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Tax-Deferred Rollovers Under Subsection 85(1) – Joint Tax Elections

Tax election forms must be completed, as this type of rollover is not automatic

On occasion, there are corporate mergers, acquisitions and reorganizations in which Canadian resident shareholders have been given the option to acquire new shares of the acquiring corporation in exchange for their old shares on a tax-deferred basis using subsection 85(1) of the Canadian Income Tax Act. The process involved in obtaining the tax-deferred rollover is more complex than just making the decision of which reorganization option to choose. The failure by the shareholder to follow the appropriate steps as outlined below may cause the loss of the tax-deferred rollover, and potentially result in additional taxes and penalties.

The content in this article is for information purposes only and does not constitute tax or legal advice. It is imperative that you obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances are properly considered and that action is taken based on the most current legislation.

Subsection 85(1) – What Is It?

The Canadian Income Tax Act (ITA) contains a series of provisions that allow the owner of a security to exchange that security for another and defer the recognition of any unrealized capital gain and hence the tax on the gain until the new substituted security is actually disposed. One of the most commonly used provisions is subsection 85(1), titled "Transfer of property to corporation by shareholders [rollover]".

Subsection 85(1) allows the owner of the security (property) along with the acquiring corporation to jointly elect to have the adjusted cost base (ACB) of the security being transferred to the corporation flow through to the new shares that are received by the owner. As the tax election must be made jointly, the election is usually referred to as a "joint tax election". In all cases, the acquiring corporation must be a Canadian corporation.

Example #1 – An individual, who owns 1,000 XYZ Common shares with an ACB of $50 per share, is offered 3 shares of AcquireCo (a Canadian corporation) for each share of XYZ Common tendered. Each share of AcquireCo has a Fair Market Value (FMV) of $40. AcquireCo also offers the XYZ Common shareholder the option of making a joint tax election under subsection 85(1) of the ITA. In this case, if the joint tax election is not made, the result would be an immediate capital gain of $70,000 [(1,000 shares x (3 for 1 exchange ratio) x $40 FMV) - (1,000 shares x $50 cost)]. As with all capital gains realized, only 1/2 of this amount would be taxable. However, if the individual makes the joint tax election, then the recognition of a capital gain of $70,000 may be deferred until such time as the shares of AcquireCo are ultimately disposed.

As a subsection 85(1) election must have a Canadian corporation as the acquirer, this means that foreign based acquisitions of Canadian corporations may qualify for this type of tax deferred rollover if the foreign acquirer sets up a Canadian subsidiary to acquire the shares of the Canadian takeover target.

If the owner of the security is in a loss position on that security (i.e. the ACB is greater than the FMV of the total consideration received in the exchange), then the subsection 85(1) joint tax election cannot be filed. In this case the capital loss is generally automatically triggered on the exchange.

Even the Receipt of Some Cash in the Reorganization May be Tax-Deferred

There are also rules about how much of the unrealized capital gain can be deferred. If only shares are received, as described above, then the entire capital gain may be deferred. But if some non-share consideration (such as cash) is received in the exchange, then there may be some current taxes due.

Rule #1 – If the total cash received is less than the investor's ACB, then it is possible to defer all of the capital gain when using a subsection 85(1) election.

Example #2 – Assume in this new example that the individual described above was offered $40 cash plus 2 shares of AcquireCo for each share of XYZ Common given up. As the individual's total ACB ($50,000) of the XYZ Common shares was greater than the total cash received ($40,000) in the transaction there could potentially be no capital gain to be recognized on the transaction if the joint tax election is made.

If the ACB of the individual was less than the total cash (non-share consideration) received, then the difference (i.e. cash minus ACB) is a capital gain that would be taxable in the year of receipt with no opportunity for deferral.

Example #3 – Assume instead that the individual described above was offered $80 cash plus 1 share of AcquireCo for each share of XYZ Common share given up. If the individual makes the subsection 85(1) joint tax election, then the first $50 received in cash (equal to the ACB) per XYZ Common share can be tax deferred until the sale of AcquireCo (i.e. similar to a return of capital). However, the remaining $30 received per XYZ Common share would be taxable as a capital gain immediately. As with all capital gains realized, only 1/2 of this amount would be taxable.

Example #4 – Assume instead that the individual described above was offered only $120 cash for each share of XYZ Common share given up. As only cash is received in this transaction a joint tax election cannot be filed. As well, for Canadian tax purposes, the full capital gain or capital loss on the transaction must be recognized.

The Elected Amount – The Key to the Election

The elected amount is the value that is jointly agreed upon by the individual security owner and the acquiring corporation for the purpose of making the election. This value has to be chosen carefully as it must be within the limits set in the ITA. The rules require that the minimum elected amount must be at least equal to the ACB of the shares given up or the non-share consideration (such as cash) received in the transaction, whichever is greater. The maximum elected amount is limited to the FMV of the shares given up in the transaction.

Rule #2 – If the elected amount is equal to the ACB of the tendered shares, then no capital gain will be triggered on the subsection 85(1) election.

If the elected amount is equal to the ACB of the tendered shares, then there would be no capital gain to recognize on the transaction. To the extent that the elected amount exceeds the ACB of the shares given up, a capital gain would have to be recognized. This situation is demonstrated in Example #3 (above) where the cash received was greater than the ACB, which in turn meant that the elected amount had to be greater than the ACB.

The Elected Amount and the ACB

The elected amount is also very important because it will impact the ACB of the new shares on a going forward basis. The ACB of the new shares would be equal to the elected amount less any non-share (cash) consideration received. Another way to do this calculation of the new ACB would be to start with the ACB of the old shares, subtract any non-share (cash) consideration received and add back any capital gains recognized on the transaction.

For example, in Example #3 above, the new ACB of each AcquireCo share would be equal to zero. This would be calculated by taking the assumed AcquireCo ACB of $50 per share (rolled over from the XYZ Common shares) and subtracting the non-share consideration received of $80 and adding back the capital gain of $30 that had to be recognized on the transaction.

On occasion, an individual may want to elect an amount that is greater than the ACB of their shares to deliberately realize capital gains on the transaction. For example, this could happen in Example #2 above if the elected amount was determined to be $60 per XYZ Common share (total elected amount of $60,000). This would result in a capital gain of $10 per XYZ Common share exchanged and an increase in the ACB of the AcquireCo shares received from $5 to $10 per share or a total ACB for the 2 shares received of $20 ($60 elected amount - $40 cash received

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equal $20 allocated to the 2 shares of AcquireCo received). This type of situation may occur if the individual has unused capital losses to apply against an elected capital gain or if the individual is temporarily in a lower tax bracket. Note that as capital losses can be carried forward indefinitely, in many cases it may not be beneficial to create gains using this election.

Completing the Election Form

Subsection 85(1) joint tax election forms can be extremely complex and subject to penalties if completed incorrectly and not filed on a timely basis. Therefore, it is imperative that the election forms be completed by your qualified tax advisor.

The election must be made jointly between the acquiring corporation and the shareholder by filing Canada Revenue Agency (CRA) Form T2057, "Election on Disposition of Property by a Taxpayer to a Taxable Canadian Corporation". Quebec has a similar form for this purpose called Form TP-518-V, which should be used when filing Quebec provincial tax returns. If copies of these forms are not available from the acquiring corporation, these forms can be obtained from the CRA's website (www.cra-arc.gc.ca) and Revenu Quebec's website (www.revenuquebec.ca) respectively. As well, your qualified tax advisor would have access to these forms.

In many instances, the acquiring corporation provides instructions along with the election forms on their website closer to the effective date of the transaction.

If instructions are not provided by the acquiring corporation, then you may want to provide your qualified tax advisor with a copy of the Management Information Circular. The Management Information Circular will have details about the terms of the election, including answering the how, where and when questions relating to the particular election. It is important that these directions are followed because no two subsection 85(1) elections are alike. These circulars are usually sent to all shareholders of record of the corporation that is being acquired. However, it is possible to obtain a copy on SEDAR (www.sedar.com) if you have misplaced yours or did not receive one. Your RBC advisor can also provide a copy if requested.

Once the election form is completed by you and your qualified tax advisor, it must be sent to the acquiring corporation (or their appointed agent) in order for the corporation to complete the section of the form that shows that it is making the election jointly with the shareholder. The corporation will then send the completed form directly to the CRA or back to you for you to send to the CRA. Note that until the election is sent to and accepted by the CRA, it will not be effective.

As the tax election is completed by you and your qualified tax advisor, the amount that will become the ACB of the newly acquired shares going forward will not be known to your RBC advisor. It is recommended that you inform your RBC advisor if you have completed an effective subsection 85(1) election and request that they adjust the ACB of the newly acquired shares in your account records. The correct values are important for tax reporting, account statements and investment management purposes.

Don't Delay – Missing Deadlines can be Costly

The Management Information Circular will contain details of the time limit in which to complete the election form and provide it to the acquiring corporation for its execution. Many transactions have strictly imposed deadlines, which if missed, will prevent you from obtaining the tax-deferred rollover. For example, many acquiring corporations have stated that they will not execute any joint tax election received more than 75 or 90 days after the effective date of the transaction. However, some corporations are more forgiving and will assist you with late elections, but this does depend on the individual corporation. If the corporation signs the joint tax election form and returns it to you for filing with the CRA, then you must file the joint tax election form by the earlier of either your regular income tax filing deadline or the tax filing deadline of the acquiring corporation.

Example #5 – Assume that AcquireCo

Please contact us for more information about the topics discussed in this article.

made the offer for XYZ Common shares with an effective date of June 30. As well, AcquireCo said that they would make the joint election with former XYZ Common shareholders for up to 90 days after the effective date of the transaction. The regular corporate year end of AcquireCo is December 31 and the former XYZ Common shareholder is an individual with a taxation year that corresponds with the calendar year.

In order to make the joint tax election under subsection 85(1) there are two deadlines that would have to be considered. The first deadline is the 90 day limit imposed by AcquireCo. The former XYZ Common shareholder would have to ensure that the properly completed tax election form was forwarded to AcquireCo as required before the end of September. The second deadline to consider is the CRA deadline. In order to avoid late filing penalties the former XYZ Common shareholder would have to file the jointly signed and completed tax election form with the CRA by the earlier of the tax filing deadline of AcquireCo (which would be June 30 of the following year) or the filing deadline of the former XYZ Common shareholder (which we assume to be April 30 of the following year). In other words if the jointly signed and completed tax election forms are not filed with the CRA by April 30 of the following year, in this example, then late filing penalties would be imposed. If a late joint election can be filed, the CRA will impose penalties equal to the lesser of:

(1) 0.25% of the difference between the FMV, at the time of the transaction, of the property transferred and the elected amount multiplied by the number of months or partial months that the election is filed late; and

(2) $100 multiplied by the number of months or part of a month that the election is filed late.

However, the total penalty cannot exceed $8,000. As well, there is only a three year window in which a late election can be made. If the joint tax election is not filed, then in most cases the recognition of the capital gain will be required in the year of the reorganization transaction.

Other Types of Reorganizations

This article concentrates on the tax deferred rollovers available under subsection 85(1) of the ITA, however there are many other types of reorganizations that are commonly used. Some of these reorganizations result in the mandatory recognition of dispositions at FMV for tax purposes and other types result in automatic rollovers. Each reorganization is different and as such each must be examined to determine the various tax implications of the options available. For more information, consult with your own qualified tax advisor.

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