



Tax Reorganizations: A “Plain Language” Explanation

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Tax Reorganizations

- What is a “tax reorganization”?
 - Change in the share ownership of one or more private (usually closely held) corporations
 - Typically involves persons who are related (or otherwise non-arm’s length) with the corporation(s) and/or other shareholders/intended shareholders
 - Objective: anticipate/manage provisions of the *Income Tax Act* (the “ITA”) that apply to related party transactions

Tax Reorganizations

- Why do we reorganize?
 - Income splitting
 - Access to the capital gains exemption for qualified small business corporation (“QSBC”) shares
 - *Purification: ensuring QSBC test is met*
 - *Multiplication of access*

Tax Reorganizations

- Why do we reorganize?
 - Divisive reorganizations
 - Succession planning
 - Estate planning/wealth preservation
 - Creditor protection

Tax Reorganizations

- Income Splitting
 - Common starting point: founder of the business is the sole shareholder (result: only the founder can receive dividends)
 - Objective: Give other family members access to dividend income
 - Strategies:
 - *Issue discretionary dividend shares to family members (valuation/taxable benefit concerns)*
 - *Freeze founder's shares/introduce family trust*

Tax Reorganizations

- Income Splitting
 - Typical inter vivos family trust
 - *Settled with nominal funds by arm's length settlor*
 - *Trustee(s) typically business founder and possibly spouse*
 - *“Principal Trustee” concept is being more commonly used*

Tax Reorganizations

- Income Splitting/Family Trusts
 - Beneficiaries are typically family members
 - *Be mindful of inadvertent association of corporations under the ITA due to selection of beneficiaries*
 - *Inclusion of non-family member beneficiaries could impact QSBC eligibility*
 - Ability to add beneficiaries later doubtful

Tax Reorganizations

- Income Splitting/Family Trusts
 - Allocations of income/capital completely discretionary
 - Ability to impact allocations of income/capital through terms of the principal trustee's will
- Take the time necessary to understand client's needs

Tax Reorganizations

- Access to the CGE
 - Purification: If corporation has excessive passive assets status as QSBC may be lost (reorganize to remove excessive passive assets on a tax-efficient basis)
 - Multiply access: If QSBC shares are held by a family trust, gain on sale can be allocated to multiple beneficiaries, effectively multiplying access to the CGE (\$835,716 for 2017)

Tax Reorganizations

- Constantly-shifting tax landscape
 - Amendments to intercorporate dividend rules in subsection 55(2) of the ITA (April 21, 2015 federal budget)
 - Amendments to s. 125 of the ITA to restrict multiplication of small business deduction for partnerships/quasi-partnerships (March 22, 2016 federal budget)
 - Review of tax planning strategies involving private corporations (March 22, 2017 federal budget)

Tax Reorganizations – Preliminary Considerations

- Clarifying the scope of the retainer/engagement: Who is providing the tax advice/planning?
- Comprehensive minute book review is critical
 - Are there deficiencies that should/must be corrected?
 - Is this an opportunity to clean up the capital structure?

Tax Reorganizations – Preliminary Considerations

- Closing Agenda: The key control document
 - Summary of corporate attributes (confirmation that minute book review has taken place)
 - Detailed explanation of each step (required documentation, timing and allocation of responsibilities)
 - Post-closing matters

Tax Reorganizations

- Relevant ITA provisions
 - Section 85
 - Section 86
 - Section 85.1
 - Section 51

Tax Reorganizations

- ITA Section 85 “rollover”
 - disposition by a taxpayer
 - of eligible property
 - to a taxable Canadian corporation
 - for consideration that includes shares
 - taxpayer and corporation jointly elect

Tax Reorganizations

- ITA Section 85
 - Eligible property (85(1.1) ITA):
 - *Capital property (other than real property/option/interest in real property owned by a non-resident person)*
 - *Canadian or foreign resource property*
 - *Inventory (other than real property/option/interest in real property)*
 - *Capital property that is real property/option/interest in real property owned by a non-resident person and used in a business carried on in Canada*

Tax Reorganizations

- ITA Section 85
 - Taxable Canadian corporation – defined in ITA 89(1):
 - *Canadian corporation*

resident in Canada
and
incorporated in Canada
or
resident in Canada since June 18, 1971
 - *Not tax exempt*

Tax Reorganizations

- ITA Section 85
 - Consideration paid by the transferee corporation must include shares (ie. at least one share)
 - Consideration can include non-share consideration (“boot”)
 - *Promissory note*
 - *Assumption of liabilities*

Tax Reorganizations

- ITA Section 85
 - Transferor and transferee jointly election deemed proceeds
 - T2057
- Election due on or before the earliest of the tax return filing deadline for the transferor and transferee

Tax Reorganizations

- ITA Section 85
 - Permissible range of elected amount:
 - *Cannot elect less than the FMV of boot (if any)*
 - *Cannot elect more than the FMV of the transferred property*
 - *Cannot elect less than the lesser of FMV and cost amount (ie. tax basis) of the transferred property*

Tax Reorganizations

- ITA Section 85
 - Elected amount will determine:
 - *Taxpayer's proceeds of disposition for the transferred property*
 - *Corporation's cost of acquiring the property*
 - *Cost to taxpayer of shares and boot*

Tax Reorganizations

- ITA Section 85
 - Cost to taxpayer of shares and boot:
 - *Boot: Deemed cost equal to FMV*
 - *Preferred shares: Lesser of (i) FMV of the preferred shares; and (ii) Proceeds of disposition (ie. elected amount) less FMV of the boot (pro-rated based on value if there is more than one class of preferred shares)*
 - *Common shares: Proceeds of disposition (ie. elected amount) less FMV of boot and less cost of preferred shares (pro-rated based on value if there is more than one class of common shares)*

Tax Reorganizations

- ITA Section 85
 - Aggregate of paid-up capital (“PUC”) of share consideration and FMV of boot may not exceed elected amount (any excess PUC will be ground down under 85(2.1))
 - Typically stated capital/PUC will be set at less than FMV of transferred asset so that “corporate PUC” will equal “tax PUC”

Tax Reorganizations

- ITA Section 85 – valuation issues
 - 85(1)(e.2) – Applies if FMV of consideration received by transferor is less than FMV of transferred property and any portion of the excess is a benefit conferred on a related person
 - 15(1) – Applies if FMV of consideration received by transferor exceeds FMV of transferred property

Tax Reorganizations

- Options for share consideration
 - Common Shares
 - *Can be used if there is only one shareholder/no plans to introduce new shareholders (example: Incorporation of sole proprietorship)*
 - *Limited ability to utilize a price adjustment clause*

not possible to adjust value of common shares
repurchasing/cancelling to adjust is a disposition
can possibly adjust via conversion feature

Tax Reorganizations

- Options for share consideration
 - Preferred shares with a set redemption value (ie. “freeze shares”)
 - Redemption value can be adjusted if FMV of transferred property is challenged by CRA

Tax Reorganizations

- Options for share consideration – preferred shares
 - Non-voting (except as expressly permitted by corporate statute)
 - Redeemable at redemption value equal to FMV of transferred property
 - Retractable (redeemable at the option of the holder) at redemption value equal to FMV of transferred property

Tax Reorganizations

- Options for share consideration – preferred shares
 - Non-cumulative dividend at prescribed rate (4301(c) of the Income Tax Regulations)
 - Terms might include “redemption amount reducing dividends”
 - Priority on dissolution over common shares and possibly other classes of preferred shares
 - Restrictions on dividends/distributions on other classes of shares (preserve ability of corporation to redeem prefs)

Tax Reorganizations

- Options for share consideration
 - Consider need to specify common share terms
 - Presumption of equality between/among classes of shares
 - Clean up cluttered capital structure

Tax Reorganizations

- Section 85 “rollover” agreement
 - Price adjustment clause (to work in conjunction with share terms)
 - If non-share consideration is involved (ie. promissory note or assumption of liabilities) the adjustment clause must ensure that boot is adjusted as necessary to ensure that FMV of boot does not exceed lesser of cost amount and FMV of transferred property (less PUC of share consideration)

Tax Reorganizations

- Section 85 “rollover” agreement
 - Clause requiring transferor and corporation to jointly elect
 - Clause providing for filing an amended T2057 if necessary
- Basic representations/warranties (including that the transferor is not a non-resident of Canada)

Tax Reorganizations

- Section 86 share exchange
 - taxpayer disposes of all of the shares (the “old shares”) of a particular class
 - old shares were held by the taxpayer as capital property
 - consideration receivable from the corporation includes other shares (“new shares”) of the corporation
 - exchange occurs “in the course of a reorganization of the capital” of the corporation

Tax Reorganizations

- Section 86 share exchange – result:
 - Cost to taxpayer of non-share consideration is FMV of non-share consideration
 - Cost to taxpayer of new shares = ACB of old shares – FMV of non-share consideration (pro-rated based on FMV if there are multiple classes of new shares)
 - Taxpayer deemed to dispose of old shares for proceeds equal to cost of new shares and non-share consideration

Tax Reorganizations

- Section 86 share exchange
 - No election required (but can elect out of rollover treatment by filing a section 85 election)
 - “Reorganization of the capital of the corporation”: Not defined, but generally involves the creation of at least one class of shares

Tax Reorganizations

- Section 86 share exchange
 - 86(2): If
 - *FMV of the old shares exceeds cost to taxpayer of non-share consideration (ie. FMV of non-share consideration) + FMV of new shares*
 - *Any portion of excess is a benefit conferred on a related person*

Result: Deemed proceeds are adjusted, leading possibly to a taxable gain on the disposition or a capital loss that is denied

Tax Reorganizations

- Section 86 share exchange
 - 86(2.1) PUC grind: PUC of new shares cannot exceed PUC of old shares less FMV of non-share consideration
 - Exchange can be implemented by:
 - *Share Exchange Agreement; or*
 - *Amending articles to change shares of one class into shares of another class (CBCA 173(1)(h)/OBCA 168(1)(h)/NSCA 19(1)(a)(v), if permitted by Articles of Association)*

Tax Reorganizations

- Section 85.1
 - Canadian corporation (“purchaser”)
 - issues shares of a particular class to a taxpayer (“vendor”)
 - in exchange for capital property of the vendor that is shares (“exchanged shares”) of another corporation
 - that is a taxable Canadian corporation

Tax Reorganizations

- Section 85.1 - result
 - Vendor is deemed to have disposed of the exchanged shares for proceeds equal to the ACB of the exchanged shares
 - Vendor is deemed to have acquired the shares of the purchaser at a cost equal to the ACB of the exchanged shares

Tax Reorganizations

- Section 85.1 - result
 - Cost to purchaser of each exchanged share is deemed to be the lesser of
 - *FMV of the share; and*
 - *PUC of the share*

immediately before the exchange

Tax Reorganizations

- Section 85.1
 - Does not apply
 - *if the vendor and the purchaser were, immediately before the exchange, not at arm's length*
 - *if immediately after the exchange any combination of the vendor and non-arm's length persons control the purchaser/hold shares representing more than 50% of value*
 - *if the vendor reports any portion of the gain or loss, otherwise determined*

Tax Reorganizations

- Section 85.1
 - Does not apply
 - *The vendor and purchaser jointly elect under subsection 85(1) or (2)*
 - *The vendor receives consideration other than shares of the particular class*

Tax Reorganizations

- Section 85.1
 - 85.1(2.1) PUC grind: PUC of purchaser shares reduced to the extent the PUC determined under corporate law exceeds the PUC of the exchanged shares
 - PUC reduction is allocated among classes of shares issued based on relative PUC increases

Tax Reorganizations

- Section 51
 - Taxpayer acquires from a corporation shares of the corporation in exchange for
 - *Capital property that is another share of the corporation; or*
 - *Capital property that is debt of the corporation that confers on the holder the right to make the exchange (the “convertible property”); and*
 - Taxpayer receives no consideration for the convertible property other than the share

Tax Reorganizations

- Section 51 - result
 - Exchange is deemed not to be a disposition of the convertible property
 - Cost to taxpayer of new shares is deemed to be the adjusted cost base of the convertible property (pro-rated amongst classes based on FMV)

Tax Reorganizations

- Section 51(2): FMV of convertible property exceeds FMV of shares received and it is reasonable to regard any portion of the excess as a benefit conferred on a related person
- Consequences:
 - Taxpayer deemed to receive proceeds equal to lesser of:
 - *FMV of convertible property; and*
 - *Aggregate of ACB of convertible property and the “gift portion” of the excess amount*

Tax Reorganizations

- Consequences (continued):
 - Any capital loss is deemed to be nil
 - Cost to taxpayer of shares of each class acquired deemed to be equal to the lesser of:
 - *Adjusted cost base to the taxpayer of the convertible property immediately before the exchange; and*
 - *FMV of shares received by the taxpayer plus any denied capital loss*
- Pro-rated among share classes based on FMV*

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Thank you
Questions/Comments

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