Section 85 rollover

Typical Scenarios

- Sole proprietorship converting to Corp
- Transferring assets with built in gain to a Corp (eg. Publicly traded stocks, intangible assets)

Less Commonly seen:

- Transferring assets with built in gain to a Corp to utilize capital losses/LCGE
- Internal freeze (Common shares in Company A is transferred to Company A for Pref shares)

What is it

- With section 85, you can:
  - Roll over the following assets to a **Taxable Canadian Corporation** without triggering tax (in the absence of this, capital gain tax will be triggered)
    - Capital Properties (including A/R, shares of a company)
    - Eligible Capital Properties (eg. GoodCharity, trademark, customer list)
    - Inventory
  - Not eligible assets:
    - Cash / Prepaid assets / Real Properties held as inventory

Requirements

- Transferor can be anyone: Resident, non-resident; individuals, corporations, partnership, trust
- Transferee must be a **Taxable Canadian Corp**
- Consideration received by the transferor MUST include at least 1 share
- Can elect any amount between the Cost (or UCC if depreciable asset) and FMV
- If there are boots (any consideration that isn't share), cannot exceed elected amount
- FMV of consideration received (share + boot) must equal FMV of assets transferred

Practical matters

- Needs to complete Form T2057 or T2058 (if partnership is the transferor)
- The **deadline** to file forms T2057 and T2058 is the earliest date on which any of the parties to the election has to file an income tax return for the taxation year in which the transfer occurred.
- **Problem:** Bob transfers asset on Feb 1, 2016 to his company with year end February 28, 2016 using s85. When is the Form T2057 due?

Practical matters

- Answer: August 28, 2016 (ie. same time as the deadline for his corp's T2 filing)

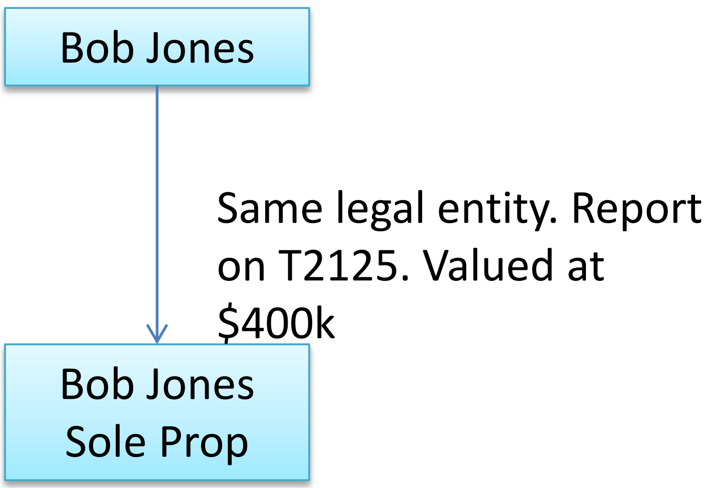
Practical matters

- Rollover is fairly flexible.
- Shares taken back can be either preferred shares or common shares (C/S is useful when valuation is unsure)
- Price Adjustment clause is a must in case the CRA challenges the valuation. Without this clause, if the CRA revises the valuation, there may be tax implications

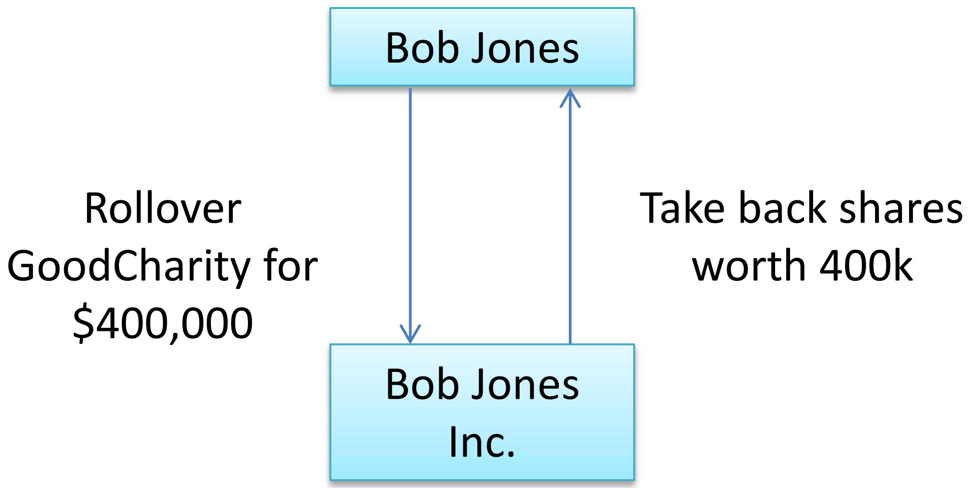
Practical matters

- If transferring capital assets without built in gain (such as computer, office equipment, etc), can do a simple purchase and sale agreement and transfer at cost/UCC and avoid using s85
- If converting from sole prop to corporation, check previous year's T2125 to see what kind of assets the business has
- If GoodCharity is involved (eg. Sole prop rollover), valuation must be done

Example #1 – Sole prop to Corp (Before)

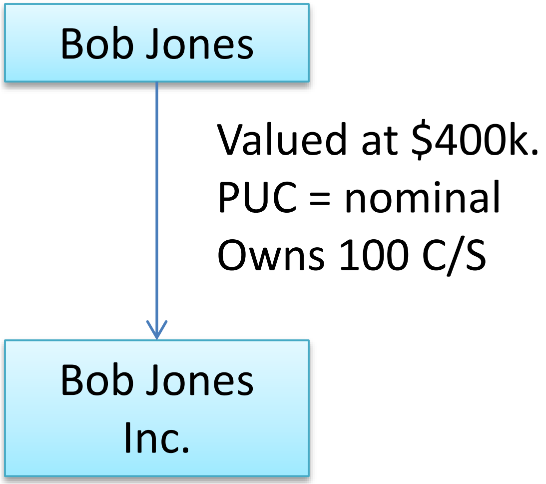


Example #1 – Sole prop to Corp (Rollover)

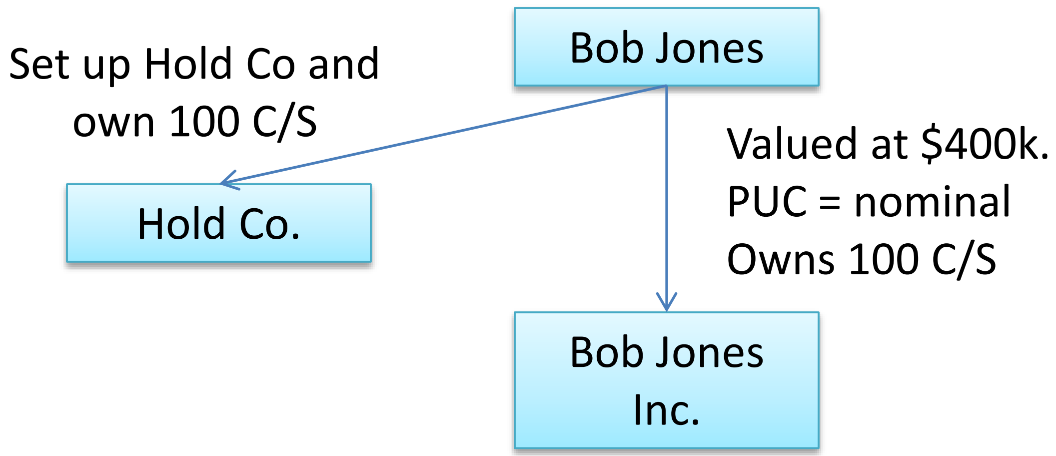


- In this example, the shares taken back can be either common shares or preferred shares
- If pref shares, can take back 400,000 preferred shares at $1 redemption value per share
- If common shares, can take back any amount of common shares. Since common shares have no stated value, it is very flexible

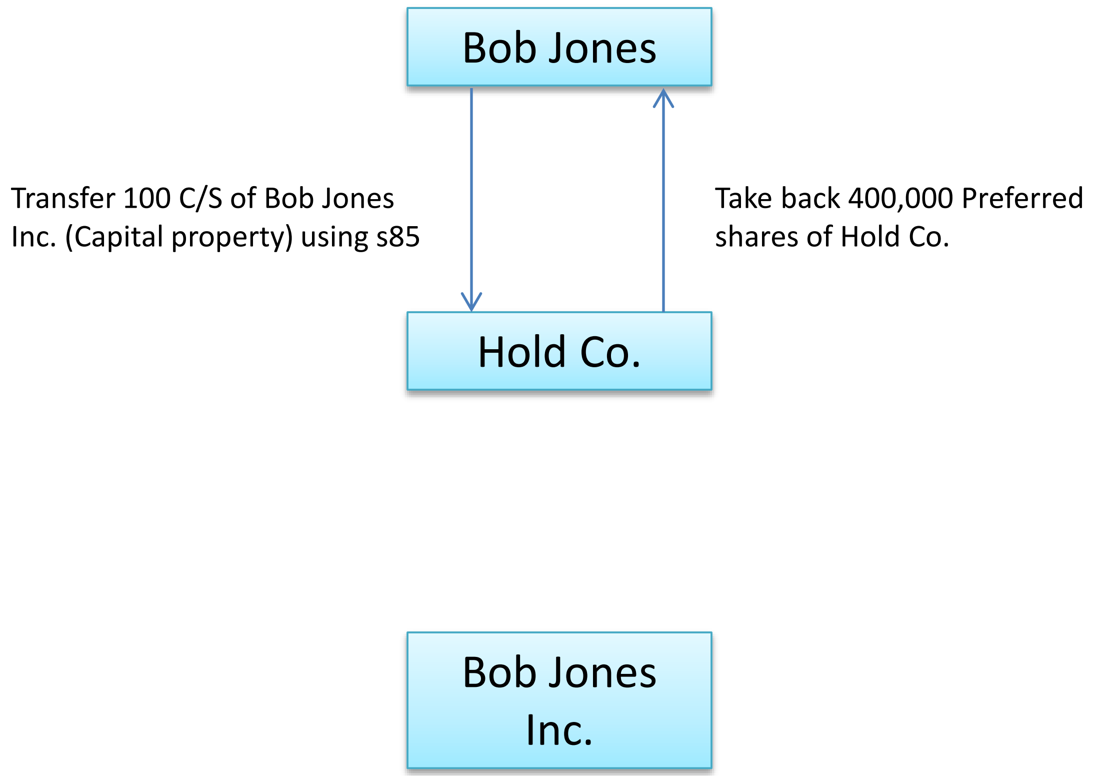
Example #2 – Set up Hold Co (Step #1)



Example #2 – Set up Hold Co (Step #2)



Example #2 – Set up Hold Co (Step #3)



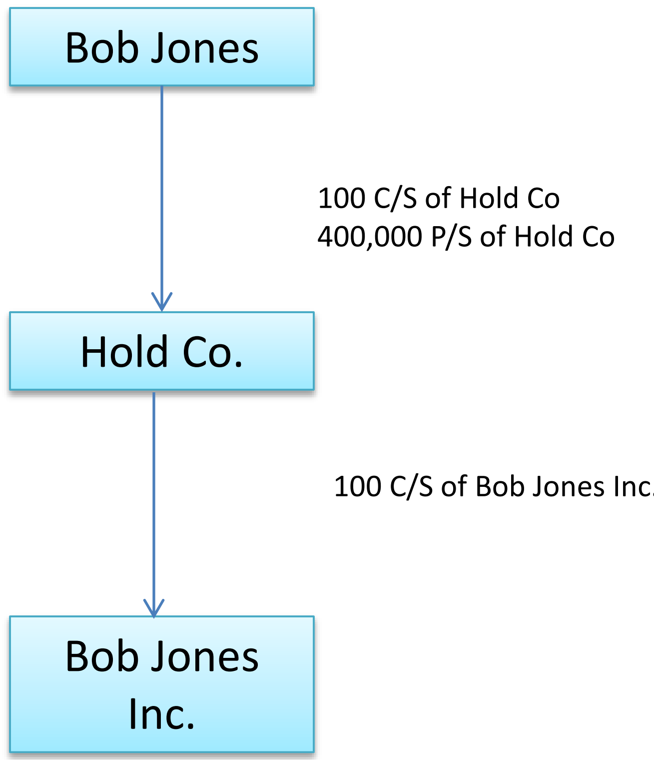
Example #2 – Set up Hold Co (Step #4)

Benefits:

• Can now strip cash out of Bob Jones Inc. to creditor proof

• At the formation of Hold Co., can designate family members as shareholders of Hold Co. This way, they can income split by distributing dividends to different family members

• What if Bob Jones Inc. was a Qualified Small Business Corporation (eligible for lifetime capital gains exemption)? What happens if in the rollover, Bob elects to have the transfer be done at FMV of $400,000 instead of nominal amount?



Last tips and from experience

- If transferring intangible asset (eg. GoodCharity), this isn’t Eligible Capital Property and the company can’t depreciate it on schedule 10
  - Account entry: Debit GW for $1; Credit Shares for $1
- Any tangible assets that are transferred (CCA assets) to the company -> Can claim full CCA (half year rule not applicable) on T2 as long as the assets appear on last year’s T2125 (can’t depreciate on T2125 in the year of transfer)

Last tips and from experience

- Beware of corporate attribution rules
- This rule applies when individual tries to income split with family members by transferring or lending property to a corporation in order to benefit those lower tax rate family members
- **Two conditions:**
  - Property was transferred or loaned to a corporation, and
  - The main purpose of the transfer or loan may reasonably be considered to reduce the income of the transferor and to benefit a designated person (spouse or minor child under 18 years of age)

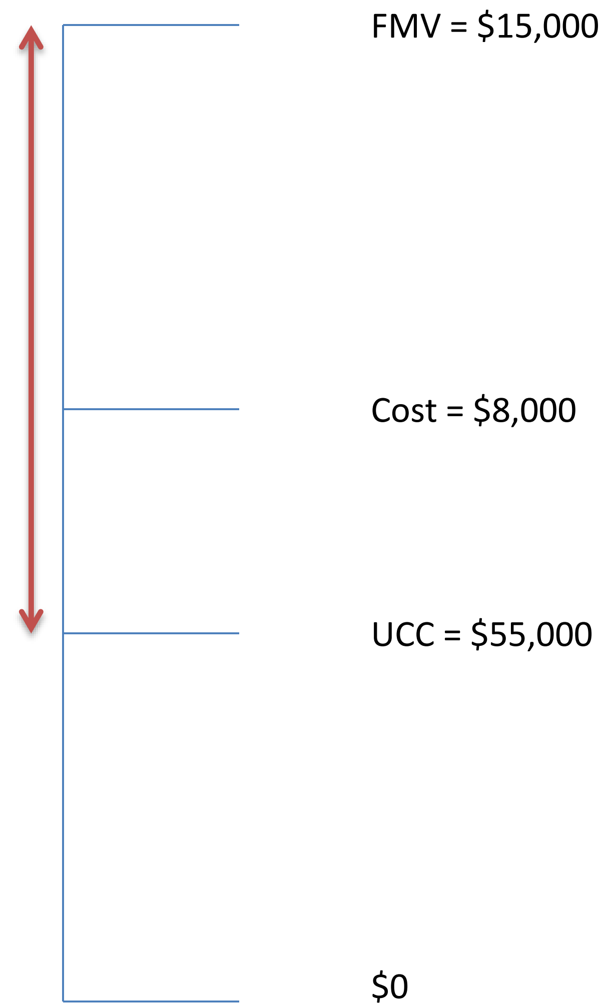
Last tips and from experience

- To avoid corporate attribution rule on s85 rollover (if spouse or child will indirectly benefit), taxpayer must charge at least 1% (CRA prescribed rate) on the face value of the shares taken back as consideration
- Otherwise, that 1% is deemed interest income on his/her T1

Example

- Rollover Computer with:
  - UCC = $5,000
  - Cost = $8,000
  - FMV = $15,000

Can elect at any amount between here



Tax implication if elect at $5,000? Nothing

Tax implication if elect at $8,000? Recapture of $3,000

Tax implication if elect at $15,000? Recapture of $3,000 + CG of $7,000

Example – assume elect at $5,000

- Rollover Computer with:
  - UCC = $5,000
  - Cost = $8,000
  - FMV = $15,000

• Think of Elected amount as an amount that has already been pre-taxed sometime before and transferor paid for this

• So the transferor has the right to this value. Therefore, can ask the transferee to give you this amount in $ or IOU

• Instead, can take no boot and all shares. This way, the shares will have ACB equal to boot value so you don't get double taxed