

SHARE EXCHANGES, AMALGAMATIONS AND SECTION 88 WIND-UPS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on various types of corporate reorganisations. Due to the complexity of the legislation in this area, this memorandum is not intended to be exhaustive and should not be acted upon without further consultation with professional advisers. In addition, care must be taken not to trigger the provisions of the general anti-avoidance rule in implementing any type of corporate reorganisation. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

A. SECTION 86 ROLLOVERS

1. Tax Aspects

Section 86 of the *Income Tax Act* (Canada) (the "Act") allows a tax-free rollover in the situation where, under a reorganisation of the capital structure of a corporation, a taxpayer disposes of all the shares of any particular class of the capital stock of the corporation ("old shares") in consideration for which property is receivable by the taxpayer from the corporation that includes other shares of the capital stock of the corporation ("new shares"). The Section 86 rollover does not apply: (i) to the disposition of securities other than shares, such as bonds or other debt securities; (ii) to the disposition of shares which do not constitute capital property of the shareholder; and (iii) to dispositions by a shareholder of less than all of the shares of a particular class of the corporation's capital stock. The Section 86 rollover occurs by operation of law and therefore, no election form needs to be filed.

There are certain restrictions which may limit the effectiveness of the Section 86 rollover. Namely, the effect of a Section 86 rollover will be reduced in cases where the value of the new shares and the property other than the shares is less than the value of the old shares, and it is reasonable to consider the difference as being a gift to a person related to the taxpayer. In this instance, subsection 86(2) of the Act provides a formula which determines the amount of the proceeds of disposition of the old shares and the adjusted cost base of the new shares received on the reorganisation. The automatic application of this formula in the aforementioned circumstances may result in the triggering of a capital gain on the disposition of the old shares.

2. Tax Planning Considerations

The Section 86 rollover is most commonly used in the course of an estate freeze. This would involve the re-classification of the common shares of a corporation into special shares by filing Articles of Amendment for the corporation and the transfer of shares of the corporation on a tax-free basis pursuant to a Section 86 rollover to a holding corporation in exchange for redeemable, retractable, demand special shares from the holding corporation that are worth the current fair market value of the shares of the initial corporation. These special shares would control the holding corporation. Adult children of the transferor would then purchase common shares of the holding corporation for a nominal value. Dividends may be paid on these shares to the adult children without any attribution of dividend income on any deemed receipt of interest income back to the transferor, thus permitting a fluctuating dividend to be payable on the special shares.

The value of these special shares does not increase after the date of the estate freeze, while all the future growth of the holding corporation passes to the adult children by virtue of their ownership of the common shares of the holding corporation. This may considerably reduce the transferor's liability for capital gains tax at death.

B. SECTION 51 ROLLOVERS

Section 51 of the *Act* permits a tax-free rollover where the taxpayer exchanges convertible securities for shares of the same corporation. As an alternative to a share-for-share exchange rollover pursuant to section 86 of the *Act*, a corporation may reorganize its share capital by using section 51 of the *Act* to defer the realization of capital gains. This provision allows for a deferral of capital gains on a share-for-share exchange; as a result, the adjusted cost base of the exchanged shares will be the same as the adjusted cost base of the shares which were converted.

A section 51 rollover is available even if the terms and conditions of the exchanged shares do not provide a right of exchange or conversion. Subsection 51(1) of the *Act* may be used in cases where it is desirable to create two or more classes of convertible shares for the purpose of declaring different types of dividends on each class of shares.

One of the requirements under section 86 is that all of the shares of a particular class of a corporation which are owned by the taxpayer must be exchanged for the new shares of the corporation. However, in order to obtain the deferral benefits of a section

51 share for share exchange, this is not necessary and the taxpayer is permitted to merely exchange a portion of his shares of a particular class of the corporation for the new shares of the corporation.

In the event that the transaction results in an indirect gift to a related person, whereby the value of the received shares is less than the value of the convertible property, subsection 51(2) of the Act will apply and override subsection 51(1) of the Act. As a result the taxpayer may be forced to recognize a capital gain on the conversion and to change the adjusted cost base of the exchanged shares.

Subsection 51(3) of the Act contains a provision whereby a paid-up capital deficiency on the exchanged shares will flow through to the shares received by the taxpayer as a result of the share exchange. This provision ensures that the share exchange will not result in any increase in the paid up capital of the exchanged shares to which section 84 of the Act could apply to deem a dividend to have been received by the taxpayer.

Subsection 51(4) provides that a section 51 share for share exchange will only apply to transactions where the provisions of subsections 85(1), 85(2) or section 86 do not apply. Therefore, care must be taken when documenting the transaction to specify that it is the taxpayer intends that the share for share exchange is being governed by the provisions of section 51 of the Act.

C. SECTION 85.1 ROLLOVERS

1. Overview

Section 85.1 permits a taxpayer who holds shares in a taxable Canadian corporation as capital property (“Exchanged Shares”) to dispose of those shares in exchange for treasury shares of a Canadian corporation (“New Shares”) on a tax free basis thereby deferring recognition of any gain or loss until the New Shares are sold in a subsequent taxable transaction. It is important to note that a section 85.1 rollover will not apply if a taxpayer chooses to include the gain or loss from the disposition of the Exchanged Shares in computing the taxpayer’s income in the year of disposition.

2. Requirements

Pursuant to subsections 85.1(1) and 85.1(2) of the Act, the requirements for a section 85.1 rollover are as follows:

- (i) the taxpayer disposing of the Exchanged Shares (the “Vendor”) must have held those shares as capital property;
- (ii) the Corporation acquiring the Exchanged Shares (the “Purchaser”) must be a “Canadian Corporation” and the Exchanged Shares must be shares of a “Taxable Canadian Corporation”;
- (iii) the New Shares must be treasury shares of the Purchaser;
- (iv) the Vendor and the Purchaser must be dealing at arm’s length immediately prior to the section 85.1 rollover;
- (v) The Vendor, persons not dealing at arm’s length with the Vendor, or a combination thereto must not “control” the Purchaser or beneficially own shares of the Purchaser having a fair market value greater than 50% of the total value of the outstanding shares of the Purchaser;
- (vi) There must be no election made under subsection 85(1) or 85(2) of the Act by either the Vendor or the Purchaser;
- (vii) Pursuant to Paragraph 85.1(2)(d) of the Act, the sole consideration given to the Vendor in exchange for the Old Shares must be treasury shares; however the Purchaser may also acquire other Exchanged Shares from the Vendor outside of the provisions of section 85.1 of the Act for a combination of treasury shares and other consideration or entirely for other consideration; and
- (viii) In the case of a Vendor that is a “foreign affiliate” of a resident in Canada at the end of the year in which the exchange took place, the Vendor must not include a gain or loss from the Exchanged Shares in its Foreign Accrual Property Income (“FAPI”).

3. Tax Aspects

A formal election need not be filed in order for a taxpayer to obtain the benefits of a section 85.1(1) rollover. A section 85.1(1) rollover is automatic so long as the taxpayer does not include in income any part of the gain or loss arising from the disposition of the Exchanged Shares.

The tax implications of a section 85.1(1) rollover are as follows:

- (i) The Exchanged Shares are deemed to have been disposed of at their Adjusted Cost Base (ACB);
- (ii) The cost of the New Shares are deemed to be equal to the ACB of the Exchanged Shares; and
- (iii) Where the Exchanged shares were taxable Canadian property of the Vendor, the New Shares are also deemed to be taxable Canadian property of the Vendor.

4. Foreign Corporations and Exchanges

Subsection 85.1(5) of the Act extends the benefits of a section 85.1 rollover to shareholders involved in foreign corporate takeovers. Subsection 85.1(5) of the Act applies on the disposition of shares of one foreign corporation for shares of another on a “share-for-share” exchange or foreign merger. Subsection 85.1(5) of the Act does not require that the foreign corporations be residents of the same foreign jurisdiction.

In the October 2000 Economic Statement, the Government announced that it would consult with interested parties on the merits and technical design of a tax deferral provision that would, if implemented, apply to cross-border share-for-share exchange, (i.e. when a Canadian-resident shareholder exchanges shares of a domestic corporation for shares of a foreign corporation). On September 27, 2005, a representative from the Tax Policy Branch of the Department of Finance stated that the proposals announced in the October 2000 Economic Statement: (i) will be released soon in draft form for discussion purposes; and (ii) will include provisions designed to constrain outbound exchanges followed by treaty exempt sales. To date, the Department of Finance has not yet issued a draft of these proposed changes.

5. Recent Cases

The Queen v. Tremblay et al 2010 DTC 5079 (FCA)

In this Federal Court of Appeal case, the taxpayers owned Telesag (T), a corporation, through a management company (MHT). MHT sold its shares of T to a public corporation, Videotron (V) in exchange for convertible preferred shares of V.

The taxpayers then prepared to emigrate from Canada and sought to reorganize their business affairs to facilitate their departure. As a result, they incorporated a new corporation (8855), and caused MHT to transfer its convertible V preferred shares to 8855. Subsequently, the taxpayers entered into an agreement with V which included a section 85.1 share-for-share exchange wherein the taxpayers transferred all of the outstanding shares of 8855 to V in exchange for newly issued common shares of V. The taxpayers then used a section 88 rollover winding 8855 up into V. As a result, the convertible preferred shares of V held by 8855 were distributed to V and cancelled for no consideration. The taxpayers then left Canada and avoided the provisions of section 128.1 providing for a deemed disposition of each property owned by a taxpayer where the taxpayer ceases to be a resident in Canada, since the newly issued common shares of V qualified as “taxable Canadian property” which are exempt from the deeming provisions of section 128.1 of the Act.

The Minister did however reassess each of the taxpayers for their 1994 taxation year in connection with the disposition of their shares of 8855 by including taxable dividends in their income pursuant to the deeming provisions under subsection 84(2) of the Act. Subsection 84(2) of the act applies where funds or property of a corporation resident in Canada have been distributed or otherwise appropriated to or for the benefit of shareholders on the winding-up, discontinuance or reorganization of the business. The purpose of subsection 84(2) is to prevent shareholders from ending up with a corporation’s property without having to bear the tax consequences of such a distribution or appropriation. The taxpayers took the position that subsection 84(2) of the Act did not apply to the transaction.

The Tax Court of Canada sided with the taxpayer allowing the appeal and held that subsection 84(2) of the Act did not apply. The Tax Court found that although it is possible for subsection 84(2) of the Act and section 85.1 of the Act to apply concurrently, subsection 84(2) did not apply in this case because the legal nature of the common shares of V held by the taxpayers was different than that of the preferred shares held by 8855.

The Federal Court of Appeal decided not to comment on whether the two above-mentioned provisions could apply concurrently. However, the Court of Appeal affirmed the decision of the Tax Court of Canada and held subsection 84(2) of the Act did not apply in this case. The Federal Court stated that in order for subsection 84(2) of the Act to be triggered, “the property distributed or appropriated by the recipient must be property of the Canadian resident corporation in question”. In this case, since the shares issued to V were newly issued shares they could have never been the property of 8855 and, as a result, subsection 84(2) of the Act was not triggered.

D. AMALGAMATIONS

1. Income Tax Aspects

An amalgamation under section 87 of the Act is an effective method of merging together two or more companies into one corporation. Pursuant to section 87 of the Act, a rollover of the assets of the predecessor corporations into the amalgamated corporation is automatically deemed to occur such that all assets, liabilities and various tax accounts of the predecessor corporations flow through to the amalgamated corporation with no tax impact. In order for the Section 87 rollover to occur, the following qualifications must be met: (i) the amalgamation must qualify as a merger of two or more taxable Canadian corporations to form one amalgamated corporation; (ii) each of the predecessor corporations must have the same incorporating jurisdiction; (iii) all of the property and liabilities of each of the predecessor corporations must become the property and liabilities of the amalgamated corporation, subject to certain exemptions; (iv) all of the shareholders of the predecessor corporations immediately before the amalgamation must receive shares of the amalgamated corporation by virtue of the merger, with the exception of shares held by one predecessor corporation in another; (v) the merger must not arise as a result of one corporation acquiring the property of another corporation by virtue of a purchase or a winding-up; and (vi) shares in the predecessor corporations must be held as capital property.

The resulting implications of an amalgamation pursuant to section 87 of the Act are as follows:

- a. The taxation year of each predecessor corporation terminates on the day before the amalgamation and therefore, each predecessor corporation must file a tax return; and

- b. The shareholders of each predecessor corporation, except for shareholders who are other predecessor corporations, are deemed to have disposed of their shares in the predecessor corporations for proceeds equal to the adjusted cost base of such shares. The shareholders are then deemed to have acquired shares in the amalgamated corporation at a price equal to the adjusted cost base of their shares in the predecessor corporations. As a result, no deemed dividend, capital gain or capital loss will result.

2. HST Aspects

On July 1st, 2010, the Government of Ontario implemented the Harmonized Sales Tax ("HST"), which replaced the existing provincial retail sales tax ("RST", also referred to as "PST") and federal goods and services tax ("GST"). The relevant *Excise Tax Act* ("ETA") legislation has not been updated to include the HST amendments as of yet; however, the proposed HST amendments will follow the GST legislation closely.

With respect to the HST implications on an amalgamation, no HST is payable on the transaction, since the transfer of property by the predecessor corporations to the amalgamated corporation is not deemed to be a "supply" within the definition set out in the ETA. Furthermore, while the new amalgamated corporation will generally be deemed to be a separate entity from its predecessor corporations, for certain HST purposes, it will be deemed to be the same corporation and a continuation of its predecessor corporations. For instance, in order to determine the corporation's reporting requirements under the ETA, reference is made to the amount of supplies made by the predecessor corporations. Also, where a new corporation acquires receivables from a predecessor corporation which are subsequently written off as a bad debt, the new corporation is able to recover the HST included in this receivable in the same manner that the predecessor corporation would have been entitled to claim. Finally, on an amalgamation of two corporations, one engaged in a commercial activity and the other making exempt supplies, the change-in-use rules in the ETA may be triggered.

3. Ontario Land Transfer Tax Aspects

In the event that, by virtue of an amalgamation of two or more corporations, the land of the predecessor corporations becomes vested in the amalgamated corporation, the value of the consideration for the conveyance of land is deemed to be nil for the

purposes of determining the land transfer tax eligible on the conveyance. As a result, no land transfer tax would be payable on an amalgamation.

4. Ontario Retail Sales Tax Act Aspects

On July 1, 2010, the federally administered Harmonized Sales Tax (“HST”) replaced the Ontario Retail Sales Tax (“RST”). Section 2.0.0.1 of the *Ontario Retail Sales Tax Act* (the “ORSTA”) has set out certain transitional rules relating to the winding down of the RST. However, pursuant to the former administrative position of the Ministry of Finance, an amalgamation does not result in the transfer of tangible personal property which would give rise to the payment of RST.

5. Tax Planning Considerations

The following tax planning opportunities should be considered in connection with amalgamations:

(a) Consolidation of Businesses:

An amalgamation may be used to consolidate business enterprises, thereby eliminating unnecessary companies within a corporate group;

(b) Losses:

An amalgamation may be used to permit the utilization of the losses of a predecessor corporation against the profits of another corporation through the merged entity, subject to the change of control provisions;

(c) Acquiring Corporations:

An amalgamation may be used as a means of acquiring another corporation;

(d) Squeezing the Minority:

An amalgamation is also used as a means of squeezing a minority to accomplish the acquisition objectives; and

(e) **Asset Bump-Up:**

The new corporation formed on the amalgamation of a parent corporation and a wholly-owned subsidiary corporation may increase its cost of non-depreciable capital property acquired by it from the subsidiary on the amalgamation. This increase is the amount that would have been available if the subsidiary had been wound up into the parent and section 88(1) of the Act had applied to the winding-up. See the commentary regarding the Section 88(1) asset bump-up provisions contained in this memorandum for the limitations regarding the asset bump-up.

E. SECTION 88 WIND-UPS

1. Income Tax Aspects

Section 88 of the Act sets out the general rules dealing with the winding-up or dissolution of a Canadian corporation. There is no definition in the Act of a “winding-up.” However, the CRA, pursuant to Interpretation Bulletin IT-126R2, considers a corporation to have been wound up: (i) where it has followed the procedures for winding-up and dissolution as provided by the appropriate federal or provincial Corporations Act or the federal *Winding-Up Act*; or (ii) where a corporation has carried out a winding-up and has been dissolved pursuant to the provisions of its incorporating statute.

The tax treatment of a winding-up depends upon whether the dissolving corporation is a taxable Canadian corporation that is a wholly-owned (90% or more) subsidiary of another taxable Canadian corporation. In this situation, a tax-free rollover is available with respect to property distributed to the parent and shares of the subsidiary held by the parent. No rollover is available for minority shareholders.

Where the Section 88(1) rollover does apply, the parent company will be deemed to have disposed of its shares in the subsidiary for proceeds equal to the greater of: (i) the adjusted cost base of the shares immediately before the winding-up; and (ii) the lesser of the paid-up capital of the subsidiary and the tax value of its net assets immediately before the winding-up. If the parent’s adjusted cost base of the shares of the subsidiary is equal to or greater than the paid-up capital of the shares, no gain will arise on the winding-up. Also, no capital loss will ever occur on a winding-up, given that the proceeds of disposition must be equal to or greater than the adjusted cost base of the shares. Where a winding-up would trigger a capital gain, an amalgamation instead of a winding-up may be considered. Another option may be to increase the net assets of

the subsidiary in a manner which would increase the adjusted cost base of the shares but not the paid-up capital. Alternatively, the paid-up capital could be reduced or a dividend could be paid to reduce the tax values of the net assets on hand immediately prior to the winding-up.

With respect to the winding-up of a Canadian corporation which is not a wholly-owned subsidiary of another Canadian taxable corporation, no rollover is available on the winding-up. Therefore, the corporation is considered to have disposed of all assets distributed by it to its shareholders at the fair market value of such assets immediately before the winding-up. This will result in either gains or losses, and therefore, an income tax liability may result. In addition, each shareholder in the corporation is considered to have disposed of all of his shares in the corporation. As a result, the corporation is deemed to have paid a dividend equal to the amount by which the value of the cash or property distributed to the shareholders exceeds the amount by which the paid-up capital of the shares is reduced by the distribution. Each shareholder is deemed to receive the dividend on a pro-rata basis.

2. Ontario Land Transfer Tax Aspects

With respect to the land transfer tax implications of a winding-up, land transfer tax will be eligible in respect of any Ontario land that is conveyed by the corporation to a shareholder in the course of a winding-up. This tax is based on the fair market value of the land at the time the conveyance is tendered for registration. In addition, the *Land Transfer Tax Act* now imposes land transfer tax on unregistered dispositions of a beneficial interest in land. However, the land transfer tax legislation does provide a procedure for applying for a deferral of land transfer tax where the underlying control of the corporate group and the interest in the land will remain within the corporate group for three years following the disposition. For the purpose of determining whether this requirement has been met, a corporation which was an affiliate of another corporation immediately before winding-up shall be deemed to continue to exist. Therefore, provided that the disposition of the beneficial interest in the land is made from a corporation prior to its winding-up to an affiliate of that corporation and the underlying control and interest in the land remains with that affiliated corporation for three years, the amount of tax deferred will no longer be owing.

The situation addressed in the *Land Transfer Tax Act* contemplates that the legal title remains in the name of the wound-up corporation. This creates a problem, since both the *Corporations Act* and the *Business Corporations Act* provide that upon dissolution, undisposed real property of a corporation is forfeited to the Crown. One

possible solution is for the corporation to convey legal title to a trustee corporation prior to winding-up and then transfer beneficial title to the affiliate. Since a conveyance to a trustee corporation is not subject to land transfer tax until it is tendered for registration, there is a tax deferral on that transaction. The trustee corporation will then have the power to convey legal title to the lands at a future time on a tax-exempt basis to the beneficial owner which in turn may convey to a person outside of the corporate group. Land transfer tax will be payable upon registration of the conveyance to the outside party.

3. HST Aspects

With respect to the HST consequences of a winding-up, where a subsidiary corporation is wound up and at least 90% of the shares of each class of the subsidiary are owned by the parent corporation, the parent is deemed to be the same corporation and a continuation of the subsidiary for HST purposes. Therefore, no HST will be payable on the wind-up, since the assets of the subsidiary are deemed not to have been “supplied” to the parent within the meaning set out in the ETA. In addition, to determine the parent’s reporting period for HST purposes, any taxable supplies made by the subsidiary before it is wound up will be treated as if such supplies were made by the parent. If the 90% share ownership test is not met, HST must be charged on the fair market value of the assets distributed to the shareholders.

4. Tax Planning Considerations

The following tax planning opportunities should be considered in connection with a winding-up:

(a) Consolidation of Businesses:

A winding-up may be used to consolidate business enterprises, thereby eliminating unnecessary companies with a corporate group. It should be noted that for the purposes of a winding-up, as opposed to an amalgamation, the two companies need not have the same incorporating jurisdiction;

(b) Losses:

A winding-up may be considered in order to permit the future utilization of net capital and non-capital losses of a subsidiary against the profits of the parent, provided that no change of control occurs as a result of the winding-up. It should be noted that deductibility of such losses by the parent commences only in the taxation year of the parent that follows the year in which the winding-up of the subsidiary took place. Therefore, the timing of the winding-up should consider the expiry of the loss carry forwards; and

(c) Asset Bump-Up:

When the parent company acquires the property distributed to it by the subsidiary on a Section 88(1) winding-up, it will be deemed to acquire most of the assets of a subsidiary at their cost amount for tax purposes. A feature of a Section 88(1) winding-up and an amalgamation of a wholly-owned parent corporation with its subsidiary is the availability of a bump-up in the tax cost of non-depreciable capital property of a subsidiary in certain circumstances. For instance, where (i) the adjusted cost base of the shares held by the parent in the subsidiary exceeds (ii) the aggregate of the cost amounts to the subsidiary of property distributed by the subsidiary to the parent, a potential exists to bump-up the tax costs of certain non-depreciable capital assets. Namely, the bump-up is only available with respect to non-depreciable capital property that was owned by the subsidiary when the parent last acquired control and has been owned without interruption since then. It should be noted that the bump-up is not available in connection with property transferred in the course of the winding-up or the amalgamation of a subsidiary corporation that was part of a series of transactions or events that involved a butterfly reorganisation. However, the asset bump-up will be available if the property was the subject of a prior butterfly reorganisation. Examples of non-depreciable capital property that would be eligible for the bump-up are land (excluding land held as inventory), securities such as shares in another corporation and partnership interests. Regardless of the type of non-depreciable capital asset being acquired by the parent in the course of a winding-up or amalgamation with a subsidiary, the cost basis of such asset cannot be increased to an amount which is greater than the fair market value of each capital property at the time control was acquired.

In order to take advantage of this optional bump-up provision, the parent corporation must designate the amount of the bump in respect of each capital property to which the bump-up is applied in the parent company's tax return for the taxation year

in which the subsidiary is wound up or the amalgamation occurs. Therefore, the determination of the potential amount of the bump-up is not automatic.

Certain additional conditions must be satisfied in order for a corporation to obtain an increase in the adjusted cost base of capital property distributed to the parent in the course of the winding-up of its subsidiary or in the course of an amalgamation of a parent corporation with its subsidiary corporation. In particular, the list of property which is ineligible for this increase in adjusted cost base includes property that is transferred to the subsidiary by the parent corporation or by a person or partnership that was not dealing at arm's length with the parent corporation, except by reason of a right referred to in paragraph 251(5)(b) of the Act.

Property ineligible for the bump-up also includes property distributed to the parent corporation which is subsequently disposed of by the parent corporation as part of the series of transactions that includes the winding-up or amalgamation, to a transferee who was a specified shareholder (i.e. the owner of at least 10% of the shares of the corporation either directly or indirectly) of the subsidiary corporation before the parent corporation last acquired control of the subsidiary corporation. This rule prevents taxpayers from circumventing the rules against purchase butterflies by means of a series of transactions that effectively result in a sale of part of a corporation's assets to an arm's length corporate purchaser on a tax deferred basis.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

No part of this publication may be reproduced by any means without the prior written permission of Alpert Law Firm.

© 2012 Alpert Law Firm. All rights reserved.