CHAPTER 12

ORGANIZATION, CAPITAL STRUCTURES, AND INCOME DISTRIBUTIONS OF CORPORATIONS

Review Questions

1. “To function, a corporation must have some capital contributed by its shareholders. When capitalizing a corporation, the shareholder must provide only share capital.” Is this statement true? Explain.

2. Why is it that a corporate debt owed to a shareholder may be considered as part of the shareholder’s equity of the corporation? How is a shareholder’s loan treated for tax purposes?

3. “When a corporation is partly capitalized with shareholder debt, the amount of corporate income that may be subject to double taxation is reduced.” Explain. Does it matter whether the shareholder debt pays interest or not?

4. If a corporation that is in financial difficulty has been capitalized with shareholder debt and a small amount of share capital as opposed to the reverse, the shareholder may be at less financial risk and the corporation may have a better chance of surviving. Why is this so?

5. A corporation owned solely by shareholder A has a value of $100,000. Individual B intends to acquire a 50% equity interest in the corporation. The cost to that individual of acquiring 50% of the corporation’s shares may be either $100,000 or $50,000. Explain.

6. What is a buy-back of corporate shares?

7. Describe the tax treatment to the shareholder when a corporation buys back its own shares. Is the tax treatment to the shareholder different if that shareholder sells the shares to another party, rather than back to the corporation that issued them?

8. “If a corporation no longer requires the initial common share capital provided by the shareholders, all or a portion of it can be returned to the shareholders without any tax consequences to the shareholders.” Is this statement true? Explain.

9. Would your answer to question 8 be different if the share capital consisted of non-participating preferred shares or if the initial capital had been provided by the shareholders as a shareholder loan?

10. Identify and briefly explain two alternative tax treatments that can apply when assets are transferred to a corporation by a shareholder or a proposed shareholder.

11. When a shareholder sells property to their corporation at fair market value for tax purposes, what impact may the sale have on the shareholder and on the corporation?

12. If a shareholder sells property to a corporation at fair market value for legal purposes but elects an alternative price for tax purposes, what are the tax implications to the shareholder and to the corporation acquiring the asset? Why is this election option referred to as a “rollover”?

13. When a shareholder sells property to a corporation, that property has a value greater than its cost amount, and the shareholder chooses to use the elective option for tax purposes, what is the maximum amount of non-share consideration that the shareholder can receive from the corporation as payment?

14. A corporation purchases an asset from a shareholder for the market value price of $20,000 and pays the shareholder by issuing preferred shares of $8,000 and a note payable to the shareholder for $12,000. Both the shareholder and the corporation elect that the transfer price for tax purposes is $12,000. What are the tax consequences for the shareholder if the corporation pays the debt and buys back the shareholder’s preferred shares? What would the tax consequences be if the shareholder sold the acquired preferred shares to another party?

15. What types of property, if any, are not eligible for the elective option when they are transferred to a corporation?

16. Can the elective option be used when one corporation transfers property to another corporation?

17. What are the tax consequences to a corporation and its shareholder when that corporation declares a dividend but, instead of paying cash, distributes to the shareholder property that has a value greater than the cost amount to the corporation?

Solutions to Review Questions

R12-1. The statement is not true. A shareholder may capitalize a corporation by providing share capital only or by providing a combination of share capital and debt. In other words, the shareholder can act both as shareholder and as a creditor in providing capital funds to the corporation.

R12-2. In some circumstances, a shareholder will loan money to their corporation for terms that are favorable compared to the terms that would be required if funds were borrowed from a third party. This normally occurs in closely held corporations, where the affairs of the corporation and the shareholder are closely linked. For example, a shareholder may capitalize a new corporation with $50,000 consisting of $1,000 of share capital and a shareholder loan of $49,000. It is unlikely that the corporation could have borrowed $49,000 from an arm's length party with an equity base of only $1,000. In such circumstances, the shareholder debt is, in fact, a part of the shareholder's equity. It is a debt in form only, but not in substance. However, for tax purposes, a shareholder loan is always considered to be a debt and is treated accordingly.

R12-3. A debt owing to a shareholder may require that the corporation pay interest on that debt. Interest paid by the corporation is deductible from its income and is taxable to the shareholder. Because corporate income is reduced by the amount of interest paid to the shareholder, the amount of corporate income that is subject to two levels of tax (corporate tax plus shareholder tax on future dividends) is reduced. Capitalization by shareholder debt provides the shareholder with a return in the form of interest which is taxed only once in the hands of the shareholder. In comparison, capitalization with share capital provides a return in the form of dividends which means that two levels of tax are paid and, if the corporate tax rate exceeds the rate where perfect integration occurs, either 27.5% or 13%, an element of double taxation will occur. The element of double taxation is not avoided if the shareholder debt does not pay interest, as this increases corporate income and converts a portion of the shareholder's return to dividends where double taxation may occur.

R12-4. Capitalization with more shareholder debt and less share capital may provide a tax advantage when a corporation experiences financial difficulty. The tax advantage is provided to the shareholder and relates to the timing of the loss recognition for tax purposes. A loss on a shareholder loan is recognized by the shareholder/creditor for tax purposes when it is established to be uncollectible. In comparison, a loss on share capital is only recognized when the shares are actually sold, the corporation has become legally bankrupt or when it is insolvent and the business operation has ceased [ITA 50(1)].

Therefore, a loss on a shareholder loan can normally be recognized for tax purposes before a loss on share capital. Provided that the related capital loss, or allowable business investment loss, as the case may be, can be used to reduce the shareholder’s taxable income, cash flow from tax savings may be created sooner from a loan loss. This cash flow can be reinvested in the corporation to enhance its chances of survival, or can simply be retained by the shareholder to diminish the real loss in after-tax cash terms from the investment.

R12-5. The cost of acquiring 50% of the equity for a company valued at $100,000 may be $50,000 or $100,000 as a consequence of the method by which the shares are acquired. The new shareholder can acquire a 50% interest in the corporation either by purchasing 50% of the existing shareholder’s shares, or by purchasing new shares directly from the corporation. If shares are acquired from the existing shareholder, the cost will be $50,000 (1/2 of

$100,000) and cash will be paid to the existing shareholder. The value of the company remains at $100,000.

However, if new shares are acquired directly from the corporation, the existing shareholder will retain all of his/her shares in the corporation which must remain at a value of $100,000. The contribution of new share capital increases the resources and the value of the corporation. Therefore, to obtain a 50% interest, the new shareholder must contribute an amount equal to the existing shareholder's value of $100,000. After the issue of new shares, the corporation has an increased value of $200,000 of which 50% ($100,000) belongs to the existing shareholder and 50% ($100,000) belongs to the new shareholder.

R12-6. A buy-back of corporate shares means that a shareholder sells previously issued shares back to the corporation that issued them. The transaction is also referred to as a share redemption, and involves the distribution of corporate property (normally cash) to the shareholder in return for the cancellation of all or a portion of the shares. A share buy-back diminishes the resources and the value of the corporation as it involves the direct return of share equity to the shareholders.

R12-7. When a corporation buys back its own shares, the shareholder is deemed to have received a dividend and also has a disposal of shares for capital gains purposes. The deemed dividend is equal to the amount by which the redemption price (i.e., the fair value of the shares) exceeds the paid-up capital (normally the original issue price) of the shares [ITA 84(3)]. The treatment is identical to when the corporation pays a dividend to its shareholders. The shareholder, who is an individual, is entitled to claim a dividend tax credit on the deemed dividend.

Because the shareholder has given up shares, a disposition also occurs. For tax purposes, the proceeds of disposition is equal to the redemption price minus the amount that is deemed to be a dividend [ITA 54]. Effectively, the proceeds of disposition is equal to the paid-up capital of the shares. The proceeds of disposition is compared to the shareholder's cost base of the shares to determine whether or not a capital gain or loss occurs. Keep in mind that the shareholder's cost base of the shares is not always equal to the paid-up capital as the shares may have been acquired from other shareholders and not from the corporation.

If the shareholders had sold the shares to a new shareholder rather than back to the corporation, only a capital gain or loss would occur as opposed to a deemed dividend. Therefore, the sale of shares back to the corporation is referred to as the dividend option whereas the sale of shares to new shareholders is referred to as the capital gain option. The tax consequences to the shareholder are quite different.

R12-8. The statement is not true for public corporations. The amount of retained earnings within the corporation and the enhanced value of any corporate assets belong to the common shares. Normally, if a public corporation does not require all of its common share capital it can return it to the shareholders by buying back a portion of the issued common shares. The buy-back price must be the proportionate value of the common shares, which means that for each share redeemed both the initial paid-up capital plus the value increase is distributed, resulting in a deemed dividend. However, a private corporation can, if it takes the appropriate legal steps, return its share capital to the shareholders without triggering a taxable dividend.

R12-9. If a public corporation obtains capital by a combination of common shares plus non-participating preference shares, the accumulated earnings and any asset value increases would accrue only to the common share equity and would not affect the value of the preference shares. Therefore, the preferred shares normally can be repaid to the shareholder without tax consequence. For example, the redemption price of preferred shares would likely be equal to the paid-up capital (the initial issue price) and no deemed dividend would occur. Therefore, capitalizing a public corporation with a small amount of common shares and greater amount of preferred shares permits the return of the initial share capital to the shareholder without returning the proportionate value increase of the corporation.

For private corporations, shareholder loans, preferred share and common share capital can all be returned without tax consequences. However, it is simpler to carry this out through the repayment of a shareholder loan.

R12-10. For tax purposes, an existing or proposed shareholder can transfer assets to a corporation either:

- at a price that is equal to fair market value, or
- at an elected price that is normally equal to the asset's cost amount for tax purposes [S.85(1)]

The transfer of assets to the corporation constitutes a sale for tax purposes. Therefore, regardless of which of the above options are chosen for tax purposes, the transfer price for legal and accounting purposes is usually the fair market price and includes an equivalent amount of consideration.

R12-11. In general terms, when property is sold at fair market value by a shareholder to the corporation, the fair market price becomes the proceeds of disposition. Where the value of the property is greater than the cost amount, the shareholder will incur taxable income such as capital gains, recapture of capital cost allowance or business income from the sale of eligible capital property. However, the corporation having acquired the property at fair market value has an increased cost which forms the basis for determining future deductions in arriving at taxable income.

The reader should be aware that a number of specific exceptions may modify the general treatment described above, and reference should be made to the following sections of the *Income Tax Act*.

- ITA 13(7)(e) does not permit the corporation to claim capital cost allowance on a portion of the purchase price of depreciable property. For example, where the shareholder realizes a capital gain on the transfer, the non-taxable portion of the gain (i.e., 1/2) is not eligible for CCA in the corporation. The capital cost is limited to the shareholder's cost for the property plus the taxable capital gain. This applies where the shareholder and the corporation do not deal at arm's length.

- Where the shareholder has a capital loss on the transfer, the recognition of the capital loss is deferred until the corporation disposes of the asset. This applies where the shareholder and the corporation are *affiliated persons.* The loss is a *superficial loss* [ITA 54] and is denied [ITA 40(2)(g)]. The denied loss is added to the ACB of the property acquired by the corporation [ITA 53(1)(f)]. Where the shareholder is a corporation, the denied capital loss remains with the transferor corporation [ITA 40(3.4)] and cannot be recognized until one of the following occurs:

1) asset no longer owned by affiliated person,
2) asset deemed disposed under other provisions of the ITA, or
3) control of transferor is acquired by an unrelated person.

- Where the shareholder has a terminal loss on the transfer to an affiliated person, the terminal loss is denied [ITA 13(21.2)]. The positive balance remains in the UCC of the class. CCA can continue to be claimed on the positive balance. The remaining terminal loss cannot be recognized until one of the following occurs:
  1) asset no longer owned by affiliated person,
  2) asset deemed disposed under other provisions of the ITA, or
  3) control of transferor is acquired by an unrelated person.

R12-12. The shareholder is considered to have sold the property to the corporation at the price elected notwithstanding that the legal sale price and fair market value is higher [ITA 85(1)]. If the elected price is equal to the property's cost amount for tax purposes, the shareholder will not incur taxable income on the sale. For example, no taxable gain will occur if the elected price of depreciable property is equal to its undepreciated capital cost, or the elected price for non-depreciable capital property is equal to its adjusted cost base.

The corporation, even though the legal price was at fair market value, has a cost amount for tax purposes that is tied to the elected amount [ITA 85(1)(a)]. Therefore, the adjusted cost base of non-depreciable capital property acquired by the corporation is equal to the elected amount for tax purposes. If the corporation subsequently sells the property, it will incur a capital gain to the extent that the selling price exceeds the original elected amount. If the property transferred is depreciable property and the elected amount is equal to the UCC, the corporation is deemed to have a UCC equal to the elected amount and future CCA is based on that amount. The corporation is also deemed to have a cost of the property equal to the shareholder's cost [ITA 85(5)]. For example, depreciable property that had an original cost of $10,000, but at the time of transfer had a UCC of $6,000, means that the corporation takes over the asset with a cost of $10,000 and a UCC of $6,000. If the corporation subsequently sells the property, say for $11,000, the corporation will incur a recapture of $4,000 ($10,000 - $6,000) and a capital gain of $1,000 ($11,000 - $10,000).

The election option is referred to as a rollover because the potential taxable income that would have been incurred by the vendor (shareholder), and had been avoided by the election, is effectively transferred to the corporation. In other words, the potential taxable income is not eliminated but is "rolled over" to the corporation.

R12-13. When the legal price or fair market value of the asset transferred to the corporation is greater than the elected price for tax purposes, the maximum non-share consideration (i.e., cash, debt to the shareholder, or assumption of the shareholder's liabilities by the corporation) that can be given to the shareholder as payment is equal to the elected amount [ITA 85(1)(b)]. For example, an asset transferred at an elected price of $4,000 that has a legal price of $6,600 can receive only $4,000 in non-share consideration. The balance of $2,600 ($6,600 - $4,000) must consist of share capital if the taxable income is to be deferred.

R12-14. After the asset transfer, the shareholder owns two capital properties - a note receivable of $12,000 and preferred shares of $8,000. The maximum adjusted cost base that can be assigned to these properties is the amount elected for the transfer price of the property -- in this case $12,000. This amount is first assigned to the non-share consideration and then to the share consideration [ITA 85(1)(f), (g), (h)]. The cost base of the note is, therefore,

$12,000 and the cost base of the preferred shares is zero. The repayment of the note for $12,000 would have no tax consequences to the shareholder.

The preferred shares of $8,000 have a cost base of zero but upon redemption are also deemed to have a paid-up capital of zero. Therefore, if the corporation buys back the preferred shares, a deemed dividend of $8,000 will occur for the shareholder [ITA 84(3)]. Since the proceeds of disposition are reduced by the deemed dividend [ITA 54] no capital gain results. If the shareholder sold the preferred shares to another party, the tax consequences would be different than the buy-back. The sale to a third party results in a capital gain of $8,000 ($8,000 - ACB of zero) of which one-half is taxable.

R12-15. Most types of property are eligible for the elective option with only a couple of exceptions. The most significant exception is real estate (raw land or land and building) that is not held as capital property but instead is classified as inventory because it is being held for resale. The other notable exception is real estate owned by a non-resident [ITA 85(1.1)].

R12-16. Yes, the elective option is available when property is transferred from one corporation to another [ITA 85(1)].

R12-17. When a corporation distributes property other than cash in satisfaction of a dividend payment, the following occurs [ITA 52(2)]:

- The shareholder is considered to have received a dividend for tax purposes equal to the fair market value of the property distributed.

- The corporation that distributed the property is deemed to have sold that property at its fair market value. If the property has a market value greater than its cost amount, taxable income will be created (capital gain and/or recapture of CCA depending on the nature of the property).

Key Concept Questions

QUESTION ONE

On incorporation of X Ltd. 1,000 common shares were issued to Anne Rees for $1,000. At the beginning of Year 2, 800 common shares of X Ltd. were issued to Bill Delacruz for $8,000, the fair market value of the shares on that date. At the end of Year 3, 500 Class A preferred shares of X Ltd. were issued to Carl Bray for $7,000, the fair market value of the preference shares on that date.

At the end of Year 3, determine the following:

a) The paid-up capital (PUC) of the common shares and the preference shares of X Ltd.
b) The PUC and adjusted cost base of the shares of X Ltd. owned by each of Anne, Bill and Carl.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – Paid-up capital vs. adjusted cost base. Income tax reference: ITA 89(1) (definition of paid-up capital), 54 (definition of adjusted cost base).

QUESTION TWO

William Lambe owns 100% of the issued common shares of W Ltd., which have an adjusted cost base (ACB) and paid-up capital (PUC) of $100 and are currently worth $200,000. William wants Victor Patel to acquire a 50% interest in W Ltd. Victor can acquire his 50% interest by purchasing shares from William or by purchasing previously unissued shares from W Ltd.

For both alternatives, determine the purchase price for Victor, the ACB and PUC of the shares acquired by Victor, and the tax implications for William.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – Paid-up capital vs. adjusted cost base. Income tax reference: ITA 89(1).

QUESTION THREE

Veronica Haynes owns shares of a Canadian private corporation that are worth $100,000 and have an adjusted cost base (ACB) and paid-up capital (PUC) of $60,000.

Determine the tax implications for Veronica if the shares are
a) Sold to an arm's-length party for $100,000; or,
b) Redeemed by the corporation for $100,000.

CPA Competency 6.3.3 Analyzes specific tax-planning opportunities for individuals. Income tax reference: ITA 54 (definition of proceeds), 84(3).

QUESTION FOUR

Eric Mejia owns a building that originally cost $100,000 and has an undepreciated capital cost of $70,000. Eric sells the building to a corporation at the fair market value price of $140,000 in exchange for debt of $80,000 and preferred shares with a value of $60,000. Eric and the corporation will make a Section 85 election with respect to the sale.

Determine the minimum elected transfer price under Section 85.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – basic rules of section 85. Income tax reference: ITA 85(1).

QUESTION FIVE

Pat Middleton owns a non-depreciable capital asset that originally cost $20,000 and is now worth $80,000. Pat transfers the asset to a corporation, receiving as payment debt of $60,000 and preferred shares with a value of $20,000. Pat and the corporation will elect under Section 85 to avoid paying tax on the transfer.

Determine the appropriate transfer price under Section 85. Determine the cost of the asset for the corporation, and the ACB and PUC for the preferred shares received as consideration.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – basic rules of section 85. Income tax reference: ITA 85(1), (2.1).

QUESTION SIX

Cathy Ortiz owns equipment that originally cost $40,000 and that has an undepreciated capital cost of $25,000. She sells the equipment to a corporation at the fair market value price of $30,000 in exchange for a combination of preferred shares and debt. Cathy and the corporation will make a Section 85 election in order that Cathy can avoid paying tax on the sale.

(a) Determine the appropriate transfer price under Section 85.
(b) Determine the amount of debt and share consideration that Cathy can accept without any adverse tax consequences.
(c) Determine the corporation's ACB and UCC for the equipment acquired.
(d) Determine the ACB and PUC of the preferred shares received as consideration.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – basic rules of section 85. Income tax reference: ITA 85(1), (2.1).

QUESTION SEVEN

Susan McGee owns a non-depreciable capital asset that originally cost $40,000 and is now worth $160,000. She transfers the asset to a corporation receiving as payment debt of $10,000, preferred shares of $20,000, and common shares of $130,000. Susan and the corporation will elect under Section 85 to avoid paying tax on the transfer.

(a) Determine the appropriate transfer price under Section 85.
(b) Determine the ACB and PUC for the preferred shares and common shares received as consideration.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations – basic rules of section 85. Income tax reference: ITA 85(1), (2.1).

Solutions to Key Concept Questions

KC 12-1

[ITA: 89(1) – PUC; 54 ACB]

(a) The paid-up capital for tax purposes (PUC) equals the legal stated capital on the financial statements of X Ltd. which is equal to the fair market value of the assets contributed to the corporation in exchange for the shares issued.

Common shares	Number of Shares	Issue Price	Total PUC
Anne	1,000	$ 1	$1,000
Bill	800	10	8,000
Total	1,800		$9,000
Class A preferred shares	500	$14	$7,000

(b) The PUC per share is the weighted average of issue prices for issued shares of the same class. The PUC of the common shares is $9,000/1,800 = $5 per share. The PUC of the Class A preferred shares is $14 per share.

The adjusted cost base (ACB) is the amount paid by the shareholder for the shares.

PUC attaches to the shares whereas ACB attaches to the shareholder.

Shareholder	Share Description	Number of shares	PUC	ACB
Anne	Common	1,000	1,000 x $5 = $5,000	$1,000
Bill	Common	800	800 x $5 = $4,000	$8,000
Carl	Class A preferred	500	500 x $14 = $7,000	$7,000

KC 12-2

[ITA: 89(1) - PUC]

If Victor purchases 50% of William's shares, the purchase price will be $100,000. This will result in a capital gain of $99,950 for William or a taxable capital gain of $49,975. If W Ltd. is a qualified small business corporation, then, the capital gain may be sheltered from tax by the capital gains deduction. Victor's shares will have an ACB of $100,000 (purchase price) and a PUC of $50. The paid-up capital value on the corporate balance sheet remains unchanged at $100. Since Victor owns one-half the shares, the PUC of his share is $100 x ½.

If Victor purchases a 50% interest by buying previously unissued shares from the treasury of W Ltd., the purchase price will be $200,000. Since William has not disposed of any shares, even though his ownership interest diminished from 100% to 50%, he has no income to recognize for tax purposes. Victor's shares will have an ACB of $200,000 (purchase price) and a PUC of $100,050. The paid-up capital value on the corporate balance sheet is $200,100 after Victor purchases his shares. Since Victor owns one-half of the shares, the PUC associated with half of the shares is $100,050 (1/2 x $200,100).

KC 12-3

[ITA: 54, 84(3) – Share redemption vs. sale]

Veronica Haynes will have a capital gain of $40,000 if the shares are sold. She will have a dividend of $40,000 if the shares are redeemed. Only one-half of the capital gain is taxable. She will include the dividend in income at the grossed-up amount and claim the dividend tax credit.

a)	Sales proceeds	$100,000
	ACB	(60,000)
	Capital gain	$ 40,000
	Taxable capital gain	$ 20,000
b)	Redemption price	$100,000
	PUC	(60,000)
	Deemed dividend [ITA84(3)]	$ 40,000
	Proceeds (PUC) [ITA54]	$ 60,000
	ACB	(60,000)
	Capital gain	$ Nil

KC 12-4

[ITA: 85(1) – Elected transfer price]

The minimum elected transfer price under Section 85 is $80,000. The elected amount cannot be less than the non-share consideration received of $80,000 [ITA 85(1)(b)]. This will result in recapture of $10,000 (UCC $70,000 – Proceeds $80,000).

KC 12-5

[ITA: 85(1), (2.1) – Non-depreciable capital asset; Excess debt]

The elected amount can never be less that the non-share consideration received [ITA 85(1)(b)], therefore, it is not possible to elect at the tax value. The minimum elected transfer price is $60,000. This results in a capital gain of $40,000 (Proceeds $60,000 – ACB $20,000).

The corporation's cost for the asset received is the elected amount, $60,000 [ITA 85(1)(a)].

The cost of the consideration received by Pat is $60,000 (elected amount). The elected amount is allocated on a sequential basis; first to the debt up to its fair market value ($60,000) leaving nothing to be allocated to the preferred shares [ITA 85(1)(f),(g)].

The PUC of the preferred shares is reduced from its legal stated capital of $20,000 to Nil [ITA 85(2.1)].

Pat's consideration	FMV	ACB	PUC
Debt	$60,000	$60,000	N/A
Preferred shares	20,000	0	Nil
	$80,000	$60,000	$ Nil

KC 12-6

[ITA: 85(1), (2.1), (5) Depreciable property]

Taxable income can be avoided if Cathy and the corporation agree that the transfer price for tax purposes is $25,000, which is the equipment's UCC. With proceeds of $25,000 there is no recapture (UCC $25,000 – Proceeds $25,000).

Payment must include some shares in order to make a Section 85 election and the non-share consideration must not exceed the elected amount. Therefore the payment should consist of debt of $25,000 and preferred shares of $5,000 for total consideration of $30,000, which equals the fair market value of the equipment sold to the corporation.

Although the corporation's legal purchase price of the equipment is $30,000 the corporation is deemed to have a UCC of $25,000 (elected amount) and a capital cost of $40,000 [ITA 85(5)]. Note that all three values (FMV, cost and UCC) to the corporation are identical to those before the transfer. As a result, if the corporation subsequently sells the asset for $30,000, there will be recapture of $5,000 (UCC $25,000 – Proceeds $30,000).

After the transfer, the shareholder will own a note receivable from the corporation of $25,000 and preferred shares worth $5,000. The elected amount of $25,000 is allocated first to the debt, up to its fair market value ($25,000) leaving nothing to be allocated to the shares [ITA 85(1)(f),(g)]. If the shareholder subsequently sells the shares for $5,000 there will be a capital gain of $5,000 (Proceeds $5,000 – ACB $0). Note that this equals the amount of recapture that Cathy would have incurred upon selling the equipment without a Section 85 election.

The paid-up capital (PUC) of the preferred shares received by Cathy is Nil since the non-share consideration equals the elected amount [ITA 85(2.1)]. If those shares are subsequently redeemed, a deemed dividend occurs for the full redemption amount ($5,000).

KC 12-7

[ITA: 85(1), (2.1) – Non-depreciable capital asset; Two classes of shares]

Susan and the corporation should jointly elect a transfer price equal to the tax value of the asset transferred, $40,000, in order to avoid tax on the transfer. Susan's capital gain will be Nil (Proceeds $40,000 – ACB $40,000).

Where more than one class of shares is taken as consideration on the transfer, the ACB and the PUC must be allocated among the classes. The ACB is allocated on a sequential basis whereas the PUC is allocated on a pro rata basis based on the relative fair market values of the classes.

The elected amount ($40,000) becomes the cost of the consideration package, in total. The cost is allocated on a sequential basis; first to the debt up to its fair market value ($10,000) [ITA 85(1)(f)], next to the preferred shares up to their fair market value ($20,000) [ITA 85(1)(g)] and the remainder ($10,000) to the common shares [ITA 85(1)(h)].

The PUC of both classes of shares combined is reduced from its legal stated capital of $150,000 (preferred $20,000 + common $130,000) to $30,000 being the excess of the elected amount ($40,000) over the non-share consideration ($10,000) [ITA 85(2.1)]. The PUC of $30,000 is allocated between the preferred and common shares based on their relative fair market values. $4,000 ($20,000/$150,000 x $30,000) is allocated to the preferred shares and $26,000 ($130,000/$150,000 x $30,000) is allocated to the common shares [ITA 85(21.)].

Susan's consideration	FMV	ACB	PUC
Debt	$ 10,000	$10,000	N/A
Preferred shares	20,000	20,000	$ 4,000
Common shares	130,000	10,000	26,000
	$160,000	$40,000	$30,000