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The *Income Tax Act: Section 86 in Practice*

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INTRODUCTION

There are many reasons of commercial substance as to why management, directors, or shareholders of a corporation may wish to exchange one class of shares for another. Estate planning, succession, the transfer of assets within a related group, and contemplated public offerings are all common scenarios in which a share exchange may be used.

In the absence of a relieving provision, such an exchange would be considered a disposition for tax purposes. This may be quite punitive as such dispositions can be recharacterized as a dividend for tax purposes¹ resulting in a situation where the taxpayer may face a significant tax liability despite being in the same economic position.

Section 86 provides such a relieving provision, allowing for an exchange of shares of a corporation for shares of the same corporation to occur on a tax-deferred basis where certain criteria are met.

CAVEAT

Please note that all references, unless explicitly otherwise stated, are to the *Income Tax Act*, Canada (the “Act”) and its Regulations (the “Regulations”). All comments, references, and commentary herein is based upon the author’s understanding of the Act, the Regulations, Canada Revenue Agency administrative positions, and the outcome of certain Canadian jurisprudence at the time of writing. Any opinions expressed herein are not, and should not be construed to be, legal opinions.

The principal author of this paper is not a lawyer and has no legal training. All commentary herein is based upon his experience as a Chartered Professional Accountant experienced in income tax matters.

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SECTION 86: HOW IT WORKS

At a high level, Section 86 functions very similarly to section 51. Both involve the issue of shares of a corporation for capital property of the taxpayer. The preamble of subsection 86(1) is more narrowly defined than that of subsection 51(1) and allows a tax-deferred treatment only where all the shares

¹ Subsection 84(3) of the Act recharacterizes proceeds of disposition resulting from a corporation requiring its own shares into a taxable dividend to the extent that the proceeds exceed the paid-up capital of the shares. Note that subsection 84(6) provides certain exceptions to this, notably for public companies.

of a particular class of the issuing corporation are the property exchanged. Subsection 51(1), as discussed in a previous session, allows for the tax-deferred treatment on a broader array of convertible properties.

Section 51 exchanges are legislatively subordinate to those under subsection 86(1).² The determination as to when it applies to supersede section 51 is based upon ‘the course of the reorganization of capital of the corporation’ as defined specifically for this provision. The Act itself does not define this concept, though Canada Revenue Agency has published its administrative position on it stating a reorganization of capital would ordinarily require amendments to the articles of a corporation.³

The preamble to Section 86(1) also requires that the shares exchanged be capital property to the taxpayer. Capital property is very broadly defined in the Act to include any property that if disposed, would result in a capital gain.⁴ This can limit the availability of Section 86 to corporations that are in the business of trading shares, as the gains and losses from such shares may be considered business income, and the shares inventory as opposed to capital property. In such circumstances, the practitioner may wish to consider Section 85, which can allow for exchanges of share inventory⁵.

Where Section 86 applies, the taxpayer is deemed to dispose of their exchanged shares for proceeds of disposition equal to the cost of the shares plus any other property received on the exchange.⁶ Any property other than shares of corporation received on exchange is deemed to have a cost equal to its fair market value at the time of the disposition of the property.

Generally, the cost base of the shares received by the taxpayer will be equal to the old shares exchanged. There are certain adjustments where other consideration is issued on the exchange or if the shares received have a fair market value that differs from the shares exchanged.⁷ The latter issue may be a significant consideration where shares received have different attributes than those

² Subsection 51(4) of the Act

³ CRA Income Tax Ruling 2010-0373471C6

⁴ Section 54 of the Act. Depreciable property of the taxpayer is also included, though share capital is excluded from the definition of depreciable property as set out in the Regulations.

⁵ Where all the securities disposed are Canadian securities, the practitioner may also wish to consider filing an election under subsection 39(4) of the Act, which deems all Canadian securities to be deemed to be capital property. Section 85 has additional compliance requirements and costs, and is generally more visible to Canada Revenue Agency, which may not be optimal for the client. Note that land inventory cannot be exchanged under Section 85. A discussion of the requirements of Section 85 is beyond the scope of this paper.

⁶ Paragraph 86(1)(c) of the Act

⁷ Paragraph 86(1)(b) of the Act