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SECTION 85 TRANSFERS - INCOME TAX CONSIDERATIONS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on various types of corporate reorganizations. 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, corporate-commercial transactions, estate administration, tax dispute resolution and tax litigation. Howard Alpert has been certified by the Law Society as a Specialist in Corporate and Commercial Law, and also as a Specialist in Taxation Law.

A. GENERAL RULES

The general rule governing a transfer of assets to a corporation is that assets must be transferred at their fair market value. Subsection 85(1) of the *Income Tax Act* (Canada) (the "Act") rollover provides an exception to this general rule. In particular, pursuant to a subsection 85(1) rollover, parties can elect to transfer certain assets to a corporation in exchange for shares at amounts which will result in either a deferral or minimization of tax.

Assets which are eligible for a tax deferred transfer to a corporation pursuant to a subsection 85(1) rollover include: (i) capital property, including depreciable assets and accounts receivable; (ii) eligible capital property, such as goodwill; (iii) inventory (other than real estate), including the work in progress of a taxpayer who is a professional; and (iv) Canadian resource property and foreign resource property. Assets which are not eligible for a Section 85 rollover include: (i) real property, or an interest therein or an option in respect thereof, where the transferor is a non-resident person or a non-Canadian partnership; (ii) real property that represents inventory to the taxpayer; and (iii) prepaid expenses.

To qualify for a subsection 85(1) rollover, the transferor of the property must receive at least one share in the capital stock of the purchasing corporation as consideration for the transfer. In addition to this one share, the transferor may also receive non-share consideration from the purchasing corporation. Such non-share

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consideration could include cash, promissory notes, the assumption of liabilities or any other property.

B. JOINT PRESCRIBED ELECTION

In order to claim the subsection 85(1) rollover, the purchasing corporation and the transferor must jointly execute and file with the CRA an election on the prescribed form on or before the earlier of the days on which the transferor and the purchasing corporation are required to file their respective tax returns for the taxation year in which the transaction occurred.

On the prescribed election form, the parties must state an “elected amount” for each asset transferred. This elected amount is then deemed to be the transferor’s proceeds of disposition for the asset and the purchasing corporation’s cost thereof. Subject to certain limitations, the parties usually choose an elected amount equal to the transferor’s tax cost of the asset transferred, as follows: (i) for a non-depreciable capital asset such as land or shares, the transferor’s adjusted cost base; (ii) for a depreciable asset such as a building, machinery or equipment, the transferor’s undepreciated capital cost; (iii) for eligible capital property such as goodwill, four-thirds of the transferor’s cumulative eligible capital; and (iv) for other assets such as inventory, the transferor’s cost; provided that no subsection 85(1) election may be made in respect of real property inventory. By following these rules in choosing the elected amounts, the transferor will not be liable for tax on the transfer of the property; rather, the purchasing corporation will assume the transferor’s position with respect to the capital gain, recaptured depreciation or other unrealized income inherent in the assets.

It is open to the parties to choose a different elected amount other than the tax cost of the transferred asset within certain limitations set out in subsection 85(1) of the Act. The upper limit on the elected amount is the asset’s fair market value at the time of the transfer. In the event that the parties elect a higher amount, the elected amount is automatically reduced to the fair market value. The lower limit on the elected amount is the lesser of: (i) the value of the asset at the time of the transfer; or (ii) the cost amount of the asset to the transferor (i.e. the adjusted cost base for a non-depreciable asset, the undepreciated capital cost for a depreciable asset, four-thirds of the cumulative eligible capital for eligible capital property or the cost of other assets). In the event that the parties choose an elected amount which is lower than the lower limits imposed by subsection 85(1) of the Act, the elected amount is automatically increased to the lower limit. In addition, the parties cannot choose an elected amount which is less than the value of any non-share consideration received for the transferred asset. Again, in the

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event that the parties choose an elected amount which is less than the value of any non-share consideration received by the transferor as consideration for the transferred asset, their elected amount would be automatically increased to the value of the non-share consideration, which may result in the triggering of tax consequences to the transferor.

C. TAXABLE CANADIAN PROPERTY

After March 4, 2010, the definition of taxable Canadian property was narrowed. The change in the rule provided that shares of a corporation not listed on a designated stock exchange will only fall under the definition of taxable Canadian property if, at any time within the preceding 60 months, more than 50% of the fair market value of those shares were derived from (i) real estate in Canada; or (ii) Canadian resource or timber resources properties. This amendment is consistent with most of Canada's tax treaties, which typically limit Canada's right to tax a non-resident's capital gains from a disposition of shares to situations where the value of the shares is derived primarily from real property located in Canada.

Shares of a corporation listed on a designated stock exchange, a share of the capital stock of a mutual fund corporation or a unit of a mutual fund trust will also be considered taxable Canadian property if they meet the same standards as above. To be deemed Taxable Canadian property, however, more than 25% of the issued and outstanding shares of the corporation, mutual fund corporation, or units of the mutual trust fund must be owned by the taxpayer, or an individual not at arms length from the taxpayer. As of December 2014, this second qualification has expanded to include partnership interests of which the taxpayer is a part.

Subparagraph 85(1)(i) of the Act was thus amended to bring the provision more closely in line with the change in the definition of "taxable Canadian property". Previously, shares received by a taxpayer pursuant to a subsection 85(1) rollover were deemed to be taxable Canadian property of the taxpayer for an indefinite period of time if the property transferred was taxable Canadian property of the taxpayer. Following the amendment that was implemented on March 4, 2010, the taxable Canadian property status of shares received in such circumstances will only apply for 60 months after the transaction.

From a tax planning perspective, the rule in subparagraph 85(1)(i) of the Act could have the effect of deeming shares as taxable Canadian property when they would not otherwise be defined as such. Thus, careful consideration should be given as to

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whether the deeming provision in subparagraph 85(1)(i) will be triggered prior to engaging in a section 85 rollover. For example, consider a situation where a Canadian real estate holding company, with 90% of its assets comprised of Canadian real estate, sold all of its real estate and invested the proceeds in a variety of other marketable securities. If, 59 months after the sale, its shareholders decided to implement a section 85 rollover, all of the new shares acquired would be deemed to be taxable Canadian property for 60 months after the rollover. However, if the shareholders had waited an extra month to implement the rollover, the new shares received in exchange would not be deemed to be taxable Canadian property.

D. <u>PARTNERSHIP INTERESTS</u>

Subsection 85(2) of the Act provides a virtually identical rollover to the subsection 85(1) rollover where a partnership transfers property to a corporation. Similar to the rule under subsection 85(1) of the Act, there is a rule that prevents a rollover of real estate inventory. Similar to the rule under subsection 85(1) of the Act that an election cannot be made with respect to real property, an interest therein or an option in respect thereof owned by non-residents of Canada, subsection 85(2) of the Act provides that an election cannot be made with respect to real property, an interest therein or an option in respect thereof owned by a partnership that is not a Canadian partnership at the time of disposition. Subsection 102(1) of the Act defines a Canadian partnership as a partnership whose members were resident in Canada at any time in respect of which the expression is relevant. In addition, the election under subsection 85(2) of the Act must be made jointly by the corporation and all members of the partnership in prescribed form.

Subsection 85(3) of the Act provides a rollover where a partnership has transferred property, including shares, to a corporation under subsection 85(2) of the Act and where the following conditions have been met: (i) the partnership is wound up within 60 days of the disposition of property; and (ii) immediately before the winding-up, there was no partnership property other than money or property received from the corporation as consideration for the disposition of property. Taken together, subsections 85(2) and 85(3) of the Act provide a means whereby partnership property may be transferred to a corporation and the related partnership interests may be converted into share holdings without the realization of gains or losses at either level.

In particular, subsection 85(3) of the Act contains the following rules to determine the value of proceeds of disposition of the partnership interest to any member of the partnership:

(a) the cost of property distributed by the partnership to a member of the partnership before the winding-up of the partnership is deemed to be its cost amount immediately before distribution;

(b) the cost to any member of the partnership of any property (other than shares of the capital stock of the corporation or a right to receive any such shares) received as consideration for the disposition of the partnership interest on the winding-up is deemed to be the fair market value of the property at the time of the winding-up;

(c) the cost to any member of the partnership of any preferred shares receivable as consideration for the disposition of the partnership interest on the winding-up is deemed to be the adjusted cost base of the partnership interest minus the value of property described in (b). If common shares are also received, the cost of the preferred shares is their fair market value immediately after the winding-up. If more than one class of preferred shares is distributed, the cost is allocated between them in proportion to their fair market values;

(d) the cost to any member of the partnership of any common shares receivable as consideration for the disposition of the partnership interest is deemed to be the adjusted cost base of the partnership interest minus the value of the property described in (b) and minus the fair market value of any preferred shares of the corporation received in (c). If more than one class of common shares is distributed, the cost is allocated between them in proportion to their fair market values; and

(e) the proceeds of disposition of the partnership interest to any member of the partnership is deemed to be the sum of the costs of all shares and property receivable or received as consideration for the disposition described in (a), (b), (c) and (d) above plus any money received as consideration for the disposition on the winding-up of the partnership.

E. <u>SPECIAL RULES</u>

Previously, subsection 85(4) of the Act operated to prevent a taxpayer from recognizing a capital loss or taking a terminal deduction in respect of capital property or eligible capital property where the property in respect of which the loss or deduction arose was transferred to a corporation controlled by the taxpayer, his spouse or a

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person or group which controlled the taxpayer. Instead, the taxpayer was required to add an offsetting amount in computing his adjusted cost base of any shares which he held in the transferee corporation, thereby reducing the amount of a future capital gain arising on a subsequent disposition of such shares.

Subsection 85(4) of the Act was repealed and replaced with a set of rules that apply to dispositions that take place after April 26, 1995, as follows:

(a) Where an individual disposes of a non-depreciable capital asset to an affiliated corporation which continues to own the assets 30 days after the original disposition, then any loss incurred on the disposition is regarded as a “superficial loss” that is considered to be nil pursuant to paragraph 40(2)(g) of the Act. The corporation acquiring this asset is able to add the amount of the “superficial loss” to its adjusted cost base of the asset, so that on a future disposition it will incur a larger capital loss or a smaller capital gain, pursuant to the provisions of paragraph 53(1)(f) of the Act. Under the tests contained in section 251.1 of the Act, a corporation is affiliated with a person and/or the spouse or common-law partner of such person that controls the corporation directly or indirectly in any manner whatsoever, and this test of control is now a “de facto control test;”

(b) Subsections 40(3.3) and (3.4) of the Act set out rules that defer losses on certain dispositions of non-depreciable capital property. Under subsection 40(3.3) of the Act, these rules apply where (i) a corporation, trust or partnership has disposed of a non-depreciable capital property, (ii) the transferor or a person “affiliated” with the transferor acquires the transferred property or an identical property (either of which is termed the “substituted property”) during the period that begins 30 days before and ends 30 days after the disposition, and (iii) at the end of that period, the transferor or an affiliated person owns the substituted property.

(c) Where these conditions are met, subsection 40(3.4) of the Act provides that no loss may be recognized on the transfer. Instead, any loss is deferred until the earliest of the following events:

    (i) a subsequent disposition of the property to a person that is neither the transferor nor a person affiliated with the transferor (provided that for 30 days after that later disposition, neither the transferor nor an affiliated person owns the substituted property or an identical property acquired after the beginning of the 61-day period described above);

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(ii) a deemed disposition of the property under section 128.1 of the Act (change of residence) or subsection 149(10) of the Act (change of taxable status);

(iii) in the case of a corporation, an acquisition of the corporation's control;

(iv) where the substituted property is a debt or a share, a deemed disposition under section 50 of the Act; or

(v) where the transferor is a corporation, a winding-up of the transferor (other than a winding-up to which subsection 88(1) of the Act applies).

(d) Subsections 40(3.3) and (3.4) of the Act differ from subsection 85(4) in two material respects:

(i) they do not apply to transfers by individuals other than trusts, but can, as a result of the adoption of the definition of "affiliated persons" in new section 251.1 of the Act, have application to transfers of non-depreciable capital property transferred to individuals, corporations and partnerships in cases where subsection 85(4) of the Act would not have applied; and

(ii) the denied loss is not added either to the cost of any shares held by the transferor in the transferee after the disposition or to the cost to the transferee of the transferred property. Instead, the loss is preserved in the transferor's hands to be deducted as a loss from the transferred property when it is no longer owned by an affiliated person, when it is deemed to have been disposed of under other provisions of the Act, or when control of a corporate transferor is acquired.

(e) Subsection 13(21.2) of the Act applies on the transfer, by an individual, corporation, trust or partnership, of a depreciable property whose tax cost is greater than the amount that would otherwise be the transferor's proceeds from the transfer. Where these conditions exist, and the transferor or a person "affiliated" with the transferor holds or has a right to acquire the property 30 days after the disposition, no terminal loss may be recognized on the transfer. Instead, such a loss is deferred until the earliest of the following events:

(i) a subsequent disposition of the property to a person that is neither the transferor nor a person affiliated with the transferor (provided that neither

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the transferor nor an affiliated person acquires or has a right to acquire the property within 30 days after that later disposition);

(ii) a change in the property's use from an income-earning to a non-income-earning purpose;

(iii) a "deemed disposition" of the property under section 128.1 of the Act (change of residence) or subsection 149(10) of the Act (change of taxable status);

(iv) where the transferor is a corporation, an acquisition of control of the transferor; or

(v) where the transferor is a corporation, a winding-up of the transferor (other than a winding-up under subsection 88(1) of the Act).

(f) The tax cost of a depreciable property is, for the purposes of this rule, treated as being the proportion of the undepreciated capital cost of the class to which the property belongs that the value of that property is of the value of all properties in the class. The amount by which that tax cost exceeds the amount that would otherwise be the transferor's proceeds of disposition of the transferred property's value is treated as the capital cost of a property, of the same class as that from which the property came, acquired by the transferor before the taxation year in which the transfer took place. This new property will be treated as being owned by the transferor until the earliest of the events described above. As a result, the transferor will be permitted to claim capital cost allowance after the transfer on the difference between the transferred property's tax cost and the transferor's proceeds of disposition otherwise determined. As well, any portion of the difference not claimed as capital cost allowance may be eligible for recognition as a terminal loss when any of the events described above occurs, provided the transferor has no other properties of the same class. Subsection 13(21.2) of the Act replaces former subsection 85(5.1) of the Act, which denied the recognition of a loss on the transfer of a depreciable property to a corporation controlled by the transferor or that controlled the transferor.

(g) Subsection 13(21.2) of the Act provides that the "subsequent owner" of the transferred property is treated for the purposes of measuring any potential recapture with respect to the transferred property as having the same capital cost of the property as it had to the transferor, and as having deducted as capital cost

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allowance in previous years the amount by which the capital cost of the transferred property exceeds the property's value at the time of disposition.

(h) Subsection 14(1)(b) of the Act provides for a formula used to determine the eligible capital property of a corporation used in calculation of the income of that corporation. Part of that calculation involves subtracting half of the "cumulative eligible capital" as part of the calculation (this is "C" within the ITA formula given). As of 2014, the calculation of cumulative eligible capital requires an additional calculation set out in s.85(1)(d.1), which serves generally to reduce the gain realized by the transferee corporation on a subsequent disposition of the eligible capital property.

Further, the same amendment also added a provision (s.85(1)(d.12)) which requires the calculation of "cumulative eligible capital to also add an amount to the numbers used in letters A and F of the formula that is set out in section 85(1)(d.11)". The s. 85(1)(d.11) formula was designed to ensure that all recaptured deductions that would have been taxable in the hands of the transferor remain taxable in the hands of the transferee. The s. 85(1)(d.12) addition ensures that recaptured deductions that are declared by the transferor cannot subsequently be declared by the transferee corporation.

(i) Subsection 14(12) of the Act applies where a corporation, trust or partnership has disposed of eligible capital property and would, but for this new rule, have been entitled as a consequence of the disposition to claim a deduction under subsection 24(1) of the Act for any undeducted amounts remaining in its cumulative eligible capital pool in respect of that business. (In general terms, subsection 24(1) of the Act would ordinarily permit such a deduction where the taxpayer has ceased to carry on the business and no longer owns any eligible capital property of value with respect to that business). Where (i) these conditions exist, (ii) the transferor or a person "affiliated" with the transferor acquires an identical property or the transferred property itself (either of which is termed the "substituted property") within the period beginning 30 days before and ending 30 days after the disposition, and (iii) the transferor or an affiliated person owns the property at the end of that period, no deduction may be recognized on the transfer.

(j) Instead, such a deduction is deferred until the earliest of the following events:

(i) a subsequent disposition of the property to a person that is neither the transferor nor a person affiliated with the transferor (provided that for 30

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days after that subsequent disposition neither the transferor nor an affiliated person owns either the substituted property or an identical property acquired after the beginning of the period described above);

(ii) a change whereby the property no longer constitutes eligible capital property of a business of the transferor or an affiliated person;

(iii) a "deemed disposition" of the property under section 128.1 of the Act (change of residence) or subsection 149(10) of the Act (change of taxable status);

(iv) in the case of a corporation, an acquisition of the corporation's control; or

(v) where the transferor is a corporation, a winding-up of the transferor (other than a winding-up under subsection 88(1) of the Act).

(k) If subsection 14(12) of the Act applies, the transferor will be treated as continuing to own eligible capital property of the business in respect of which the transferred property was used. This will enable the transferor to continue to claim annual cumulative eligible capital amounts under paragraph 20(1)(b) of the Act in respect of the remaining eligible capital property pool, and to claim a loss for any portion of the pool that remains undeducted when any of the events described above occurs.

(l) Subsection 14(12) of the Act replaces former subsection 85(4) of the Act, insofar as subsection 85(4) applied to transfers of eligible capital property. Former subsection 85(4) of the Act operated to the same effect in denying the recognition of a loss on the transfer of eligible capital property to persons such as a corporation controlled by the transferor. However, subsection 14(12) of the Act differs from former subsection 85(4) of the Act in two material respects:

(i) it does not apply to transfers by individuals other than trusts, but can, as a result of its adoption of the definition of "affiliated persons" in section 251.1 of the Act, apply to eligible capital property transfers to individuals, corporations and partnerships in cases where former subsection 85(4) of the Act would not have applied; and

(ii) the rule does not add the denied deduction to the cost of any shares received by the transferor in exchange for the property but, instead,

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retains it in the transferor's hands to be amortized and (to the extent of any unamortized portion) deducted under subsection 24(1) of the Act.

(m) As a result of the repeal of former subsection 85(4) of the Act, where an individual other than a trust has ceased to carry on a business and has disposed of all of his eligible capital property of any value to a corporation controlled directly or indirectly, in any manner whatsoever, by the individual, then the provisions of subsection 24(2) of the Act apply as follows:

(i) the individual is prevented from claiming a terminal loss on such property; and

(ii) there is an automatic roll-over of such asset on a tax-deferred basis to the controlled corporation which carries on the business, and the corporation takes over the individual's positive pool balance, if any, as calculated immediately before the roll-over and can claim a paragraph 20(1)(b) of the Act deduction for the transferee's first taxation year for the business.

F. <u>LATE FILED AND AMENDED ELECTIONS</u>

Subsection 85(6) of the Act prescribes the time limits within which an election under subsection 85(1) or 85(2) of the Act must be filed. In particular, an election must be made on the earliest date when any party to the election must file an income tax return for the taxation year in which the transfer occurred pursuant to section 150 of the Act. Subsection 150(1) of the Act requires an individual to file an income tax return for the calendar year in which the individual has disposed of a capital property or has a taxable capital gain.

Subsection 85(7) of the Act allows an election to be filed up to three years after the filing deadline set out in subsection 85(6) of the Act, where an estimate of the penalty is paid by the taxpayer or partnership, as the case may be, when the election is made.

Subsection 85(7.1) of the Act allows an election to be filed beyond three years after the filing deadline set out in subsection 85(6) of the Act, or an election to be amended, where it would be just and equitable in the circumstances. The election or amended election must be made in prescribed form, and an estimate of the penalty must be paid.

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Pursuant to Information Circular No. 76-19R3, an amended election will generally be accepted under subsection 85(7.1) of the Act if it involves: (i) a change to the result of an inaccurate valuation of the property that gave rise to unintended tax consequences; (ii) a reduction of the agreed amount of transferred shares to the correct cost amount when a transfer at cost was intended; (iii) a correction of situations where it is clear that the insertion of an amount was made in error; or (iv) a correction of other situations which give rise to unintended tax consequences. The Department will correct clerical errors without requiring an amended election.

An amended election will not be accepted where, in the view of the Department, the main purpose of the amended election is: (i) to effect retroactive tax planning; (ii) to take advantage of statutory amendments enacted after the election was filed; (iii) to avoid or evade tax; or (iv) to increase the agreed amount in a statute-barred year.

Subsection 85(8) of the Act prescribes the penalty for a late and amended election made pursuant to subsections 85(7) or 85(7.1) of the Act. In particular, the penalty is the lesser of the following: (i) one-quarter (1/4) of one percent (1%) of the amount, if any, by which the fair market value of the property at the time of disposition exceeds the amount agreed upon in the election or amended election by the taxpayer or partnership, as the case may be, and the corporation, for each month or part of a month after the original due date and before the filing of the late or amended election and (ii) $100 for each month or part of a month after the original due date and before the filing of the late or amended election, not to exceed $8,000, provided that the election form is filed within three years of the due date. Elections filed after the three-year deadline will only be accepted if, in the opinion of the Minister of National Revenue, it is just and equitable to allow the late-filed election subject to the late filing penalty. It should be noted that the penalty is not discretionary and the Act does not permit a reduction or waiver of the penalty.

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