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The *Income Tax Act*: Drafting Considerations for Section 85 Rollovers

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THE *INCOME TAX ACT:* DRAFTING CONSIDERATIONS FOR SECTION 85 ROLLOVERS

INTRODUCTION[1]

A corporation is a separate legal entity and exists independent from its shareholder or shareholders. It can enter into contracts, be sued, and own property.

When property is transferred between individuals and/or corporations that do not act at arms' length, for purpose of the *Income Tax Act* (Canada) (**"ITA"**),[2] the property must, subject to the provisions of the ITA, be transferred for proceeds of disposition (i.e., sales price) ("**POD**") equal to its fair market value (**"FMV"**) to avoid double taxation.[3] This may result in an immediate tax liability. If no cash is paid on the transfer, how will the vendor fund the tax bill?

There are a number of different provisions in the ITA that permit a tax-deferred transfer of property, one of which is section 85. Other provisions include section 51 and 86 share exchanges, section 73 spousal rollover, and a subsection 107(2) rollout by a personal trust.

The purpose of section 85 is to permit tax-deferred or "rollover" treatment to the disposition of eligible property. A section 85 rollover allows for the transfer of property between a taxpayer or partnership ("transferor") to a taxable Canadian corporation ("transferee") on a tax-deferred basis where the consideration for the transferred property includes shares of the transferee corporation. Generally, when the conditions of section 85 of the ITA are satisfied, the transferor and transferee can elect, within prescribed limits, that the transfer occur for POD other than FMV for income tax purposes. This elected amount becomes the cost of the transferred property to the transferee corporation.

This paper identifies situations where a section 85 rollover can be used as a tax planning tool. It reviews the legislative requirements and mechanics of the provision and considers related income tax and sales tax matters. This paper also discusses how to document a section 85 rollover transaction against this technical background. This paper is not meant to be a treatise of section 85 and related tax planning considerations. Rather, the writer's intention is to provide some context for drafting purposes.

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[1] Thank you to Bryant Frydberg of Miller Thomson LLP for his insights and assistance in drafting this paper.

[2] Subsection 251(1) of the *Income Tax Act* (Canada), RSC 1985, c1 (5th Supp) (the "ITA"). Unless otherwise provided, all legislative references are to the ITA.

[3] See section 69.

WHEN TO USE SECTION 85

A section 85 rollover should be considered any time property with an accrued gain is transferred between non-arm's length parties. There are several situations where a section 85 rollover is commonly used. These include, but are not limited to the following:

1. **Transition a business from a sole proprietorship or partnership structure to a corporate structure.** This may be done for a variety of purposes, including to limit the sole proprietor or partner's personal liability or to take advantage of lower corporate tax rates.

2. **Introduce a holding corporation between the shareholder(s) and the operating corporation.** This may be done for a variety of reasons, such as for creditor protection purposes. Instead of leaving excess cash in the operating corporation and potentially accessible to creditors, excess cash can, generally, be distributed to the holding corporation by way of a tax-free incorporate dividend[4] and invested by the holding corporation, or loaned back to the operating corporation, as required.

3. **Transition a division or branch to a separate corporation.** This may be done to protect divisions or branches from creditors of another division of branch or to isolate the division or branch in preparation for a sale.

4. **Separate major assets from the operating corporation.** This may be done for creditor protection purposes. For example, a building or intellectual property can be held separately from the operating business and leased or licensed back to the operating entity.

5. **Consolidate assets**. This may be done for loss consolidation purposes by transferring an income-producing asset to a corporation with unused losses. This may also be done in the context of a business merger.

6. **Transition the business.** For example, the owner of a business may wish to transfer the business to the next generation or to key employees.

7. **Facilitate complex corporate reorganizations.** For example, a section 85 rollover is commonly used as part of a "purification" or "butterfly" transaction.

The PowerPoint presentation that accompanies this paper includes diagrams that depict how some of these objectives may be achieved (see Appendix G).

[4] Subject to subsection 55(2). A discussion of subsection 55(2) is outside of the scope of this paper.