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UNDERSTANDING ROLLOVERS

This paper is designed to .provide a general overview of section 85 and 86 rollovers. It does not purport to deal with the myriad of technical problems which can arise in relation to these rollovers. For a more detailed discussion of other issues, refer to one of the many tax services available.

I. SECTION 85 ROLLOVERS

A. ESSENTIALS OF THE ROLLOVER

1. The Basic Rules

Section 85 of the Income Tax Act enables a taxpayer to transfer most types of assets to a corporation without immediate tax consequences. In the absence of the section 85 rollover, any such transfer would be a disposition of those assets, and could result in the recognition of capital gains or the recapture of capital cost allowance.

In order to obtain the benefit of the rollover on a sale of assets, requirements of section 85 must be met. They are as follows:

(a) The assets to be transferred can be:

any capital property (other than real property owned by a non-resident)

- certain resource properties,
- eligible capital property, or
- inventory (other than real property inventory).

(b) The transferee must be a taxable Canadian corporation.

(c) The consideration received by the transferor for the transfer must include shares in the capital stock of the transferee corporation. (The consideration may include other things as well).

(d) The transferor and the transferee must file a joint election with Revenue Canada in relation to the transaction.

The transferor can-receive non-share consideration (sometimes called "boot") on the transfer of property, in addition to the required share consideration. Non-share consideration is usually cash, a promissory note, or the assumption of the outstanding indebtedness against the subject property.

The transferor and the transferee must agree on an "elected amount" for the transaction. The elected amount will then be the transferor's proceeds of disposition on the sale, and the transferee's cost basis for tax purposes in relation to the property which it acquired. (This assumes that the elected amount is not subject to adjustment under one of the many sub-paragraphs in section 85. A more detailed discussion of those adjustments appears under the heading "The Elected Amount" below).

In most rollovers the elected amount will be the transferor's cost basis for tax purposes for the property, so that no capital gain will be recognized, and there will be no recapture of capital cost allowance, as a result of the sale. The Income Tax Act also contains rules on what the cost basis will be for tax purposes of the consideration received by the taxpayer on the rollover that is, the non-share consideration, and the preference or common shares issued in exchange for the property. Sub-sections 85(1)(f)(g) and (h) provide that the elected amount will be allocated among these types of consideration as follows:

(a) First, to non-share consideration such as cash, promissory notes and debt, to the extent of their fair market value;

(b) Second, to the preference shares, to the extent of their fair market value; and

(c) Any excess, to the common shares.

2. The Elected Amount

The assets that can be rolled into a corporation can be divided into four basic categories:

(a) Depreciable property. Depreciable property will have a capital cost (the original price of the property

to the transferor) and an undepreciated capital cost (which is the undepreciated portion of the capital cost. Put another way, it is the original capital cost, less capital cost allowance claimed by the transferor.) .

(b) Inventory. Inventory has a "cost amount", which is the lesser of its cost to the taxpayer or its fair market value, generally speaking.

(c) Capital property other than depreciable property. This category includes land and shares. Capital property has an adjusted cost base to the transferor, which is the original cost of the property to the transferor, plus or minus permitted adjustments. For example, a share for which the transferor paid $10.00 in 1978 has an adjusted cost base of $10.00, assuming there were no subsequent transactions which are allowed to affect the adjusted cost base. Land purchased in 1960 for $10,000.00 but with a Valuation Day (December 31st, 1971) value of $25,000.00 will have an adjusted cost base of $25,000.00.

(d) Eligible capital property. This includes the goodwill of a business. In most cases, goodwill is not paid for, and accordingly has no cost amount.

The transferor and the transferee can agree on the "elected amount" for the rollover. In theory, there is an elected

amount for each item of property being rolled in to the corporation. In practice, for lawyers doing the rollover agreement, it is usually sufficient to provide an elected amount for each type of property, and for each class of depreciable property. In normal circumstances, the determination of the elected amount is straightforward; it is the cost amount of the property to the transferor. Choosing this type of elected amount means, in most cases, that no income gain will be recognized on the transfer, and no deduction will be lost.

If the transferor has allowable capital losses to offset against capital gains, it may be appropriate to choose an elected amount which exceeds the adjusted cost base of the property. This will result in the recognition of some capital gain, which can be offset against the allowable capital loss.

You cannot choose an elected amount less than the adjusted cost base in order to recognize a capital loss. See the discussion on the "Stop Loss Rules" below.

There are a number of specific restrictions in section 85 on the elected amount. If the chosen elected amount is outside these parameters in any particular transaction, the elected amount is deemed to be changed. There is no resulting penalty, but the change may result in an unwanted recognition of income. The rules are:

(1) The elected amount must be at least equal to the fair market value of the non-share consideration received by the transferor. Accordingly, the elected amount must be at least as much as the promissory note, cash, or debts assumed [Section 85(1)(b)].

(2) The elected amount must not be more than the fair market value of the property being transferred to the corporation [Section 85(1)(c)].

(3) In the case of inventory, or capital property other than depreciable property of a prescribed class, the elected amount cannot be less than the lesser of:

(a) The fair market value of the property; or

(b) The cost amount of the property to the transferor.

In the case of capital property, this means that the elected amount cannot be less than what is usually the adjusted cost base of the property to the transferor [Section 85(1)(c.1)]. Inventory often has a cost amount of zero, particularly in the case of grain inventory in a farm. However, the elected amount must be more than zero, so in those circumstances the elected amount is usually $1.00.

(4) For eligible capital property, the elected amount cannot be less than the least of the following:

(a) Twice the taxpayer's "cumulative eligible capital" in respect of the eligible capital property. (The cumulative eligible capital is a pool equal to half of the cost of the eligible capital property, less depreciation claimed. It can be depreciated at the rate of 10% per year);

(b) The cost to the taxpayer of the eligible capital property; and

(c) The fair market value of the eligible capital property.

The cost of eligible capital property is frequently zero, in which case the cumulative eligible capital is probably also zero [Section 85(1}(e)].

(5) In case of depreciable property of a prescribed class (which would not include Part XVII property), the agreed amount cannot be less than:

(a) The undepreciated capital cost of the class;

(b) The cost to the transferor of the particular depreciable property; and

(c) The fair market value of the depreciable property.

Each item of depreciable property is deemed to be taken out of the class in order. The transferor can specify the order, and if he or she does not do so, the department may specify an order [Section 85(1)(e.l)].

(6) If the transaction results in a gift to someone the elected amount will be increased by the amount of the gift. This issue will result in the immediate recognition of capital gain [Section 85(1)(e.2)]. This will be discussed at greater length later in the paper.

The elected amount will usually (though not always) be:

(a) In the case of depreciable property, the undepreciated capital cost of the property;

(b) In the case of inventory, the cost amount of the inventory. In the case of grain inventory on a farm, the cost amount of the inventory is often zero, as all of the components which go into the production of the inventory are expenses to the business:

(c) For capital property other than depreciable property, the adjusted cost base of the property;

(d) For eligible capital property, assuming there was a cost for the property, twice the cumulative eligible capital amount. In many cases, however, there is no such cost, and the elected amount will be zero.

Example No.1 - A taxpayer farmer bought a quarter section of farmland in 1976 for $25,000.00. It is now worth $100,000.00. The farmer wishes to set up a corporation and transfer the farmland to the

corporation without immediate tax liability. The rollover can be done in several ways:

(a) The land could be transferred to the corporation on a rollover basis under s.85 in return for one voting, participating share in the capital stock of the corporation. As long as this was the only share issued in the corporation, or as long as all of the other shares were issued to the farmer, the transaction can be done as a rollover. The elected amount would probably be $25,000.00 (unless the farmer had some unused capital losses). The adjusted cost base of the land to the corporation would be $25,000.00 and the adjusted cost base of the share would be $25,000.00.

(b) The land could be rolled into the corporation in return for a promissory note for $25,000.00 and one voting, participating share in the corporation. This is the more common way to structure this type of rollover, as the farmer can receive payment on the promissory note from the corp,oration without further payment of tax (assuming there is no interest payable on the note). The elected amount would have to be at least $25,000.00 [Section 85(l)(b)]. Again, the adjusted cost base of the land to the corporation would be $25,000.00, but the

adjusted cost base of the share to the farmer would be zero.

(c) Assuming the farmer financed the purchase of the land, and there is still $15,000.00 owing to the credit union on the mortgage, the corporation could assume payment of the $15,000.00 mortgage, give the farmer a $10,000.00 promissory note, and issue to him one voting, participating share. The total non-share consideration is again $25,000.00, the elected amount would be at least $25,000.00, and the adjusted cost base of the share is again zero.

3. The Rollover Agreement

A rollover is essentially a sale of the subject assets, with the addition of certain covenants to meet the requirements of section 85. The agreement should include sale covenants, a covenant to sign a joint section 85 election form, and must contain an agreement on the elected amount.

Appendix A is a basic section 85 rollover agreement, reflecting a rollover of farm land in accordance with Example l(b) above. As noted in the agreement, the elected amount is $25,000.00, which was the farmer's adjusted cost base of the land, and is the fair market value of the non-share consideration (i.e. the cash).

The adjusted cost base to the farmer of the one class A share in the capital stock of Farmco Ltd. will be zero, as there is nothing remaining of the elected amount after taking away the fair market value of the non-share consideration.

B. AREAS OF CONCERN

1. Transfers of Growth - the **s.** 85(1}(e.2) Problem

As mentioned above, if a section 85 rollover transaction results in a gift to anyone, the elected amount on the rollover will be increased by the amount of the gift. This could occur where property was transferred to a corporation which had existing holders of participating (growth) shares. In that case, if the fair market value of the share and non-share consideration received by the transferor on the rollover is less than the fair market value of the assets transferred to the corporation, the excess could well be regarded as a gift to the remaining shareholders. This would result in an increase of the elected amount, and the resulting recognition of capital gain or recapture of capital cost allowance, or other income amount to the transferor.

It is very difficult to value growth shares in a closely held corporation. The usual way to avoid valuation problems, and to prevent the recognition of capital gains, is to have the share consideration issued on the rollover be preference

shares having an ascertainable fair market value. The total consideration on the rollover is then non-share consideration having a fair market value equal to the elected amount, and preference shares having a fair market value equal to the difference between the value of the assets rolled into the corporation, and the value of the non-share consideration.

Because it is often equally difficult to arrive at a fair market value for the assets being rolled into the corporation, the rollover agreement should include a price adjustment clause to adjust the preference share consideration to reflect any subsequent agreement on the fair market value, or any new fair market value imposed by court order. The concerns which should be kept in mind in relation to the rights attaching to the preference shares, and the provisions of the price adjustment clauses, are discussed below.

(a) Preference Share Attributes

Revenue Canada's main concern in relation to the attributes of preference shares issued on a rollover is that they be such that the value of the preference shares is maintained over the course of time. The issue of the terms and conditions to be attached to the shares was addressed at the Revenue Canada Round Table session during the 32nd Canadian Tax Foundation Tax Conference in 1980. The Department's position is set out at page 602 of the Conference Report. Revenue Canada requires that the preference shares have the following terms and

conditions:

(i) They must be retractable (i.e. redeemable at the option of the holder). They can also be redeemable at the option of the corporation.

(ii) They should be entitled to a dividend. There is no requirement that the dividend entitlement be cumulative. Further the dividend should be reasonable, and accordingly should be significantly less than prevailing interest rates at the time of the issuance of the shares.

(iii) There can be no restriction on the transferability of shares, other than restrictions required by corporate law to qualify the corporation as a private company. In Saskatchewan, in order for a corporation to qualify as a "Private Company" under The Securities Act, (for whatever that is worth) the articles must "restrict the right to transfer its shares". In light of this ambiguous requirement, it is suggested that restrictions on the transfer of these rollover shares be limited to a prohibition on transfer when the holder of the shares is indebted to the corporation, and other innocuous and justifiable restrictions.

(iv) The articles should increase the liquidity requirements which must be met prior to declaring a

dividend. Section 40 of The Saskatchewan Business Corporations Act requires that a corporation not declare or pay a dividend "if there are reasonable grounds for believing that ••• the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes." The stated capital of the preference shares will doubtless be nominal in comparison to their value (this issue is discussed under the heading "The Stated Capital Account" below). Accordingly, the articles should provide that no dividends will be paid on any class of shares if there are reasonable grounds for believing that, after the payment, the realizable value of the corporations's assets would be less than the aggregate of its liabilities and the amount that would be required to redeem all of the rollover shares, and all shares of any class having a right to be redeemed in priority or pari passu with the rollover shares.

(v) The rollover shares must have a preference on any distribution of the assets of the corporation.

(vi) The corporation should be prevented from repurchasing any shares of any other class if, after the purchase, the realizable value of the corporation's assets would be less than the aggregate of its liabilities and the amount required to redeem the

rollover shares and all shares of any other class having a right to be redeemed in priority to or pari passu with the rollover shares. The existing liquidity restriction on the repurchase of shares in section 32 of The Business Corporations Act refers only to liabilities plus the "stated capital of all classes" of shares, which is not adequate to meet Revenue Canada's concerns in this situation.

(vii) The voting rights attaching to the shares must at least be sufficient to prevent any detrimental change to the repurchase, dividend or redemption restrictions. In that context, the rights in section 170 of The Business Corporations Act may not be adequate, and should be expanded.

(b) Price Adjustment Clauses

If the estimated fair market value of the assets being rolled into the corporation is not accurate, Revenue Canada may well reassess the transferor or the transferee on the transaction. For example, Revenue Canada may allege that the fair market value is higher than estimated, with the result that there was an indirect gift to another shareholder of the corporation on the rollover. This would result in a deemed increase in the elected amount under section 85(I)(e.2), and a capital gain or other income amount to the transferor. To avoid this

potential problem, it is wise to include in the rollover agreement a price adjustment clause, to provide that in the event that the true fair market value turns out to be different than the estimated fair market value used for the purposes of the agreement, the value of the share consideration received by the transferor will be adjusted up or down accordingly.

Revenue Canada has issued Interpretation Bulletin IT-169 respecting price adjustment clauses. It sets out a position in relation to price adjustment clauses that the department will accept. However, it should be emphasized that it is not necessary that a price adjustment clause comply with the requirements in that Interpretation Bulletin. For example, the bulletin is based on an assumption that the price adjustment clause will operate if the Department of National Revenue determines that the true fair market value is something different than that stated in the agreement. It is highly unlikely that the parties wish to accept the unilateral view of Revenue Canada in these circumstances: it is more common to require an opinion of a different value from Revenue Canada in conjunction with either a court order or the consent of the parties.

One further rule to be kept in mind is that the estimate of fair market value, and the intention to rely on the price adjustment clause, must be genuine. In the case of Guilder

News Co. (1963) Ltd. v. M.N.R. [1973] C.T.C. 1, the Federal Court of Appeal considered the issue of whether or not a benefit or advantage had been conferred by a corporation on one of its shareholders. There was a price adjustment clause in the agreement in question, and the taxpayers attempted to rely on the price adjustment clause in support of their argument that there was no benefit conferred on the shareholder. The price used in the transaction was obviously less than fair market value. The Court rejected the taxpayers' argument, and held that, from an examination of the agreement including the price adjustment clause, the sale was a sale to take place at a specified price, with an adjustment to be made subsequently should Revenue Canada issue a reassessment. The Court pointed out that this was significantly different from a sale that is expressly made at a bona fide estimate of fair market value, and stated to be made for fair market value, with an adjustment to be made should the genuine estimate of fair market value subsequently be found to be inaccurate. Accordingly, it is important that the estimated fair market value used in the agreement be arrived at in a bona fide manner, and that the sale be expressed as intended to be a sale at fair market value.

There are two ways to adjust the value of the share consideration received by the transferor on the rollover:

(1) The number of shares received by the transferor can be adjusted: or

(2) The value of each share received can be adjusted.)

There are, of course, advantages and disadvantages to each.

(i) Adjusting the Number of Shares

In this type of price adjustment clause, the number of preference shares issued to the transferor would be adjusted if the actual fair market value is subsequently determined to be different than the estimated fair market value used for the purposes of the agreement. As a result, in the event of an adjustment to the fair market value, it will be necessary to either cancel some of the issued preference shares, or issue additional preference shares for no additional consideration. Attached as Appendix B is a sample Share Rollover Agreement containing a price adjustment clause in which the number of shares is adjusted.

There are several technical concerns with the operation of this type of provision, involving, as it does, the issuance or cancellation of shares. Accordingly, it may be safer to adjust the redemption price.

(ii) Adjusting the Redemption Price

This is the preferred price adjustment clause from the perspective of Revenue Canada. Under this arrangement, in the event of an adjustment to the fair market value in the agreement, the redemption price of the preference shares will be adjusted so that the value of the issued preference shares

will increase or decrease to the extent of the change in the fair market value. The number of issued shares does not change.

Attached as Appendix C are share rights for preference (class B) shares to be used in this type of price adjustment clause. You will note that, under these share rights, the redemption value will change without the necessity of a special resolution of the shareholders to amend the articles of the corporation.

It is not adequate in this type of price adjustment clause to have the redemption price of the shares fixed by the articles, with the price adjustment clause in the agreement containing a covenant to change the redemption price should the fair market value determination be changed. Such a change to the redemption price requires a special resolution of the shareholders, and it is conceivable that that resolution may not be obtainable. Also, it is probably not adequate to have the articles provide that the redemption price will be fixed from time to time by the directors, as that implies an ability to change the redemption price at will, rather than only in the circumstances contemplated by the rollover agreement.

(iii) Adjusting the Elected Amount

In some circumstances, it will not be possible to determine with certainty the elected amount which one wishes to use in a

rollover. In that event, one may wish to be able to subsequently adjust the elected- amount, when more facts are known so as to enable the desired elected amount to be determined with certainty. Unfortunately, Revenue Canada is of the view that adjustments to the elected amount can be made only in limited circumstances. The Department's position was set out in the Revenue Canada Round Table session at the 32nd Canadian Tax Foundation Tax Conference in 1980. The Department indicates its position at page 603 of the Report, as follows:

> "The only circumstance in which an adjustment to the elected amount can be made is set forth in paragraph 14 of Information Circular 76-19R. The agreed amount expressed in dollars will be adjusted where:
>
> a} Taxpayers have indicated on the election form that the amount is the estimated acb [i.e. adjusted cost base] ,
>
> b} The acb is based on V-Day value, and
>
> c} A reasonable attempt was made to determine V-Day value correctly.
>
> It should be noted that the adjustment to the agreed amount would be to reflect the change in the V-Day value only. Other errors and omissions would not be picked up in calculating the acb."

2. Double Taxation

One should always be aware that a section 85 rollover results

in a potential for double taxation. On the rollover, the corporation will take the subject assets at their cost base for tax purposes to the transferor. On any subsequent disposition of the assets, the corporation will- realize the same capital gain or other income amount as would have been realized had the transferor disposed of the assets.

At the same time, though, the transferor receives shares in the capital stock of the corporation, which shares will have an adjusted cost base for tax purposes of an amount, at most, equal to the transferor's cost basis for tax purposes of the assets rolled in to the corporation. If the assets rolled into the corporation are worth more than the elected amount (as will be the situation in almost every section 85 rollover, because you wouldn't be doing it otherwise), the value of the shares issued to the transferor will be greater than their adjusted cost base. Accordingly, if the transferor were to sell the shares, he or she would recognize a capital gain.

As a result of the section 85 rollover, one potential capital gain is converted to two potential capital gains. In most cases, however, the deferral of tax available as a result of the transfer to the corporation will make the exposure to double taxation worthwhile. However, in every case consideration should be given to the intentions of the transferor in relation to the property, to ensure that there will be a potential to benefit from the deferral.

3. The Stop Loss Rules

Revenue Canada objects to the recognition of a certain losses on transfers of property between related persons. This is the reason for subsections 85(4) and (5.1) of the Income Tax Act. It should be noted that these rules are not limited in their application to transfers in respect of which the parties file a rollover election under section 85. However, they must be kept in mind in almost every section 85 rollover, as the vast majority of such rollovers are transactions between related persons.

Where a transfer of property occurs between the taxpayer and a corporation that "immediately after the disposition was controlled, directly or indirectly in any manner whatever, by the taxpayer, by the spouse of the taxpayer or by a person or a group of persons by whom the taxpayer was controlled, directly or indirectly in any manner whatever" and the transaction would otherwise give rise to a capital loss, or an income deduction with respect to eligible capital property, the loss or deduction is denied by reason of s. 85(4}.

To be fair, though, the Act also provides that if the transferor owns shares in the transferee corporation immediately after the disposition (which would occur in every section 85 rollover) the amount of the disallowed capital loss or twice the disallowed income deduction will be added to the adjusted cost base of the transferor's shares in the

corporation.

Similarily, if a terminal loss on the disposition of depreciable property would be denied by virtue of subsection 85(5.1), the undepreciated capital cost of the property to the transferee will be the same as its ucc to the transferor, even though the fair market value is less.

4. Other Concerns

(a) Land Inventory

Section 85(1) specifically provides that the rollover is not available in respect of land which is inventory in the hands of the taxpayer. In some situations, it is difficult to determine if real property is inventory or capital property in the hands of the owner. If real property is transferred to a corporation on the assumption that it is capital property and can have the benefit of the rollover, and the land is subsequently determined to be inventory, the difference between the fair market value of the property at the time of the attempted rollover, and its cost base for tax purposes at that time, will be included in the income of the transferor. This could result in a significant unanticipated tax liability.

For guidance in relation to whether real property is capital property or inventory, refer to Interpretation Bulletin IT-218.

It is possible that land inventory could be transferred to a partnership pursuant to the provisions of section 97(2), and the partnership interest thereafter be rolled to a corporation under section 85. However, a discussion of the details of such a transaction is beyond the scope of this paper.

(b) Debt in Excess of Adjusted Cost Base

In most cases where one is transferring property to a corporation under section 85 in return for non-share consideration that includes the assumption of debt, the debt assumed is a debt incurred on the acquisition of the property, and is accordingly usually no greater than the adjusted cost base of the property. However, there are situations, particularly where the property was refinanced after its acquisition, where the amount outstanding on the debt will be greater than the adjusted cost base.

> Example No.2 A taxpayer farmer bought a quarter section of farmland in 1976 for $25,000.00. It is now worth $100,000.00. The farmland was refinanced in 1980, and the outstanding balance on the mortgage is $35,000.00. The farmer wishes to transfer the farmland to a corporation on a rollover basis.
>
> If the corporation assumes the obligation to make payment on the mortgage, then by reason of section 85(1)(b), the elected amount on the rollover will be at least

$35,000.00. This will result in the recognition of $10,000.00 in capital gains. There are several ways to avoid this:

(a) If other assets are being rolled in at the same time, the debt assumed can be allocated among the other assets. As long as the amount allocated to any other asset is no more than the adjusted cost base of the asset, no capital gain will be recognized. If there are no other assets to be rolled in, the farmer can roll in cash along with land. The rollover agreement would then provide for the roll in of land and cash, with the elected amount being $35,000.00, and the debt assumed being allocated $25,000.00 to the land and $10,000.00 to the cash.

(b) Alternatively, Revenue Canada has stated, in the Revenue Canada Round Table Session at the 36th Canadian Tax Foundation Tax Conference in 1984, that section 85(1)(b) will not be applied if the excess $10,000.00 is assumed by the transferee in consideration of the delivery by the transferor of a promissory note in the amount of $10,000.00. As a result, then, the transferor is transferring to the corporation a promissory note for $10,000.00 and land and the corporation is assuming payment of the $35,000.00 mortgage.

C. THE STATED CAPITAL ACCOUNT·

The Business Corporations Act requires a corporation to maintain a separate stated capital account for each class and series of shares that it issues. The stated capital account is the equivalent of paid up capital for tax purposes under The Income Tax Act. In most cases, on the issuance of shares, the corporation must add to its stated capital account for that class of shares the full amount of the consideration received for the share issuance. This would mean, in the context of a section 85 rollover, that the fair market value of the assets transferred to the corporation would have to be added to the stated capital account.

However, section 26(1.2) of The Business Corporations Act of Saskatchewan provides as follows:

> "•••where a corporation issues shares in exchange for:
>
> a) property of a person who immediately before the exchange does not deal with the corporation at arms length within the meaning of that term in The Income Tax Act (Canada); or
>
> b) shares of a body corporate that, immediately before the exchange or, because of the exchange, immediately after the exchange does not deal with the corporation at arms length within the meaning of

that term in The Income Tax Act (Canada);

the corporation may, subject to subsection 1.3, add to the stated capital accounts maintained for the shares of the classes or series issued the whole or any part of the amount of the consideration it received in the exchange."

Subsection 1.3 provides an upper. limit on the amount to be added to the stated capital account, being the amount of the consideration received for the shares.

The result of this section is that, for both section 85 and section 86 rollovers, if the parties do not deal with each other at arms length (which is the usual situation in a rollover), there is considerable flexibility in the resulting stated capital account. The parties can choose, within limits, the paid up capital of the shares for tax purposes.

The significance of paid up capital for tax purposes is felt on a subsequent disposition of the shares. If the shares have a low paid up capital and an equally low adjusted cost base, but a high redemption price (in tax parlance, these are "hi-low shares"), when the shares are redeemed the holder will be deemed to have received a dividend equal to the difference between the redemption price received and the paid up capital.

If the stated capital (and thus the paid up capital) is elected to be equal to the fair market value of the assets

rolled into the corporation, on any redemption the difference between the redemption price and the adjusted cost base of the shares will be taxed in the hands of the transferor as a capital gain (assuming, of course, that the transferor treats the shares as capital property as opposed to property which gives rise to income gains or losses).

In most cases, dealing with the rollover of shares, it is best to allocate a nominal amount to the stated capital account, due to the provisions of section 84.1 of the Income Tax Act. That section contains rUles which, in the case of a non-arms lenghth disposition of shares (which is the case in most section 85 rollovers) may have an adverse effect on the adjusted cost base of the shares or debt, or may result in an immediate capital gain.

D. ROLLDOWN OF ASSETS

A holding company can be established to hold the shares of an operating company in two ways:

a) By incorporating a new corporation to be the holding company, and rolling the shares of the owners into the holding company under section 85 in return for the holding company issuing shares in its capital stock to the owners:

b) By rolling the assets of the operating company into a new operating company, using a section 85 rollover, in return for shares in the new operating company. The old operating company then becomes the holding company.

Where the second route is followed, there are several additional non-tax considerations to be kept in mind. The transaction involvea, essentially, the sale of a business, and many aspects of that type of transaction must be completed in a rolldown of assets. Among other things, the following must be kept in mind:

a) The new corporation will have to apply for new business licences, new worker's compensation coverage, new education and health tax accounts, and so forth;

b) The indebtedness of the old operating company and in particular the operating line of credit must be dealt with;

c) Careful consideration should be given to the possession date, particularly in relation to claims for capital cost allowance. It may be appropriate to have the possession date be the first day of the old operating corporation's fiscal year, in order not to reduce the capital cost allowance claim;

d) New work orders, invoices and the like, bearing the name of the new corporation, must be obtained.

Generally speaking, a rolldown of assets to a new operating company will be a bit of a pain. The only consolation is that it is even more of a pain to the accountants.

II. SECTION 86 ROLLOVERS

Section 86 of The Income Tax Act is intended to allow an internal reorganization of capital in a corporation on a tax free basis. In the absence of the section 86 reogranization provisions, any such disposition of shares would result in the recognition of capital gains.

In order for section 86 to apply, the following requirements must be met:

a) The taxpayer must have "disposed" of all of the shares of a particular class which he or she owned. Some reorganizations of capital do not result in a disposition, in which case it is not necessary to rely on section 86. For example, if on a continuation of a corporation under new corporate legislation there is a minor reclassification of share rights such that the fundamental rights attaching to the shares are not significantly changed, there would be no disposition. [For circumstances in which Revenue Canada feels there is a disposition of shares when share rights change, see Interpretation Bulletin IT-448. A criticism of Revenue

Canada's position appears in Arnold and Ward "Dispositions A Critique of Revenue Canada's Interpretation", (1980) 28 Canadian Tax Journal 559].

b) The shares must be capital property to the owner;

c) The disposition of the shares must occur in the course of a reorganization of the capital of the corporation; and

d) The property received from the corporation on the disposition of the shares must include other shares in the capital stock of the corporation.

A section 86 rollover is used for small business corporations primarily in the context of an estate freeze. As in the section 85 rollovers, there are a number of rules which must be kept in mind. The most important ones in the ordinary section 86 reorganization are as follows:

1. As in a section 85 rollover, the transferor (who will be referred to as the shareholder in the context of the section 86 rollover discussion) may receive non-share consideration in addition to shares. However, if the result of the transaction is to increase or decrease the stated capital (paid up capital) of the corporation, deemed dividends could result under section 84.

Accordingly, the stated capital of the new shares should be equal to the stated capital of the old shares.

2. Section 86 contains an indirect gift rule similar to that in section 85(1)(e.2). Section 86(2) provides that where in the course of a reorganization of capital, the non-share consideration received by the shareholder plus the fair market value of the new shares issued in the course of the reorganization is less than the fair market value of the old shares disposed of, and it is reasonable to regard any portion of the difference as a benefit that the shareholder wished to have conferred on a related person, the shareholder will recognize that difference as an immediate capital gain, or, in some cases, a reduction in the adjusted cost base of the new shares.

As a result, the same precautions that one takes when dealing with a section 85(1)(e.2) problem must be considered in the context of the section 86 reorganization exchange where the other shareholders of the corporation are related to the shareholder whose shares are being exchanged. That is:

a) The fair market value of the shares received in exchange must be equal to the fair market value of the old shares less the non-share consideration. See the discussion under section 85 rollovers above for a

description of the necessary preference share attributes.

b) The agreement pursuant to which the shares are exchanged should contain a price adjustment clause. See the discussion of price adjustment clauses under section 85 above.

3. An estate freeze of shares issued before Valuation Day can result in the loss of the tax free zone. Accordingly, any freeze of pre V-day shares should be carefully examined.

Attached as Appendix D is a sample section 86 Reorganization Agreement. It contemplates a transaction where the holder of one class A share in the capital stock of the corporation, which Class A share had an adjusted cost base and stated capital of $1.00 and a fair market value of $40,286.00, is exchanged for 40,286 Class D shares. The Class D shares have a redemption price of $1.00 each. No non-share consideration is issued on a share exchange, as there would be no point in issuing such a small amount of non-share consideration.

APPENDIX A

BASIC S. 85 ROLLOVER AGREEMENT

THIS AGREEMENT made in duplicate this day of _____, A.D. 198 •

BETWEEN:

FREDERICK FARMER, of the Rural Municipality of Next Year, in the Province of Saskatchewan:

(Called "the Vendor")

AND:

FARMCO LTD., a body corporate with head office in the Rural Municipality of Next Year, in the Province of Saskatchewan;

(Called "the Purchaser")

WHEREAS the Vendor is the owner of an estate in fee simple in and to the land described in Schedule A hereto (which land is called the "Land"):

AND WHEREAS the Purchaser wishes to acquire the Land;

NOW THEREFORE THE PARTIES HERETO COVENANT AND AGREE AS FOLLOWS:

1. The Vendor does agree to transfer to the Purchaser all his right, title, property and interest in and to the Land.

2. In consideration of the transfer to it of the Land, the Purchaser does hereby agree:

(a) to pay to the Vendor the sum of $25,000.00: and

(b) to issue to the Vendor one Class "A" share in its capital stock.

3. The Vendor hereby covenants that:

(a) He is the owner of an estate in fee simple in and to the Land, and has the right to transfer the Land to the Purchaser;

(b) The Land is clear of all debts, claims, and encumbrances of any nature, kind and description; and

(c) No person, firm, or corporation has any interest in the Land.

4. The Vendor agrees to execute a registrable transfer of title to the Land under The Land Titles Act, and such transfers and other documents necessary to give clear title to the Land to the Purchaser, or as may be necessary to give effect to this Agreement according to its tenor and intent.

5. The parties hereto agree to make an election in relation to the within transaction pursuant to the provisions of section 85 of the Income Tax Act, (Canada) with the elected amount fqr this purchase to be the Vendor's adjusted cost base for federal income tax purposes for the Land, being the sum of $25,000.00.

7. The Purchaser agrees to cause to be added to the stated capital account of the Purchaser in respect of the Class "A" share agreed to be issued pursuant to this agreement the sum of One ($1.00) Dollar and no more.

8. This Agreement shall enure to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF the Vendor has hereunto set his hand and seal and the Purchaser has hereunto affixed its corporate seal, duly attested to by the hands of its proper signing officers in that behalf, the day and year first above written.

SIGNED, SEALED AND DELIVERED in the presence of:)
)
)

WITNESS

FREDERICK FARMER

FARMCO LTD.

(SEAL)

PER: _

APPENDIX B

ROLLOVER AGREEMENT WITH- PRICE ADJUSTMENT CLAUSE

THIS AGREEMENT made in duplicate this day of _____, A.D. 198 •

BETWEEN:

MARY Q. TAXPAYER, of the City of Saskatoon, in the Province of Saskatchewan;

(Called "the Vendor")

AND:

HOLDCO LTD., a body corporate with head office at the City of Saskatoon, in the Province of Saskatchewan;

(Called "the Purchaser")

WHEREAS the Vendor is the holder of 10 Class "A" Shares in the capital stock of Opco Ltd. (which shares are called the IIShares");

AND WHEREAS the Purchaser wishes to acquire the Shares;

NOW THEREFORE THE PARTIES HERETO COVENANT AND AGREE AS FOLLOWS:

1. The Vendor does agree to transfer and assign to the Purchaser all her right, title, property and interest in and to the Shares.

2. In consideration of the transfer and assignment to it of the Shares, the Purchaser does hereby agree to issue to the Vendor 40,286 Class liE" shares in its capital stock.

3. The Vendor hereby covenants that:

(a) She has the right to transfer and assign the Shares to the Purchaser;

(b) The Shares are clear of all debts, claims, and encumbrances of any nature, kind and description; and

(c) No person, firm, or corporation has any interest in the Shares.

4. The Vendor agrees to execute such transfers and other documents necessary to give clear title to the Shares to the Purchaser, or as may be necessary to give effect to this Agreement according to its tenor and intent.

5. The parties hereto agree to make an election in relation to the within transaction pursuant to the provisions of section 85 of the Income Tax Act, (Canada) with the elected amount for this share purchase to be the Vendor's adjusted cost base for federal income tax purposes for the shares, being the sum of $10.00.

6. The parties agree that, to the best of their information and belief, the fair market value of the Shares, as of the date hereof, is the sum of $4,286.00 Dollars per Share ("the Estimated Value"). The parties acknowledge. however, that this is an approximation. The parties agree that in the event that:

(a) Countem, Chargem & Company, being the accountants for the Purchaser, or

(b) Revenue Canada, with the consent of the parties to this Agreement, or, failing such consent, confirmation by a Court of competent jurisdiction,

should establish the fair market value ("the Established Value") of the Shares being sold hereunder as different from the Estimated Value, then:

(i) In the event that the Established Value is lower than the Estimated Value, the Vendor will surrender to the Purchaser for cancellation the number of Class liE" Shares in the capital stock of the Purchaser calculated by dividing 10 into the difference between Established Value and the Estimated Value;

(ii) In the event that the Established Value is higher than the Estimated Value, the Purchaser will issue to the Vendor the number of additional Class "E"shares in the capital stock of the Purchaser calculated by dividing 10 into the difference between the Estimated Value and the Established Value.

7. The Purchaser agrees to cause to be added to the stated capital account of the Purchaser in respect of the Class "E" Shares agreed to be issued pursuant to this agreement the sum of Ten ($10.00) Dollars and no more.

8. This Agreement shall enure to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF the Vendor has hereunto set her hand and seal and the Purchaser has hereunto affixed its corporate seal, duly attested to by the hands of its proper signing officers in that behalf, the day and year first above written.

SIGNED, SEALED AND DELIVERED in the presence of:)
)
)

WITNESS

MARY Q. TAXPAYER

HOLDCO.LTD.

(SEAL)

PER: _____

APPENDIX C

SHARE RIGHTS FOR REDEMPTION PRICE ADJUSTMENT
(Courtesy of Audrey Wakeling)

The rights and restrictions attaching to the Class "A" Shares and Class "B" Shares shall include the following:

A. VOTING

A.1 The holders. of the Class "A" Shares shall alone be entitled to notice of and to attend and vote at all meetings of the Corporation. Each Class "A" Share shall carry the right to one vote.

A.2 The holders of the Class "B" shares shall be entitled to vote at separate meetings of holders of Class "B" Shares called for any purpose for which a meeting of the holders of Class "B" Shares mayor shall be called pursuant to the provisions of the Business Corporations Act.

A.3 Subject to the provisions of Paragraph A.2 hereof the holders of the Class "B" Shares shall not, as such, have any voting rights, nor shall they be entitled to receive notice of or to attend any meetings of the Corporation.

B. DIVIDENDS

B.1 If in any year there shall be any profits or surplus lawfully available for dividends the Directors may in their discretion apply any or all of such profits or surplus to dividends on the Class "A" Shares, and subject to Paragraph B.2 hereof, on the Class "B" Shares, or on one such class of shares to the exclusion of the other.

B.2 The holders of the Class "B" Shares shall in each year in the discretion of the Directors be entitled out of any or all profits or surplus lawfully available for dividends to a non-cumulative dividend at a maximum rate of 8% per year of the Redemption Value of the Class "B" Shares. The holders of the Class "B" Shares shall not be entitled to any dividends other than or in excess of the dividends herein provided.

B.3 No dividends shall be paid on any class of shares if, after, such payment,

a. the Corporation would be unable to pay its liabilities as they become due, or

b. the realizable value of the Corporation's assets including goodwill would be less than the aggregate of its liabilities and the amount required to redeem

all outstanding shares which are redeemable at the option of either the holder thereof or the Directors.

C. LIQUIDATION

C.1 In the event of the liquidation, dissolution or winding up of the Corporation or other distribution of its assets among the shareholders for the purpose of winding up its affairs or on any reduction or return of capital of the Corporation, the holders of the Class "B" Shares shall be entitled to receive, in preference and priority to any payment to the holders of the Class "A" Shares, the amount of One ($1.00) Dollar per Class "B" Share held together with all declared but unpaid dividends thereon. The holders of the Class "B" Shares shall not be entitled to share any further in the distribution of the property or assets of the Corporation.

D. REDEMPTION

D.1 The Class "B" Shares or any part thereof shall be redeemable at any time and from time to time at the option of either a holder thereof or the Directors at an amount equal to the Redemption Value thereof together with any dividends declared thereon and unpaid. From and after completion of such redemption, the holder shall cease to have any rights in the shares redeemed.

D.2 The Redemption Value of each Class "B" Share shall be the amount of consideration received therefor as determined by the Directors of the Corporation upon issuance and adjusted by the Directors at any time or times so as to ensure that the Redemption Value of such Class "B" Share issued as partial or total consideration for the purchase by the Corporation of any assets or the conversion or exchange of any shares (the "Purchased Assets") shall equal the proportion of the difference between the fair market value of the Purchased Assets as at the date of purchase, conversion, or exchange by the Corporation and the aggregate value of non-share consideration, if any, issued by the Corporation that one bears to the total number of Class "B" Shares issued as partial or total consideration for the Purchased Assets.

For greater certainty, should any competent taxing authority at any time issue or propose to issue any assessment or assessments that impose or would impose any liability for tax on the basis that the fair market value of the Purchased Assets is other than the amount approved by the Directors and if the Directors or a competent Court or tribunal agree with such revaluation, then the Redemption Value of the Class "B" Shares shall be adjusted nunc pro tunc pursuant to the provisions of this Paragraph D.2 to reflect the agreed upon fair market value and all necessary adjustments, payments and repayments as may be required shall forthwith be made between the proper parties.

D.3 A holder requiring redemption shall give written

notice (the "Redemption Notice") to the Corporation at its registered office, at the office of any transfer agent of the Corporation, or at such other place as the Directors of the Corporation may from time to time designate, specifying the number of Class "B" Shares to be redeemed. The Redemption Notice shall be accompanied by the share certificate(s) representing the Shares to be redeemed properly endorsed in blank for transfer or by such share certificate(s) with an appropriate form of transfer properly executed in blank. A Redemption Notice shall be deemed to have been given when actually received at the registered office of the Corporation or at such other place referred to above at which such notice may be given. The Corporation shall redeem (or, at its option, purchase) the number of Class "B" Shares specified in the Redemption Notice, or such lesser number as the Corporation may then be entitled to redeem or purchase under the provisions of the Business Corporations Act, not later than sixty (60) days following the giving of the Redemption Notice (the "Payment Date"). Payment shall be by cheque payable in Canadian funds delivered to the holder of the Shares to be redeemed or purchased, and where mailed by prepaid registered mail to the holder at his address as it appears in the records of the Corporation shall be deemed to have been delivered two (2) days following the date of mailing.

D.4 The Corporation requlrlng redemption shall give not less than two (2) days written notice of such redemption to the holder of the Class "B" Shares to be redeemed, at his address as it appears in the records of the Corporation, specifying the date and place of redemption. If such notice of redemption has been given by the Corporation and an amount sufficient to redeem the Class "B" Shares to be redeemed has been deposited in trust for the purpose of such redemption, the holder thereof shall thereupon cease to have any rights against the Corporation in respect thereof except upon a surrender of the certificate(s) for such Class "B" Shares to receive payment therefor out of the monies so deposited in trust.

D.S Notwithstanding the foregoing, the procedure for the redemption or purchase of any Class "B" Shares may be modified by agreement between the Corporation and the holder of the Shares to be redeemed or purchased.

E. PURCHASE BY CORPORATION

E.I If the Class "B" Shares or any part thereof shall be purchased by the Corporation rather than redeemed the amount for which such Class "B" Shares are purchased shall not be less than the lesser of:

i. the amount that would have been paid had such shares been redeemed pursuant to Clause D hereof; and

ii. the proportionate part of the amount by which the realizable value of the assets of the Corporation

immediately before such purchase exceeds the aggregate of its liabilities and stated capital for Class "A" Shares that the amount that would have been payable on a redemption of such Class "B" Shares pursuant to Clause D hereof is of the amount that would have been payable on a redemption of all Class "B" Shares pursuant to Clause D hereofe

F. SERIES

F.l Subject to the Business Corporations Act the Directors may'at any time and from time to time issue any class of shares of the Corporation in one or more series, each series to consist of such number of shares as may before issuance thereof be determined by the Directors. The Directors may from time to time fix before issuance the designation, rights restrictions, conditions and limitations to attach to each such series, sUbject always to the rights and restrictions attaching to shares of that class pursuant to the provisions of this Schedule "A".

G. SPECIAL PURPOSE

G.l Pursuant to the Business Corporations Act the Class liB" Shares are created for the purpose of being issued in exchange for, and may only be issued in exchange for, either:

i. property other than a promissory note or a promise to pay, or

iie issued shares of the Corporation of a different class.

APPENDIX D

SECTION 86 REORGANIZATION AGREEMENT

THIS AGREEMENT made the _____ day of _____, A.D. 19 •

BETWEEN:

MARY Q. TAXPAYER, of the City of Saskatoon, in the Province of Saskatchewan;

(Herein called "the Shareholder")

AND:

FREEZE COMPANY LTD., a body corporate with head office at the City of Saskatoon, in the Province of Saskatchewan;

(Herein called "the Corporation")

WHEREAS the Shareholder is the holder of one (1) Class "A" share in the capital stock of the Corporation;

AND WHEREAS the Corporation wishes to reorganize its capital;

AND WHEREAS in the course of such reorganization, the Shareholder wishes to exchange and transfer her Class "A" share in the capital stock of the Corporation for Class "0" shares in the capital stock of the Corporation in accordance with the provisions of section 86 of the Income Tax Act (Canada);

NOW THEREFORE THE PARTIES COVENANT AND AGREE AS FOLLOWS:

1. The Shareholder agrees to exchange her one (1) Class "All share in the capital stock of the Corporation for 40,286 Class 110" shares in its capital stock.

2. The Shareholder hereby covenants that:

(a) She has the right to transfer her Class IIA" share;

(b) Such share is clear of all debts, claims, and

encumbrances of any nature, kind and description; and

(c) No person, firm, or corporation' has any interest in the share.

3. The Shareholder agrees to execute such transfer and other documents necessary to give clear title to the said share to the Corporation, or as may be necessary to give effect to this Agreement according to its tenor and intent.

4. The parties hereto acknowledge that section 86 of the Income Tax Act shall apply to the within transaction and that to the best of their information and belief, the fair market value of the said Class "A" share, as of the date hereof, is $40,286.00 ("the Estimated Value"). The parties acknowledge, however, that this is an approximation. The parties agree that in the event that:

(a) Revenue Canada with the consent of the parties to this Agreement or failing such consent, confirmation by a Court of competent jurisdiction; or

(b) the Corporation's accountants, within six months of the date hereof;

should establish the fair market value ("the Established Value") of the share being sold hereunder as different from the Estimated Value, then:

(i) If the Established Value is lower than the Estimated Value, the Shareholder will surrender to the Corporation for cancellation the number of Class "D" shares in the capital stock of the Corporation equal to the difference in dollars between the Established Value and the Estimated Value; and

(ii) In the event that the Established Value is higher than the Estimated Value, the Corporation will issue to the Shareholder the number of additional Class "D" shares equal to the difference in dollars between the Established Value and the Estimated Value.

5. The parties agree that the stated capital account for the Class "A" shares shall be.reduced to zero and there shall be added to the stated capital account for the Class "D" shares the amount by which the stated capital account for the Class "A" shares is so reducedo

6. This Agreement shall enure to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, successors and assigns.

IN WITNESS WHEREOF the Shareholder has hereunto set her hand and seal and the Corporation has hereunto affixed its corporate seal, duly attested to by the hands of its proper signing officers in that behalf, this day of _____, 19 .

SIGNED, SEALED AND DELIVERED in the presence of:)
)
)

WITNESS

MARY Q. TAXPAYER

FREEZE COMPANY LTD.

(SEAL)

PER: -