CHAPTER 19

BUSINESS ACQUISITIONS AND DIVESTITURES—TAX-DEFERRED SALES

Review Questions

1. While vendors may gain a tax advantage by selling a business using a tax-deferred method, they may be subjecting themselves to more risk in terms of ultimately realizing the proceeds from the sale. How is a tax-deferred sale of a business distinguished from a taxable sale? Why does a tax-deferred sale involve greater risk?

2. Give three basic reasons that a vendor may be prepared to accept a greater risk in exchange for a tax deferral on the sale of a business.

3. What four basic methods can be used to achieve a tax-deferred sale?

4. What advantages and disadvantages may arise for the purchaser when the specific business assets are acquired from a vendor corporation and the parties elect transfer prices for tax purposes at amounts that will defer tax to the vendor?

5. What is a share-for-share exchange? How does it differ from a sale of shares in which the vendor and the purchaser elect a specific price for tax purposes?

6. Why is a business acquisition using the share-for-share technique attractive to both the purchaser and the vendor?

7. A tax-deferred sale of a business by a reorganization of share capital may present more risk to the vendor than a sale of its shares to a corporate purchaser and an election of a transfer price for tax purposes. Explain why.

8. When a business owned by a closely held corporation is being sold, the vendor is often persuaded to use tax-deferred methods to structure the sale. What is a closely held corporation? What features may such a corporation have that make a tax-deferred sale attractive?

9. Why may the owner of a business want to transfer a business to their children during the owner's lifetime, rather than by way of an estate transfer upon death?

10. What feature is often found when a business is being transferred to a family member? How is the tax-deferred method of sale consistent with this feature?

11. How may the sale of a corporation's specific business assets to a purchaser with limited resources provide greater flexibility than the sale of shares of the corporation?

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Solutions to Review Questions

R19-1. In order to achieve a deferral of tax on the sale of a business (from either an asset sale or a share sale) the vendor must be prepared to accept all or a specified portion of the payment in the form of shares of the purchaser's corporation or of the vendor corporation. Such shares can be common shares or preferred shares. In other words, the vendor maintains a partial continuing equity interest in the business being sold. In comparison, a taxable sale normally results in the exchange of business assets or shares of the business corporation for assets other than shares. Payment terms from a taxable sale usually include cash and/or the deferred payment of cash secured by notes bearing interest.

A tax deferred sale results in a greater risk for the vendor because the deferred payment portion of the price that consists of shares is less secure than debt. Subsequent realization of the common or preferred shares depends upon the continued success of the purchaser corporation after it has met its own obligations. In comparison, the rights of a creditor take precedence over the shareholders.

R19-2. A vendor may be prepared to accept a greater risk to achieve tax deferral on a business sale for the following reasons:

- The vendor wants to participate in the continued growth of the business and the sale actually constitutes a business combination or merger of two active business enterprises.
- The vendor wants to enhance his or her after-tax return on investment from the proceeds of sale. By deferring the tax, the full amount of the proceeds from the sale may provide annual returns from a combination of dividends and interest. In comparison, in a taxable sale, only the after-tax proceeds provide annual returns.
- The desired purchaser may not have sufficient capital to fund the purchase and no other acceptable buyers are available.

R19-3. To achieve a tax-deferred sale of a business, the following basic alternative methods are available.

- Sale of assets from the vendor to the purchaser corporation at fair market value but, for tax purposes, electing a transfer price equal to the assets' tax values [ITA 85(1)].
- Sale of the vendor corporation's shares to the purchaser corporation using an elected transfer price for tax purposes equal to the vendor's adjusted cost base of the shares [ITA 85(1)].
- An amalgamation of the vendor corporation and the purchaser corporation [ITA 87(1)].
- A reorganization of the share capital of the vendor corporation whereby the purchaser obtains common shares but the vendor maintains a continuing interest in the form of preferred shares [ITA 86(1)].

R19-4. The purchase of business assets using the elective option for tax purposes requires that a portion of the purchase price be paid by the purchasing corporation issuing preferred and/or common shares (this portion is the difference between the elected tax price and the fair market value). The major advantage for the purchaser is that the acquisition can be achieved with the minimum amount of cash and/or debt. Depending on the terms attached to the share consideration, this method may provide greater future cash flow to the purchaser and may not impair its borrowing capacity thereby enhancing the probability of the continued success of the acquired business.

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However, this form of purchase has the following disadvantages:

- The assets acquired have a lower cost amount for tax purposes which reduces the amount of future CCA deductions. Consequently, future tax costs on profits are greater.
- Because the assets acquired have a cost amount for tax purposes that is lower than the fair market value price paid, a potential tax liability for the purchaser exists if, subsequent to the acquisition, it is necessary for the purchaser to dispose of all or some of the assets purchased.
- Normally, the purchaser is required to pay regular dividends on the shares issued to the vendor. While the dividend rate may be less than a normal interest rate, the dividend costs are not deductible from the purchaser's income for tax purposes. Therefore, the after-tax cost of servicing the shares may be greater than the after-tax cost of servicing debt.

R19-5. A share for share exchange occurs when a purchasing corporation acquires the shares of another corporation (from the existing shareholders) and the payment to the vendors consist entirely of shares issued by the purchasing corporation. When this occurs, the vendor can report the sale using the fair market value of the shares as proceeds or, provided certain other conditions are met, the vendor can report the sale using the adjusted cost base of the shares as proceeds, thereby deferring tax on the sale [ITA 85.1(1)]. This could also have been achieved by using the formal election option [ITA 85(1)]. However, unlike the election option, the share for share exchange is decided by only the vendor without the purchaser's participation. The purchaser's cost of the shares acquired is the lesser of fair market value or the paid up capital of the vendor's shares [ITA 85.1(1)(b)].

The Section 85 election option is a formal process requiring the filing of certain forms (i.e., T5027) whereas the share for share exchange method is informal and each vendor decides on their position when completing their annual tax return. In addition, the share for share exchange method must have no non-share consideration [ITA 85.1(2)(d)], whereas the Section 85 election option permits non-share consideration within specified limits.

R19-6. The share for share exchange method is attractive to the vendor because it provides maximum flexibility. If some of the vendors want to realize cash from the sale, they can tender for sale all or a portion of their exchanged shares after the share for share transaction has occurred. On the other hand, if they wish to remain as a shareholder of the purchaser corporation, they can do so without incurring a tax liability on the sale of their old shares, thereby earning investment returns on the pre-tax proceeds of sale rather than on the after-tax proceeds. The share for share exchange method is attractive to the purchaser because the acquisition can be achieved without a cash or debt requirement. However, there is also a negative aspect for the purchaser. The ACB of the acquired shares is normally the shares paid up capital amount [ITA 85.1(1)(b)] (normally lower than market value) and, therefore, a subsequent sale may result in a higher than normal taxable capital gain.

R19-7. When a business is sold using the share reorganization technique [ITA 86(1)], the previous shareholder normally exchanges his or her common shares for preferred shares of the vendor corporation. This presents two risks for the previous shareholders. First of all, the entire payment consists of share capital with no debt or cash. Secondly, the share capital received represents a continued interest in the *vendor corporation* only. Consequently, the ability to realize the value of the preferred shares at a future time rests solely with the continued success of the vendor corporation.

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In contrast, the sale of shares to a purchaser corporation using the election option provides payment by a combination of cash, share capital, and debt from the *purchaser corporation*. The existence of cash and debt by itself presents less risk of realization. In addition, the ability to realize the share consideration (and the debt) at some future time depends upon the continued success of the purchaser corporation and the vendor corporation combined. This is especially important when the purchasing corporation has substantial value of its own.

R19-8. A closely held corporation is one that is owned by a single shareholder, or a relatively small number of shareholders, such that the relationship between the corporation and the shareholders is very close. Often, the following features of a closely held corporation are evident that induce a preference for a tax-deferred method of sale:

- The owner(s) of the business is usually under greater pressure to sell the business to family members or to senior employees who have provided long service to the entity. Typically, both employees and family members do not have substantial cash resources to make the purchase and, therefore, require substantial and long-term financing from the vendor.

- A closely held business is often sold in response to the owner's desire for partial or full retirement. Therefore, there is a desire to maximize future income from investment of the sale proceeds. A taxable sale diminishes to amount of proceeds available to reinvest and accordingly reduces the amount of future income for retirement.

R19-9. When an individual leaves shares of their business corporation to children by way of an estate transfer on death, the shares are deemed to have been sold for tax purposes at their fair market value at that time. The resulting tax diminishes the value of the estate. If shares are transferred to the children at an earlier time, presumably the tax liability would be lower because the value of the shares would be lower. This, combined with the opportunity of using a tax-deferred method of transfer, results in a lower tax liability on death than would otherwise have occurred. In other words, at the time of transfer, the shareholders' potential capital gain is "frozen" at the value at that time, permitting continued growth to accrue to the benefit of the children. A further reason for a transfer before death is to provide an orderly succession and continuity of management responsibility.

R19-10. When a business is sold to a third party, the vendor is usually concerned with the security of the payment terms in order to ensure the full realization of the value of the business. The vendor will, therefore, only use the tax deferred method if they are satisfied that the payment in the form of shares is reasonably secure. However, when a sale is being made to a family member, the vendor is often less concerned about security because the value of the business will likely be transferred to that family member on the death of the owner in any case. Therefore, the deferral of tax often becomes the primary factor in choosing a method of sale to a family member. As the tax deferral methods provide less security (because of the requirement for full or partial payment in the form of shares), they are consistent with the owner's desire and need for security and, therefore, become a viable option.

R19-11. When a business is sold to a purchaser who has limited resources, it may require that the vendor finance a large portion of the purchase price by granting deferred payment terms. Therefore, security for the vendor becomes a primary issue. It is recognized that, in order to own and operate a business, it is not always necessary to own all of the assets needed for its operation. The business can be operated by having the right to use those assets without their ownership. If the sale of a business is structured as an asset sale (as opposed

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to a share sale), the vendor can retain ownership of some of the assets (e.g., land, buildings, and equipment) and lease them to the purchaser in exchange for rent. This is attractive to the purchaser with limited resources because less cash and debt is required to complete the purchase.

It is also attractive to the vendor because retained ownership of the certain assets provides maximum security and, at the same time, defers the related tax liability that would have occurred from the sale. In comparison, a sale of shares of the vendor corporation does not permit specific assets to be retained unless certain reorganization activities are carried out first. Therefore, the sale of assets appears to provide greater flexibility.

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Key Concept Questions

QUESTION ONE

Eric Farrington owns common shares of CNR, a Canadian public company. His shares have the following attributes:

Fair market value	$12,000
Adjusted cost base	4,000
Paid-up capital	1

CPC, a widely held Canadian public company, has acquired all of the shares of CNR. In exchange for his shares of CNR, Eric received common shares of CPC worth $12,000.

Determine the tax consequences for Eric.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 85.1, 85(1).

QUESTION TWO

Zoe Liang owns all the shares of Z Ltd., a Canadian-controlled private corporation, carrying on a shoe importing business. Zoe is ready to retire and would like to sell her shares of Z Ltd. to a group of long-term, trusted employees. The employees do not have the funds or the borrowing power to purchase the shares of Z Ltd. for their current value, $2,000,000. Zoe has been told that she may be able to complete the sale to the employees by reorganizing of share capital of Z Ltd.

Provide Zoe with an explanation of how a reorganization of the share capital of Z Ltd. can help her make the sale.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 86.

QUESTION THREE

Gary Wolfe owns all the shares of G Ltd., a Canadian-controlled private corporation in the import/export business. He would like for his daughter, Lilly, who has been active in the business for the past five years, to share equally with him in the future growth of the business. Unfortunately, Lilly has no savings. The shares of G Ltd. are currently worth $1,000,000 and have a PUC and ACB of $1,000. Gary has no capital gains deduction available.

Explain to Gary how his goals can be accomplished by either reorganizing the share capital of G Ltd. or by using a holding company.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 86, 85(1), 84.1.

QUESTION FOUR

Jane Lim owns all of the shares of J Ltd., a Canadian-controlled private corporation with investments in numerous Canadian public companies. Her spouse owns all of the shares of M

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Ltd., a Canadian-controlled private corporation, with excess cash. They have decided to have M Ltd. purchase the shares of J Ltd., to provide Jane with the cash required to take advantage of another investment opportunity. The shares of J Ltd. are currently worth $900,000 and have a PUC and ACB of $100,000. The plan is for M Ltd. to pay Jane $900,000 in cash for the J Ltd. shares.

Determine the tax consequences for Jane.

Income tax reference: ITA 84.1

QUESTION FIVE

Nancy Phan owns all of the shares of N Ltd., a Canadian-controlled private corporation with investments in numerous Canadian public companies. Her spouse owns all of the shares of R Ltd., a Canadian-controlled private corporation. They have decided to have R Ltd. purchase the shares of N Ltd. The shares of N Ltd. are currently worth $600,000 and have a PUC and ACB of $50,000. The plan is for R Ltd. to pay Nancy $50,000 in cash and preferred shares of R Ltd. worth $550,000. Nancy and her spouse have agreed to make a joint election under section 85 of the *Income Tax Act* in order to defer tax on the transaction.

Determine the tax consequences for Nancy.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 84.1, 85(1).

QUESTION SIX

Aidan Dalby owns all of the shares of B Ltd., a Canadian-controlled private corporation carrying on a home design business. The shares of B Ltd. are currently worth $1,000,000 and have a PUC and ACB of $150,000. In order to crystallize his remaining capital gains deduction, Aiden decides to set up a new corporation, H Ltd., and transfer his shares of B Ltd. to H Ltd. Aiden and H Ltd. will file a joint election under section 85 of the *Income Tax Act*, electing proceeds of $950,000. As consideration for the transfer, Aiden will receive a note for $950,000 and preferred shares of H Ltd. worth $50,000.

Determine the tax consequences for Aiden.

CPA Competency 6.6.4 Basic tax considerations of corporate reorganizations. Income tax reference: ITA 84.1, 85(1).

QUESTION SEVEN

[This question was contributed by Victor Waese, MBA, CPA, CGA, Instructor, Financial Management, British Columbia Institute of Technology.]

Imaan Rossi inherited 1,000 shares in OPCO Ltd. from her father. The FMV of the shares at the time of the inheritance was $500,000. Her father had founded OPCO with an investment of $1,000 (i.e., $1 per share), and had grown it into a very successful business. In his final tax return after his death, Imaan's father sheltered the full gain on these shares from taxes by claiming the capital gains exemption.

Imaan transferred the inherited shares to a 100%-owned holding corporation, HOLDCO Ltd. at

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their FMV of $500,000, receiving HOLDCO's promissory note for $500,000. Soon after this transaction, OPCO paid a dividend of $100,000 to HOLDCO, and HOLDCO redeemed $100,000 of the promissory notes held by Imaan. The expectation was that over a period of years, dividends from OPCO would be used to pay down the remainder of the notes outstanding.

What are the tax consequences of this transaction?

Income tax reference: ITA 84.1

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Solutions to Key Concept Questions

KC 19-1

[ITA: 85.1, 85(1)]

In order for the share for share rollover in Section 85.1 to apply, all of the following conditions must be met:

(i) Eric's shares of CNR must be capital property to him (consistent with the facts of this situation);

(ii) those shares must be shares of a Canadian corporation [ITA 89(1)] (consistent with the facts of this situation);

(iii) the consideration for the exchange must be only previously unissued shares of any particular class of the purchaser (CPC) [ITA 85.1(2)(d)];

(iv) there can be no capital gain or loss recognized through any other provision on this exchange [ITA 85.1(1)(a)];

(v) the vendor (Eric) and the purchaser (CPC) must be at arm's length before the exchange [ITA 85.1(2)(a)] (consistent with the facts, since Eric is one of many shareholders in a widely held Public company);

(vi) after the exchange, the vendor (Eric) may not control (legal control) the purchaser (CPC) or may not own more than 50% of the FMV of all of the outstanding shares [ITA 85.1(2)(b)] (consistent with the facts of this situation).

As long as Eric does not include in his income any portion of the gain on the CNR shares he trades in the exchange, all of the conditions of the rollover apply automatically (i.e., without an election). The tax consequences to Eric will be as follows:

P of D for CNR shares	$ 4,000
ACB	(4,000)
Capital gain	NIL

The ACB of the CPC shares acquired by Eric in the exchange will total $4,000.

Eric may file a joint election with CPC under Subsection 85(1), in which case the share-for-share rules do not apply [ITA 85.1(2)(c)]. In this case, the only benefit to him is that he could elect to recognize part of the gain, if he had some reason to do so. To obtain this potential benefit, Eric must convince CPC of the advantage to CPC of the higher cost base compared to using the share-for-share provisions. To the extent that Eric's cost ($4,000) is higher than paid-up capital ($1), CPC will have a higher ACB. Under the share-for-share provisions, CPC's cost of the CNR shares is the lesser of the fair market value ($12,000) and paid-up capital ($1) of the CNR shares [ITA 85.1(1)(b)].

The advantage of using the share-for-share exchange rules is that they provide an automatic rollover that does not require any election forms to be filed. Use of the Section 85 rollover may not be feasible in this situation, because CPC may not be willing to make joint elections with many (or all) shareholders of a widely-held public corporation, a cumbersome exercise.

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KC 19-2

[ITA: 86]

By reorganizing the share capital of A Ltd., the current value of Zoe's common shares of Z Ltd. can be frozen and new common shares can be issued to the employees at an issue price that is affordable to them. This can occur on a tax-deferred basis.

In the course of a reorganization of the share capital of Z Ltd., Zoe's common shares are exchanged for voting preferred shares of Z Ltd., having a legal stated capital ("LSC") and FMV of $2,000,000. The Z Ltd. employees then subscribe for new common shares of Z Ltd.

For tax purposes, the reorganization of share capital, in effect, results in a redemption of the old shares. As is the case in any redemption, there is a deemed dividend to the extent the non-share consideration plus the PUC of the preferred shares received in the exchange exceeds the PUC of the old shares. Care should be taken to ensure that a deemed dividend does not arise. As well, on redemption, a capital gain or loss on the disposition of the common shares of Z Ltd. is calculated as Proceeds, net of the deemed dividend, in excess of the ACB of Zoe's common shares of Z Ltd. However, Section 86 will apply automatically to defer the capital gain. Zoe will be deemed to dispose of her shares of Z Ltd for proceeds of disposition equal to the ACB of the new preferred shares received in the exchange plus the non-share consideration. If Zoe receives no non-share consideration, the ACB of her new preferred shares will equal the ACB of her old common shares.

A Section 86 rollover will apply automatically on the reorganization, because the following conditions are met:

(a) the Z Ltd. common shares are capital property to Zoe,

(b) all of the Z Ltd. common shares owned by Zoe are exchanged, and

(c) property receivable by Zoe on the exchange includes other shares.

KC 19-3

[ITA: 86]

Reorganization of the share capital of G Ltd.

In the course of a reorganization of the share capital of G Ltd., Gary's common shares are exchanged for voting preferred shares of G Ltd., having a LSC and FMV of $1,000,000. Gary and his daughter, Lilly, then each subscribe for 50% of newly issued common shares of G Ltd. for a nominal amount.

For tax purposes, the reorganization of share capital, in effect, results in a redemption of the old shares. As is the case in any redemption, there is a deemed dividend which arises when non-share consideration plus the PUC of the preferred shares received in the exchange, exceeds the PUC of the old shares. Since Gary will receive no non-share consideration, the dividend can be avoided. The PUC and ACB of Gary's new preferred shares are $1,000 (same as the PUC and ACB of his old common shares). A capital gain or loss on the disposition of the common shares of G Ltd. is calculated as Proceeds (net of the deemed dividend) ($1,000,000), in excess of the ACB of Gary's common shares of G Ltd. ($1,000). However, Section 86 will apply automatically

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to defer the capital gain. Gary will be deemed to dispose of his shares of G Ltd for proceeds of disposition equal to the ACB of the new preferred shares received in the exchange plus the non-share consideration. In this case, the ACB of the new preferred shares is $1,000 which equals the ACB of Gary's old common shares. Therefore, no capital gain is recognized.

A Section 86 rollover will apply automatically on the reorganization, because the following conditions are met:

(a) the G Ltd. common shares are capital property to Gary,

(b) all of the G Ltd. common shares owned by Gary are exchanged, and

(c) property receivable by Gary on the exchange includes other shares.

Holding company

A new corporation can be incorporated (Holdco). On incorporation, Gary and Lilly can each subscribe for 50% of the issued common shares for a nominal amount.

Gary then transfers his shares of G Ltd. to Holdco for preferred shares of Holdco, redeemable and retractable for $1,000,000. Gary and Holdco will make a Section 85 election, electing the proceeds for tax purposes to be $1,000, the ACB of Gary's common shares of G Ltd. Thus, the capital gain on Gary's G Ltd. shares is deferred until such time as he disposes of the preferred shares of Holdco.

Section 84.1 has to be considered in this case. Since Gary did not receive non-share consideration, there will not be a deemed dividend. The PUC of the preferred shares received by Gary will be $1,000, equal to the PUC of his old common shares of G Ltd.

KC 19-4

[ITA: 84.1]

Where an individual transfers shares to a related corporation and the two corporations are connected after the transfer, Section 84.1 of the *Income Tax Act* applies to deem Jane to receive a deemed dividend equal to the excess of the non-share consideration ($900,000 in this case) over the hard cost of her shares of J Ltd. ($100,000 in this case).

For tax purposes Jane will have:

- a deemed dividend of $800,000 equal to the non-share consideration she received in excess of $100,000 (PUC & ACB) [ITA 84.1(1)(b)]; and

- a taxable capital gain of $Nil calculated as follows:

Proceeds received	$900,000
Less amount deemed to be a dividend	(800,000)
Adjusted proceeds [ITA 54]	100,000
ACB	(100,000)
Capital gain	$ 0

Section 84.1 is intended to prevent the stripping out of retained earnings as capital proceeds by means of related party sales.

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The analysis above does not consider the impact of Bill C-208, which received royal assent on June 29, 2021. The Department of Finance has publicly stated its intentions to introduce further amendments in this area. At the time of this solution update, those amendments have not been released.

KC 19-5

[ITA: 84.1, 85(1)]

Where an individual transfers shares to a related corporation and the two corporations are connected after the transfer, Section 84.1 of the *Income Tax Act* applies.

For tax purposes Nancy will have:

- a deemed dividend of $0 equal to the non-share consideration she received in excess of $50,000 (PUC & ACB) [ITA 84.1(1)(b)]; and

- a taxable capital gain of $0 calculated as follows:

Elected proceeds	$50,000
Less amount deemed to be a dividend	(0)
Adjusted proceeds [ITA 54]	50,000
ACB	(50,000)
Capital gain	$ 0

Since Nancy has not attempted to strip out retained earnings as capital proceeds by means of a related party sale, the transaction is tax deferred.

KC 19-6

[ITA: 84.1, 85(1)]

The conditions for Section 84.1 to apply are met by the facts of this situation.

(a) Aiden is an individual resident of Canada (ITA 84.1 does not apply to a corporation).

(b) He will dispose of his shares of B Ltd. which are capital property.

(c) B Ltd. is a corporation resident in Canada.

(d) He will dispose of the shares to another corporation, H Ltd., with which he is not at arm's length [ITA 251].

(e) Immediately after the disposition, B Ltd. will be connected with H Ltd. [ITA 186(4)].

Proposed Plan

Aiden's plan attempts to remove a substantial amount of funds from the corporation on a tax-free basis.

Where Section 84.1 applies, the maximum non-share consideration that can be received from H

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Ltd. without adverse tax consequences is limited to the greater of the PUC and, in effect, the ACB of the B Ltd. shares, i.e., $150,000 in this case. The $150,000 reflects the recovery of the after-tax funds originally invested in B Ltd., which is the amount that could have been received tax free prior to the reorganization as a return of capital.

Non-share consideration, in excess of the $150,000, results in a deemed dividend equal to that excess. The deemed dividend in this case will be $800,000. For the purposes of calculating the proceeds of disposition on the shares for capital gain/loss purposes, the deemed dividend will reduce the proceeds of disposition, determined under ITA 85(1), to $150,000. Therefore, no capital gain will be realized and no capital gains exemption will be used as part of the proposed reorganization. Aiden's objective to crystallize his capital gains exemption has not been met with this plan. As well, Aiden would pay tax of approximately $344,000 ($800,000 x 43%) on the dividend, assuming a non-eligible dividend.

Alternative Plan

To accomplish his objective to crystallize his capital gains exemption and avoid the deemed dividend, Aiden should take no more than $150,000 in non-share consideration on the transfer of his B Ltd. shares to H Ltd.

Aiden should also receive voting, redeemable, retractable preferred shares of H Ltd. with a legal stated capital (“LSC”) and fair market value of $850,000. If the preferred shares issued to Aiden by H Ltd. are determined subsequently not to have a value of $850,000, as required in this case to balance the fair market value (“FMV”) of the B Ltd. shares transferred, the adverse tax consequences of a benefit being conferred on a related person could arise [ITA85(1)(e.2)]. In order to ensure that the preferred shares have a value of $850,000, the preferred shares should be retractable as well as redeemable.

A price adjustment clause should be included in the agreement of purchase and sale to indicate the intention of Aiden and H Ltd. to transact for fair market value consideration. If the CRA determines the value of the B Ltd. shares to be other than $1,000,000, the retraction value of the preferred shares can be adjusted accordingly, without penalty, as a result of the price adjustment clause.

The elected amount should be $950,000. This results in a $800,000 capital gain and crystallization of his remaining capital gains exemption in the ACB of the preferred shares of H Ltd. which will be $800,000.

Since all of the $150,000 of PUC of the B Ltd. shares will be recovered through the note from H Ltd., the PUC of the H Ltd. shares will be nil.

The impact of alternative minimum tax should be considered.

Note: The capital gains exemption for 2022 is $913,630. The amount is indexed annually.

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KC 19-7

[ITA: 84.1]

On its face, it appears that the dividends received by HOLDCO are neither subject to Part I nor Part IV tax, and that the transfer of the shares to HOLDCO, and the redemption of the notes are not taxable events.

However, the transfer of the shares to HOLDCO is subject to Section 84.1 because:

a. A resident individual
b. Has transferred shares in a "subject corporation"
c. That were held as capital property
d. To another corporation with which the individual does not deal at arm's length [for the purposes 84.1 a taxpayer is deemed not to deal with the purchaser corporation at arm's length if the taxpayer is one of a group of fewer than 6 persons that control the corporation [84.1(2(b)]], and
e. After the transaction, the purchaser corporation is connected with the subject corporation.

It is important to realize that Section.84.1 applies to any transaction that meets this criteria, whether a Section 85 election is used or not used.

Since Section 84.1 applies, if the non-share consideration exceeds the greater of the PUC and the ACB of the shares transferred, there is a deemed dividend in the amount of any such excess. In this case, Imaan might think that there is no deemed dividend, because the non-share consideration of $500,000 does not exceed his ACB of $500,000. Unfortunately for Imaan, the definition of ACB for purposes of Section 84.1 reduces Imaan’s ACB by the amount of any capital gains exemption claimed on those shares by any person related to Imaan [ITA 84.1(2)(a.1)(ii)]. This reduced ACB is referred to in the literature as the "hard ACB". In this case, Imaan's hard ACB is $1,000, meaning the transfer of the shares to HOLDCO gives rise to a deemed dividend of $499,000, which is the excess of the non-share consideration over the ACB. Tax on this amount will be payable in the year of the transaction.

It is interesting to observe that if Imaan had sold his shares to an arm's length person, in exchange for notes, and then that person was to transfer the shares to a holding corporation on similar terms to those that Imaan transferred the shares to HOLDCO, that arm's length person would not be subject to a deemed dividend upon the transfer to the holding corporation, as the arm's length person's hard cost of the shares would be $500,000.

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