Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Tax-deferred rollover under subsection 85(1) — Joint tax election

On occasion, corporations may undertake a merger, acquisition or reorganization where shareholders acquire new shares of the acquiring corporation in exchange for their existing shares. You are generally considered to have disposed of your existing shares for proceeds equal to the fair market value (FMV) of the consideration you received. In the normal course, a share disposition

is a taxable event and may result in taxation in the year of the transaction. However, the Canadian Income Tax Act (ITA) contains rules that, in certain circumstances, allow you to exchange your existing share for a new share and defer the recognition of any accrued capital gain on the disposition until you subsequently dispose of the new share.

This article provides an overview of a frequently used provision of the ITA, subsection 85(1), which allows a share exchange to occur on a tax-deferred basis. Subsection 85(1) can apply to property other than shares; however, for purposes of this article, the discussion is limited to a share exchange only.

The process involved in obtaining the tax-deferred rollover under subsection 85(1) is more complex than just making the decision about which reorganization option to choose. This is not an automatic tax-deferred rollover and requires a joint tax election to be filed with the Canada Revenue Agency (CRA). Failure to follow the appropriate steps may cause the loss of the tax-deferred rollover.

When does subsection 85(1) apply?

Subsection 85(1) applies where; you dispose of capital property (e.g. your existing shares) to a taxable Canadian corporation for consideration that includes shares of the corporation, if you and the corporation make a joint tax election in prescribed form. Capital property is any property, if disposed of, would

result in a capital gain or a capital loss. However, you cannot use subsection 85(1) if your capital property has an accrued loss.

The joint tax election must be filed with the CRA using their prescribed form within a stipulated time frame. The completion and filing of a joint tax election requires some coordination between you and the corporation to whom you transferred your existing shares.

The effect of an 85(1) joint tax election is to allow you and the acquiring corporation to choose the amount at which you will be considered to have dispose of your existing shares and that the corporation will be considered to have acquired your existing shares. This amount is referred to as the "elected amount" and is discussed in greater detail later.

Example #1

Mr. B, who owns 1,000 XYZ Common Shares with an adjusted cost base (ACB) of $50,000 (or $50 per share) and a fair market value (FMV) of $120,000 (or $120 per share), is offered 3 shares of AcquireCo, a taxable Canadian corporation, for each share of XYZ Common Shares tendered and the option of making a joint tax election under subsection 85(1). Each AcquireCo share has a FMV of $40 per share so 3 shares have a FMV of $120. In the exchange Mr. B would receive 3,000 AcquireCo shares with a total FMV of $120,000.

If the joint tax election is not made, the result would be an immediate capital gain of $70,000 ($120,000 - $50,000). However, if Mr. B qualifies for and makes the joint tax election, the recognition of a $70,000 capital gain in the current taxation year may be deferred until such time that the shares of AcquireCo are ultimately disposed.

What decisions do you need to make?

There are two questions you need to address:

1. Should I file a joint tax election?

2. What elected amount will I choose?

Should I file a joint tax election?

If the FMV of the consideration received is less than the ACB of your existing shares, subsection 85(1) can't be used therefore a capital loss will be triggered on the exchange.

If the FMV of the consideration received is greater than the ACB of your existing shares, you may decide to file the joint tax election to defer all or a portion of the capital gain on the exchange. If you want to trigger the entire capital gain because you have capital losses that you want to offset or for some other reason, then you do not need to file the joint tax election and the entire capital gain will be triggered on the exchange.

The next step is determining the amount that you will choose as the elected amount.

What elected amount will I choose?

The elected amount is the value that is jointly agreed upon by you and the acquiring corporation and is your proceeds of disposition on the exchange. This value has to be chosen carefully as it must be within the limits set in the ITA. The limits are as follows;

The minimum elected amount: must be at least equal to the ACB of your existing shares being exchanged or the non-share consideration received in the transaction, whichever is greater. In most cases the non-share consideration would be cash and we will use these terms interchangeably.

The maximum elected amount: is the FMV of your existing shares exchanged in the transaction.

Elected amount equal to the ACB of existing shares

If you choose the elected amount to be equal to the ACB of your existing shares exchanged, then there would be no capital gain recognize on the transaction.

Elected amount greater than ACB of existing shares

To the extent that you choose the elected amount to exceed the ACB of your existing shares exchanged, a capital gain will be recognized.

On occasion, you may want to elect an amount that's greater than the ACB of your existing shares but less than the FMV to deliberately trigger a portion of the capital gain on the transaction. This type of situation may occur if you have unused capital losses to apply the capital gain against or if you are temporarily in a lower tax bracket.

What if I receive some cash in the reorganization?

In some instances, cash will be paid as part of the exchange. For example, you may be offered shares and cash for each of your existing shares exchanged. The amount of cash received may have an impact on the elected amount that you can choose. If the cash you receive is less than or equal to the ACB of your existing shares then you may still be able to defer your entire capital gain. However, if the cash you receive is more than the ACB of your existing shares then you will have a capital gain. Let's look at some examples.

Cash received is less than the ACB of your existing shares

Example #2

Assume instead that Mr. B was offered $40 cash plus 2 shares of AcquireCo for each share of XYZ Common. This means that he will receive $40,000 cash and 2,000 shares

of AcquireCo for his 1,000 XYZ Common Shares. Since Mr. B's ACB ($50) of his XYZ Common Shares is greater than the cash received ($40) in the exchange, there would generally be no capital gain recognized on the transaction if the joint tax election is made with an elected amount at his ACB ($50 per share). Mr. B's proceeds of disposition would be $50 less his ACB of $50, so no gain or loss.

Cash received is greater than the ACB of your existing shares

If the total cash received is greater than your ACB, then the difference (cash minus ACB) is the minimum capital gain that would be taxable in the year of receipt. This is because the minimum elected amount must equal the greater of your ACB or the cash received. However, there may still be an opportunity to defer a portion of the capital gain that would otherwise result if no joint tax election is made.

Here are some examples to illustrate how this works.

Example #3

Assume instead that Mr. B was offered $80 cash plus 1 share of AcquireCo for each share of XYZ Common. If Mr. B makes the subsection 85(1) joint tax election, then the minimum elected amount would be $80 (the cash received). This would result in a capital gain of $30 ($80 less the ACB of $50) per share. In this scenario, it is still possible to defer a portion of the total capital gain on this transaction by doing the joint tax election. The total capital gain per share if the joint tax election is not made would be $70 (FMV of $120 less the ACB of $50).

The joint tax election with an elected amount at the minimum will allow Mr. B to defer a portion of the capital gain of $40 per share.

Example #4

Assume instead that Mr. B was offered only $120 cash for each share of XYZ Common Share. As only cash is received in this transaction, a joint tax election can't be filed because the condition of there being some share consideration isn't met. As well, the full capital gain or capital loss on the transaction must be recognized.

The elected amount and the ACB of your new shares

The elected amount is also very important because it will be used to determine the ACB of the new shares received on the exchange. The ACB of the new shares would be equal to the elected amount less any non-share consideration received. Another way to do this calculation would be to start with the ACB of the shares you exchanged, add any capital gain realized on the exchange and subtract any non-share consideration received.

As the joint election is completed by you and your qualified tax advisor, the elected amount that will become the ACB of the newly acquired shares going forward will not be known to your RBC advisor. You may want to inform your RBC advisor if you've completed an effective subsection 85(1) election and request that they adjust the book cost of the newly acquired shares in your account records.

When does the joint tax election need to be filed?

The joint tax election must be filed by the earliest income tax return filing due date for the year the transaction occurred for either you or the acquiring corporation. For example, if you are an individual and the corporation's filing due date is June 30, the joint tax election must be filed on or before April 30 of the year after the transaction occurred. If you or your spouse are self-employed, the filing due date may be June 15.

Until the election is filed with the CRA, it will not be effective. And, failure to file an election with all of the required information and signatures by the due date may result in late filing penalties or the loss of the tax-deferred rollover, taxes and penalties.

As the timely filing of the joint tax election requires coordination between you and the acquiring corporation, you need to be aware of any deadlines imposed by them. If you miss the acquiring corporation's deadline, you may miss the opportunity to do the tax-deferred rollover. The joint tax election cannot be completed and filed without the acquiring corporation's approval and signature. The corporate documents describing the transaction (e.g. Management Information Circular) should contain details of the time limit in which to complete the tax election form and instructions for submitting it to the acquiring corporation for its execution. In many instances, the acquiring corporation provides instructions along with the election forms or links for inputting the relevant information on their website closer to the effective date of the transaction.

Example #5

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

To make the joint tax election under subsection 85(1), there are two deadlines that have to be considered:

- The first deadline is the 90-day limit imposed by AcquireCo. The XYZ shareholder would have to ensure that the properly completed election form was forwarded to AcquireCo as required on or before September 28 (i.e. 90 days after June 30).
- The second deadline to consider is the CRA deadline. The jointly signed and completed election form would have to be filed 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 XYZ shareholder (which is assumed to be April 30 of the following year). The earlier date is April 30.

Missing the tax-filing deadline may be costly

It may be possible to file a late joint tax election with the CRA, but they will impose late filing penalties equal to the lesser of:

1. 0.25% of the difference between the FMV of your shares exchanged, on the date of the transaction, 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 partial months that the election is filed late, up to a maximum of $8,000.

Generally, there's 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 capital gain triggered on the reorganization will have to be reported in the year the transaction occurred.

Conclusion

You may be able to defer taxation on a reorganization that involves a transfer of your shares to a taxable Canadian corporation in exchange for consideration that includes shares of the acquiring corporation using a joint tax election under 85(1). This is a highly complex tax election that should be completed with the help of a qualified tax advisor.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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