FMV is $500,000. Canada Ltd. has excess cash of $300,000 that Hans would like to take out of the company personally.



In order to transfer the cash to Hans, Canada Ltd. could pay him a dividend of $300,000. This dividend would be subject to Part XIII tax, with the result that Hans would receive $255,000 (after the withholding tax of 15%, stipulated in the tax convention).

Planning

In order to avoid payment of Part XIII tax on the dividend, Hans could incorporate a new Canadian corporation, Holdco Ltd., to which he would sell the shares of Canada Ltd. for $500,000, payable by the issuance of a $500,000 note. As a result of this transaction, Holdco Ltd. and Canada Ltd. would be connected corporations within the meaning of subsection 186(4).



Were it not for section 212.1, the sale of the shares of Canada Ltd. to Holdco Ltd. would result in a taxable capital gain for Hans of $245,000 [($500,000 – $10,000) × 1/2] which, under the tax convention, would not be subject to tax in Canada.

Canada Ltd. would then pay a dividend to Holdco Ltd. This dividend would not be subject to Part I tax, since it would be deductible under section 112. Nor would it be subject to Part IV tax, except insofar as Canada Ltd. was entitled to a dividend tax refund, since Holdco Ltd. and Canada Ltd. would be connected corporations.

Holdco Ltd. would then pay Hans $300,000 of the $500,000 note. This payment would have no tax consequence in Canada for Hans. In the future, the balance of $200,000 could be paid in the same manner, at points when Canada Ltd. had cash available.

To prevent this type of transaction, an anti-avoidance rule was introduced into the ITA. Under this rule, which is similar to section 84.1 (applicable only to Canadian residents), the non-resident may not withdraw, on a tax-free basis, more than the paid-up capital of the shares transferred.

Section 212.1 applies when

(i) a non-resident disposes of shares of a corporation resident in Canada to another corporation resident in Canada with which he does not deal at arm's length

and

(ii) immediately after the disposition, the first corporation is connected, within the meaning of subsection 186(4), to the purchaser corporation

Under subsection 212.1(3), the concept of not dealing at arm's length is extended, as in the case of section 84.1, to the following situation:

(i) the vendor was, immediately before the disposition, one of a group of less than six persons that controlled the corporation whose shares are transferred;

and

(ii) the vendor was, immediately after the disposition, one of a group of less than six persons that controlled the purchaser corporation, each member of which was a member of the group referred to in (i).

The same assumptions as were studied with respect to section 84.1 apply in determining whether the vendor was one of a group of less than six persons.

Immediate dividend

If the non-resident receives proceeds other than shares of the purchaser corporation, he will be deemed to have received a dividend equal to the difference between the fair market value of the non-share consideration and the PUC of the shares transferred. This dividend will be subject to Part XIII tax. Furthermore, if the non-resident wishes to avoid the withholding of 25% of the POD under section 116, he must obtain a certificate for the disposition of taxable Canadian property.

Under paragraph (k) of the definition of "proceeds of disposition" in section 54, the amount of the dividend is excluded from the POD of the shares.

Example 3-9 shows how subsection 212.1 applies when the non-resident receives only non-share consideration.

EXAMPLE 3-9

Assuming the facts are the same as in Example 3-8, apply the provisions of paragraph 212.1(1)(a) to the sale of the Canada Ltd. shares to Holdco Ltd.

Tax consequences

For Hans:

Deemed dividend [212.1(1)(a)]

Non-share consideration	$ 500,000
PUC of transferred shares	(10,000)
Deemed dividend subject to Part XIII tax	$ 490,000
Part XIII tax (15% pursuant to the convention)	$ 73,500

Capital gain on the sale of the Canada Ltd. shares

Selling price	$ 500,000
Deemed dividend [212.1(1)(a)]	(490,000)
POD [54]	10,000
ACB	(10,000)
Capital gain	$ —

Note that the application of paragraph 212.1(1)(a) has the effect of making $490,000 subject to Part XIII tax, whereas Hans has received only $300,000 in cash. This is because the remaining $200,000 that he may receive in the future as a result of the issuance of the note is taken into account immediately.

Reduction of paid-up capital

If the non-resident receives shares as consideration, the PUC of the class of shares that includes the shares received in exchange may be reduced. This reduction is equal to the excess of

- the increase in the PUC of the purchaser corporation

less

- the excess of:
  - the PUC of the shares transferred

  over

  - the FMV of any non-share consideration received

If the shares of more than one class of shares are issued in consideration of the transfer, the PUC reduction will be divided among the different classes on the basis of the increase in the PUC of the class in relation to the increase in the PUC of all the classes.

The result of this PUC reduction is that, when the shares are redeemed, the non-resident will be taxed on a deemed dividend.

Read paragraphs 13 to 19 of IT-489R which explain section 212.1.

Example 3-10 illustrates the effect of subsection 212.1(1) where the transaction involves both share and non-share considerations.

EXAMPLE 3-10

Alain Chamonix, a non-resident of Canada, sells all his shares in Oxford Ltd. to Harper Ltd., a wholly-owned corporation of Alain. Oxford Ltd. and Harper Ltd., two corporations resident in Canada, are related following the transaction.

You have obtained the following information with respect to the transaction:

Sale price	$250,000
Consideration received	
Cash	$ 50,000
100 Class Z shares of Harper Ltd. having a legal PUC of	$200,000
PUC and ACB of the shares transferred — Oxford Ltd.	$ 1,000
FMV of the shares transferred — Oxford Ltd.	$250,000

No other Class Z shares of Harper Ltd. were issued before the transaction.

Tax consequences

Subsection 212.1(1) applies, since the conditions set out in it are met:

- Alain is a non-resident.
- Alain transfers shares of a corporation resident in Canada, Oxford Ltd.
- The transfer is made to another corporation resident in Canada, Harper Ltd., with which Alain does not deal at arm's length, since he holds 100% of its shares.

and

- Immediately after the transfer, Oxford Ltd. and Harper Ltd. are connected corporations.

Since Alain receives both a share consideration and a non-share consideration, paragraphs 212.1(1)(a) and (b) apply.

The following is a breakdown of the tax consequences of the transaction for the parties involved:

1. Reduction of the PUC of the Class Z shares [212.1(1)(b)]:

Computation of the reduction

Increase of the PUC in Harper Ltd.		$200,000
Less:		
the excess of:		
• PUC of the shares transferred	$ 1,000	
over		
• FMV of the non-share consideration	(50,000)	(—)
Reduction of the PUC of the 100 Class Z shares of Harper Ltd. held by Alain		$200,000

Computation of the PUC

PUC of the 100 Class Z shares of Harper Ltd. before reduction	$200,000
Less:	
Reduction of the PUC [212.1(1)]	(200,000)
PUC of the 100 Class Z shares for tax purposes	$ —

2. For Alain:

Deemed dividend [212.1(1)(a)]

Non-share consideration	$ 50,000
PUC of the shares transferred	(1,000)
Deemed dividend subject to Part XIII tax	$ 49,000

Capital gain on the sale of the shares of Oxford Ltd.[1]

Selling price	$250,000
Deemed dividend [212.1(1)]	(49,000)
POD [54]	201,000
ACB	(1,000)
Capital gain	$200,000
Taxable capital gain (1/2)	$100,000[2]

[1] If the shares of Oxford Ltd. are TCP, then the procedures under section 116 should be followed to avoid the withholding of 25% of the POD provided for in that section.

[2] This taxable capital gain may be exempt from Canadian income tax under a tax convention.

ACB of 100 Class Z shares received from Harper Ltd.	$200,000
PUC of the 100 Class Z shares of Harper Ltd.	
Since Alain holds all the Class Z shares: 100% × $0	$ —

3. For Harper Ltd.:

ACB of the shares of Oxford Ltd.	$250,000

Subsection 212.1(2) provides for an increase in the PUC of the class where there is a redemption or purchase of a portion of the shares of the class whose PUC was reduced under subsection 212.1(1). This increase is necessary to eliminate the effect of the overall PUC reduction on the purchase or redemption.

The increase is equal to the lesser of

- the excess of:
  - deemed dividends computed on the shares of the class

  over
  - the amount of deemed dividends, which would have been computed if there had not been a PUC reduction under section 212.1

and
- the amount of the PUC reduction

Example 3-11 shows how subsection 212.1(2) applies.

EXAMPLE 3-11

Using the same information as in Example 3-10, assume that 50 Class Z shares received from Harper Ltd. are redeemed by the corporation at a price of $100,000.

Tax consequences

1. For Alain:

Deemed dividend [84(3)]

Redemption price	$ 100,000
PUC of the 50 shares redeemed	(—)
Deemed dividend [84(3)]	$ 100,000

This dividend is subject to Part XIII tax.

Capital gain

Redemption price	$ 100,000
Deemed dividend [84(3)]	(100,000)
POD [54]	—
ACB	(100,000)
Capital loss	$ (100,000)

This loss is subject to the provisions of subsection 40(3.6) since Alain is the only shareholder of Harper Ltd. and is therefore affiliated with Harper Ltd. Under this subsection, the loss is deemed to be nil and added to the ACB of the shares that Alain still owns in proportion to their FMV.

2. Increase in PUC of non-redeemable Class Z shares

Computation of the addition [212.1(2)]

The lesser of the following amounts:		
• the excess of:		
◦ the deemed dividend	$ 100,000	
over		
◦ the deemed dividend if there had not been a PUC reduction ($100,000 – $100,000)	—	
	$ 100,000	
and		
• the PUC reduction [212.1(1)(b)]	$ 200,000	$ 100,000

Computation of PUC

Legal PUC of the remaining 50 Class Z shares	$ 100,000
PUC reduction [212.1(1)(b)]	(200,000)
	(100,000)
PUC increase [212.1(2)]	100,000
PUC of the 50 Class Z shares	$ —

The capital gain on the disposition of the shares of Oxford Ltd. in Example 3-10 and the capital loss on the redemption of 50 Class Z shares in Example 3-11 could have been avoided if an election had been made under subsection 85(1) and if the agreed amount had been set at $50,000, which is the amount of the non-share consideration. The POD would then have been:

Amount agreed upon [85(1)(a)]	$ 50,000
Deemed dividend	(49,000)
POD	$ 1,000

which is an amount equal to the ACB of the transferred shares. In addition, the cost of the Class Z shares would then have been nil under paragraph 85(1)(g) or (h).

Amount agreed upon [85(1)(a)]	$ 50,000
Cost of the note [85(1)(f)]	(50,000)
Cost of Class Z shares	$ —

Thus, when the Class Z shares were redeemed, there would not have been a capital loss.

In Example 3-10, the deemed dividend under paragraph 212.1(1)(a) could have been avoided by limiting the non-share consideration to an amount less than or equal to the PUC of the transferred shares, namely, $1,000. In such a case, in order to avoid a capital gain, the agreed amount on the rollover under subsection 85(1) should have been set at $1,000, that is, the ACB of the transferred shares.

READING 3-2

Reorganization of capital

LEVEL 1

General rules

The provisions governing reorganizations of capital are very important and are commonly used in tax planning. If it were not for these rules, the reorganization of a corporation's capital would often result in a disposition of the exchanged shares at their FMV at that time with all the resulting tax consequences.

The rules in subsection 86(1) apply on the "reorganization of capital" of a corporation. This expression is not defined either in the ITA or in corporate law. However, it is recognized that the reorganization of capital entails modifying the share capital of the corporation in a manner approved by the shareholders. The modification is generally confirmed by an amendment to the articles of incorporation.

Subsection 86(1) provides for a rollover where, in the course of a reorganization of capital, a taxpayer disposes of all his shares of any class of the capital stock of the corporation (the old shares) in exchange for other shares of the capital stock of the same corporation (the new shares). For the rollover to apply

- the taxpayer must dispose of *all* his shares of the class;
- the shares must be capital property of the taxpayer;
- the taxpayer must receive shares of the same corporation as consideration for the old shares. The consideration is not required to consist solely of shares. However, in order for the reorganization not to have any tax consequences, the non-share consideration must be equal to or less than the ACB and the PUC of the old shares;
- section 85 must not apply to the transaction. [86(3)]

It is important to note that in order for subsection 86(1) to apply, it is not necessary that the corporation be a Canadian corporation or a corporation resident in Canada. Moreover, section 86 applies to all taxpayers whether or not they are resident in Canada.

Section 86 applies automatically. It is not necessary to make an election or file a form for this purpose.

Where all of the preceding conditions are met, the following rules apply to the taxpayer whose shares have been exchanged [paragraphs 86(1)(a), (b), and (c)]:

- The cost of any property (other than shares) received in exchange is equal to the FMV of the property at the time of the exchange.
- The cost of the new shares received in exchange is equal to the ACB of the old shares minus the FMV of the non-share consideration. If shares of more than one class are received, the cost is allocated in proportion to the FMV, immediately after the exchange, of the shares of each class.
- The POD of the old shares are equal to the cost of the new shares and any other property received in exchange. A capital gain will be realized only if the FMV of the non-share consideration is greater than the ACB of the old shares. No capital loss may be realized given that the POD cannot be less than the ACB of the old shares.

Examples 3-12, 3-13, and 3-14 illustrate how the provisions of subsection 86(1) apply.

EXAMPLE 3-12

Dynamite Ltd. is wholly owned by Rosa Rose. The authorized share capital of the corporation consists only of common shares. On incorporation, 1,000 common shares were issued to Rosa for $10,000. Today, the common shares of Dynamite Ltd. are worth $1,000,000.

Rosa wishes to provide an incentive for the corporation's three key employees. These employees do not have the funds to purchase Rosa's shares at their current FMV. It was therefore agreed that a reorganization of capital would be carried out as follows:

- All the common shares currently issued would be converted to non-participating preferred shares having a legal PUC of $10,000 and fixed dividend, and they will be redeemable at the option of the corporation or shareholder for $1,000,000.
- New common shares would be created and issued to Rosa and the three employees in the desired proportions.

Tax consequences

Subsection 86(1) applies, since all the conditions set out in it are met:

- Rosa disposes of all her common shares of Dynamite Ltd. in a reorganization of capital.
- The common shares of Dynamite Ltd. are a capital property for Rosa.
- Rosa receives preferred shares of Dynamite Ltd. in exchange for her common shares of the same corporation.
- No election was made under section 85.

The POD of the common shares disposed of are determined under subsection 86(1). It is then necessary to compute the capital gain on the disposition of the shares.

The following is a breakdown of the tax consequences of the transaction for Rosa.

For Rosa:

Effect of subsection 86(1)

Cost of the new preferred shares [86(1)(b)]:

ACB of the old common shares	$ 10,000
FMV of any non-share consideration	(—)
	$ 10,000

POD of the old common shares [86(1)(c)]:

Cost of any non-share consideration	$ —
Cost of the new preferred shares	10,000
	$ 10,000

Capital gain on the disposition of the old common shares

POD of the old common shares	$ 10,000
ACB of the old common shares	(10,000)
	$ —

EXAMPLE 3-13

Pierre Fortin and Chi Chong are equal shareholders of Salinex Corporation Ltd.

Chi holds 1,000 common shares having a PUC of $50,000 and a FMV of $200,000. These shares have an ACB of $10,000 for Chi.

Chi no longer wants to play an active role in the affairs of Salinex Corporation Ltd., and thus she no longer wishes to participate in its future profits. Chi needs only $30,000 in the short term. She does not require the balance of the FMV of her common shares immediately, provided that she obtains a reasonable return on that value.

An agreement is reached on the reorganization of the share capital of Salinex Corporation Ltd. Chi will exchange her 1,000 common shares of Salinex Corporation Ltd. for:

- a $30,000 promissory note payable on demand, bearing interest at 6%; and
- 1,000 preferred shares of Salinex Corporation Ltd. with a legal PUC of $20,000 and a FMV of $170,000.

Tax consequences

Subsection 86(1) applies, since all the conditions set out in it are met:

- Chi disposes of all her common shares of Salinex Corporation Ltd. in a reorganization of capital.
- The common shares of Salinex Corporation Ltd. are a capital property for Chi.
- Chi receives preferred shares of Salinex Corporation Ltd. in exchange for her common shares of the same corporation.
- No election was made under section 85.

The POD of the common shares disposed of are determined under subsection 86(1). It is then necessary to compute the capital gain on the disposition of the shares.

The following is a breakdown of the tax consequences of the transaction for Chi.

For Chi:

Effect of subsection 86(1)

Cost of the note [86(1)(a)]	$ 30,000
Cost of the new preferred shares [86(1)(b)]:	
ACB of the old common shares	$ 10,000
FMV of the note	(30,000)
(cannot be negative)	$ —
POD of the old common shares [86(1)(c)]:	
Cost of the note	$ 30,000
Cost of the new preferred shares	—
	$ 30,000

Capital gain on the disposition of the old common shares

POD of the old common shares [86(1)(c)]	$ 30,000
ACB of the old common shares	(10,000)
Capital gain	$ 20,000
Taxable capital gain (1/2)	$ 10,000

Example 3-13 shows that, when the non-share consideration exceeds the ACB (but not the PUC) of the old shares, the shareholder realizes a capital gain equal to the amount in excess of the ACB. If the non-share consideration exceeded the PUC of the old shares, there could be a deemed dividend under subsection 84(3), as will be illustrated in Example 3-18.

EXAMPLE 3-14

NSC 7 PUC

Suppose the facts are the same as in Example 3-13, but this time assume that the ACB of the old common shares for Chi is $250,000 rather than $10,000.

Tax consequences

For Chi:

Effect of subsection [86(1)]

Cost of the note [86(1)(a)]	$ 30,000
Cost of the new preferred shares [86(1)(b)]:	
ACB of the old common shares	$250,000
FMV of the note	(30,000)
	$220,000
POD of the old common shares [86(1)(c)]:	
Cost of the note	$ 30,000
Cost of the new preferred shares	220,000
	$250,000

Capital gain on the disposition of the old common shares

POD of the old common shares [86(1)(c)]*	$250,000
ACB of the old common shares	(250,000)
	$ —

* Note that the capital loss of $50,000 ($250,000 – $200,000) accumulated on the old common shares is not recognized in the reorganization of capital because the POD of the old shares cannot be less than their ACB.

If the old shares were held on December 31, 1971, the tax-free zone will be transferred to the new shares only if one class of shares of the corporation was received as consideration and if subsection 86(2) does not apply [ITAR 26(27)]. Accordingly, whenever a reorganization of capital concerns shares held on December 31, 1971, it is important that the consideration received for these shares be shares of a same class of the corporation in order to preserve the tax-free zone.

Gift or benefit conferred

Subsection 86(2) sets out a rule preventing the rollover under subsection 86(1) from being used to benefit a related person.

Note that in the following comments we refer to the FMV of the non-share consideration, whereas the ITA refers to the cost of the property constituting the non-share consideration. Recall that under paragraph 86(1)(a) the cost of the property is equal to its FMV at the time of

the exchange; hence there is no error in this reading. In our opinion, using the FMV makes it easier to understand the intent of subsection 86(2).

Subsection 86(2) applies where

- the shares are exchanged in the course of a reorganization of capital to which subsection 86(1) applies
- the FMV of the old shares immediately before the exchange was greater than the FMV of the non-share consideration plus the FMV, immediately after the exchange, of the shares received

and

- it is reasonable to regard the excess calculated above as a "benefit" that the taxpayer desired to have conferred on a related person

Where all of the preceding conditions are met, the following rules apply [paragraphs 86(2)(c), (d), and (e)]:

- the POD of the old shares are deemed to be equal to the lesser of
  - the FMV of the non-share consideration plus the amount of the benefit previously computed
  - the FMV of the old shares immediately before the exchange
- any capital loss incurred by the taxpayer on the disposition of the old shares is deemed to be nil
- the cost of the new shares received in exchange is deemed to be equal to the excess, if any, of the ACB of the old shares over the FMV of the non-share consideration plus the amount of the benefit conferred on a related person. If more than one class of shares is received, the cost is allocated among the shares of the various classes in proportion to the FMV, immediately after the exchange, of the shares of each class

The result of these computations may give rise to an immediate capital gain or a reduction in the ACB of the new shares received, depending on the facts.

Example 3-15 illustrates the rules that apply when a benefit is conferred on a related person in a reorganization of capital.

EXAMPLE 3-15

Dan Farrell has been the sole shareholder of Atlas Ltd. since its incorporation in 1985. At that time, Dan had invested $1,000 to acquire 1,000 common shares of Atlas Ltd. Now, at age 65, Dan is considering retiring in favour of his daughter who is actively involved in the business operated by Atlas Ltd. The 1,000 shares of Atlas Ltd. are presently worth $200,000.

Dan decides to reorganize the capital of Atlas Ltd. in order to have his daughter become a common shareholder of the corporation. Dan exchanges his 1,000 common shares for 1,000 preferred shares having a total legal PUC of $1,000 and a redemption value of $150,000. His daughter then acquires 100 common shares for $100.

Tax consequences

Subsection 86(2) applies, since

- Dan exchanges his common shares of Atlas Ltd. for preferred shares of Atlas Ltd. in a reorganization of capital;
- The FMV of the common shares was $50,000 more than that of the preferred shares received in exchange ($200,000 – $150,000);

and

- It is reasonable to believe that Dan wanted his daughter, a person with whom he has a non-arm's length relationship, to benefit in the amount of $50,000.

The following is a breakdown of the tax consequences of the transaction for Dan.

For Dan:

Benefit [86(2)]

FMV of old common shares		$ 200,000
Less: FMV of non-share consideration	$ —	
FMV of new preferred shares	150,000	(150,000)
Benefit		$ 50,000

Capital gain on the disposition of the old common shares

POD [86(2)(c)]		
The lesser of the following amounts:		
(i) FMV of the non-share consideration + amount of the benefit (0 + $50,000)	$ 50,000	
(ii) FMV of the old shares	$ 200,000	$ 50,000
ACB		(1,000)
Capital gain		$ 49,000
Taxable capital gain (1/2)		$ 24,500

Cost of the new preferred shares [86(2)(e)]

ACB of the old common shares		$ 1,000
Less the total of:		
(i) FMV of any non-share consideration	$ —	
(ii) Amount of the benefit	50,000	(50,000)
Cost of the preferred shares (cannot be negative)		$ —

In Example 3-15, there is an immediate capital gain because the amount of the benefit exceeds the ACB of the old shares. Where the amount of the benefit plus the FMV of any non-share consideration is less than the ACB of the old shares, there is no immediate capital gain. However, the cost of the new shares is reduced by the amount of the benefit. Tax on the benefit conferred on a related person is thus deferred until the disposition of the new shares.

Valuation and characteristics of the new shares

In carrying out a reorganization of capital, one of the major tasks is valuation of the shares exchanged so that an appropriate consideration can be given in the exchange. Both in cases where the reorganization of capital is carried out in order to bring in new, unrelated shareholders, and in the case of related shareholders, this valuation enables the current shareholder to recover his due when the reorganization takes place. He is not interested in making a "gift" to unrelated persons, and he generally wants to avoid triggering the application of subsection 86(2) in the case of related persons. Also, the new shareholders do not want the shareholder whose shares are exchanged to receive more than his due.

Valuation of the shares must be done according to the rules that apply to valuation of a business, and this task should be conferred on someone who is competent in valuation. Valuation by the client is generally not reliable, since the client tends to overvalue the business in many cases.

A second important aspect to keep in mind in a reorganization of capital is the consideration paid, and more specifically the characteristics of the shares issued in exchange for the old shares. Different characteristics may be attached to the shares, which may be

- voting or non-voting
- with fixed or discretionary dividends
- with cumulative or non-cumulative dividends
- redeemable at the option of either the corporation or the holder, the holder only, or the corporation only
- redeemable for a fixed amount or at a premium
- superseding other shares with respect to dividends or upon winding up, and so on.

The characteristics given to shares serve to determine their value. When the parties involved in the reorganization are not related, CRA is seldom concerned with the characteristics of the new shares, since subsection 86(2) does not apply in this case. On the other hand, if the parties are related, CRA looks at whether the characteristics are attractive enough for the person to be considered to have received a consideration equal to the FMV of the shares exchanged.

From a practical standpoint, CRA has at different times stated its position on the FMV of preferred shares. Thus, the redemption value of preferred shares will be considered to be their FMV when they have the following characteristics:

- The shares are retractable (at the option of the shareholder).
- The shares entitle the shareholder to a reasonable dividend. However, this dividend may be non-cumulative.
- The shares may or may not entitle the shareholder to vote in all circumstances. If they are non-voting shares, they must nevertheless provide for a right to vote with respect to any change affecting the class.
- The shares must have priority in the event of distribution of the assets of the corporation on a liquidation or dissolution.
- No dividend may be payable on the shares of the other classes if the amount of the dividend is such that the corporation cannot redeem the preferred shares for the amount stipulated for the redemption.

Because of the many problems that arise in valuing exchanged shares, a price adjustment clause should normally be included in the description of the shares received in exchange. This clause provides that if CRA disputes the FMV of the exchanged shares, the redemption value of the shares issued in exchange will be adjusted or there will be a share issue or cancellation, as the case may be. The conditions set out in IT 169 must be met in order for CRA to accept the price adjustment clause.

Computation of paid-up capital

Subsection 86(2.1) provides for adjustments to the PUC of the class of shares that includes the shares received as consideration in a reorganization of capital if, as part of the reorganization, there is an increase in the PUC of the shares of the corporation. This may occur if the PUC of the new shares was greater than the PUC, for tax purposes, of the shares exchanged. Without the adjustment provided for in subsection 86(2.1), such an increase in capital would have resulted in a dividend under subsection 84(1).

Paragraph 86(2.1)(a) provides for a reduction in the PUC of the new shares of a particular class, to be computed as follows:

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

where

A = increase in the PUC of the classes of shares following the reorganization of capital

B = excess of the PUC of the old shares over the FMV of the non-share consideration

C = increase in the PUC of the particular class

The second part of the calculation, expressed by the fraction C/A, has effect only when shares of more than one class are issued as consideration for the old shares in the reorganization. If shares of only one class are issued, the result of the fraction C/A is 1.

Example 3-16 illustrates a situation in which paragraph 86(2.1)(a) applies.

EXAMPLE 3-16

Anne Gauthier holds 10 common shares of Beta Inc., a CCPC. These shares have an FMV of $100,000 and a PUC and an ACB of $1,000. In a reorganization of capital to which section 86 applies, she exchanges her 10 common shares for 1,000 preferred shares retractable for $100,000, with a legal PUC of $100,000 ($100 per share). The 1,000 preferred shares are the only preferred shares issued by Beta Inc.

Tax consequences

1. PUC of the preferred shares:

Reduction of PUC [86(2.1)(a)]

$(A - B) \times \frac{C}{A} = (\$100{,}000 - 1{,}000) \times \frac{\$100{,}000}{\$100{,}000}$	$ 99,000

Computation of the PUC of the preferred shares

Legal PUC	$100,000
PUC reduction [86(2.1)(a)]	(99,000)
PUC for tax purposes of the preferred shares	$ 1,000

or $1 per share

2. For Anne:

Effect of subsection 86(1)

Cost of 1,000 new preferred shares [86(1)(b)]:

ACB of the old common shares	$ 1,000
FMV of any non-share consideration	—
	$ 1,000

POD of the old common shares [86(1)(c)]:

Cost of any non-share consideration	$ —
Cost of the 1,000 new preferred shares	1,000
	$ 1,000

Capital gain on the disposition of the old common shares

POD of the old common shares	$ 1,000
ACB of the old common shares	(1,000)
	$ —

PUC of the 1,000 new preferred shares

Since Anne holds all the preferred shares:	
100% × $1,000	$ 1,000

Paragraph 86(2.1)(b) provides for an increase in the PUC of the class of shares that underwent a reduction of PUC under paragraph 86(2.1)(a) where there is a subsequent deemed dividend on the redemption, cancellation, or reduction of capital of the shares in this class. The increase generally corresponds to the fraction of the deemed dividend attributable to the reduction of PUC. This adjustment is necessary since the reduction of PUC under paragraph 86(2.1)(a) affects this class across the board. If the shares are redeemed or cancelled, it is necessary to ensure that the PUC of the remaining shares is affected only to the extent of their share of the PUC reduction.

Example 3-17 illustrates the increase in PUC under paragraph 86(2.1)(b) when there is a redemption of shares giving rise to a deemed dividend under subsection 84(3).

EXAMPLE 3-17

Suppose the facts are the same as in Example 3-16, but assume that Beta Inc. redeems 500 preferred shares for $50,000.

Tax consequences

1. For Anne:

Deemed dividend [84(3)]

Amount received on redemption	$ 50,000
PUC of preferred shares (500 × $1)	(500)
	$ 49,500

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when included in Anne'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 varies depending on Anne's province of residence.

Capital gain

POD [54]		
Amount received on redemption	$ 50,000	
Deemed dividend [84(3)]	(49,500)	$ 500
ACB of 500 preferred shares ($1,000 × 500 ÷ 1,000)		(500)
Capital gain		$ —

2. PUC of the remaining 500 preferred shares of Beta Inc.:

Increase in PUC [86(2.1)(b)]

The lesser of:

(i) Deemed dividend on redemption	$ 49,500	
Less: Deemed dividend if there had been no reduction under 86(2.1)(a)	—	
	$ 49,500	$ 49,500
(ii) Reduction of PUC [86(2.1)(a)]	$ 99,000	

PUC of the 500 preferred shares remaining after the increase

Legal PUC of remaining shares (500 × $100)	$ 50,000
Reduction of PUC [86(2.1)(a)]	(99,000)
Increase in PUC [86(2.1)(b)]	49,500
PUC for tax purposes of the 500 preferred shares	$ 500

or $1 per share

Deemed dividend under subsection 84(3)

When a reorganization of capital is carried out by a corporation resident in Canada, the consideration received must be determined carefully if a deemed dividend under subsection 84(3) is to be avoided.

A dividend may be deemed under subsection 84(3) if the FMV of the non-share consideration received in exchange plus the PUC of the new shares exceeds the PUC of the old shares, as illustrated in Example 3-18.

EXAMPLE 3-18

Ito Okamoto holds 1,000 common shares of Romance Ltd. that have an ACB and a PUC of $1,000. These shares have a FMV of $200,000. In a reorganization of capital to which section 86 applies, Ito receives the following in exchange for his 1,000 common shares of Romance Ltd.:

- a note for $50,000
- preferred shares having a legal PUC of $1,000 and a redemption value of $150,000

No preferred shares were issued before the reorganization of capital.

Ito and Romance Ltd. are resident in Canada.

Tax consequences

For Ito:

Effect of section 86

Cost of the note [86(1)(a)]		$ 50,000
Cost of the new preferred shares [86(1)(b)]		
ACB of the old common shares	$ 1,000	
FMV of the note	(50,000)	$ —

POD of the old common shares [86(1)(c)]		
Cost of the note	$ 50,000	
Cost of the new preferred shares	—	$ 50,000
PUC of the new preferred shares:		
Legal PUC	$ 1,000	
Reduction of PUC [86(2.1)(a)]		
$(\$1{,}000 - \$0) \times \frac{1{,}000}{1{,}000}$	(1,000)	$ —

Deemed dividend [84(3)]

Amount paid		
Note	$ 50,000	
PUC of the new preferred shares [84(5)(b)]	—	$ 50,000
PUC of the common shares cancelled		(1,000)
Deemed dividend [84(3)]		$ 49,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when included in Ito'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 varies depending on Ito's province of residence.

Capital gain on the disposition of the old common shares

POD [54]		
POD [86(1)(c)]	$ 50,000	
Deemed dividend [84(3)]	(49,000)	$ 1,000
ACB		(1,000)
Capital gain		$ —

Contrary to what one may believe from an initial reading of section 86, this example demonstrates that a transaction cannot be structured to create a capital gain eligible for the CGD on a reorganization of capital. The interrelationship among section 84, the definition of proceeds of disposition in section 54 and section 86 gives rise to a deemed dividend and a reduction in the POD of the old shares, thereby placing the shareholder in the same position as before the reorganization of capital with regard to the distribution of the surplus of the corporation. This means that the shareholder cannot receive funds from the corporation in the form of a capital gain rather than a dividend.

Using a reorganization of capital

A reorganization of capital is frequently used in acquiring an enterprise, chiefly where the purchasers are employees who have insufficient funds. It should be remembered, however, that the vendor who exchanges common shares for preferred shares will have a deemed dividend on the redemption of the preferred shares rather than a capital gain that may be eligible for the CGD.

A reorganization of capital is most commonly used in an estate freeze. The taxpayer who wishes to transfer the future increase in value of a corporation to his children may freeze the value of his shares by exchanging his common shares for non-participating preferred shares. The children may then subscribe for new common shares.

Property convertible to shares of a corporation

LEVEL 1

General rule under subsection 51(1)

Generally, where a capital property is exchanged for another property and the provisions of section 85 or 86 do not apply, there is a disposition of that capital property at its FMV, and a capital gain or loss is immediately realized. Section 51 provides that such a disposition will not occur where a taxpayer exercises the right to convert certain securities of a corporation in exchange for shares of the share capital of the corporation. Where the conditions of section 51 are met, the rollover provisions apply automatically, and no election is required.

This automatic rollover favours the issue of convertible securities, such as obligations convertible into common shares by public corporations. The section 51 rules apply to convertible securities of all corporations, whether public or private, and whether or not they are resident in Canada.

Convertible property is often used in tax planning. The security may be issued with the conversion right attached or the right may be added on a subsequent amendment to the terms of the security. In the latter case, CRA has indicated in paragraph 5 of IT-448 that the addition of an optional conversion feature does not generally involve a disposition, and therefore no tax consequences result.

If the shares of a corporation are exchanged for other shares of the same corporation, the rollover provided for in section 51 applies even if the terms relating to the shares exchanged do not confer the right to make the exchange.

The conditions contained in subsection 51(1) are that

- the exchanged property is capital property of the taxpayer;
- the exchanged property is a share, bond, debenture or note of the corporation;
- the property received in exchange is shares of the share capital of the same corporation. These shares may be shares of one or more classes. A fraction of a share is sufficient to meet this condition, since the definition of the word "share" in subsection 248(1) states that a fraction of a share is considered a share for the purposes of the ITA;
- the exchange is made with the corporation;
- where the property exchanged is a bond or a note, the terms of the security confer on the holder the right to make the exchange.

If all of these conditions are met, the following rules apply [paragraphs 51(1)(c), (d), and (e)]:

- the exchange is deemed not to be a disposition;
- the cost of the shares received is deemed to be equal to the ACB of the convertible property immediately before the exchange. Where shares of more than one class are received, the cost of the shares of each class is computed as follows:

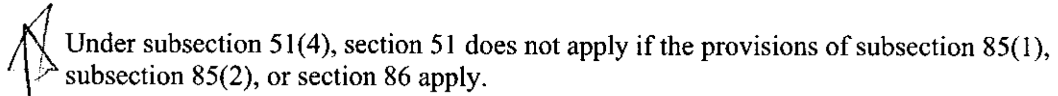
$$\text{ACB of the convertible property} \times \frac{\text{FMV, immediately after the exchange, of the shares of the class acquired on the exchange}}{\text{FMV, immediately after the exchange, of all the shares acquired on the exchange}}$$

and

- for purposes of the attribution rules contained in sections 74.4 and 74.5, the exchange is deemed to be a transfer of property to the corporation.

You will note that, under ITAR 26(24), if the convertible property was held on December 31, 1971, the tax-free zone is transferred to the shares received in exchange.

Generally, subsection 51(1) does not apply if, on the exchange, the taxpayer receives consideration other than shares. However, in IT-115R2, CRA states that it will agree to apply section 51 where a minimal payment ($200 or less) is made on the conversion to avoid issuing a fraction of a share. Refer to paragraphs 3 and 4 of IT-115R2 for details of the tax treatment of the amount paid.



Under subsection 51(4), section 51 does not apply if the provisions of subsection 85(1), subsection 85(2), or section 86 apply.

Example 3-19 explains the application of subsection 51(1).

EXAMPLE 3-19

Since 2003, Jojo Reed has owned 2,000 Class A preferred shares in Public Ltd. for which she paid $10 per share. The shares are redeemable at $12 each at the holder's option and are entitled to a fixed annual dividend of 7%. In addition, the Class A shares are convertible to common shares of Public Ltd. at the rate of two Class A shares for one common share. In August 2008, the common shares of Public Ltd. were trading on a Canadian stock exchange at $25 per share. Jojo wishes to exercise her conversion option with respect to 1,000 of the Class A preferred shares.

Tax consequences

Subsection 51(1) applies, since all the conditions set out in it are met:

- The Class A preferred shares of Public Ltd. are a capital property for Jojo.
- The property exchanged consists of shares.
- The property received in exchange consists of shares of the capital stock of the same corporation, Public Ltd.
- The exchange is made by Public Ltd.
- Section 85 does not apply since no election was made to this effect, and section 86 does not apply since there was no reorganization of the capital of Public Ltd. This is an exchange allowed under the conversion privilege associated with the preferred shares. Furthermore, even if there had been a reorganization of capital, section 86 would not be applied, since there is no exchange of all the shares held by Jojo.

The following is a breakdown of the tax consequences of the transaction for Jojo.

For Jojo:

No disposition of the 1,000 Class A shares [51(1)(c)]

Cost of the common shares [51(1)(d)]

ACB of the 1,000 Class A shares (1,000 × $10)	$ 10,000
Number of common shares received in conversion (1,000 ÷ 2)	500
ACB per common share of Public Ltd.	$ 20

Gift or benefit conferred under subsection 51(2)

Subsection 51(2) contains rules to prevent using the provisions of subsection 51(1) to make a gift to or confer a benefit on a related person. Thus, if the FMV of the convertible property is greater than the FMV of the shares received in exchange and it is reasonable to regard any portion of such excess as a benefit that the taxpayer wished to confer on a related person, the following rules apply [paragraphs 51(2)(d), (e), and (f)]:

- the convertible property is deemed to have been disposed of for POD equal to the lesser of
  - the ACB of the convertible property plus the portion of the excess considered to be a benefit
  - the FMV of the convertible property immediately before the exchange
- the taxpayer's capital loss from the disposition of the convertible property, if any, is deemed to be nil
- the cost of the shares received in exchange is deemed to be the lesser of
  - the ACB of the convertible property
  - the total of the FMV of the shares received and the capital loss resulting from the disposition of the convertible property (before it is deemed to be nil)

If shares of more than one class have been received, the cost will be allocated among the shares of the various classes based on their FMV immediately after the exchange.

Example 3-20 illustrates the tax consequences of a share conversion conferring a benefit on related persons.

EXAMPLE 3-20

Mira Desmarais is the sole shareholder of Fun Products Ltd. She owns 50 common shares that have an ACB of $5,000 and a FMV of $100,000. The common shares are convertible into 50 Class B preferred shares which have a FMV of $60,000.

On September 1, 2008, Mira decides to exercise her conversion option. Her three children subscribe for new common shares of Fun Products Ltd.

Tax consequences

Subsection 51(2) applies, since

- Mira exchanges shares worth $100,000 for Class B preferred shares worth $60,000

and

- It is reasonable to believe that Mira wants her children — persons with whom she has a non-arm's length relationship — to benefit from the difference, namely $40,000 ($100,000 – $60,000).

The following is a breakdown of the tax consequences of the transaction for Mira.

For Mira:

Capital gain

POD [51(2)(d)]

The lesser of:		
(i) ACB + the excess of the FMV of the convertible shares over the FMV of the shares received $5,000 + ($100,000 – $60,000)	$ 45,000	
(ii) FMV of the convertible property	$100,000	$ 45,000
ACB		(5,000)
Capital gain		$ 40,000
Taxable capital gain (1/2)		$ 20,000

Cost of Class B preferred shares [51(2)(f)]

The lesser of:		
(i) ACB of the convertible common shares	$ 5,000	
(ii) FMV of the Class B preferred shares	$ 60,000	$ 5,000

As you can see, the effect of subsection 51(2) is to tax the amount corresponding to the benefit conferred, namely, $40,000, immediately and to defer taxation of the gain corresponding to the value converted into shares. Note that the proceeds of disposition are computed in such a way that the gain immediately taxable can never exceed the capital gain accrued on the convertible property as at the conversion date.

Valuation and characteristics of the new shares

The comments on valuation of the shares exchanged and the characteristics of the new shares in a reorganization of capital (Reading 3-2) also apply to an exchange of shares under subsection 51(1).

Computation of paid-up capital

Paragraph 51(3)(a) provides for a reduction of the PUC of new shares issued in an exchange of shares to which subsection 51(1) applies when the PUC of the new shares exceeds the PUC of the exchanged shares.

The purpose of this reduction is to ensure that the exchange does not result in an increase in the PUC of the shares of the corporation. The reduction of the PUC with respect to a particular class is computed as follows:

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

where

A = increase in the PUC of all the classes of shares following the exchange

B = the PUC of the shares exchanged

C = increase in the PUC of the particular class

Note, once again, that the second part of the operation, expressed by the fraction C/A, has effect only when shares of more than one class are issued in the exchange. If shares of only one class are issued, the result of the fraction C/A is 1.

Example 3-21 illustrates a reduction of PUC under subsection 51(3).

EXAMPLE 3-21

Boris Ostroff holds 1,000 preferred shares of Reno Ltd., a CCPC with which he deals at arm's length. These 1,000 preferred shares were acquired in 1996 in a transaction to which subsection 85(1) applied. They are retractable for $100,000 and are convertible to Class B common shares of Reno Ltd., until December 31, 2009, at the rate of one common share for 10 preferred shares. The ACB of the 1,000 preferred shares for Boris is $1,000. Their legal PUC is $100,000 but their PUC for tax purposes is $1,000 as a result of a reduction of PUC under subsection 85(2.1).

On October 31, 2008, Boris decides to convert 500 preferred shares of Reno Ltd. to 50 Class B common shares with a legal PUC of $50,000 ($1,000 per share).

Tax consequences

1. For Boris:

<u>No disposition of the 500 preferred shares [51(1)(c)]</u>

<u>Cost of the 50 Class B common shares [51(1)(d)]</u>

ACB of the converted preferred shares:

$\$1,000 \times \frac{500}{1,000}$	$ 500
Number of Class B shares	50
ACB of each of the Class B common shares	$ 10

2. PUC of the Class B common shares (assuming there are no other Class B common shares issued)

<u>Reduction in PUC [51(3)(a)]</u>

$(A - B) \times \frac{C}{A} = (\$50,000 - \$500) \times \frac{\$50,000}{\$50,000}$	$ 49,500

<u>Computation of the PUC of the 50 common shares</u>

Legal PUC	$ 50,000
PUC reduction	(49,500)
PUC for tax purposes of the 50 common shares	$ 500

or $10 per share

Paragraph 51(3)(b) provides for an increase in the PUC of the class that underwent a reduction of PUC under paragraph 51(3)(a) when there is a deemed dividend subsequent to the redemption, cancellation or reduction of capital of the shares of that class. The amount of the increase corresponds to the amount of the deemed dividend under subsections 84(3),

84(4), or 84(4.1) that can be attributed to the reduction in PUC under paragraph 51(3)(a). The computation of the increase is identical to the computation provided for in subsection 85(2.1), subsection 84.1(3), and in paragraph 86(2.1)(b) all of which you studied previously.

Example 3-22 illustrates an increase in PUC under paragraph 51(3)(b).

EXAMPLE 3-22

Return to the facts of Example 3-21, but assume that Reno Ltd. purchases, with a view to cancellation, 10 Class B common shares held by Boris for $15,000.

Tax consequences

1. For Boris:

Deemed dividend [84(3)]

Amount paid on purchase	$ 15,000
PUC of 10 Class B common shares (10 shares × $10)	(100)
Deemed dividend	$ 14,900

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when included in Boris'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 varies depending on Boris's province of residence.

Capital gain

POD [54]		
Amount received	$ 15,000	
Deemed dividend [84(3)]	(14,900)	$ 100
ACB (10 shares × $10)		(100)
Capital gain		$ —

2. PUC of the remaining 40 Class B common shares of Reno Ltd.:

Increase in PUC [51(3)(b)]

The lesser of:		
(i) Deemed dividend on purchase	$ 14,900	
Less: Deemed dividend if there had been no reduction of PUC under 51(3)(a) ($15,000 – $10,000)	(5,000)	
	$ 9,900	
(ii) Reduction in PUC [51(3)(a)]	$ 49,500	
		$ 9,900

PUC of the 40 Class B common shares remaining after the increase

Legal PUC of remaining shares (40 × $1,000)	$ 40,000
Reduction in PUC [51(3)(a)]	(49,500)
Increase in PUC [51(3)(b)]	9,900
PUC of the 40 Class B common shares	$ 400

or $10 per share

Using convertible property

The provisions of section 51 may be used on a public offering to attract a certain type of investor. Thus, by offering fixed-yield shares convertible into common shares, a corporation may attract more conservative investors.

Section 51 may also be useful to convert a shareholder's interest into shares of another class when the provisions of section 86 regarding reorganizations of capital do not apply. For example, Mario Lucia and Jane Bolton each own 100 common shares of Tremco Ltd. Mario wishes to gradually retire from Tremco Ltd., but he does not require all the funds immediately. It has therefore been agreed that Mario will immediately convert 50 common shares of Tremco Ltd. into fixed-dividend preferred shares, retractable by Mario at the FMV of the 50 common shares, and that he will convert the remaining 50 common shares in three years, when he has fully retired from Tremco Ltd. While the first conversion could be carried out through a reorganization of capital, section 86 does not apply since Mario did not exchange all the common shares that he held. Therefore, under section 51, the exchange may be carried out without tax consequences.

Furthermore, section 51 may be used to carry out an estate freeze.

Comparison between sections that apply in the case of an exchange of shares

Subsection 85(1), section 86, and section 51 may apply where shares of a corporation are exchanged for shares of the same corporation. Exhibit 3-4 should help you distinguish between the different conditions under which each provision applies, as well as the consequences of their application. Since this is a summary for purposes of comparing the different provisions, not all points previously studied are repeated.

EXHIBIT 3-4

	85(1)	86	51
Conditions			
Status of corporation	• Taxable Canadian corporation	• Corporation resident in Canada or not	• Corporation resident in Canada or not
Type of transaction	• Disposition of shares to the corporation [see 84(9)]	• Disposition of shares as part of a reorganization of capital	• Acquisition of shares of a corporation in exchange for another share of the corporation
Transferred shares	• Some or all of the shares are exchanged	• All shares in the class are exchanged	• Some or all of the shares are exchanged
Possible consideration	• Shares of the same corporation and NSC	• Shares of the same corporation and NSC	• Only shares of the same corporation
Forms	• Election to be made in prescribed form (T2057)	• No form to be filed	• No form to be filed
Priority	• Priority over sections 86 and 51 if the election is made	• Does not apply if the election under 85(1) is made and takes priority over section 51	• Does not apply if subsection 85(1), 85(2) or section 86 applies

Consequences			
Old shares	• Disposition of shares • Total or partial rollover depending on agreed amount elected • Agreed amount subject to specific limits • Possibility of tax consequences if the NSC is greater than the ACB or PUC of the transferred shares	• Disposition of shares • Total rollover if no NSC • Possibility of tax consequences if the NSC is greater than the ACB or PUC of the transferred shares	• No disposition of shares • Total rollover
New shares	• ACB is equal to the ACB of the old shares less the FMV of the NSC	• ACB is equal to the ACB of the old shares less the FMV of the NSC	• ACB is equal to the ACB of the old shares
PUC of the class of the new shares	• PUC: adjustment under 85(2)[1]	• PUC: adjustment under 86(2.1)	• PUC: adjustment under 51(3)

When seeking to create a capital gain in an exchange of shares of a corporation for shares of the same corporation, the best choice is an internal rollover using subsection 85(1). This is the only provision that allows the selection of an agreed amount that will result in the desired capital gain. It is also the only provision that requires filing of a prescribed form. When subsection 85(1) is chosen, sections 86 and 51 become inoperative.

[1] Subsection 84.1(1) does not apply, since the shares of one corporation are exchanged for shares of the same corporation.

READING 3-4

Exchange of shares of one corporation for shares of another corporation

LEVEL 1

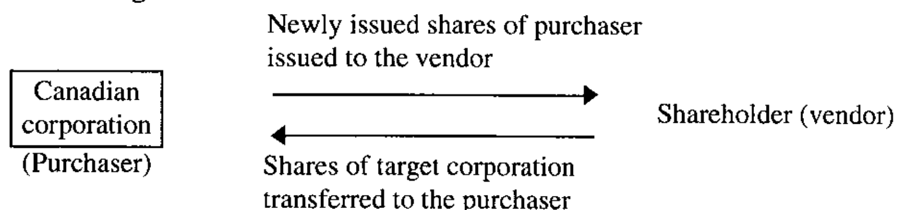
Conditions

The exchange of shares of a Canadian corporation for shares of another Canadian corporation is a type of transaction that is often used in the takeover of one corporation by another. In such a case, the corporation that wants to acquire control of the target corporation approaches the shareholders of the target corporation and offers to exchange shares of its share capital for their shares of the target corporation. Exhibit 3-5 illustrates a transaction to which section 85.1 applies.

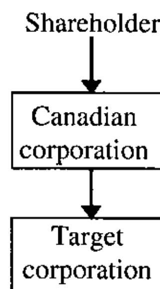
EXHIBIT 3-5

Before the exchange

The exchange



After the exchange



Generally, this type of exchange involves a disposition of the exchanged shares by the vendor for an amount equal to the FMV of the shares received in exchange and the acquisition of the shares of the target corporation by the purchaser corporation for the same amount.

Section 85.1 provides for an automatic rollover (which does not require the filing of any prescribed forms) if all the following conditions are met:

- There must be a disposition by the taxpayer of shares of a corporation (target corporation) in exchange for newly issued shares of the purchaser (purchaser corporation).
- The purchaser must be a Canadian corporation.
- The exchanged shares must be capital property of the vendor and must be shares of a taxable Canadian corporation.
- The vendor and the purchaser must be dealing at arm's length immediately before the exchange.
- After the exchange, the vendor and persons with whom the vendor does not deal at arm's length may not control the purchaser nor beneficially own more than 50% of the FMV of the outstanding shares of the purchaser.
- An election under subsections 85(1) or 85(2) must not have been made with respect to the exchanged shares.
- As consideration for the exchanged shares, the vendor must receive shares of a single class of the purchaser.
- Consideration other than shares must not have been paid.

With respect to the last condition, where consideration other than shares is given to avoid issuing fractions of shares, CRA provides some flexibility similar to that outlined with respect to convertible property. The value of the consideration must not exceed $200. Review paragraph 6 of IT-450R for CRA's policy on this matter.

In addition, under paragraph 85.1(2)(d), the transaction may be structured in such a way that the vendor exchanges one portion of his shares for shares of a particular class of the purchaser and another portion for consideration other than shares. The rollover applies only on the shares exchanged for shares of a particular class of the purchaser. In such a case, the exchange agreement should clearly establish the distinction between the shares exchanged for cash or other property and those exchanged for shares of a particular class of the purchaser.

According to paragraph 7 of IT-450R, where the vendor receives shares and cash or other consideration, for each exchanged share, subsection 85.1(1) may be utilized with respect to the portion of each exchanged share for which only shares were received, provided the offer or exchange agreement clearly indicates that the share consideration will be exchanged for a particular portion of each share offered and that the non-share consideration will be allocated to the balance.

Tax consequences for the vendor

Where the conditions just mentioned are met, the following tax consequences under paragraph 85.1(1)(a) apply to the vendor:

(i) the vendor is deemed to have disposed of the exchanged shares for POD equal to their ACB immediately before the exchange

and

(ii) the vendor is deemed to have acquired the shares of the purchaser at a cost equal to the ACB of the exchanged shares immediately before the exchange

and where the exchanged shares were taxable Canadian property of the vendor, the acquired shares will also be deemed to be taxable Canadian property.

However, the vendor may choose not to take advantage of the rollover by including the gain or loss resulting from the disposition in his tax return for the year of the exchange. Where the vendor chooses to apply section 85.1 to shares owned on December 31, 1971, the tax-free zone of the old shares is transferred to the new shares under ITAR 26(26).

Tax consequences for the purchaser corporation

Under paragraph 85.1(1)(b), the purchaser corporation will be deemed to have acquired each share of the target corporation at a cost equal to the lesser of:

(i) the FMV of the share of the target corporation immediately before the exchange

or

(ii) the PUC of the share of the target corporation immediately before the exchange

Paid-up capital of the shares issued by the purchaser corporation

For share-for-share exchanges after June 5, 1987, the PUC of the shares issued by the purchaser corporation may be adjusted under subsection 85.1(2.1). Under paragraph 85.1(2.1)(a), the PUC of the shares of a particular class issued by the purchaser corporation is reduced by the following amount:

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

where

A = the increase in the PUC of all the classes of shares of the capital stock of the purchaser after the issue

B = the PUC of all the shares of the target corporation received by the purchaser on the exchange

C = the increase in the PUC of the particular class of shares

The effect of subsection 85.1(2.1) is to reduce the PUC of the shares issued by the purchaser corporation to an amount equal to the PUC of the shares of the target corporation. The purpose of this reduction is to prevent:

- the vendor from increasing the PUC of his shares on the exchange and thus converting a deemed dividend, such as on the redemption of shares, to a capital gain eligible for the CGD

and

- the purchaser corporation from increasing the tax cost of the acquired shares by carrying out a series of share-for-share exchanges

Under paragraph 85.1(2.1)(b), the PUC of the class of shares that has undergone a reduction of PUC under paragraph 85(2.1)(a) is increased where there is a subsequent deemed dividend on the redemption, purchase or reduction in the capital of the shares of the class, due to a reduction in the first computation. This adjustment is required because the PUC reduction affects the class of shares as a whole. Where shares of the class are redeemed or purchased, the effect of the PUC reduction on the redeemed or purchased shares must therefore be removed so that the remaining shares are affected only by their portion of the PUC reduction. The PUC increase is computed in the same manner as in subsections 84.1(3) and 85(2.1). The amount of the deemed dividend on the redemption, purchase or reduction of PUC that was caused by the PUC reduction under paragraph 85.1(2.1)(a) must normally be added to the PUC of the class.

Examples 3-23 and 3-24 detail the tax consequences of a share-for-share exchange under section 85.1, including how the PUC of a class of shares is reduced and increased in connection with a share-for-share exchange pursuant to subsection 85.1(2.1).

EXAMPLE 3-23

Micro Ltd., a taxable Canadian corporation, wishes to acquire control of Video Ltd., another taxable Canadian corporation with which it deals at arm's length. Micro Ltd. makes an offer to the sole shareholder of Video Ltd. to acquire the common shares of this corporation. For each common share of Video Ltd., Micro Ltd. offers to issue one Class A share from its share capital which will have a FMV and a legal PUC of $25. No other share of this class is issued before the exchange.

Luc Dubé, who owns the 10,000 common shares of Video Ltd., accepts the offer. Luc acquired his 10,000 common shares in 1992 for $10 per share. The PUC of the shares is equal to the price paid, or $10.

After the Class A shares of Micro Ltd. are issued to Luc, he will hold less than 1% of the vote and the value of the issued shares of Micro Ltd.

No election under section 85 has been made.

Tax consequences

Subsection 85.1 applies, since

- There is a disposition by Luc of shares of Video Ltd. in exchange for newly issued Class A shares of another corporation, Micro Ltd.
- Micro Ltd. is a Canadian corporation.
- The shares of Video Ltd. are a capital property for Luc.
- Luc and Micro Ltd. deal with each other at arm's length before the exchange.
- After the exchange, Luc neither controls Micro Ltd. nor holds shares representing more than 50% of the FMV of the outstanding shares of Micro Ltd.

The following is a breakdown of the tax consequences of the transaction for the parties involved.

1. PUC of the 10,000 Class A shares of Micro Ltd.:

<u>PUC reduction [85.1(2.1)(a)]</u>

$$(A-B)\times\frac{C}{A} = (\$250{,}000-\$100{,}000)\times\frac{\$250{,}000}{\$250{,}000} = \quad \underline{\underline{\$\ 150{,}000}}$$

<u>Computation of the PUC of the Class A shares of Micro Ltd.</u>

Legal PUC of the Class A shares	$ 250,000
PUC reduction	(150,000)
PUC for tax purposes of the 10,000 Class A shares	$ 100,000

or $10 per share

2. For Luc:

Capital gain on the disposition of the shares of Video Ltd.

POD of the 10,000 shares of Video Ltd. [85.1(1)(a)] (10,000 × $10)	$ 100,000
ACB of the 10,000 shares of Video Ltd.	(100,000)
Capital gain	$ —

Cost of the 10,000 Class A shares of Micro Ltd. received in exchange	$ 100,000

or $10 per share

PUC of the 10,000 Class A shares of Micro Ltd.

Since Luc hold all the Class A shares: 100% × $100,000	$ 100,000

Luc may choose not to take advantage of the rollover and realize a capital gain of $150,000 ($250,000 – $100,000). The cost of the shares of Micro Ltd. would then be $250,000. If the shares of Video Ltd. are qualified small business corporation shares, Luc may claim the CGD allowed for this type of property.

3. For Micro Ltd.:

Cost of the shares of Video Ltd. [85.1(1)(b)]

The lesser of:		
(i) PUC of the shares of Video Ltd.	$ 100,000	
(ii) FMV of the shares of Video Ltd.	$ 250,000	$ 100,000

EXAMPLE 3-24

One year later, under a special agreement with Luc, Micro Ltd. redeems one-half of the Class A shares owned by Luc for $30.

Tax consequences

1. For Luc:

Deemed dividend [84(3)]

Amount paid on redemption (5,000 × $30)	$ 150,000
PUC of the 5,000 Class A shares (5,000 × $10)	(50,000)
Deemed dividend	$ 100,000

Under paragraph 82(1)(b), this amount must be grossed up by 25% or 45% when included in Luc'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 varies depending on Luc's province of residence.

Capital gain

POD [54]		
Amount received	$ 150,000	
Deemed dividend [84(3)]	(100,000)	$ 50,000
ACB (5,000 × $10)		(50,000)
Capital gain		$ —

2. PUC of 5,000 remaining Class A shares of Micro Ltd.:

Increase in PUC [85.1(2.1)(b)]

The lesser of:

(i) Deemed dividend on the redemption	$ 100,000	
Less: Deemed dividend if there had not been a PUC reduction under 85(2.1)(a) [5,000 × ($30 – $25)]	(25,000)	
	$ 75,000	
(ii) PUC reduction [85.1(2.1)(a)]	$ 150,000	$ 75,000

PUC after the increase

Legal PUC of shares remaining (5,000 × $25)	$ 125,000
PUC reduction [85.1(2.1)(a)]	(150,000)
PUC increase [85.1(2.1)(b)]	75,000
PUC of the 5,000 Class A shares	$ 50,000

or $10 per share

Using a share-for-share exchange

Section 85.1 is used on the total or partial takeover of a corporation by a Canadian corporation. Even though this section is often used by public corporations, it also applies to private corporations. It is a relatively simple provision to apply for both the purchaser and the vendor, as there is no prescribed form to be filed.

Nevertheless, remember that this section does not apply to transactions between persons not dealing at arm's length or to transactions where the vendor, either alone or with persons not dealing at arm's length, emerges from the transaction controlling the purchaser or beneficially owning shares representing more than 50% of the FMV of the shares issued.

Sometimes, it will be more advantageous for a purchaser corporation to undertake an acquisition using the provisions of section 85 rather than section 85.1. This is the case where the ACB and FMV of the shares of the target corporation for the vendor are greater than the PUC of the shares. In these circumstances, if section 85 is used, the purchaser corporation will have a higher cost for the shares acquired without any additional tax consequences for the vendor. There is also a lesser reduction in the PUC of the shares issued on the exchange. Example 3-25 shows a situation in which it would be more advantageous to use the provisions of section 85 rather than section 85.1.

EXAMPLE 3-25

Omega Ltd., a Canadian corporation, wishes to acquire Target Ltd., another Canadian corporation. It makes an offer to the sole shareholder of Target Ltd. to purchase her shares in exchange for 5,000 of its own Class C shares, having a legal PUC and FMV of $200,000.

Nicole Corbeil, Target Ltd.'s sole shareholder, owns 1,000 common shares of Target Ltd. having a PUC of $1,000. The ACB of Nicole's shares in Target Ltd. is $50,000. Nicole accepts Omega Ltd.'s offer.

Nicole deals at arm's length with Omega Ltd. both before and after the exchange and the 5,000 Class C shares she receives represent 5% of the vote and the FMV of all the shares of the capital stock of the purchaser corporation.

Tax consequences

1. For Nicole:

Capital gain: under section 85.1, disposition at ACB		$ —
Capital gain: under section 85, disposition at ACB, if the agreed amount is equal to the ACB of the shares of Target Ltd.		$ —
ACB of the 5,000 Class C shares of Omega Ltd. received in exchange under both sections		$ 50,000

2. For Omega Ltd.:

Cost of the shares of Target Ltd. if section 85.1 applies

The lesser of the following amounts:		
(i) PUC of the shares of Target Ltd.	$ 1,000	
(ii) FMV of the shares of Target Ltd.	$200,000	$ 1,000

Cost of the shares of Target Ltd. if section 85 applies

Equal to the agreed amount		$ 50,000

3. PUC of the Class C shares of Omega Ltd.:

If section 85.1 applies

Legal PUC	$200,000
PUC reduction [85.1(2.1)(a)]	
$(\$200{,}000 - \$1{,}000) \times \dfrac{\$200{,}000}{\$200{,}000}$	(199,000)
PUC for tax purposes of the 5,000 Class C shares	$ 1,000

If section 85 applies

Legal PUC	$200,000
PUC reduction [85(2.1)(a)]	
$(\$200{,}000 - \$50{,}000) \times \frac{\$200{,}000}{\$200{,}000}$	(150,000)
PUC for tax purposes of the 5,000 Class C shares	$ 50,000

In this example, Nicole incurs the same immediate consequences whether she uses the provisions of section 85 or 85.1. However, it would be more advantageous for Omega Ltd. to use section 85, because its cost of the shares of Target Ltd. would then be $50,000 rather than $1,000 if the provisions of section 85.1 had been used. In addition, if section 85 is used, the PUC of the Class C shares would be $50,000 whereas if section 85.1 is used, the PUC of the shares will be only $1,000. The increased PUC could be advantageous to Nicole in the future if the Class C shares were redeemed or cancelled, since the deemed dividend would then be lower.