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SECTION 85 TRANSFERS - ADDITIONAL TAX CONSIDERATIONS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on various types of corporate reorganisations. Due to the complexity of the legislation in this area, this memorandum is not intended to be exhaustive and should not be acted upon without further consultation with professional advisers. In addition, care must be taken not to trigger the provisions of the general anti-avoidance rule in implementing any type of corporate reorganisation.

Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, corporate-commercial transactions, estate administration, tax dispute resolution and tax litigation. Howard Alpert has been certified by the Law Society as a Specialist in Corporate and Commercial Law, and also as a Specialist in Taxation Law.

A. Accounts Receivable

Section 22 of the *Income Tax Act* (Canada) (the "Act") deals with the sale of accounts receivable and is applicable upon the joint election in prescribed form by a vendor and a purchaser, where the vendor sells all or substantially all (i.e. at least 90%) of the assets of a business that was carried on in Canada to a purchaser who proposes to continue the business. The business assets sold must include all the accounts receivable of the vendor that are outstanding at the time of the sale.

If Canada Revenue Agency (the "CRA") accepts the election, then the Vendor is entitled to deduct in the year of sale any loss on sale of the accounts receivable computed as the difference between the proceeds received and their face value (excluding those accounts previously written off by the Vendor as bad debts under paragraph 20(1)(p) of the Act). The loss is computed without regard to any reserve for doubtful debts, whether or not such reserve has been previously allowed as a deduction under paragraph 20(1)(l) of the Act.

The amount that the Vendor is allowed as a deduction in the year of sale pursuant to paragraph 22(1)(a) of the Act is required to be included in the Purchaser's income in the year of the purchase. Paragraph 22(1)(c) of the Act provides that the Purchaser may then deal with the accounts receivable for tax purposes as though they had arisen while such Purchaser was the owner of the business (i.e. for these accounts receivable). The Purchaser may claim a deduction for a reserve for doubtful debts under

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paragraph 20(1)(l) of the Act and may deduct bad debts under paragraph 20(1)(p) of the Act. A receivable that the Vendor previously deducted under paragraph 20(1)(p) of the Act may not be deducted by the Purchaser. In the event that the Purchaser should collect a receivable previously deducted by the Vendor under paragraph 20(1)(p) of the Act, it must be included in the Purchaser's income.

The portion of the sale price of the business that is the consideration for the accounts receivable is required to be set out in the joint election which the Vendor and Purchaser must execute pursuant to subsection 22(2) of the Act. The joint election must be made on form T2022 and should be filed with the tax return for the taxation year of the sale.

The amount that is stated in the joint election to be the consideration for the accounts receivable is final for tax purposes as far as the Vendor and Purchaser are concerned and cannot later be altered. However, the joint election is not necessarily binding on the CRA, and may be challenged on assessment if it is considered not to reflect the facts of the sale, such as when the face value of the debts sold is incorrectly stated or when the consideration actually paid is different from that set out in the election as paid. If the Vendor and Purchaser are not dealing at arm's length and the fair market value of the accounts receivable sold was more or less than the consideration paid for them, the provisions of paragraph 69(1)(a) or (b) of the Act will be applied to the transaction. A price adjustment clause should be used to retroactively readjust the sale price and the consideration received to fair market value.

If the Vendor sells the assets of a business to a Purchaser with whom he does not deal at arm's length, and if the amount paid for the accounts receivable is greater or less than the fair market value of the accounts, the provisions of subsection 69(1) of the Act apply. Subsection 69(1) of the Act generally operates only to adjust one side of the transaction. Where the sale price is below fair market value, it increases the transferor's proceeds of disposition to fair market value but does not increase the Purchaser's cost. Alternatively, where the sale price is above fair market value, it adjusts the transferee's cost downward to fair market value but does not reduce the Vendor's proceeds.

If the asset purchase agreement does not specify which part of the total consideration is for the accounts receivable, a reasonable allocation must be made between accounts receivable and other assets included in the sale.

It is desirable that the asset purchase agreement should contain a list of the accounts receivable which are being sold and an allocation of the purchase price

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specifying the amount of the consideration relating to the accounts receivable, which should attempt to reflect their fair market value.

B. HST

The Harmonized Sales Tax ("HST") applies to most supplies of goods and services at a rate of 13%, consisting of a 5% federal portion and an 8% provincial portion.

The transfer of assets pursuant to a subsection 85(1) rollover is not generally exempt from HST. Rather, the impact of the HST on the transfer of each of the assets will, with certain exceptions, depend upon the HST rules applicable on the transfer of each type of asset. In particular, the transfer of certain assets including (i) cash; (ii) prepaid expenses (unless they relate to an exempt supply); (iii) inventory (unless the goods in inventory are zero-rated under the HST legislation); (iv) fixed assets; and (v) intangible property supplied in Canada, will be subject to HST based on the fair market value of the assets being transferred. Any transfer of tangible personal property will also be subject to HST.

Pursuant to the ETA, all "taxable supplies" made in Canada, that is, supplies made in the course of commercial activity in Canada, will be subject to HST. Accordingly, the transfer of real property, unless specifically exempted under the Act, is a commercial activity and is taxable. Transfer of real property includes any sale of real property other than: (i) used residential real property; and (ii) certain personal-use real property. Therefore, any sale and lease of non-residential real property will be subject to HST. Furthermore, builders selling newly constructed or substantially renovated homes will also be subject to HST.

By contrast, the transfer of debt securities or loans, accounts receivable or residential real estate, other than new or substantially renovated homes, will not attract HST, since these are exempt supplies pursuant to the ETA, and therefore the transferee corporation will not be able to claim an input tax credit for HST paid on the costs of the transfer. The supply of "financial services" is also exempt pursuant to the ETA. The definition of "financial services" includes "transfer of ownership of a financial instrument". Accordingly, a transfer of shares, debt security, equity security, or partnership interest will not attract HST. For transfers of assets, the entire value of goodwill on the sale of a business or part of a business, regardless of whether the goodwill is attributable to commercial or non-commercial activity, is exempt from HST.

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Where such assets constitute assets of a business which is carrying on a commercial activity within the meaning set out in the ETA, the transferee corporation would be able to claim an input tax credit for the HST paid on the costs of the transfer, including legal and accounting fees. If the corporation is a large business, which supplies in excess of $10 million in a fiscal year, then a temporary restriction on input tax credits is imposed on specified supplies, namely: (i) specified energy; (ii) specified telecommunication services; (iii) specified vehicles; and (iv) food, beverages and entertainment. This restriction was in place for a period of five years commencing July 1, 2010, with the input tax credits being phased in over three years commencing July 1, 2015. There should be no restrictions on input credits from now on, but it is worthwhile to consider whether the transfer began before July 1st, 2015.

Consideration should be given to the place-of-supply rules to determine whether HST is collectable when rolling assets into a corporation. HST is only collectable when the supply has been made in a "participating province". A participating province (i.e. Ontario) is a province that charges HST, whereas a non-participating province (i.e. Alberta) only charges GST.

Pursuant to Schedule IX of the ETA, the following general place of supply rules apply:

(a) A transfer of real property will be regarded as made in the province in which the real property is situated;

(b) A transfer of tangible personal property will be regarded as made in the province in which the tangible personal property is delivered or made available to the recipient of the supply;

(c) A transfer of intangible personal property will be subject to additional rules largely dependent on where the intangible personal property can be used, namely:

(i) If the property can only be used in a single participating province, then the supply will be regarded as made in that participating province;

(ii) If the property can be used in multiple participating provinces, then the supply will be regarded as made in: (a) the province with the greatest proportion of use; (b) the province where the address of recipient is situated; or (c) the province with the highest rate of the provincial component of the HST;

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(iii) If property can only be used primarily in a non-participating province, then the supply will be regarded as made in the non-participating province; and

(iv) If property can be used both outside and within the participating province, then the supply will be regarded as made where the: (a) address of the recipient is situated; or (b) in the province with the highest rate of the provincial component of the HST.

(d) Where the transfer of property is made in a non-participating province, but consumption or use of that property will occur in a participating province, then the individual is required to self-assess the provincial component of the HST. Furthermore, where the transfer of property is made in a province with a lower HST (i.e. British Columbia at 12%), but consumption or use of that property will occur in a participating province with a higher HST (i.e. Ontario at 13%), then the individual is required to self-assess the HST portion applicable to the particular transaction at a rate that is the difference between the provincial component of the two provinces.

There are two types of elections under the ETA, which may apply to effectively eliminate the HST payable on a subsection 85(1) transfer of assets to a corporation. The first election under section 167 of the ETA applies where both the transferor and the transferee are registrants and all or substantially all of the assets used by a business in a commercial activity are being transferred. In this case, the transferor and the transferee may file a joint election to treat the transfer as a zero-rated supply. As a result, (i) the transferee would be able to claim an input tax credit for the HST paid on the acquisition costs (note the restrictions on input tax credits stated above); and (ii) the applicable rate of HST would be nil.

For transfers of assets pursuant to a subsection 85(1) rollover, the following rules apply with regards to the above-mentioned election: (i) this election is also available upon the sale of <u>part</u> of a business of a supplier, provided that this part constitutes all or substantially all of the property that the recipient would require to carry on that part as a business; (ii) this election applies to property sold as part of a business used in both commercial and non-commercial activities, rather than only to property used in commercial activities; and (iii) this election is available for transfers of <u>either</u> ownership, possession or use of all or substantially all of the property that the recipient requires to operate the business, which would allow some of the property to be leased to the recipient. Where the conditions of this election are met, it will be effective if the prescribed election form is filed with the recipient’s return for the reporting period in which the supply is made.

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The second election under section 156 of the ETA applies where Canadian resident registrants who are members of a closely related group and exclusively engaged in commercial activities make an election to deem most supplies made between them to be made for nil consideration. When such an ongoing election is made, the supply is not subject to tax. A closely related group is defined as a group of corporations or partnerships with at least 90% common ownership. It should be noted that transfers of real property or goods not for use exclusively in a commercial activity between such corporations are not covered under this election. For transfers of other assets between qualifying corporations, the election is available regardless of whether or not all or substantially all of the assets used in a commercial activity are being transferred.

Currently, registrants are required to complete and retain with their business records the prescribed joint election form. This election is automatically revoked on the day on which either of the joint electors ceases to qualify as a specified member of a closely related group. This joint election or a voluntary revocation of such an election can be made at any time but must specify its effective date.

Under this regime, a new corporation or partner cannot make the election at the time it initially acquires assets from another member of its closely related group if the new corporation or partner has no other property before making the election and has not made any taxable supplies. At the present time, there is no requirement for a prescribed group election form to be filed with the CRA under section 156.

As of January 1, 2015, the 2014 Budget requires the parties to a new section 156 election to file an election in a prescribed manner. The deadline for filing the new election will be the first day on which any of the electing parties is required to file a corporate tax return for the period in which the election becomes effective. Also effective January 1, 2015, the 2014 Budget extended the availability of group relief to new members of a group of corporations that have not yet acquired any property, provided that the new members continue as going concerns engaged exclusively in commercial activities. Finally, the 2014 Budget made parties to an existing or new group relief election subject to a joint and several liability provision with respect to the GST/HST liability that may arise in relation to supplies made between them on or after January 1, 2015

C. Ontario Land Transfer Tax

With respect to the land transfer tax implications of a subsection 85(1) rollover, where such a rollover involves the transfer of land from a shareholder which is a corporation to an affiliate of the vendor corporation, a deferral of land transfer tax will be available upon the application to the Ministry of Revenue where the underlying control of the corporate group remains in the same hands and the interest in land remains within the corporate group for three years after the disposition.

Likewise, where the shareholder who is an individual transfers land pursuant to a subsection 85(1) rollover to a family business corporation (where the shareholders are members of the family or a same-sex partner of the individual transferor) as defined in the land transfer tax regulations, an application for exemption from land transfer tax will also be considered by the Ministry of Revenue.

In addition, for unregistered dispositions of a beneficial interest in land from one corporation to another through a subsection 85(1) rollover as part of a butterfly reorganisation, an application for an exemption from land transfer tax can be made to the Ministry of Revenue. However, this exemption does not eliminate the imposition of land transfer tax payable upon the registration of a change in legal ownership following a butterfly reorganisation. Consideration should be given to having a bare trustee corporation hold the title to the land in anticipation of the butterfly reorganisation in order to avoid this problem.

D. Ontario Retail Sales Tax Act

The federally administered HST replaced the Ontario Retail Sales Tax ("RST") in 2010. Vendors are no longer allowed to obtain a permit under the *Ontario Retail Sales Tax Act* (the "*ORSTA*"). Section 2.0.0.1 of the *ORSTA* has set out certain transitional rules relating to the winding down of the RST. Generally, the existing Ontario RST will not apply to the sales of goods where the goods are delivered, and ownership of the goods has passed to the purchaser after June 30, 2010. RST refunds and rebates will continue to remain in place until the existing time limited for claiming them expires for the transaction to which they relate, or June 30, 2014, whichever is earlier.

Private purchases of "specified vehicles" from an individual who is not a HST registrant will continue to be subject to RST at a rate of 13%. Specified vehicles are defined as follows: (i) motor vehicles that require a permit under the *Highway Traffic Act*; (ii) off-road vehicles or motorized snow vehicles; (iii) boats; and (iv) aircrafts.

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However, it is important to note that transfers of “specified vehicles” between related parties, such as those between corporations and shareholders, will continue to be exempt from RST.

E. Tax Planning Considerations

The following tax planning opportunities should be considered in connection with subsection 85(1) rollovers:

1. Incorporation

A subsection 85(1) rollover may be used to transfer an unincorporated business to a taxable Canadian corporation from an individual in order to take advantage of the small business rate of tax available to the corporation and to gain access to the $750,000.00 capital gains exemption available in connection with dispositions of qualifying shares of small business corporations.

2. Losses

A subsection 85(1) rollover may be used to transfer assets to permit the utilization of the losses of a corporation, subject to the change of control provisions.

3. Butterfly Reorganisations and Corporate Spin-Off Transactions

A subsection 85(1) rollover may be used to accomplish a divestiture of corporate assets on a tax-deferred basis in the course of a “butterfly reorganisation” or a “spin-off transaction”. A “butterfly reorganisation” may be instituted for a variety of reasons, including but not limited to the following: (i) performing a tax-deferred separation of assets where shareholders wish to split up and carry on business or investments separately; (ii) splitting up family holdings for estate planning purposes; (iii) separating a business division of a corporation into a separate corporate entity while retaining the other assets of the corporation; (iv) loss utilization by transferring profitable income-generating assets to shareholder corporations which may be able to shelter the income with losses or deductions from other sources; and (v) protecting assets from exposure to liability by transferring them to new corporations.

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4. Estate Planning

A subsection 85(1) rollover may also be used to establish holding companies designed to achieve income splitting and estate planning objectives. When subsection 85(1) of the Act is used to effect an estate freeze, adult beneficiaries of the estate freeze first subscribe for common shares in a holding corporation. Then, the transferor transfers assets to the holding corporation in exchange for a promissory note and preferred shares, or preferred shares alone, of the holding corporation pursuant to a section 85 rollover. As a result, (i) the future growth of the assets will accrue to the beneficiaries of the estate freeze, and (ii) income splitting will be achieved, since any income earned by the assets which is distributed to the common shareholders of the holding corporation will be taxed in the hands of the beneficiaries of the freeze.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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