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An Introduction to Tax-Deferred Share Exchanges and Section 51

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AN INTRODUCTION TO TAX-DEFERRED SHARE EXCHANGES AND SECTION 51

INTRODUCTION

The first part of this paper discusses the purpose of a tax-deferred share exchange and introduces some fundamental concepts that advisors must understand in order to plan or implement a share exchange. The second part of the paper contains a high-level discussion of the technical requirements and mechanics of section 51 of the *Income Tax Act* (Canada) (the "**ITA**").[1] The third and final part of the paper reviews some issues that arise in planning or documenting a section 51 share exchange.

Appendix "A" contains a set of example documents for the implementation of a basic section 51 exchange of common shares for preferred shares by an individual shareholder.

This paper does not discuss section 86 share exchanges or subsection 85(1) rollovers, which will be covered in other presentations at this event.

Unless otherwise noted, all legislative references are to the provisions of the ITA.

SHARE EXCHANGES GENERALLY

Purpose of a Share Exchange

As part of a corporate reorganization, a shareholder may exchange the shares of one class of a corporation for shares of one or more other classes of the same corporation.[2] We refer to a share exchange involving one shareholder and one corporation as an "internal share exchange". An internal share exchange may achieve a number of objectives, either alone or in combination with other transactions. For example:

Example 1: Shareholder 1 and Shareholder 2 each hold 50 Class A Common shares of a family-owned corporation. Shareholder 1 plans to exchange his or her 50 Class A Common shares of the corporation for 50 Class B Common shares of the corporation. Subject to the share rights in the articles of incorporation, the corporation will then have the ability to pay a dividend to Shareholder 2 on the Class A Common shares without paying an equal dividend to Shareholder 1 on the Class B Common shares, or vice-versa.[3]

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[1] R.S.C. 1985, c. 1 (5th Supp).

[2] For simplicity, we assume throughout that all shares of a class are issued in a single series.

[3] There are a multitude of other relevant tax considerations that are not discussed in this paper such as, for example, the tax on split income or "TOSI" rules in section 120.4 and the corporate attribution rule in section 74.4.