CHAPTER 14

MULTIPLE CORPORATIONS AND THEIR REORGANIZATION

Review Questions

1. “A corporate reorganization usually involves a change in form, rather than a change in substance.” Explain this statement.

2. What unique tax treatment does a corporate reorganization provide? What is the logic for permitting this to occur?

3. Is it possible for unrelated corporations to combine their business activities through a reorganization? If so, what must occur in order to ensure that the transaction will not be treated as an outright sale of property at fair market value?

4. Identify four basic reorganization techniques.

5. Briefly describe two alternative tax treatments when the business assets of one corporation are transferred to another corporation. Are these two alternatives available only if the corporation acquiring the assets is owned by the corporation selling the assets? Explain.

6. If Corporation A wishes to transfer its business operations to Corporation B by way of an asset transfer, must all of the assets relating to that business be transferred? Explain. How will the future income of each corporation be different if some but not all of the business assets are transferred?

7. Describe what takes place when two or more corporations amalgamate.

8. Distinguish between a wind-up of a wholly owned subsidiary corporation and an amalgamation of the parent and subsidiary.

9. What is the tax treatment of a corporation’s unused net capital losses and/or non-capital losses after that corporation has been amalgamated with another corporation or has been wound up into its parent corporation?

10. What form of reorganization permits the current common shareholders to retain their existing value in the corporation and, at the same time, alters the ratio relating to the sharing of future growth beyond the existing value? Explain how this reorganization can be accomplished without any immediate tax consequences to the shareholders.

11. What is a holding corporation?

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12. Dividends received by a corporation from another taxable Canadian corporation are excluded from taxable income and therefore are not usually subject to tax. However, in certain circumstances, a Canadian-controlled private corporation may be subject to a special refundable tax on the receipt of Canadian dividends. In what circumstances will this special tax apply, what is the rate of tax, and why is it referred to as a "refundable tax"?

13. What is the primary benefit of using a holding corporation to hold investments in the shares of other corporations, rather than holding those investments personally?

14. Briefly explain why a holding company may be useful when the shares of an active business corporation are being acquired.

15. Briefly explain how using a holding company to own the shares of an active business corporation may be beneficial when the shares of the active business corporation are about to be sold. In what circumstances may using a holding company be disadvantageous when the shares of the active business corporation are being sold? Explain.

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Solutions to Review Questions

R14-1. A corporate reorganization normally involves the relocation of a business, or specific assets, from one corporation to another corporation that is owned by the same shareholder or group of shareholders. In other words, the owner continues to conduct the same activities but from within a different entity. This is a change in form but not in substance, because the owners before the reorganization continue ownership after the reorganization.

R14-2. The relocation of a business or specific assets from one corporation requires the transfer of assets (i.e., a sale and a purchase). Normally this would be at fair market value resulting in the creation of taxable income to the transferor. However, when a corporate reorganization occurs, the parties involved in the reorganization may, if they so desire, choose a form of transaction, which, for tax purposes, does not result in the fair market value disposition of assets. Consequently, the creation of taxable income is deferred.

The logic for permitting this tax treatment was explained in the answer to question 1 above. A real change in ownership has not occurred because the same owner(s) continue to conduct the same activity but from a different entity. In effect, this change in form (but not substance) does not constitute a real sale and so the special tax treatment is provided.

R14-3. Yes, unrelated parties can combine their operations in the form of a reorganization, thereby permitting the opportunity to defer tax. This may be accomplished if each of the separate parties has a continued interest in the combined or reorganized entity. For example, the business of two separate corporations owned by different shareholders may combine both businesses into a single entity, whereby the ownership of the new entity includes the shareholders of the other separate entities. In other words, both parties continue ownership. This is different from an outright sale, which requires that one party give up their interest in the business in exchange for cash, notes receivable, or other assets other than shares in the continuing activity.

R14-4. The four basic reorganization techniques are as follows:

- *Asset transfers*: this method permits activities to be combined or separated by transferring assets related to the activity from one entity to another. It is a simple form of reorganization, because it does not involve the restructuring of the corporations. It also provides flexibility, because either all, or only a specified portion, of an entity's activities can be transferred. [ITA 85]

- *Amalgamations*: this method involves the merging of two or more corporations into a new single corporation [ITA 87].

- *Wind-up*: this technique combines the entire activities of a subsidiary corporation with its parent corporation [ITA 88(1)].

- *Share reorganization*: this technique does not alter the activities within the corporation but rather alters the ownership rights of the shareholders [ITA 86].

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R14-5. The transfer of assets from one corporation to another involves the actual sale of property with an established price and payment terms. In spite of the established legal price, the transfer price for tax purposes is automatically considered to be equal to the asset's fair market value or, if the corporations so elect, an agreed transfer price can be chosen. The agreed transfer price is normally the property's cost amount for tax purposes.

Normally a transfer at fair market value results in the creation of taxable income to the vendor corporation. However, the corporation acquiring the asset has a higher cost base for tax purposes, which may create future tax savings from capital cost allowance deductions. On the other hand, taxable income will not be created for the vendor when the elected transfer price is equal to the asset's cost amount. In this case, the purchaser's cost amount of the assets is tied to the elected price, and future tax deductions are based on the lower elected price.

The ability to use the election option is not restricted to the sale of property from a parent corporation to its owned subsidiary corporation (a vertical transfer). The election option can be used on the sale of corporate assets to any other corporation if the rules of the election option are adhered to. For example, the election option can be used when corporation 1 (owned by shareholder X) sells property to corporation 2 (owned by shareholder Y). This is referred to as a horizontal transfer.

R14-6. If Corporation A wants to transfer its business operations to Corporation B it is not always, necessary to transfer all of the assets associated with that business. For example, the business operations in Corporation A may utilize land, buildings, equipment and inventory. Corporation B could acquire the right to operate the business by purchasing only the inventory and goodwill, and lease the land, buildings, and equipment from Corporation B. To acquire a business does not mean that one must purchase all of the assets associated with that business, but rather one must obtain the right to use those assets.

While leasing avoids any complications associated with asset transfers, it does, however, change the amount of profits that are shifted from Corporation A to Corporation B. Because Corporation B must pay a rent for the use of the land, buildings, and equipment, the profits associated with the business may decline leaving some rental income in Corporation A.

R14-7. An amalgamation involves the complete merging of two or more corporations by combining their assets and liabilities as well as their shareholdings. All of the predecessor corporations cease to exist and a new legal corporation is born. Effectively, all assets and debt of the old corporations are transferred to a new corporation and each of the shareholders gives up their shares in the old corporation. Shares of the new corporation are distributed to the shareholders in proportion to the value of their shares in the former corporations. [ITA 87]

For tax purposes, the predecessor corporations are deemed to have sold their assets to the new corporation at their tax values. Similarly, the shareholders are deemed to have sold their shares of the former corporation at their cost amounts (ACB) in exchange for shares of the new corporation having the identical cost base. In effect, all former tax positions of the corporations and their shareholders are preserved in the new entity.

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R14-8. The wind-up of a subsidiary corporation involves the transfer of all of the assets of the subsidiary to its parent corporation followed by the elimination of the subsidiary corporation. Effectively, the parent continues to exist but in an expanded form [ITA 88(1)]. In contrast, the amalgamation of a parent and subsidiary results in the termination of both corporations and the creation of an entirely new combined entity [ITA 87].

The tax treatment of a wind-up is similar to an amalgamation in that the assets are normally transferred, for tax purposes, at their tax values resulting in no immediate tax consequences. However, in order for this special tax treatment to apply on a wind-up, the parent corporation must own at least 90% of each class of the subsidiary's shares. This requirement does not exist for an amalgamation of a parent and subsidiary.

Under both an amalgamation and a wind-up tax account balances, including losses, carry forward into the combined corporation. However, after a wind-up, the losses of the former subsidiary are not available to the parent until the parent's taxation year commencing after the year in which the wind-up occurred.

R14-9. Normally, when a corporation that has, unused non-capital losses and/or net capital losses is wound-up or amalgamated with another corporation, those losses simply continue to be carried forward in the new entity. In addition, any restrictions that were previously attached to those losses (such as a limited time for carry forward or a restriction of the types of income that they can be offset against) simply continue in the combined corporation [ITA 87(2.1), 87(2.11), 87(1.1)].

In some circumstances, the status of unused losses of a predecessor corporation may change upon amalgamation. Non-capital losses from a business activity can normally be offset against any other source of income. However, upon a change in control by the shareholders, these unused losses can only be offset against future profits from the business that incurred the loss or from a similar business [ITA 111(5)]. A change in control eliminates the unused net capital losses [ITA 111(4)(a)]. An amalgamation within a related group does not constitute a change in control for this purpose. However, the losses may be affected when unrelated corporations are amalgamated. This occurs only when the shareholders of the corporation that has the unused losses does not control the new combined corporation after amalgamation. When this occurs, the net capital losses expire and the non-capital business losses can only be offset against the business profits of the business that incurred the losses or a similar business. If the predecessor corporations are in a similar line of business, the change in control has no real effect on the non-capital losses.

R14-10. The common shareholders of a corporation can alter their sharing ratio of future growth of the entity, but retain their existing value in the corporation by using the reorganization technique referred to as a reorganization of share capital [ITA 86].

For example, consider a corporation whose common shares are valued at $200,000 and are owned equally by shareholder A and B ($100,000 value each). At this point, all future growth is shared fifty-fifty. Through a reorganization of share capital, A and B could exchange all of their common shares for preferred shares having a value of $200,000 ($100,000 each). At this point, the full value of the company is attached to the preferred shares, which are fixed in value and will achieve no further growth. Because the full value of the company is attributed to the preferred shares, new common shares can be issued (as part of the reorganization) at a nominal value. If A subscribes for seven common shares and B for three common shares, any growth in value of the company beyond $200,000 will accrue 70% to A and 30% to B.

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Therefore, both A and B retain their existing equity value of $100,000 each but share future growth on a 70-30 basis rather than 50-50.

A reorganization of share capital permits the shareholders to convert their common shares to preferred shares without tax consequences. In other words, the tax status (ACB and paid-up capital) of the new preferred shares is the same as the old common shares [ITA 86(2.1)].

R14-11. A holding corporation is a corporation, owned by an individual or group of individuals, the primary purpose of which is to own shares of other corporations. For example, rather than directly owning the shares of an active business corporation, an individual may own all of the shares of a holding corporation which in turn owns shares in the active business corporation, and perhaps shares of other active business corporations. A holding corporation can be a private corporation owning shares of other private corporations or public corporations. It can also be a public corporation created for investing in shares of other public corporations.

R14-12. A Canadian private corporation is subject to a special tax (referred to as a Part IV tax) on the receipt of dividends from other Canadian corporations when the dividend received is from a corporation that is not connected for tax purposes. Normally, a corporation is not connected if it owns 10% or less of the other corporation's voting shares [ITA 186(4)]. The Part IV tax is equal to 38 ⅓% of the dividend received [ITA 186(1)(a)]. It is referred to as a refundable tax because the tax is fully refundable to the corporation when it decides to distribute its earnings to its own shareholders as dividends [ITA 129(1)&(3)].

In some circumstances a Part IV tax will be payable on dividends even when the receiving corporation owns more than 10% of the paying corporation's voting shares and is connected for tax purposes. This occurs when the payer is distributing dividends from its accumulated investment income. In such cases, the Part IV tax is not 38 ⅓% of the dividend received, but rather is equal to the proportionate share of the paying corporation's refund [ITA 186(1)(b)].

R14-13. The primary benefit of the holding company is that it permits the shareholder to receive dividends from the operating company tax free to be reinvested in other ventures. This would not have occurred if the shares of the operating company were owned directly by an individual. In effect, the holding corporation permits corporate profits to be distributed and then reinvested without immediately paying the second level of tax on corporate distributions. Therefore, a greater amount is available for reinvestment and the second level of tax is delayed until the individual requires the funds for personal use.

R14-14. The holding corporation is especially useful for acquiring the shares of an active business corporation when the purchaser must borrow a portion of the funds required to make the purchase and looks to the acquired corporation to provide cash dividend distributions to retire the debt. If an individual acquires the shares, the corporate profits are first taxed in the corporation and are then taxed a second time when distributed to the shareholder. Therefore, the two levels of tax must be paid before payments can be made against the loan principal.

However, if the individual created a holding corporation that borrowed the funds and purchased the shares of the business corporation, the dividends would flow tax free to the holding corporation which could, in turn, pay off the debt. Because the second level of tax has been avoided, the debt can be retired faster. In addition, in some cases, the acquired corporation may have assets that are not needed to operate the business. These assets

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can be liquidated and paid to the holding corporation without tax and used to retire the debt further.

In the above situation, the holding corporation could pose a problem because it has no taxable income, which can be used to offset the interest costs on the debt. This can be solved by amalgamating the holding corporation with the acquired operating company.

R14-15. If the shares of an operating company that are about to be sold are owned by a holding corporation, a substantial tax-free dividend can be paid to the holding company before the operating company shares are sold. As a result, the value of the operating company's shares will diminish by the amount of the dividend. The shares can then be sold for a lesser amount resulting in less tax on the disposition, and increasing the after-tax proceeds (from the dividend and share sale) available for reinvestment in another venture. This could not have been achieved if an individual owned the shares of the operating company.

If the shares of the corporation being sold qualify as small business corporation shares, the holding corporation may create a disadvantage. An individual who sells shares of a qualified small business corporation (QSBC) is entitled to a capital gains deduction on such shares, which exempts $913,630 (in 2022) of the gain from tax [ITA 110.6]. However, if a holding corporation sells the shares the deduction is not available.

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Key Concept Questions

QUESTION ONE

Hazel Bray owns all of the shares of H Ltd. Krystal Clarke, owns all of the shares of K Ltd. The owners plan to combine their businesses by amalgamating the two corporations on April 1 of the current year. The shares of H have an ACB of $100 and are currently worth $40,000. The shares of K have an ACB of $200 and are currently worth $60,000. H and K are both Canadian corporations.

Describe the tax implications of the amalgamation of H Ltd. and K Ltd.

Income tax reference: ITA 87(1), (2), (4).

QUESTION TWO

M Ltd., a Canadian corporation, owns 100% of the shares of P Ltd. The P shares have an ACB of $40,000 and are now worth $100,000. P's only asset is land having a cost of $25,000 and a current value of $100,000. The land was worth $40,000 when M purchased P's shares. Both corporations have December 31 year ends.

Determine the tax implications for M Ltd. and P Ltd. from winding up P Ltd. into M Ltd. on April 1 of the current year.

Income tax reference: ITA 88(1), (1.1), (1.2).

QUESTION THREE

Profit Ltd., a Canadian public corporation owns 85% of the shares of Loss Ltd. Profit Ltd. has a December 31 year end, while Loss Ltd. has a July 31, year end. The fair market value and tax value of the non-depreciable assets owned by Loss Ltd. total $8,000,000 and $3,000,000, respectively. The values have increased substantially from their $5,000,000 value at the time Profit Ltd. acquired Loss Ltd. The shares of Loss Ltd. are currently worth $10,000,000 and have an ACB of $4,000,000. Profit Ltd. wants to use the losses of Loss Ltd. to reduce its taxable income. Profit Ltd. and Loss Ltd. will be combined on August 1 of the current year.

Should a windup of Loss Ltd. into Profit Ltd. or an amalgamation of Profit Ltd. and Loss Ltd. be used to combine the two corporations? Explain why.

Income tax reference: ITA 87, 88.

QUESTION FOUR

Mr. Senior owns all of the issued shares of X Ltd. These common shares have an ACB and PUC of $100 and are worth $1,200,000. Senior would like to freeze his interest in the company at today's value so that future increases in value accrue to his son, Mark. To accomplish this, Senior exchanged his common shares for preferred shares of X in the course of a reorganization of share capital. The preferred shares are redeemable for $1,200,000. Mark then acquired newly issued common shares of X for $100.

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Determine the tax implications for Mr. Senior.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 84(3), 86(1), (2.1).

QUESTION FIVE

Valerie Hansen owns all of the common shares of V Ltd. The shares have an ACB and PUC of $10,000 and are worth $800,000. In the course of a reorganization of capital, Valerie exchanges all of her common shares for $700,000 of redeemable preferred shares of V and $100,000 of debt.

Determine the tax implications for Valerie.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 84(3), 86(1), (2.1).

QUESTION SIX

X Ltd. owns all of the shares of Y Ltd. The shares of Y have an adjusted cost base of $40,000 and a fair market value of $940,000. Y has retained earnings of $100,000 (earned after 1971) and no eligible or non-eligible refundable dividend tax on hand. Y plans to pay a dividend of $900,000 to X. Subsequently, X will sell the shares of Y Ltd. to an arm's-length person for $40,000.

Determine the tax consequences to X Ltd. of these transactions.

Income tax reference: ITA 55(2).

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Solutions to Key Concept Questions

KC 14-1

[ITA: 87(1), (2), (4) – Amalgamation]

The corporate entity formed as a result of the amalgamation (HK Ltd.) is deemed to be a new corporation with its first taxation year commencing on April 1st. It can select a year-end for tax purposes anytime within 53 weeks after April 1st. The taxation years of H Ltd. and K Ltd. are deemed to have ended on March 31, immediately before the amalgamation [ITA 87(2)(a)].

The amalgamation will result in a tax-deferred combination because the following conditions have been met [ITA 87(1)]:

- H Ltd. and K Ltd. are Canadian corporations,
- All assets and liabilities of H Ltd. and K Ltd. will become assets and liabilities of HK Ltd.
- Both Hazel and Krystal will be shareholders of HK Ltd.

H Ltd. and K Ltd. are deemed to have sold their assets to HK Ltd. at their tax values (ACB, UCC). Similarly, Hazel and Krystal are deemed to have sold their shares of H Ltd. and K Ltd. at their tax values in exchange for shares of HK Ltd. that have the same tax values [ITA 87(4)].

All carry forward balances in H Ltd. and K Ltd. (RDTOH, CDA, Losses, GRIP, etc.) become the opening balances in HK Ltd. Any restrictions that were previously attached to the losses simply continue as restrictions in HK Ltd. The former tax positions are preserved in HK Ltd.

Before the amalgamation, Hazel owned shares with an ACB of $100 worth $40,000 and Krystal owned shares with an ACB of $200 worth $60,000. After the amalgamation, HK Ltd. is worth $100,000. Hazel will own 40% of the shares of HK Ltd. worth $40,000 with an ACB of $100. Krystal will own 60% of the shares of K Ltd. worth $60,000 with an ACB of $200. Any losses in H Ltd. will be subject to the acquisition of control restrictions since Krystal did not control H Ltd. but will control HK Ltd. after the amalgamation.

In its first year, HK Ltd. will be liable for tax instalments based on the combined instalment bases of H Ltd. and K Ltd.

KC 14-2

[ITA: 88(1), (1.1), (1.2) – Tax-deferred Wind-up]

On a wind-up, P Ltd. ceases to exist and M Ltd. continues. Since M Ltd. owns at least 90% of each class of issued shares of P Ltd., the wind-up occurs on a tax-free basis.

M Ltd. is deemed to have sold the shares of P Ltd. at their tax value (ACB $40,000) in exchange for the net assets of P Ltd.

P Ltd. is deemed to have sold its asset (land) to M Ltd. at its tax value ($25,000).

The carry forward balances in P Ltd. (RDTOH, CDA, Losses, GRIP/LRIP, etc.) become available

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to M Ltd. Any restrictions that were previously attached to the losses simply continue as restrictions in M Ltd. However, the losses are not available to M Ltd. until its taxation year that commences after the year in which the windup takes place. Thus, the taxation year ending December 31, 2023 is the first taxation year in which M Ltd. can use the losses of P Ltd.

When the ACB of the shares of the subsidiary exceeds the tax values of the net assets of the subsidiary received by the parent on a windup of the subsidiary, it is possible to bump the ACB of the non-depreciable capital property. The amount of the bump allocated cannot raise the ACB of the asset above its fair market value at the time the parent acquired control of the subsidiary.

The bump in this case is calculated as follows:

ACB of the shares of P Ltd	$40,000
Less: Tax values of the net assets of P Ltd.	(25,000)
Dividends paid by P Ltd. to M Ltd.	(0)
Bump	$15,000

Therefore, M Ltd.'s ACB for the land will be $40,000 ($25,000 + $15,000).

This bump is also available under an amalgamation of a parent with a subsidiary if the parent owns 100% of the subsidiary.

KC 14-3

[ITA: 87, 88]

An amalgamation of Profit Ltd. and Loss Ltd. should be used to combine the two corporations.

Since Profit Ltd. owns less than 90% of the issued class of shares of Loss Ltd., it is not possible to wind-up Loss Ltd. on a tax-deferred basis [ITA 88(1)]. The $5,000,000 gain on the assets and the $6,000,000 gain on the shares of Loss Ltd. would have to be recognized for tax purposes [TIA 88(2)].

If Profit Ltd. and Loss Ltd. are amalgamated, the combination will occur on a tax-deferred basis since the following conditions have been met [ITA 87(1)]:

- Profit Ltd. and Loss Ltd. are Canadian corporations,
- All assets and liabilities of Profit Ltd. and Loss Ltd. will become assets and liabilities of the new corporation formed on the amalgamation, and
- The current shareholders of Profit Ltd. and Loss Ltd. will be shareholders of the new corporation formed on amalgamation.

Profit Ltd. and Loss Ltd. are deemed to have disposed of their assets to the new corporation at their tax values (ACB, UCC). Similarly, the shareholders of Profit Ltd. and Loss Ltd. are deemed to dispose of their shares at ACB and to acquire shares in the new corporation at that same amount. Profit Ltd. is deemed to dispose of the shares of Loss Ltd. at $4,000,000 (ACB).

The taxation years of Profit Ltd. and Loss Ltd. are deemed to end immediately before the amalgamation [ITA 87(2)(a)]. The new corporation formed as a result of the amalgamation can

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select a year-end for tax purposes anytime within 53 weeks after the amalgamation. The Loss Ltd. losses will be available immediately to the corporation formed on amalgamation.

The bump [ITA 88(1)(d)] is not available on the amalgamation because Profit Ltd. does not own 100% of Loss Ltd.

The draw back to the amalgamation is that the outside shareholders who currently own 15% of Loss Ltd. and none of Profit Ltd. will now own an interest in the new amalgamated corporation, which will own the business carried on by Profit Ltd. as well as Loss Ltd.

KC 14-4

[ITA: 84(3), 86(1),(2.1) – Exchange of shares in a Reorganization]

Where by amendment to the articles, all the shares of a particular class owned by the shareholder are exchanged for newly issued shares in the course of a capital reorganization, section 86 automatically provides for a deferral of any accrued gain on the shares exchanged provided the value of the non-share consideration plus the PUC of the shares received does not exceed the PUC of the exchanged shares. The PUC of the new shares will normally be equal to the PUC of the exchanged shares less any non-share consideration.

New shares:

- The PUC of the new shares is equal to the PUC of the old shares ($100) since only shares were received (no debt) [ITA 86(2.1)].

- The ACB of the new shares is equal to the ACB of the old shares ($100) since no non-share consideration was received.

When the shares are exchanged, new shares are issued and the old shares are redeemed.

Redemption of old shares:	
Redemption proceeds (PUC of new shares $100 + Debt $Nil)	$100
PUC of old shares	(100)
Deemed dividend [ITA 84(3)]	$ Nil
Proceeds (PUC of old shares) [ITA 54]	$100
ACB	(100)
Capital gain	$ Nil

In summary, the exchange has occurred on a tax-deferred basis. Mr. Senior now owns preferred shares with the same value, ACB, and PUC as the common shares he owned before the exchange. Therefore, when he disposes of the preferred shares, he will recognize the gain that he deferred.

The common shares held by Mark, will have an ACB of $100 and this is also their current fair market value. However, all future increases in the value of X Ltd. will now accrue to Mark.

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KC 14-5

[ITA: 84(3), 86(1),(2.1) – Exchange of shares in a Reorganization]

Where by amendment to the articles, all the shares of a particular class owned by the shareholder are exchanged for newly issued shares in the course of a capital reorganization, section 86 automatically provides for a deferral of any accrued gain on the shares exchanged provided the value of the non-share consideration plus the PUC of the shares received does not exceed the PUC of the exchanged shares. The PUC of the new shares will normally be equal to the PUC of the exchanged shares less any non-share consideration.

Where the non-share consideration exceeds the PUC of the old shares, as it does in this case, a deemed dividend occurs [ITA 84(3)]. Valerie is deemed to receive a dividend of $90,000. She will include the grossed-up dividend in her income and claim the dividend tax credit.

When the shares are exchanged, new shares are issued and the old shares are redeemed.

New shares:

- The PUC of the new shares is Nil since the PUC of the old shares was removed on the exchange [ITA 86(2.1)].
- The ACB of the new shares is Nil (ACB of old shares $10,000 - Debt $100,000) [ITA 86(1)(b)].

Redemption of old shares:

Redemption proceeds (PUC of new shares $Nil + Debt $100,000)		$100,000
PUC of old shares		(10,000)
Deemed dividend [ITA 84(3)]		$ 90,000
Proceeds (PUC of old shares) [ITA 54]	$10,000	
ACB	(10,000)	
Capital gain	$ Nil	

If the debt had been limited to the PUC ($10,000), Valerie could have avoided paying tax on the exchange.

KC 14-6

[ITA: 55(2) – Capital gains strip]

The anticipated sale will result in a tax-free dividend of $100,000 and a capital gain of $800,000.

Actual proceeds of disposition	$40,000
ACB	(40,000)
Capital gain	$ 0

The anti-avoidance rule in subsection 55(2) is applicable where:

- a corporation has received dividends that are not taxable as part of a series of transactions, involving a disposition of shares;

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- one of the purposes of the dividend was to effect a reduction in the fair market value of the shares being sold; and
- the dividend exceeds the paying corporation's safe income (tax-paid retained earnings).

Clearly, the purpose of the dividend is to reduce the value of the shares, which makes the dividend subject to re-characterization as a capital gain to the extent that the dividend exceeds the $100,000 of safe income. The result is that $800,000 of the $900,000 dividend is re-characterized as a capital gain. The remaining $100,000 is a tax-free dividend.

If the shares are sold for $940,000 without the dividend, a capital gain of $900,000 will occur ($940,000 - $40,000). By having a tax-free dividend equal to the retained earnings of $100,000, the capital gain is reduced to $800,000.

A potential capital gain can be reduced by a pre-sale tax-free dividend distribution only to the extent of the retained earnings of the company being sold.

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