

## **Section 85 Rollovers: Tips and Traps**

A Section 85 rollover allows for a tax-deferred transfer of assets to a corporation provided the consideration received includes shares of the corporation. The following are some tips and traps to consider when using Section 85.

**Incorporate for tax deferral** - The profits of a corporation are subject to a 15.5% small business tax rate whereas highest personal tax rate is 46%. The taxpayer could transfer the business assets to a corporation using Section 85 and retain 30% more of its profits each year to fund capital expenditures and pay down debt.

**Sale of proprietorship** – If a prospective purchaser were willing to buy shares, a proprietor could transfer business assets to a corporation using Section 85 immediately before the sale and claim the \$750,000 capital gains deduction on a sale of shares.

**Goodwill and other unrecorded assets** - Any asset not included on a Section 85 rollover is deemed disposed of at fair value. A late-filed or amended election can be filed in certain circumstances. If transferring a business, advisable to elect on goodwill and other assets for at least \$1 and include a price adjustment clause in the agreement.

**Depreciable property** – Where multiple properties of the same depreciation class are disposed of, the order of disposition designated can have an impact on taxes. A detailed numerical example is provided by the Canada Revenue Agency in paragraph 15 of Information Bulletin 291R3.

**Accounts receivable** - An election under Section 22 on the transfer of a business allows a corporation to claim a fully deductible bad debt in the future as opposed to capital loss treatment for an election made under Section 85.

**Eligible property** - Real property inventory is not eligible for Section 85 rollover.

**Liabilities assumed exceed tax cost of assets** - The elected amount can not be lower than greater of non-share consideration (“boot”) or tax cost. If liabilities exceed the tax basis of assets, the elected amount equals the liabilities and tax consequences will arise.

**Shifting cost basis of shares** – The cost basis of consideration received on Section 85 rollover is allocated firstly to non-share consideration, secondly to preference shares and finally to common shares. If a particular class of shares is to be sold, it may be advisable to isolate the total cost basis in that particular class of shares using Section 85.

**Consideration received** – The fair value of property disposed of to a corporation must equal the fair value of consideration received. If excess consideration is received, it is considered a shareholder benefit. If insufficient consideration is received and there are other shareholders related to the transferor, the elected amount is increased to reflect the amount of value gifted.

**Reduction of paid-up capital** – Where a taxpayer transfers shares of a corporation back to it in exchange for new shares, the paid-up capital reduction provisions in Section 85 are not always effective. A numerical example of how a taxable deemed dividend can result is provided in paragraph 29 of Information Bulletin 291R3. In a non-arm’s length situation, this problem can be remedied by having the directors pass a resolution setting the paid-up capital. In an arm’s length situation, the answer is not as clear.

**Section 84.1** – A taxpayer can not sell his shares to a non-arm's length corporation (whether under Section 85 or not) and extract the proceeds tax-free if the tax basis of the shares have been increased as a result of claiming the capital gains deduction or v-day appreciation. That portion of the proceeds would be deemed to be a taxable dividend.

Section 85 freeze - If crystallizing capital gains deduction on transfer, ITA 110.6(6) mandates that the disposition be reported on transferee's personal tax return in order to use the capital gains deduction.

Offsetting personal / corporate tax attributes – An asset with an accrued gain can be transferred by a taxpayer to a corporation under Section 85 and the gain can be recognized and offset by losses of the corporation. Alternatively, a taxpayer can transfer a property with an unrealized loss to a corporation and the corporation can trigger that loss to offset its own gains. These techniques are only effective when the individual and corporation are affiliated.