The Taxation of Corporate Reorganizations: How Are We Doing So Far?

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PRÉCIS
Cet article constitue un survol des règles régissant l’impôt fédéral sur le revenu dans le cadre de restructurations de sociétés au Canada. Les fusions, les liquidations, les restructurations par fractionnement, les transferts de biens à une société, les échanges d’actions et les restructurations de capital à l’échelle internationale sont traités dans des parties différentes de cet article. Chaque partie contient un survol des règles actuelles régissant le type particulier de restructuration, un aperçu historique de l’évolution, des commentaires sur les lacunes existantes et des suggestions sur la manière dont elles pourraient être corrigées à l’avenir. Les auteurs concluent que les règles régissant les restructurations de sociétés au Canada sont raisonnablement appropriées. Cependant, il conviendrait de réduire ou d’éliminer les complexités dans certains domaines en simplifiant les règles.

ABSTRACT
This article provides a general overview of the rules governing the federal income taxation of corporate reorganizations in Canada. Amalgamations, liquidations, divisive reorganizations, transfers of property to a corporation, share-for-share exchanges, and internal capital reorganizations are each addressed in a separate section of the article. Each section contains an overview of the current rules governing the particular type of reorganization, traces the historical development of those rules, comments on any existing deficiencies, and suggests how these might be remedied in the future. The authors conclude that the rules governing corporate reorganizations in Canada are in reasonably good shape; however, there is a need to reduce or eliminate complexities in some areas through simplification of the rules.

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INTRODUCTION

In 1995, the year in which we commemorate the 50th anniversary of the founding of the Canadian Tax Foundation, it may fairly be said that the rules in the Income Tax Act\(^1\) governing the taxation of corporate reorganizations in Canada are, for the most part, in reasonably good shape. Moreover, this has generally been the case for the past several years.

In making this assessment, we have focused primarily on the extent to which the rules achieve three principal objectives:

1) Do the rules enable taxpayers to implement transactions that result in a change in the legal form of ownership of assets but do not effect any significant change in the underlying economic ownership of those assets, without triggering adverse tax consequences?

2) Do the rules achieve tax neutrality in the sense that transactions that effect an equivalent change in economic ownership of assets may be achieved with the same tax consequences, regardless of the legal form in which the transactions are implemented?

3) Finally, are the rules understandable, so that taxpayers may implement transactions without incurring inordinate transaction costs and with the knowledge that the tax consequences of their actions are relatively certain?

Although few would dispute the appropriateness of our latter two criteria, we acknowledge that our first criterion is not universally accepted as a desirable objective. Indeed, in 1967, the Carter commission\(^2\) spoke out against “rollovers” in most corporate reorganizations, and many of its proposals in this regard were adopted by the 1969 white paper on tax reform.\(^3\) Nevertheless, the appropriateness of this objective was sanctioned by Parliament in producing the tax reform legislation of 1971\(^4\) and, with the notable exception of the ill-fated MacEachen budget of November 1981,\(^5\) has, for the most part, been endorsed by federal legislators ever since.

The journey to date, however, has not been easy, and certain difficulties have yet to be overcome. Undoubtedly, our policy makers have

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\(^1\) RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

\(^2\) Canada, Report of the Royal Commission on Taxation (Ottawa: Queen’s Printer, 1967).

\(^3\) E.J. Benson, Proposals for Tax Reform (Ottawa: Queen’s Printer, 1969).

\(^4\) SC 1970-71-72, c. 63 (herein referred to as “the 1971 tax reform legislation” or “the 1971 tax reform”). The 1971 tax reform legislation replaced the Income Tax Act, RSC 1952, c. 148, as amended (herein referred to as “the 1952 Act”). All references to section 85I are to the 1952 Act.

\(^5\) The 1981 budget purported to “tighten up on tax deferrals available to those who dispose of property” by eliminating the rollovers contained in sections 51, 85, 85.1, 86, and 97 and by limiting the availability of subsection 85(1) to situations where property was either transferred to a corporation controlled by a transferor or by a person who controlled the transferor, or transferred by an individual (other than a trust) to a Canadian-controlled private corporation eligible for the small business deduction. See Canada, Department of Finance, 1981 Budget, Budget Papers, Supplementary Information (The footnote is continued on the next page.)
benefited, and will continue to benefit, from the many contributions made to the development of the rules governing the taxation of corporate reorganizations in presentations to the various conferences sponsored by the Canadian Tax Foundation and in articles published in the *Canadian Tax Journal*.

Most of the rules governing the taxation of corporate reorganizations were introduced as part of the 1971 tax reform legislation and the advent of capital gains taxation. Provisions pertaining to corporate amalgamations, however, were introduced in 1958, and certain rules governing the taxation of distributions by a corporation on liquidation existed as early as 1924. Much of the struggle in the early years following tax reform was caused by the need to make the transition from a regime in which capital gains were not taxed to one in which they were, and by the government’s various attempts to prevent what it perceived as the abusive stripping of various types of corporate surplus. Once many of the latter rules were eliminated in the late 1970s, the regime became much more manageable.

This article provides a general overview of the rules governing the federal income taxation of corporate reorganizations in Canada. The following types of corporate reorganization are examined in separate sections of the article: amalgamations, liquidations, divisive reorganizations, transfers of property to a corporation, share-for-share exchanges, and internal capital reorganizations. Each section begins with an overview of the current rules governing the taxation of the particular type of corporate reorganization, then outlines the historical development of the rules, presents a brief assessment of any existing deficiencies, and suggests how these might be remedied in the future.

**AMALGAMATIONS**

**Introduction**

The rules governing the taxation of an amalgamation of two or more taxable Canadian corporations are contained principally in section 87 of the Act. In general terms, these rules provide that a qualifying amalgamation may be achieved on a tax-free basis, both from the perspective of the amalgamating corporations, which are referred to in the Act as the “predecessor corporations,” and from the perspective of the shareholders and other stakeholders of the predecessor corporations.

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5 Continued . . .


6 For other provisions in the Act that are relevant to an amalgamation, see, for example, subsection 7(1.5); section 53; subsections 69(13), 80(2), 80.03(1), and 80.03(3); paragraph 88(1)(e.2); subsection 88(4); subsection 89(1), the definition of “Canadian corporation”; paragraph 95(2)(d); subsection 112(7); section 128.2; section 134; subsection 251(3.1); and subsection 256(7).
Subsection 87(1) sets out the requirements to be met in order for a merger of two or more corporations to qualify as an amalgamation governed by section 87. Subsection 87(2) deems the amalgamated corporation to be a new corporation for purposes of the Act and includes a number of rules that are designed principally to flow through to the amalgamated corporation the tax attributes and accounts of the predecessor corporations. Subsections 87(3) and (3.1) deal with the calculation of the paid-up capital of the shares of the amalgamated corporation, and subsections 87(4) through (7) generally provide rollover treatment for the shareholders and other stakeholders of the predecessor corporations. Subsections 87(8) and (8.1) provide limited rules governing foreign mergers, and subsection 87(9) sets out rules governing so-called triangular amalgamations.

History
Specific rules governing the taxation of amalgamations were first introduced in 1958. Before 1972, the rules were contained in section 85 I of the Act. These rules were introduced to deal with uncertainties surrounding the taxation of an increasing number of corporate mergers taking place under relatively new provincial company law that permitted the amalgamation of two or more corporations governed by the same legislation.

The original rules were contained in just four subsections of section 85I.

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These requirements are as follows: (1) each predecessor corporation must be a “taxable Canadian corporation” as defined in subsection 89(1); (2) all property of the predecessor corporations immediately before the amalgamation (other than amounts receivable from any predecessor corporation or shares of the capital stock of any predecessor corporation) must become property of the amalgamated corporation by virtue of the amalgamation; (3) all liabilities of the predecessor corporations immediately before the amalgamation (other than amounts payable to any predecessor corporation) must become liabilities of the amalgamated corporation by virtue of the amalgamation; and (4) all persons who were shareholders of the predecessor corporations (other than any predecessor corporation) who owned shares of a predecessor corporation must receive shares of the amalgamated corporation by virtue of the amalgamation.

In The Queen v. Guaranty Properties Limited et al., 90 DTC 6363; [1990] 2 CTC 94, the Federal Court of Appeal addressed the issue whether paragraph 87(2)(a) of the Act deems an amalgamated corporation to be a new corporation for all purposes of the Act or just for some purposes. The court concluded that the deeming provision does not cause the predecessor corporations to come to an end; instead, the corporations continue in the form of the amalgamated corporation. Moreover, the court suggested that the amalgamated corporation should be considered a “new" taxpayer only for purposes of establishing year-ends. In the more recent case of The Queen v. Pan Ocean Oil Ltd., 94 DTC 6412; [1994] 2 CTC 143; rev’g. 93 DTC 5330; [1993] 2 CTC 236 (FCTD), however, the same court limited the application of the Guaranty Properties decision by finding that the decision had not established a rule of general application but had found that the deeming provision operated to cause the amalgamated corporation to be a new corporation for purposes of the provisions related to the computation of income.

SC 1958, c. 32, section 35.

At the time section 85I was introduced, the corporation statutes of Manitoba, New Brunswick, Newfoundland, Ontario, and Quebec contained a statutory amalgamation provision. The federal Companies Act, RSC 1952, c. 53, did not provide for amalgamations.
Subsection 85I(1) defined the term "amalgamation" for purposes of section 85I in essentially the same manner as that term is defined today in subsection 87(1). One notable difference was that a qualifying amalgamation was not restricted to the amalgamation of taxable Canadian corporations. Thus, a merger of companies governed by a foreign statute could qualify as an amalgamation. The postamble that appears today in subsection 87(1) was contained in the original provision and was designed to clearly distinguish a corporate merger achieved under the amalgamation provisions of various corporate statutes from other business combinations that might constitute a merger in a more general commercial sense (for example, the situation where one corporation acquired all of the assets of another corporation in exchange for shares, which were then distributed to the shareholders of the transferor corporation on its subsequent liquidation).

Subsection 85I(2) was analogous to today’s subsection 87(2), although it was much shorter, containing only 12 paragraphs. Paragraph 85I(2)(a), which is identical to today’s paragraph 87(2)(a), deemed the corporate entity formed as a result of the amalgamation to be a new corporation for purposes of the Act. At the time, certain of the provincial statutes providing for amalgamations provided that a new corporation was created on amalgamation; other provincial statutes provided that the amalgamated entity was simply a continuation of the amalgamating corporations. It appears that paragraph 85I(2)(a) was included to ensure that the tax consequences of a qualifying amalgamation would not be affected by these differences in treatment under provincial corporate law.

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11 For an amalgamation to have been governed by section 85I, all property and liabilities of the predecessor corporations immediately before the amalgamation must have become property and liabilities of the amalgamated corporation and all shareholders of the predecessor corporations (other than any predecessor corporation) must have become shareholders of the amalgamated corporation by virtue of the amalgamation. The parenthetical exceptions relating to liabilities and receivables between predecessor corporations were added by SC 1974-75-76, c. 26, section 51(1), applicable to amalgamations occurring after 1971.

12 Section 85I referred to a merger of “corporations.” A qualifying amalgamation under the 1971 tax reform legislation was restricted to the amalgamation of “Canadian corporations.” The requirement that the amalgamating corporations be “taxable Canadian corporations” was added by SC 1979, c. 5, section 28(1), applicable to amalgamations occurring after November 16, 1978.

13 See Allendale Mutual Insurance Co. v. The Queen, 73 DTC 5382; [1973] CTC 494 (FCTD). In this case, the predecessor corporations were incorporated and amalgamated under a special act of the legislature of the state of Rhode Island. The Federal Court concluded that the arrangement was nevertheless an amalgamation within the meaning of the Act.

14 The last paragraph in the 1952 Act was paragraph 85I(2)(l). Today, subsection 87(2) stretches to paragraph (uu).

15 For example, the corporate statutes of Quebec and Manitoba provided that the amalgamating corporations ceased to exist upon amalgamation and that a new corporate entity was created, while the Ontario corporations statute provided that a new corporation was not created.
The general purpose of the remaining paragraphs in subsection 85(2) was to flow through to the amalgamated corporation certain tax attributes of the predecessor corporations, such as the cost of inventory and depreciable property, as well as the ability to claim certain reserves, such as bad debt reserves. One important limitation, which is not present today, was that business losses of a predecessor corporation could not be carried forward and deducted by the amalgamated corporation.\(^{16}\) Indeed, losses of a predecessor corporation were not available for deduction by an amalgamated corporation until the introduction of subsection 87(2.1), applicable to amalgamations and mergers occurring after March 31, 1977.\(^{17}\)

Subsection 85(3) permitted an amalgamated corporation to deduct certain exploration, prospecting, and development expenses incurred by a predecessor corporation. Subsection 85(4) provided rules for calculating the undistributed income on hand of an amalgamated corporation.

Section 85 remained essentially unchanged until the 1971 tax reform, although there was a fair bit of tinkering with subsection 85(2) (as there still is today) as new tax attributes and accounts were introduced or brought to the attention of those responsible for drafting section 85.

Section 85 was renumbered as section 87 under the 1971 tax reform legislation. The essential intent of the regime, as evidenced by subsections 87(1) and (2), remained the same, although many new paragraphs were added to subsection 87(2) to accommodate various tax attributes and accounts introduced by tax reform.\(^{18}\)

The introduction of capital gains taxation required new rules to govern the treatment afforded shareholders of a predecessor corporation on an amalgamation. Paragraph 54(c) deemed a shareholder of a predecessor corporation to have disposed of shares when they were converted as a result of an amalgamation, but subsection 87(4) provided rollover treatment if certain conditions were met. The conditions initially introduced were more onerous than those currently contained in subsection 87(4). In the case of a preferred shareholder of a predecessor corporation, a rollover was available only where the shareholder received no consideration for the shareholder’s preferred shares other than preferred shares of the amalgamated corporation having substantially the same rights and conditions (other than voting rights) as the preferred shares disposed of. In the case of a common shareholder of a predecessor corporation, a rollover was available only where

1) no common shareholder of the predecessor corporation received consideration for the disposition of the shareholder’s common shares of the predecessor corporation other than shares of the amalgamated corporation; and

\(^{16}\) Paragraph 85(2)(i).

\(^{17}\) SC 1977-78, c. 1, section 42(6).

\(^{18}\) SC 1970-71-72, c. 63, subsection 87(2).
2) either
   a) the common shareholders of the predecessor corporation in the aggregate received at least 25 percent of the shares of each particular class of common shares of the amalgamated corporation; or
   b) in the case of a shareholder who owned common shares in more than one predecessor corporation, the shareholder received at least 80 percent of the shares of each particular class of common shares of the amalgamated corporation.  

These restrictions on the availability of the rollover were significantly relaxed in respect of amalgamations occurring after May 6, 1974. Since that time, rollover treatment has generally been available in respect of any qualifying amalgamation where a shareholder receives only shares of the amalgamated corporation in exchange for the shareholder’s shares of the predecessor corporation. Amendments were also made at that time to provide rollover treatment to option and debt holders of a predecessor corporation who receive options or debt obligations, as the case may be, of the amalgamated corporation on an amalgamation.

Subsection 87(1.1) was added, applicable to mergers occurring after December 14, 1975, to make section 87 applicable to short-form vertical or horizontal amalgamations.

As noted above, subsection 87(2.1) was added with respect to mergers and amalgamations occurring after March 31, 1977 to provide for the carryforward of non-capital and net capital losses of a predecessor corporation to an amalgamated corporation. Subsection 87(2.11) was added, applicable to vertical amalgamations occurring after 1989, to enable losses of an amalgamated corporation to be carried back and deducted against the income of the predecessor parent corporation for a taxation year preceding the amalgamation.

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19 Provided also that no common shareholder of the other predecessor corporations received any consideration other than shares of the amalgamated corporation.

20 SC 1974-75-76, c. 26, section 51(12).

21 In this situation, the rollover is available to a shareholder who, immediately before the amalgamation, owned shares of the capital stock of a predecessor corporation that were capital property. The deemed benefit rules of subsection 87(4) were introduced by SC 1980-81-82-83, c. 48, section 47(4), applicable to amalgamations occurring after December 11, 1979. Revenue Canada generally will not deny the rollover provided in subsection 87(4) merely because the shareholder is required to receive cash or other consideration in lieu of a fraction of a share of the new corporation: see Interpretation Bulletin IT-474R, “Amalgamations of Canadian Corporations,” March 14, 1986.

22 Subsections 87(5) to (7), introduced by SC 1974-75-76, c. 2, section 51(12), applicable to amalgamations occurring after May 6, 1974.

23 SC 1977-78, c. 1, section 42(1).

24 Subsection 87(2.11) treats the corporation resulting from an amalgamation of a corporation and one or more of its wholly owned subsidiary corporations as the same corporation as, and a continuation of, the former parent corporation, for purposes of section (The footnote is continued on the next page.)
Most of the other amendments to section 87 have been in the form of further tinkering with subsection 87(2), again to accommodate revisions to the Act affecting corporate tax attributes and accounts.

Current Issues

The existing provisions of section 87 governing amalgamations are quite effective. They generally provide rollover treatment for both the predecessor corporations and their respective shareholders. Indeed, the rules go beyond the objective of our first criterion described above, in that rollover treatment is available even where the amalgamation has the effect of changing the economic ownership of underlying assets. It may fairly be questioned why statutory amalgamations receive preferential treatment relative to, say, a merger involving a transfer of assets from one corporation to another for shares and a subsequent liquidation of the transferor corporation. This concern may, however, be largely of academic

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24 Continued . . .

111 and part IV of the Act. The April 26, 1995 proposed technical amendments add section 126 (foreign tax audits), subsections 127(5) through (12.3) (investment tax credits), subsections 181.1(4) through (7) (deduction of unused surtax against part I.3 tax), and subsections 190.1(3) through (6) (deduction of unused part I tax against part VI tax) to the list of purposes for which the new corporation will be treated as the same corporation as, and a continuation of, the former parent company. This amendment applies to amalgamations occurring after April 26, 1995. See Canada, Department of Finance, Draft Amendments to the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Children’s Special Allowances Act, the Customs Act, the Old Age Security Act, the Unemployment Insurance Act and a Related Act, April 26, 1995.

25 The version of section 87 introduced by the 1971 tax reform did not permit a rollover where the amalgamation had the effect of significantly changing the economic ownership of the underlying assets. See the text above accompanying footnote 19.

Section 256(7) of the Act describes the circumstances where control of a corporation is considered not to have been acquired, and certain circumstances where control of a corporation is considered to have been acquired, for the purposes of various provisions of the Act. Where there has been a merger of two or more corporations to form a new corporation, existing paragraph 256(7)(b) deems control of a predecessor to have been acquired for purposes of a number of provisions in the Act if the person or group of persons who control the new corporation did not control the predecessor corporation immediately before the amalgamation. The April 26, 1995 technical amendments propose to amend this paragraph for mergers occurring after April 26, 1995 (except in certain specific circumstances) to provide that control of a corporation is considered not to have been acquired solely because of a merger unless it is deemed by subparagraph 256(7)(b)(ii) to have been acquired. The amended subparagraph will deem control of a predecessor corporation and of each corporation controlled by it before the merger to have been acquired by a person or group of persons unless (1) the predecessor corporation was related, immediately before the merger, to each other predecessor corporation; or (2) if all the shares of the new corporation received by shareholders of the predecessor corporation on the merger in consideration for their shares of the predecessor corporation were acquired immediately after the merger by one person, that person would have acquired control of the new corporation.

26 The postamble of subsection 87(1) excludes from the application of section 87 a merger of two or more corporations as a result of the acquisition of property of one (The footnote is continued on the next page.)
interest, since the commercial and other tax costs of effecting a merger by way of amalgamation are usually much less than those related to a transfer of assets followed by a liquidation. Thus, there is likely no compelling commercial reason for the Act to accommodate such a merger on a tax-free basis.27

The amalgamation rules are, for the most part, quite simple and reasonably clear. Although it may seem, at first blush, rather odd to deem an amalgamated corporation to be a new corporation and then to proceed, for a myriad of purposes under the Act, to deem the amalgamated corporation to be the same corporation as, and a continuation of, each predecessor corporation, this approach can perhaps be more readily understood when put in historical context, as we have attempted to do. More important, aside from the occasional technical flaw, which, when brought to the attention of the legislators, typically is remedied, the approach is workable and practitioners have become accustomed to it. Thus, it is probably best to leave this regime essentially intact.

Recent initiatives to draw a closer parallel between the consequences resulting from a vertical amalgamation and those flowing from the liquidation of a wholly owned subsidiary are to be commended and are likely to be continued.28 Indeed, it is understood that the Department of Finance is prepared to recommend an amendment to section 87 to enable a parent corporation to increase the cost of assets acquired on a vertical amalgamation in a manner similar to that which is provided under paragraph 88(1)(d) in respect of a liquidation. If such a change were to be made, we would likely see more business acquisitions structured as an amalgamation rather than a purchase of shares followed by a liquidation. This would be a useful development in view of the commercial difficulties often associated with winding up an acquired corporation.

LIQUIDATIONS

Introduction
The principal tax rules that apply on the liquidation or winding up of a corporation are found in section 88 of the Act and, as a practical manner,

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26 Continued . . . corporation by another corporation, pursuant to the purchase of that property by the other corporation or as a result of the distribution of that property to the other corporation upon the winding up of the corporation. A merger involving a transfer of assets from one corporation to another for shares and a subsequent liquidation of the transferor in respect of which a rollover provision under the Act is unavailable may result in a corporate structure that is identical to that which would result from an amalgamation to which section 87 is applicable. The tax consequences are, however, significantly different.

27 At the time the amalgamation provisions were introduced into the Act, the relevant corporate statutes did not provide for continuance in or out of the jurisdiction. Thus, the usefulness of the amalgamation provisions was restricted. Today, however, most corporate statutes provide for continuance.

28 See, for example, subsection 87(2.11), briefly discussed in footnote 24, supra, and the accompanying text.
mainly in subsection 88(1). The latter provision governs the tax consequences where a wholly owned subsidiary that is a taxable Canadian corporation is liquidated into a parent corporation that also is a taxable Canadian corporation. Liquidations that do not come within the ambit of subsection 88(1) often result in the realization of tax at both the corporate and the shareholder levels and, for this reason, are much less common. Accordingly, the discussion in this article is largely limited to a review of the provisions in subsection 88(1) governing the liquidation of a wholly owned subsidiary.

In general terms, paragraph 88(1)(a) deems the subsidiary to have disposed of its assets distributed on the liquidation for proceeds of disposition equal to the cost amount to the subsidiary of the assets. Thus, a rollover is achieved at the subsidiary level. Paragraph 88(1)(b) generally provides for a tax-free disposition by the parent of its shares of the subsidiary, although a capital gain may be triggered in the unusual event that the lesser of the paid-up capital of the shares and the aggregate cost amount of the net assets of the subsidiary exceeds the adjusted cost base to the parent of its shares in the subsidiary. Paragraph 88(1)(c) generally deems the parent to have acquired the subsidiary’s assets at a cost equal to the cost amount to the subsidiary of the assets but also enables the parent to increase the cost to it of capital property (other than ineligible property) owned by the subsidiary at the time the parent last acquired control of the subsidiary, generally to the fair market value of the property at that time. Paragraph 88(1)(d.1) provides that the deemed dividend rules in

29 See also subsections 53(4), 69(5), 69(13), and 80(12); sections 80.01 and 80.03; subsection 84(2); paragraph 87(2)(t); subsection 89(3); section 95; subsections 98(5) and 111(5.4); section 134; subsection 137(4.3); section 142.6; subsection 186(5); and subsections 256(7) through (9).

30 Although subsection 88(1) is applicable in cases where not less than 90 percent of the issued shares of each class of the capital stock of the subsidiary corporation were, immediately before the winding up, owned by the parent, it has practical application only when 100 percent of the issued shares are owned by the parent.


32 This treatment is available for each property of the subsidiary corporation (other than an interest in a partnership) that was distributed to the parent on the winding up. Any partnership interest owned by the subsidiary is deemed not to have been disposed of by the subsidiary, except for purposes of paragraph 98(5)(g).

33 If the application of paragraph 88(1)(b) will result in a capital gain, such a result can generally be avoided by reducing the corporation’s paid-up capital before the windup. For purposes of this article, the expression “aggregate cost amount of the net assets of the subsidiary” refers to the sum of the aggregate cost amount of the subsidiary’s assets and the amount of money of the subsidiary on hand, less the amount of debt of the subsidiary.

34 And thereafter without interruption until it was distributed by the subsidiary to the parent on the winding up.

35 See paragraph 88(1)(d).
subsection 84(2) do not apply to the liquidation.\footnote{Under subsection 84(2), where a corporation resident in Canada has distributed property to shareholders of a class on the winding up of its business, the corporation is deemed to have paid, and the shareholders are deemed to have received, a dividend equal to the difference between the fair market value of the property distributed and the amount by which the paid-up capital of the class of shares has been reduced by virtue of the distribution.}

Paragraphs 88(1)(e.1) through (i) generally provide for the flowthrough of various tax attributes and accounts of the subsidiary to the parent. Finally, subsections 88(1.1) and (1.2) provide for the flowthrough to the parent of the subsidiary's non-capital and net capital loss carryforwards.

**History**

Subsection 88(1) was introduced into the Act at the time of the 1971 tax reform. Its first incarnation was relatively simple, containing only six paragraphs in one section. Most of the basic principles that exist today appeared in the original version: the disposition by the subsidiary of its assets at cost amount and the acquisition by the parent of such assets at a cost equal to the same amount (subject to the ability of the parent to increase the cost of non-depreciable capital property to fair market value); and the disposition by the parent of its shares in the subsidiary for proceeds generally equal to the adjusted cost base of the shares.\footnote{Similar to the situation that exists today, the parent could realize a capital gain on the disposition of the subsidiary's shares if its adjusted cost base in the shares were less than the lesser of the cost amount of the net assets of the subsidiary and its paid-up capital limit.} The original version also provided that the subsidiary was deemed to have paid a dividend to the parent equal to the difference between the cost amount of its net assets and its paid-up capital limit.\footnote{This provision appeared as paragraph 88(e) in the 1971 tax reform legislation; was renumbered as paragraph 88(1)(e) by SC 1973-74, c. 14, section 27(1); and was eventually repealed by SC 1977-78, c. 1, section 43(8), applicable to corporate windups commencing after March 31, 1977.} Generally, however, this dividend would be received by the parent on a tax-free basis. An important omission from the original section 88, however, was the ability to flow through tax accounts, such as reserves, from the subsidiary to the parent, similar to the way in which such accounts flowed through to an amalgamated corporation following a vertical amalgamation. This omission was later remedied, effective for windups after May 6, 1974.\footnote{See, for example, paragraph 88(1)(e.1) as originally added by SC 1974-75-76, c. 26, section 52(4).}

In general terms, the approach adopted was to incorporate by reference many of the provisions in section 87 that provide for a flowthrough of tax attributes and accounts on an amalgamation.\footnote{See paragraph 88(1)(e.2) as originally introduced by SC 1974-75-76, c. 26, section 52(4), applicable to windups ending after May 6, 1974.}

The original version of section 88 also did not provide for a flowthrough to the parent of losses incurred by the subsidiary. In this regard, this...
omission was consistent with the rules at the time relating to amalgamations. Effective for windups commencing after March 31, 1977, however, subsections 88(1.1) and (1.2) were added to provide for the flowthrough to the parent of non-capital losses and net capital losses incurred by the subsidiary.41

Although the conceptual framework of subsection 88(1) is generally quite straightforward, the rules in paragraphs 88(1)(c) and (d) relating to the ability of the parent to increase the cost to it of certain capital property of the subsidiary are among the more complicated in the Act. It may therefore be helpful to trace their development.

Initially, these rules were drafted in a simpler form. In general terms, the parent was entitled to increase the cost of non-depreciable capital property by the difference between its adjusted cost base in the subsidiary’s shares and the cost amount of the subsidiary’s net assets.42 The intention was that the parent should be compensated, in part, for tax basis that would be lost as a result of the liquidation.43 A minor amendment was made, effective for windups after May 6, 1974, to increase the “bump” potential by the amount of certain reserves deducted by the subsidiary in computing its income for the year of the windup.44 A perceived opportunity for abuse was shut down, effective for windups after March 31,
1977, when paragraph 88(1)(d) was amended to restrict the property eligible for the bump to property owned at the time the parent last acquired control of the subsidiary.\textsuperscript{45} Before this change was made, a parent could transfer non-depreciable capital property with a latent gain to the subsidiary on a rollover basis and later bump the tax basis of the property on a subsequent liquidation of the subsidiary.

Effective for windups commencing after November 16, 1978, the Act was amended to reduce the bump amount by the amount of certain dividends received from the subsidiary by the parent or by corporations with which the parent did not deal at arm’s length.\textsuperscript{46} Before this change was made, the payment by the subsidiary of tax-free dividends to the parent would reduce the cost amount of the subsidiary’s net assets without reducing the adjusted cost base to the parent of its shares in the subsidiary and would therefore increase the bump potential. Effective for distributions occurring after June 28, 1982, the Act was amended to exclude the ability to bump property acquired by the subsidiary in the course of a butterfly reorganization.\textsuperscript{47} Effective for windups beginning after February 21, 1994, further additions were made to the definition of property ineligible for the bump, principally consequential to amendments to the provisions governing butterfly reorganizations.\textsuperscript{48}

**Current Issues**

Like the amalgamation rules, the rules governing the liquidation of a wholly owned subsidiary are quite effective. They generally provide rollover treatment for both the parent and the subsidiary in a manner that is relatively straightforward, and the tax consequences of liquidating a wholly owned subsidiary are reasonably clear. Although, as noted above, the drafting in paragraphs 88(1)(c) and (d) is exceedingly complicated, for the most part the complexity is found in those parts of the provisions that are designed to prevent misuses. In other words, if taxpayers do not try anything fancy, the regime is quite straightforward.

The bump provisions may result in what may be considered lack of neutrality in the context of a corporate takeover. In a corporate takeover, an acquiror corporation may often wish to sell one or more business units of the target corporation. If these units are in separate subsidiary corporations, the acquiror may achieve its objective in a tax-efficient manner by

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\textsuperscript{45} Paragraph 88(1)(c) was amended in this regard by SC 1977-78, c. 1, section 43(3), applicable to corporate windups commencing after March 31, 1977.

Subsection 88(4), which applies to deem control of a corporation not to have been acquired by virtue of an amalgamation, was introduced into the Act by SC 1977-78, c. 1, section 43(12), applicable to corporate windups commencing after March 31, 1977. The exception relating to triangular amalgamations was added by SC 1979, c. 5, section 29(6), applicable to corporate windups commencing after November 16, 1978.

\textsuperscript{46} SC 1979 c. 5, section 29.

\textsuperscript{47} SC 1980-81-82-83, c. 140, section 53(1).

\textsuperscript{48} SC 1995, c. 3, section 24(3).
liquidating the target corporation following the acquisition and bumping
the tax basis of the shares of the subsidiaries to be sold to fair market
value. The subsidiaries can then be sold without triggering any tax liabil-
ty under the Act. If, however, the unwanted business units are carried on
in divisions of the parent corporation, an undesirable acquirer may be
disadvantaged relative to, say, a white knight. Without the cooperation of
the target, the undesirable acquirer will generally not be able to dispose
of those units without triggering tax. The target may, however, undertake
to the white knight to incorporate the unwanted units before completion
of the white knight’s bid, so that the white knight can sell the units on a
tax-efficient basis after winding up the target. This arrangement may en-
able the white knight to make a better offer for the shares of the target,
thereby introducing an unfair bias against the other potential acquirer.

The bump rules can similarly operate as a form of poison pill in the
context of a takeover bid. If the target corporation owns a business unit in
subsidiary form which it believes an unfriendly suitor may wish to sell,
the target can cause the tax-free liquidation of the subsidiary as a means
of making itself less desirable to that potential acquirer.

The application of the current tax rules in both of these situations can
interfere with and distort the normal functioning of the marketplace. Per-
haps some modification of the rules is desirable—for example, to enable
an acquirer to incorporate divisions shortly after an acquisition and still
qualify for the bump.

DIVISIVE REORGANIZATIONS

Introduction

The rules providing for the tax-deferred distribution of corporate assets
among corporate shareholders in a divisive reorganization are contained
in paragraphs 55(3)(a) and (b) of the Act. Somewhat curiously, these
rules are exceptions to the specific anti-avoidance rule, contained in sub-
section 55(2), preventing in prescribed circumstances the realization of
an economic gain on shares in the form of a tax-free intercorporate divi-
dend. The rule in paragraph 55(3)(a) is quite restrictive in that it permits
a tax-free divisive reorganization only where all relevant parties are re-
lated to each other. The rule in paragraph 55(3)(b), applicable to what is
generally referred to as the “butterfly” reorganization, permits in pre-
scribed circumstances the pro rata distribution of each type of property of
a corporation to its corporate shareholders.

We do not propose to review in any detail the mechanics of imple-
menting a butterfly reorganization, since these are generally well known
to practitioners and are discussed extensively elsewhere. Instead, we

49 See, for example, Robert J. Dart and Howard J. Kellough, “The Butterfly Reorgani-
ization: A Descriptive Analysis,” in Report of Proceedings of the Forty-First Tax Conference,
1989 Conference Report (Toronto: Canadian Tax Foundation, 1990), 20:2-32; Robert J.
(The footnote is continued on the next page.)
will provide an overview of the historical development of the butterfly rules and comment briefly on the current issues related to them.

History
The first description of a so-called butterfly reorganization in a public forum appeared in a paper presented to the 1977 annual conference of the Canadian Tax Foundation. In very simple terms, the paper described how an Opco could distribute one of its two businesses to one of its shareholders, Mr. X, on a tax-free basis. Mr. X would incorporate X Holdco, to which he would transfer his shares of Opco on a tax-free basis under subsection 85(1). Opco would incorporate X Co, to which it would transfer one of its businesses on a tax-free basis under subsection 85(1) in exchange for preferred shares. X Holdco would subscribe for common shares of X Co, which would use the share proceeds to redeem the preferred shares held by Opco. Opco would use the cash to purchase for cancellation its shares held by Holdco. These transactions could be structured so that the share redemption and cancellation would result in the tax-free receipt of dividends by X Holdco and Opco.

Not surprisingly, Revenue Canada soon became concerned that this mechanism could be used to effect a tax-free sale of assets. The department developed guidelines identifying those transactions that would be acceptable in this regard and suggested that it might apply the anti-avoidance provisions in subsections 247(1) and 55(1) to prevent unacceptable transactions. The Department of Finance, however, was concerned that the existing anti-avoidance provisions were not adequate to prevent butterflies that Revenue Canada might perceive to be abusive. Thus, the Act was amended in 1981 to add a new anti-avoidance rule in subsection 55(2). In general terms, this provision could apply to recharacterize the dividends received by X Holdco and Opco in the example above as taxable capital gains. The amendments also included exceptions to the application of subsection 55(2) in paragraphs 55(3)(a) and (b).

The butterfly exception provided that the anti-avoidance provision in subsection 55(2) would not apply to recharacterize as capital gains dividends received in the course of a reorganization in which property of a corporation was distributed to one or more corporate shareholders of the corporation, provided that each type of property was distributed pro rata to its shareholders. A further amendment was made in 1982 to make it

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49 Continued . . .

clear that, with one limited exception, the butterfly was not available where there had been any change in the shareholdings in the distributing corporation during the series of transactions that included the reorganization. Thus, the so-called purchase butterfly was prohibited.

In 1984, however, further amendments were introduced which significantly expanded the butterfly exemption by permitting so-called purchase butterflies. Following these amendments, Revenue Canada developed a series of guidelines to assist taxpayers in complying with the rules. For example, Revenue Canada took the position that, for purposes of the exemption, there exist three types of property: cash, business assets, and investment property. Similarly, Revenue Canada introduced the so-called consolidated lookthrough approach, which enables a corporation that holds shares of a subsidiary to look through to the underlying assets of the subsidiary in determining its types of property. Thus, under this approach, the corporation does not treat the shares of the subsidiary as investment property.

The 1984 amendments resulted in a significant increase in the number and size of asset acquisitions that were structured as butterfly reorganizations. Although tax generally was payable at the shareholder level, it was avoided at the corporate level. Revenue Canada became concerned about the potential for serious erosion of its revenue base. In particular, it was concerned about the use of the purchase butterfly by non-resident shareholders to effect an asset sale, since the non-resident shareholder was often exempt from tax by virtue of a treaty exemption. The Department of Finance responded to this concern with technical amendments designed to curtail cross-border butterflies. Finally, the Department of Finance introduced wholesale changes to the butterfly rules in 1994, the principal effects of which were to outlaw purchase butterflies and so-called partial butterflies where property of one type is distributed to shareholders.

**Current Issues**

From the start, the butterfly rules were among the more complicated rules in the corporate reorganization area, not so much for what they provided, but for what they did not provide. As a result, Revenue Canada retained so much administrative discretion that it was generally felt imprudent to

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52 See subsection 55(3.1), which was added by SC 1994, c. 21, section 24(1), applicable to dividends received after May 4, 1993, other than a dividend received as part of a series of transactions or events in which a foreign vendor was obliged on May 4, 1993 to dispose of property described in paragraph 55(3.1)(a) under a written agreement entered into before May 5, 1993.

undertake a butterfly reorganization of any significant size without an advance income tax ruling. After a number of years, however, the department’s guidelines became fairly widely known and, for the most part, manageable, although issues relating to the characterization of types of property often were problematic. Now the new butterfly provisions are probably among the most difficult in the Act. Although we will likely see fewer butterfly reorganizations in the light of the new prohibition against purchase butterflies, the rules do continue to permit an internal divisive reorganization of a corporation. Given that the rules are generally limited to this type of reorganization, it is hoped that Revenue Canada, or perhaps the Department of Finance, might see fit to relax somewhat the rules on characterizing types of property.

SHARE-FOR-SHARE EXCHANGES

Introduction

Subsection 85.1(1) provides a tax-deferred rollover where a shareholder (referred to as “the vendor”) sells shares of a taxable Canadian corporation that are capital property of the vendor to another Canadian corporation (referred to as “the purchaser”) in exchange for shares of the purchaser. The rollover is available only where the vendor and purchaser deal at arm’s length; the vendor does not control or own shares of the purchaser having a fair market value greater than 50 percent of the fair market value of the outstanding shares of the purchaser after the exchange; and the vendor receives no consideration for the exchanged shares other than shares of the purchaser. Furthermore, subsection 85.1(1) does not apply where the vendor and purchaser have made an election under subsection 85(1) of the Act.54

From the vendor’s perspective, where the conditions for the application of subsection 85.1(1) are satisfied, the rollover applies automatically unless the vendor includes a portion of the gain or loss on the disposition of the exchanged shares in the vendor’s tax return for the year of disposition. Where subsection 85.1(1) applies, the vendor is deemed to have disposed of the exchanged shares for proceeds of disposition equal to the adjusted cost base to the vendor of the shares and to have acquired the shares in the purchaser for a cost equal to the same amount.55 The cost of the shares acquired by the purchaser corporation is deemed to be the lesser of the fair market value of the shares and their paid-up capital.56 Where the conditions of subsection 85.1(1) apply, this latter rule applies whether or not the vendor has reported any gain or loss on the shares.

Subsection 85.1(2.1) applies to limit the addition to the paid-up capital of the purchaser corporation on the issue of its shares in the exchange to the amount of the paid-up capital of the shares acquired. Subsections

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54 See subsection 85.1(2).
55 See paragraph 85.1(1)(a).
56 See paragraph 85.1(1)(b).
85.1(3) and (4) provide limited rules governing the disposition of the shares of a foreign affiliate of a taxpayer to another foreign affiliate of the same taxpayer.

History
Section 85.1 was added to the Act in 1976 and was generally made applicable to transactions occurring after May 6, 1974. Before the introduction of section 85.1, a sale of shares in exchange for shares constituted a taxable transaction unless the transaction satisfied the requirements of section 85 and the parties elected to rely upon that provision. Section 85.1 was introduced to provide a rollover on a share-for-share exchange in the context of a public company takeover, where it would be impractical for public shareholders of the target company to execute a section 85 election with the acquiring corporation.

The original conditions for the application of section 85.1 were essentially the same as those that exist today. One notable exception is that the provision was originally applicable in respect of share-for-share exchanges involving any target corporation. Effective for exchanges of shares occurring after December 20, 1991, however, the section was amended to apply only to share-for-share exchanges involving target corporations that are taxable Canadian corporations.

Where subsection 85.1(1) applies, the consequences to the vendor have been the same since the introduction of the provision. From the perspective of the purchaser, however, the rule determining cost to the purchaser of the exchanged shares changed significantly with respect to share exchanges after February 17, 1987. Originally, the rule provided that the cost to the purchaser of the exchanged shares was the fair market value of the exchanged shares immediately before the exchange if, at any time after the exchange, the purchaser owned shares of the acquired corporation having a fair market value of at least 10 percent of the fair market value of all the attributable shares of the acquired corporation and entitling the holder to at least 10 percent of the votes outstanding to all shares of the acquired corporation. If the 10 percent votes and value test was not met, the purchaser’s cost of the exchanged shares was deemed to be nil.

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57 Subsection 85.1(3) dealing with the disposition of shares of a foreign affiliate was made applicable to the 1972 and following taxation years.

58 The 1974 budgets (May 6, 1974 and November 18, 1974) introduced a number of provisions intended to address the impediments to business reorganizations that capital gains were perceived to cause. As discussed elsewhere in this article, the 1974 budgets removed the 80 percent share restriction on the rollover provided under section 85 and the 25 percent test under section 87. These changes were explicitly intended to recognize that most reorganizations were business-motivated and were essential to the maintenance of a vital and efficient business community.

59 With respect to exchanges occurring before April 1, 1977, the exclusion in subparagraph 85.1(2)(b)(ii) referred to ownership by the vendor of shares of the purchaser representing more than 50 percent of the paid-up capital of the purchaser’s shares, as opposed to shares having a fair market value of more than 50 percent of the fair market value of all the purchaser’s shares.
The February 18, 1987 budget changed the rule to its present form, deeming the purchaser’s cost to be the lesser of the fair market value and the paid-up capital of the exchanged shares immediately before the exchange.

Current Issues
The addition of section 85.1 has undoubtedly facilitated takeovers of Canadian public corporations by other Canadian companies. Nevertheless, there are a number of aspects of section 85.1 that, we believe, warrant further consideration by our policy makers. First, it is unclear why the application of the provision should be excluded where the vendor receives non-share consideration for the exchanged shares.60 Where a purchaser corporation wishes to make a bid combining cash and share consideration, it is necessary in the bid documentation to state specifically what percentage of a vendor’s shares are to be exchanged for share consideration and what percentage for cash consideration. This approach has been accepted by Revenue Canada as not disqualifying application of the provision.61 This approach is unduly cumbersome, however, and often results in confusion in the minds of vendor shareholders. The situation can become exceedingly complex when the offeror wishes to provide vendors with the discretion to choose any combination of cash and share consideration, perhaps subject to certain limits on the total amount of cash that will be paid or the number of shares that will be issued to all vendor shareholders. It might well be appropriate to amend the provision to eliminate this confusion by affording vendors the flexibility, similar to that afforded under subsection 85(1), to receive non-share consideration for all of their transferred shares up to the adjusted cost base of the transferred shares and still to enjoy full rollover treatment. This would also enable vendors to receive on a rollover basis cash equal to their entire tax basis in the exchanged shares. Under today’s rules, in a combination share-cash bid, a vendor will trigger a capital gain on those shares exchanged for cash, even though the entire cash proceeds received may be less than the aggregate tax basis to the vendor of all of the vendor’s exchanged shares.62

The provision in paragraph 85.1(1)(b) limiting the purchaser’s cost of the exchanged shares to the lesser of their fair market value and their paid-up capital immediately before the exchange is unduly onerous where the vendor has reported a gain on the sale of the exchanged shares. Where the vendor has reported a gain based on proceeds of disposition equal to the fair market value of the exchanged shares, the purchaser should probably be entitled to obtain a cost in the exchanged shares equal to the same amount. Although at first blush it may seem difficult from a practical perspective for an acquirer to know whether a vendor has reported a gain, presumably an undertaking by the vendor in a letter of transmittal that it

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60 Paragraph 85.1(2)(d).
62 Such a vendor will have some carryover basis in the shares exchanged for shares.
intends to report a gain should be sufficient evidence to enable a pur- 
chaser to obtain a step-up in cost.

The limitation that section 85.1 is available only where the vendor 
holds the exchanged shares as capital property is somewhat difficult to 
justify from a fairness perspective. It is unclear why vendors who hold 
their exchanged shares on income account should not also benefit from a 
rollover. On the other hand, this limitation may provide a purchaser with 
a step-up in basis to the extent that it can demonstrate that a vendor did 
not hold the exchanged shares as capital property. This may be the case, 
for example, where arbitrageurs acquire shares of the target during the 
currency of the bid.

The requirements in subsection 85.1(2) that the vendor and purchaser 
deal at arm’s length and that the vendor not control the purchaser after 
the exchange may no longer be justified now that the purchaser cannot 
generally step up basis in the exchanged shares where the vendor has not 
reported a gain.

TRANSFERS OF PROPERTY TO A CORPORATION

Introduction

In general terms, subsection 85(1) permits a taxpayer to defer the tax 
liability that would otherwise arise on a transfer of certain types of prop-
erty to a taxable Canadian corporation provided that the consideration 
received by the taxpayer includes shares issued by the transferee corpora-
tion and a joint election is filed by the taxpayer and the transferee 
corporation. Subsection 85(1) establishes certain upper and lower limits 
on the elected amount. Subject to these limitations, the amount elected by 
the taxpayer and the transferee corporation is deemed to be the transferor’s 
proceeds of disposition of the transferred property and the transferee cor-
poration’s cost of the property.63 The elected amount also establishes the 
cost to the transferor of the consideration received. Subsection 85(1) gen-
erally permits a transferor to receive non-share consideration or “boot” 
up to the transferor’s adjusted cost base of the transferred property with-
out sacrificing the availability of the rollover. The transferor may be an 
individual, a trust, or a corporation, whether or not a resident of Canada. 
Subsection 85(2) provides for a similar rollover where property is trans-
ferred by a partnership to a corporation. Only eligible property as defined 
in subsection 85(1.1) may be the subject of an election under subsection 
85(1). The definition of eligible property includes most types of property 
but excludes real property that is inventory and, in the case of a non-
resident transferor, any real property.64

63 See paragraph 85(1)(a). A number of rules in subsection 85(1) may operate to deem 
the elected amount to be different from the amount actually designated.

64 There is an exception to this rule in respect of non-resident insurers. Eligible prop-
erty includes real property owned by a non-resident insurer where that property and the 
property received as consideration for that property are property used by it in the year in, 
or held by it in the year in the course of, carrying on an insurance business in Canada.
Subsection 85(2.1) contains rules adjusting the paid-up capital of the shares of the transferee corporation in certain circumstances where an election has been made under subsection 85(1) in respect of a transfer of property to a corporation. The provision ensures that the paid-up capital of the transferee corporation cannot be increased by an amount greater than the agreed or elected amount, or, where there has been non-share consideration in respect of the transfer, by the agreed amount less the fair market value of that non-share consideration. Subsection 85(5) deals with the transfer of depreciable property by a taxpayer and is designed to preserve the continuity of the rules in respect of capital cost allowance. Subsections 85(6) through (9) deal with the section 85 election itself, including provision for a late-filed election as well as penalties.65

History
Section 85 was introduced into the Act as part of the 1971 tax reform. Initially, the rule applied only in respect of transfers of capital property or eligible capital property.66 More significantly, the rule applied only where the transferor owned at least 80 percent of the issued shares of each class of the transferee corporation immediately after the transfer. Interestingly, the transferor was not required to receive any shares of the transferee in consideration for the actual transfer of the property.

Significant amendments were made to section 85 applicable to disposions of property after May 6, 1974.67 First, the requirement that the transferor own at least 80 percent of the shares of the transferee corporation was dropped, although the transferor was required to receive shares of the transferee in consideration for the transferred property. Second, inventory (other than real property inventory) was added to the list of properties eligible for rollover treatment, and capital property that was real property or an option in respect thereof owned by a non-resident was excluded. Third, an ordering rule was introduced in paragraph 85(1)(e.1) in respect of transfers of more than one depreciable property enabling a taxpayer to designate the order in which the properties would be considered to be transferred. The provision enabled the transferor to have greater control over the effect of the election on the transferor’s capital cost allowance pools. Finally, the anti-gifting rule in paragraph 85(1)(e.2) was introduced effectively to prevent a transferor from enjoying a full rollover where the fair market value of the transferred property exceeded the value of the consideration received by the transferor and it was reasonable to

65 Subsections 85(4) and (5.1) are provisions of general application. Subsection 85(4) is to be repealed and replaced by subsection 14(12) and subsections 40(3.3) and (3.4). Subsection 85(5.1) also is to be repealed and replaced by subsection 13(21.2). See the April 26, 1995 technical amendments, supra footnote 24.

66 In 1974, the provision was amended retroactively to the beginning of 1972 by SC 1973-74, c. 14, section 25(1), to enable certain resource properties to be transferred on a rollover basis.

67 SC 1974-75-76, c. 26, sections 48(1) through (3).
regard any portion of the excess as a gift made by the transferor to or for the benefit of any other shareholder.68

Subsection 85(1) was amended again with respect to dispositions occurring after December 11, 1979 to limit its availability to transfers of property to a taxable Canadian corporation.69 The amendments since that time have for the most part related to the definition of the types of transferred property in respect of which an election may be made.70

Current Issues
Section 85 has stood the test of time very well. It is a very flexible provision and seems to be working effectively.

INTERNAL CAPITAL REORGANIZATIONS

Introduction
Subsection 86(1) enables a corporation to reorganize its share capital without triggering a capital gain in the hands of its shareholders who hold their shares as capital property. In general terms, the rule applies where, in the course of a reorganization of the capital of a corporation, a taxpayer disposes of capital property that was all of the shares of any particular class of the corporation owned by the taxpayer and property is receivable from the corporation that includes other shares of the corporation. Provided that the taxpayer does not receive non-share consideration having a fair market value in excess of the adjusted cost base to the taxpayer of the old shares, a complete rollover can be achieved. The taxpayer’s basis in the old shares is allocated as basis first to non-share consideration and then to the new shares received on the reorganization. Where shares of more than one class are received, the basis is allocated pro rata to the new shares on the basis of the respective fair market value of the shares received of each class. Section 86 does not apply to any transaction to which subsection 85(1) or (2) applies.

68 This provision was later amended to apply only where it was reasonable to regard any part of the excess as a benefit that the transferor desired to have conferred on a person related to the transferor (see SC 1988, c. 55, section 58(4), applicable to dispositions occurring after June 1988). The provision was amended again by SC 1994, c. 7, schedule II, section 64(2), effective for dispositions occurring after June 1988 where the person receiving the benefit was a wholly owned subsidiary of the transferor immediately after the transfer.

Subsections 85(6), (7), (8), and (9) also were added retroactive to 1972 to prescribe the time for filing the election and to permit late-filed elections provided that a prescribed penalty was paid (see SC 1974-75-76, c. 26, section 48(6)). Previously, the time limit for filing the election was prescribed in regulation 4500, and no provision was made for a late filing. Finally, paragraph 85(1)(i), applicable to dispositions of property after May 6, 1974, was added by SC 1974-75-76, c. 26, section 48(3), to deem any shares received on the transfer to be taxable Canadian property.

69 SC 1980-81-82-83, c. 48, section 45(1). At the same time, the provision was amended to exclude any interest in real property or capital property owned by a non-resident, effective for dispositions occurring after August 28, 1980.

70 See the definition of “eligible property” in subsection 85(1.1) and the amendments thereto.
Subsection 86(2) is an anti-gift provision similar to those contained in sections 85 and 87. Subsection 86(2.1) ensures that the paid-up capital of the new shares does not exceed the amount, if any, by which the paid-up capital of the old shares exceeds the fair market value of any non-share consideration paid for the old shares.

**History**

Section 86 was introduced into the Act as part of the 1971 tax reform. As originally enacted, section 86 applied only where a corporation acquired, and a shareholder disposed of, shares of the capital stock of the corporation in the course of a reorganization of the capital of the corporation. Where the reorganization took the form of an exchange of old shares of any class for new shares of any class, the adjusted cost base of the old shares was flowed through to the new shares. Where two or more new classes of shares were received on the exchange, the original provision relied upon a concept of “category A” and “category B” shares to apportion the adjusted cost base of the old shares to the new shares. As originally drafted, the provision had little practical application to reorganizations of corporate capital structure. The principal shortcoming of the provision was the requirement that the corporation acquire its own issued and outstanding capital stock. As most corporate statutes prohibited a corporation from acquiring its own shares in all but very limited circumstances, the provision was not very effective.

Subsection 86(1) was amended, with application to reorganizations of capital after May 6, 1974, to remove the requirement that the corporation “acquire” its own issued and outstanding capital stock, to eliminate the concept of “category A” and “category B” shares, and to restrict application of the provision to situations where the taxpayer disposed of all shares of a class owned by the taxpayer and the shares constituted capital property of the taxpayer. Subsection 86(1) has since remained substantially the same. The anti-gift provision in subsection 86(2) was introduced effective for reorganizations occurring after December 11, 1979. The rule in subsection 86(2.1) was added with application to exchanges occurring after August, 1992. Before that time, a reorganization of capital could have resulted in a deemed dividend under subsection 84(1) where the corporate law did not permit the stated capital of the new shares to be limited to the stated capital of the old shares.

**Current Issues**

Section 86 is generally a very simple and useful provision. It provides rollover treatment provided that any non-share consideration received is limited in amount to the amount of the adjusted cost base in the old shares. It is not clear, however, why the provision is limited to taxpayers

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71 SC 1974-75-76, c. 26, section 50(1).
72 SC 1980-81-82-83, c. 48, section 46(2).
73 SC 1994, c. 21, section 38(1).
who hold their shares as capital property. It seems somewhat harsh for taxpayers holding shares as inventory to be required to recognize a gain where a reorganization of capital is implemented at the instance of the corporation.

**CONCLUSION**

As suggested at the outset, the rules in the Act governing the taxation of corporate reorganizations are in reasonably good shape. It is unlikely that we will see significant changes to these rules in the near future. If, however, there is a significant increase in the integration of the North American economies under the North American Free Trade Agreement, it is possible that the rules may be loosened to permit the tax-deferred movement of assets among corporations outside Canada, provided that those assets remain within the free trade zone. Aside from this prospect, there will undoubtedly be some tinkering, and some of the issues that we have focused on may be addressed. It is hoped that any such tinkering will not unduly complicate the rules and, indeed, will reduce or eliminate some of the complexities that already exist.