***Canadian Tax Principles, 2022-2023* (Byrd/Chen)**

**Chapter 16 Rollovers under Section 85**

16.1 Online Exercises

1) In the absence of ITA 85(1), income tax concepts would make it difficult to incorporate a business. Briefly explain the reason for this statement.

Answer: The owner of a business carried on as a sole proprietorship will usually have various business properties with value including goodwill. The incorporation process requires selling the business property to the corporation. The ITA requires that FMV be used meaning that all business properties would be sold at FMV resulting in potential capital gains, recapture etc that would result in an income tax liability. When incorporating a business the corporation must also pay the FMV price however the corporation are often newly incorporated with little cash meaning that the corporation often pays for the business properties by issuing promissory notes and issuing shares. The result is that the individual seller has no additional cash to pay the income tax liability. These factors would discourage the incorporation of a business were it not for rollover provisions such as ITA 85(1).

Type: ES

Topic: Rollovers (ITA 85) - general concepts

2) Identify who can participate as a transferor in an ITA 85 rollover transaction and the reason for the transfer.

Answer:

• An **individual** who wishes to incorporate a business carried on as a sole proprietor.

• A **member of a partnership** who wishes to incorporate their interest in the partnership.

• A **corporation** that wishes to transfer property to another corporation.

• A **trust** that wishes to transfer property to a corporation.

• A **partnership** that wishes to incorporate a business carried on by the partnership.

Type: ES

Topic: Rollovers (ITA 85) - the basic rules

3) ITA 85 allows the rollover of many types of property to a corporation at specified elected amounts, a process that can lead to a deferral of income tax that avoids any immediate tax as a result of qualifying property transfers from certain persons and partnerships to a corporation. There are, however, certain types of property that are ineligible for this rollover treatment. Identify the types of property that do not qualify for rollover treatment and explain the reasons for their exclusion.

Answer: Eligible property is defined under ITA 85(1.1) as including depreciable and non-depreciable capital property, resource property, and inventories other than real property inventory. Some of the principal exclusions are:

• inventories of real property (e.g. real estate such as land and buildings); and

• real property owned by a non-resident (unless used in a business carried on in Canada).

The justification for these exclusions is the recognition that profits on inventories are fully included in income and that the disposition of certain property by non-residents may also lead to amounts that are fully included in income. The rules of ITA 85 could be used in a manner that would permit persons owning these type of properties to convert the appreciation in value to capital gains that are either only 50% required to be included in income in the case of Canadian residents or may be entirely exempt from Canadian income as a result of an income tax treaty in the case of non-residents. The property exclusions are designed to prevent that result.

Type: ES

Topic: Rollovers (ITA 85) - eligible property (ITA 85(1.1))

4) When a business is incorporated it is important that all of the business properties transferred to a corporation are listed in the election form. Why is this the case?

Answer: The importance of ensuring that all business properties transferred to a corporation are listed is to take advantage of the rollover. If property are unintentionally left off the election the disposition of that property will not benefit from the rollover and will instead be considered to have been disposed of at FMV. This can result in income or capital gains that will result in an income tax liability. The most common example of this is goodwill.

Type: ES

Topic: Rollovers (ITA 85) - general concepts

5) When ITA 85(1) is being used, careful consideration must be given to the elected amount. Briefly explain the importance of the elected amount.

Answer: The elected amount is a key concept in the rollover that ensures that a disposition to a corporation can occur with no or minimal income tax implications. Specifically the elected amount establishes three important objectives.

• The elected amount becomes the POD of property disposed of by a person or partnership to the corporation.

• The elected amount is used to establish the cost of consideration received by the transferor on the disposition of property to the corporation.

• The elected amount represents the cost of property acquired by the corporation from the transferor.

Type: ES

Topic: Rollovers (ITA 85) - the basic rules

6) What is boot? What is its significance in the application of ITA 85(1)?

Answer: Boot is a word with a legal meaning that generally refers to NSC received by the transferor as payment by the corporation for the purchase of property. NSC most often means debt issued by the corporation or debt of the transferor assumed by the corporation. The significance of "boot" is that the elected amount cannot be set at an amount that is less that the FMV of the boot. If the boot falls between the tax cost and FMV of property then the FMV of the boot will reset the acceptable range.

Type: ES

Topic: Rollovers (ITA 85) - the basic rules

7) In determining the elected amount to be chosen when using an ITA 85 rollover, there are general rules that set the range of amounts that apply to all eligible property. Briefly describe these rules.

Answer: The **general** rule is that when transferring a specific eligible property that the elected amount can not exceed the FMV of that property or be set at an amount below its tax cost which varies for each type of property. These rules are designed to prevent the creation of artificial gains or losses. In addition the range of acceptable elected amounts may change depending on the FMV of NSC received.

Type: ES

Topic: Rollovers (ITA 85) - the basic rules

8) When an individual incorporates a business using the ITA 85 rollover, it is often suggested that the accounts receivable not be included in the rollover election. What is that the case?

Answer: When accounts receivable are sold, any loss will be treated as a capital loss given that accounts receivables are non-depreciable capital property. This means that only one-half of the loss is actually deductible and restricted to a deduction only if there are taxable capital gains to apply the loss against. ITA 22 provides an alternative to ITA 85 where accounts receivables have declined in value. ITA 22 allows any loss to be fully deductible and allows the corporate purchaser to treat the accounts receivables as if they originated with that corporation. This allows the corporation to claim doubtful debt and bad debt reserves which would not otherwise be permitted with respect to purchased receivables. The ITA 22 elective treatment must be jointly elected by the transferor and the transferee corporation. Accounts receivables that have utilized the ITA 22 election are not permitted to use ITA 85.

Type: ES

Topic: Rollovers - accounts receivables & ITA 22 vs ITA 85

9) When an individual sells non-depreciable capital property to an affiliated person, any resulting capital loss is disallowed to that individual. Give three examples of affiliated persons.

Answer: Affiliated persons are defined in the text as follows:

A. An individual is affiliated to another individual only if that individual is a spouse or common-law partner.

B. A corporation is affiliated with:

1. a person who controls the corporation;

2. each member of an affiliated group of persons who controls the corporation; and

3. the spouse or common-law partner of a person listed in (1) or (2).

C. Two corporations are affiliated if:

1. each corporation is controlled by a person, and the person by whom one corporation is controlled is affiliated with the person by whom the other corporation is controlled;

2. one corporation is controlled by a person, the other corporation is controlled by a group of persons, and each member of that group is affiliated with that person; or

3. each corporation is controlled by a group of persons, and each member of each group is affiliated with at least one member of the other group.

The required three examples can be selected from any example presented in this definition.

Type: ES

Topic: Affiliated persons - ITA 251.1

10) Why is there a special ITA 85 rule for depreciable property that considers property of the same class to be deemed disposed on in a specific order?

Answer: When a business is incorporated all of the property is generally sold at the same time under one contract of purchase and sale. This means that when determining the elected amounts for depreciable property which use UCC as one of the factors a disposition of all property of a class at the same moment in time could result in recapture which could be avoided if there was an option to sell each depreciable property of a class in a specific order. ITA 85(1)(e.1) provides the individual who is incorporating a business with that opportunity.

Type: ES

Topic: Rollovers (ITA 85) - ordering of depreciable property (ITA 85(1)(e.1))

11) When eligible property is sold to a corporation using ITA 85, the transferor/seller can be paid with consideration that consists of a combination of common shares, preferred shares, and NSC. Briefly explain how the elected amount is applied to determine the cost of this consideration.

Answer: The elected amount is applied in a specific order as a result of ITA 85(1)(f) and (g). The elected amount is first applied to any NSC in an amount equal to its FMV. If any part of the elected amount remains after the allocation to NSC, it would then be allocated to any preferred shares up to their FMV. If any elected amount remains after these first two allocations than the remaining amount is allocated to any common share consideration.

Type: ES

Topic: Rollovers (ITA 85) - allocating the elected amount (ITA 85(1)(f) & (g))

12) When a depreciable property is sold to a corporation using the rollover of ITA 85, the elected amount will usually be the UCC of the property. In these circumstances, the corporation is required to retain the capital cost of the property, with the difference between the capital cost and the UCC elected amount being treated as deemed CCA. What is the reason for this rule?

Answer: If the transferor had simply sold the property for an amount in excess of the UCC but less than the capital cost, the difference between the UCC and the capital cost would be fully taxable recapture. If the corporate transferee was allowed to treat the transferor's UCC as its capital cost, in a later sale of the property, this difference would be treated as a capital gain, only one-half of which is required to be included in income. The requirement that the transferee retain the transferor's capital cost ensures that the potential recapture to the transferee is retained by the corporate purchaser.

Type: ES

Topic: Rollovers (ITA 85) - depreciable property (ITA 85(5)) recapture preservation

13) When a taxpayer sells depreciable property using the rollover of ITA 85, the elected amount may exceed the property's capital cost resulting in a capital gain. In such a case, how will the corporate transferee's capital cost for CCA purposes be determined?

Answer: The capital cost for CCA purposes will be equal to the transferor's capital cost, plus one-half of any capital gain recognized by the transferor as a result of the transfer. ITA 13(7)(e). This rule however only applies if the seller and the corporation are non-arm`s length at the time of the disposition.

Type: ES

Topic: Rollovers (ITA 85) - depreciable property (ITA 13(7)(e)) capital cost limitation

14) In general, when there has been a disposition of eligible property using the rollover of ITA 85, a PUC reduction is frequently required. Explain briefly how the amount of this PUC reduction is determined.

Answer: The PUC reduction is calculated by subtracting any excess of the elected amount over the FMV of NSC from the increase in legal stated capital that resulted from the issuance of shares by the corporation. The objective is that the PUC of the share consideration make up the difference between the elected amount and the FMV of NSC.

Type: ES

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

15) If more than one class of shares have been issued as share consideration as part of the ITA 85 rollover, how is the PUC allocated to the multiple classes of shares?

Answer: The total PUC reduction is divided among the multiple classes of shares on the basis of their relative FMV which is almost always based upon their relative legal capital. The resulting amounts are then subtracted from the legal capital of each class of shares to determine the PUC for each class of shares.

Type: ES

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

16) An individual wishes to incorporate a business using ITA 85. The individual wants to structure the transaction in such a way as to maximize the amount of cash that can be withdrawn while avoiding any income tax liability with respect to the incorporation of that business. How should the transaction be structured to achieve that objective?

Answer: To achieve the desired objectives the eligible property of the business should be transferred using an elected amount equal to the tax cost of each eligible property to avoid any income tax liability on the incorporation of that business. In addition NSC should be taken that equals the combined elected amounts for all eligible property. This means that that tax cost and PUC of any share consideration will be nil. In a typical transaction with a newly incorporated company there will likely be no cash available and the company will issue a promissory note which can be paid off over time without any income tax implications to the corporation or the individual transferor.

Type: ES

Topic: Rollovers (ITA 85) - tax planning considerations

17) One of the most useful types of tax planning available to individuals with significant income is income splitting with family members. In implementing an income splitting arrangement, one of the most useful planning techniques is to have an individual sell property to a corporation on a rollover basis under ITA 85. However, if such a transfer is not carefully structured, any income splitting objectives may not be achieved. What precautions must be taken in the restructuring to ensure that there are no income tax implications as a result of the incorporation of eligible property?

Answer: An individual who participates in a rollover under ITA 85 where family members may be involved in the corporation must ensure that there are no shifts of value from the eligible property transfers that indirectly increase the FMV of shareholdings of family members and that the individual does not take back consideration that is less than the FMV of eligible property sold to the corporation.

This means that the individual transferor must ensure that the FMV of the eligible property transferred to the corporation is equal to the FMV of consideration received from the corporation as payment for that eligible property. Abiding by this general rule should prevent any issues when allowing family members to become shareholders for minimal amounts. If there are concerns about the FMV of eligible property this can be remedied with a proper and genuine price adjustment clause (PAC). It is also important that family members use their own money to acquire shares of the family corporation.

Type: ES

Topic: Rollovers (ITA 85) - tax planning considerations

18) Mr. Lawson, who is a resident of the United States, owns a number of rental properties in various cities throughout Canada. Having reached 65 years of age, he would like to see these properties eventually transferred to his children. However, he does not have sufficient cash to pay the income taxes that would arise if the rental properties were gifted to the children because gifts are treated as dispositions at FMV. He is somewhat aware of the provisions of ITA 85 and is considering transferring the properties to a U.S. corporation in which his children would be the shareholders. Advise Mr. Lawson as to the soundness of this plan.

Answer: Mr. Lawson's plan would not be an effective method of avoiding a disposition at FMV and therefore incurring a Canadian income tax liability. There are two reasons for this. First, in order to use the rollover of ITA 85, the property must be disposed of to a taxable Canadian corporation, rather than a non-resident corporation. However, if he were to incorporate a corporation in Canada, Mr. Lawson would have to deal with his second problem. This is the fact that ITA 85 does not apply to real property owned by a non-resident. In short, Mr. Lawson cannot use ITA 85 in his circumstances.

Type: ES

Topic: Rollovers (ITA 85) - tax planning considerations

19) ITA 85 contemplates a gifting transaction that results in the shift of value to a related person from the transferor. Explain how this can occur and the income tax consequences to both the transferor and the related person who benefits from the gift.

Answer: A gift or shift of value occurs when the FMV of eligible property transferred to a corporation exceeds the value of the consideration paid by the corporation for that eligible property. In other words the result is that additional value has been left in the corporation. The gift occurs when that additional value increases the value of shares of that corporation owned by the related person.

The tax consequence of a gift to the transferor would be that the amount of the gift would be added to the elected amount, resulting in additional income that is usually a capital gain which is equal to the gift amount. The related person would experience and increase in the FMV of their shares without any corresponding increase in the ACB of their shares. This would mean that on a subsequent sale of the related person's shares there would be a capital gain equivalent to the gift amount that would have been included in the income of the transferor. In effect the same amount would have been subject to income tax twice - once by the transferor and a second time by the related person.

Type: ES

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

20) A Section 85 rollover can result in an ITA 15(1) shareholder benefit to the transferor. Explain how this benefit can occur.

Answer: An ITA 15(1) shareholder benefit will arise in a transaction with a corporation in which the individual is a shareholder if the value of consideration received by the individual as payment from the corporation exceeds the value of the property sold to that same corporation. This issue can be resolved in advance of the transaction through the proper use of a price adjustment clause (PAC).

Type: ES

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

21) What is the purpose of the dividend stripping anti-avoidance rule of ITA 84.1?

Answer: The purpose of ITA 84.1 is to prevent an individual from removing corporate surplus in the form of a capital gain rather than as a taxable dividend. As a rule capital gains are subject to lower rates of income tax than are taxable dividends encouraging this type of planning however if the capital gain also qualifies for the capital gains deduction then the income tax savings are considerable. The planning involves multiple transactions that include a non-arm's length sale of shares that often leave the original controlling shareholders position unchanged once the transactions have been completed. The mechanics of ITA 84.1 restrict what can be received as NSC on the non-arm's length share sale. If these limits are exceeded then all or a part of the capital gain that arose would be effectively converted to a deemed dividend.

Type: ES

Topic: Dividend stripping - ITA 84.1

22) What is the purpose of ITA 55(2), the capital gains stripping rules?

Answer: The capital gains stripping rules are anti-avoidance rules designed to prevent a corporation from structuring transactions in a way that results in a sale of corporate property (typically shares of other corporations) without realizing a capital gain. Instead the transactions involve the capital gain being replaced by inter-corporate taxable dividends that are tax free under Part I because of the corporate taxable income deduction in ITA 112(1). ITA 55(2) applies numerous exceptions to narrow the focus to abusive transactions.

Type: ES

Topic: Capital gains stripping - ITA 55(2)

23) The taxpayer who is the seller/transferor in an ITA 85(1) rollover must generally receive at least a one share of the transferee corporation.

Answer: TRUE

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

24) The elected amount in an ITA 85(1) rollover can never be less than the FMV of NSC received.

Answer: TRUE

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

25) ITA 85(1) can only be used to incorporate a business.

Answer: FALSE

Explanation: ITA 85(1) can be used for many purposes and is not restricted to the incorporation of a business.

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

26) For purposes of ITA 85(1), eligible property includes real property owned by a non-resident person that is used in the year in a business carried on by that non-resident person in Canada.

Answer: TRUE

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

27) In an ITA 85(1) rollover, consideration paid by the corporation to the seller/transferor can only include debt and common shares.

Answer: FALSE

Explanation: Consideration can also include NSC other than debt, as well as preferred shares.

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

28) In a Section 85(1) rollover, the elected amount serves as POD of the property to the seller/transferor, the tax cost property to the corporation and the base for the tax cost of consideration paid by the corporation to the transferor.

Answer: TRUE

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

29) In the context of ITA 85(1) rollovers, the term "boot" refers to any consideration received by the transferor other than common shares.

Answer: FALSE

Explanation: The term refers only to NSC and this would exclude both preferred and common shares.

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

30) The elected amount in an ITA 85(1) rollover can never be more than the FMV of the NSC.

Answer: FALSE

Explanation: The elected amount can never be more than the FMV of the eligible property sold to the corporation.

Type: TF

Topic: Rollovers (ITA 85) - the basic rules

31) For an individual, the only individuals that are "affiliated persons" are spouses or common-law partners.

Answer: TRUE

Type: TF

Topic: Affiliated persons - ITA 251.1

32) When depreciable property is transferred in an ITA 85(1) rollover in a non-arm's length transaction, the seller/transferor may elect an amount in excess of the capital cost of the property as long as the amount does not exceed the FMV of the property. For the transferee corporation, the elected amount will be its capital cost for CCA purposes.

Answer: FALSE

Explanation: The capital cost for CCA purposes will be the transferor's capital cost, plus one-half of any capital gain that results from the transfer if the transaction is between non-arm's length persons.

Type: TF

Topic: Rollovers (ITA 85) - depreciable property (ITA 13(7)(e)) capital cost limitation

33) In an ITA 85(1) rollover, any required PUC reduction will be allocated first to preferred shares, with any remaining balance allocated to common shares.

Answer: FALSE

Explanation: Any required PUC reduction will be allocated to preferred and common shares using a pro-rata allocation based on their relative FMV.

Type: TF

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

34) If eligible property that is depreciable property is sold/transferred in an ITA 85 rollover in a non-arm's length transaction at an elected amount that results in a capital gain to the transferor, the cost to the transferee corporation for CCA purposes will be the transferor's cost, plus one-half of the excess of the elected amount over the transferor's capital cost.

Answer: TRUE

Type: TF

Topic: Rollovers (ITA 85) - depreciable property (ITA 13(7)(e)) capital cost limitation

35) Which of the following properties **CANNOT** be sold/transferred to a corporation under the provisions of ITA 85(1)?

A) Real property owned by a non-resident person and used in the year in a business carried on by that person in Canada.

B) Canadian Resource Property.

C) Non-Depreciable Capital Property owned by residents.

D) Prepayments.

Answer: D

Explanation: D) Prepayments. Prepayments or prepaid expenses are not property for income tax purposes.

Type: MC

Topic: Rollovers (ITA 85) - eligible property (ITA 85(1.1))

36) Which of the following would **NOT** be considered part of the boot received by a transferor in an ITA 85(1) rollover?

A) Bonds issued by the new corporation.

B) Redeemable preferred shares of the new corporation.

C) The assumption of transferor debt by the new corporation.

D) A non-interest bearing promissory note issued by the new corporation.

Answer: B

Explanation: B) Redeemable preferred shares. This would be share consideration and not NSC.

Type: MC

Topic: Rollovers (ITA 85) - the basic rules

37) Which of the following statements fully describes a transferor or transferee under the provisions of ITA 85(1) and (2)?

A) A transferee must be a corporation or trust.

B) A transferee must be a taxable Canadian corporation.

C) A transferor must be an individual or a corporation.

D) Only individuals are permitted to be transferors under ITA 85(1).

Answer: B

Explanation: B) A transferee must be a taxable Canadian corporation.

Type: MC

Topic: Rollovers (ITA 85) - the basic rules

38) There is only one requirement specified in ITA 85(1) with respect to the consideration that the corporation must give the transferor in exchange for property transferred to the corporation. What is it?

A) The consideration given to the transferor must include shares of the corporation.

B) The consideration given to the transferor must include cash equal to the tax value of the property transferred to the corporation.

C) The consideration given to the transferor must include cash equal to the FMV of the property transferred to the corporation.

D) The consideration given to the transferor can only include cash and shares of the corporation.

Answer: A

Explanation: A) The consideration given to the transferor must include shares of the corporation.

Type: MC

Topic: Rollovers (ITA 85) - the basic rules

39) Which of the following would be considered part of the boot received by a transferor in an ITA 85(1) rollover?

A) Common shares of the transferee.

B) Redeemable preferred shares of the transferee.

C) Non-redeemable preferred shares of the transferee.

D) The assumption of transferor debt by the transferee.

Answer: D

Explanation: D) The assumption of transferor debt by the transferee.

Type: MC

Topic: Rollovers (ITA 85) - the basic rules

40) Which of the following scenarios would be most appropriate for an ITA 85 rollover?

A) A shareholder of a corporation wishes to sell/transfer eligible property with a FMV of $150,000 and a tax cost of $100,000 to a corporation.

B) A shareholder of a corporation wishes to sell/transfer eligible property with a FMV of $100,000 and a tax cost of $150,000 to a corporation.

C) An individual shareholder of a corporation wishes to purchase eligible property with a FMV of $150,000 and a tax cost of $100,000 from a corporation.

D) An individual shareholder of a corporation wishes to purchase eligible property with a FMV of $100,000 and a tax cost of $150,000 from a corporation.

Answer: A

Explanation: A) A shareholder of a corporation wishes to transfer eligible property with a FMV of $150,000 and a cost of $100,000 to a corporation.

B) There are no benefits from using ITA 85 for property with accrued unrealized losses.

C) ITA 85 requires a sale of property to a corporation not the reverse.

D) ITA 85 requires a sale of property to a corporation not the reverse.

Type: MC

Topic: Rollovers (ITA 85) - the basic rules

41) Myron Cohen owns a retail store that he is currently operating as a sole proprietorship. In incorporating the business properties to a corporation under the provisions of ITA 85(1), the elected amount for the depreciable property will exceed the UCC but is less than the capital cost. This will result in:

A) a capital gain.

B) a terminal loss.

C) recapture of CCA.

D) a capital loss and recapture of CCA.

Answer: C

Explanation: C) Recapture of CCA.

D) Can never have a capital loss on depreciable property.

Type: MC

Topic: Rollovers (ITA 85) - determining the elected amount

42) Mary Battle sells/transfers a depreciable property with a FMV of $100,000, a capital cost of $85,000, and a UCC of $47,500 to Battle Ltd. In consideration she receives cash of $60,000 and shares with a FMV of $40,000, for a total consideration value of $100,000. Using the ITA 85(1) rollover for the transfer, she elects an amount of $90,000. Which of the following statements is correct?

A) Mary will have to report a capital gain of $5,000 and no recapture of CCA.

B) Because she is using ITA 85, she does not have to report any income.

C) Mary will only have to report recapture of CCA of $37,500.

D) Mary will have to report a capital gain of $5,000 and recapture of CCA of $37,500.

Answer: D

Explanation: D) Mary will have to report a capital gain of $5,000 and recapture of $37,500.

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

43) ITA 85(1) sets out rules for establishing acceptable election amounts. Which of the following statements accurately describes the maximum elected amount or ceiling?

A) The FMV of the share consideration given to the transferee.

B) The FMV of the NSC given to the transferee.

C) The FMV of the eligible property sold/transferred to the corporation.

D) The FMV of the share and non-share consideration given to the transferee.

Answer: C

Explanation: C) The FMV of the eligible property sold/transferred to the corporation.

Type: MC

Topic: Rollovers (ITA 85) - determining the elected amount

44) In incorporating a business, accounts receivable can be sold using either ITA 22 or ITA 85(1), but not both. One advantage of using ITA 22 is:

A) the seller will be able to deduct a capital loss.

B) the corporation will be able to deduct a doubtful debt reserve after the sale.

C) the seller will not have to add back to income any previously deducted doubtful debt reserve.

D) the seller will have a capital loss that may be considered superficial.

Answer: B

Explanation: B) The corporation will be able to deduct a doubtful debt reserve after the sale.

Type: MC

Topic: Rollovers - accounts receivables & ITA 22 vs ITA 85

45) Eric Lehnserr owns 100% of Magnus Products Ltd. The shares were originally issued in 1993 for $20,000. In 1997, they were acquired by Eric's father for $25,000. In 2013, Eric's father died and left the shares to Eric. At that time, they were deemed to have been disposed of for $100,000. On the terminal return for Eric's father, a capital gain of $75,000 was reported, and tax was paid on the taxable capital gain of $37,500. Eric wishes to sell the shares, now valued at $250,000, to a wholly-owned holding corporation, electing under ITA 85(1). Magnus Products Ltd. has never paid dividends of any kind.

Which one of the following amounts represents the minimum possible elected amount under ITA 85(1), ignoring the impact of consideration received?

A) $20,000.

B) $25,000.

C) $100,000.

D) $250,000.

Answer: C

Explanation: C) $100,000. This represents the ACB of the shares to Eric which was established when he inherited the shares from his father.

Type: MC

Topic: Rollovers (ITA 85) - determining the elected amount

46) Noor Ali sells shares in Ali Manufacturing Inc. to Ali Holdings Ltd., a corporation which she controls. The shares have an ACB of $35,000 and a FMV of $5,000. Noor elects to transfer the shares under ITA 85(1) at an elected amount of $5,000. The $30,000 capital loss on this transfer:

A) will be disallowed but available to the corporation when the corporation is subject to an acquisition of control or is wound up.

B) will be disallowed and added to the ACB of the shares to Ali Holdings Ltd.

C) will be deductible to Noor Ali since the transferor is an individual.

D) will be deductible to the corporation since the seller is an individual.

Answer: B

Explanation: B) will be disallowed and added to the ACB of the shares to Ali Holdings Ltd.

Type: MC

Topic: Rollovers (ITA 85) - superficial losses

47) Ali Manufacturing Inc. owns shares in Ali Holdings Inc, which it will sell to Family Holdings Ltd., an affiliated person, using ITA 85(1). The shares have an ACB of $35,000 and a FMV of $5,000, and an elected amount of $5,000 is used. The $30,000 capital loss on the sale:

A) will be disallowed but available to the transferor if Family Holdings Ltd. is subsequently subject to an acquisition of control, is wound up under ITA 88(2) or the shares are sold to a non-affiliated person.

B) will be disallowed with no opportunity to deduct the loss in the future.

C) will be added to the ACB of the shares owned by Family Holdings Ltd.

D) will be carried forward as a net capital loss to Family Holdings Ltd.

Answer: A

Explanation: A) will be disallowed but available to the transferor if Family Holdings Ltd. is subsequently subject to an acquisition of control, is wound up under ITA 88(2) or the shares are sold to a non-affiliated person.

Type: MC

Topic: Rollovers (ITA 85) - superficial losses

48) Mayumi Tajima sells/transfers a depreciable property to a CCPC in which she is the only shareholder. The property has a capital cost of $100,000 and a UCC of $64,000. Mayumi will elect an amount equal to the FMV of the property of $150,000. This transfer will result in:

A) a taxable capital gain of $43,000 with the capital cost of the property to the corporation being $150,000.

B) a taxable capital gain of $25,000, recapture of $36,000 and the capital cost of the property to the corporation will be $100,000.

C) a taxable capital gain of $25,000, recapture of $36,000 and the capital cost of the property to the corporation will be $150,000.

D) a taxable capital gain of $25,000, recapture of $36,000 and the capital cost of the property to the corporation will be $125,000.

Answer: D

Explanation: D) a taxable capital gain of $25,000, recapture of $36,000 and the capital cost of the property to the corporation will be $125,000.

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

49) Meng Zheng wishes to sell/transfer machinery to a corporation using ITA 85(1). This machinery is currently used to earn business income. It has a capital cost of $250,000, a UCC balance of $58,000 and a FMV of $50,000. Which of the following statements is correct?

A) ITA 85(1) does not apply. The terminal loss will be denied permanently if the property is sold/transferred to the corporation.

B) This proposed transfer can be completed using ITA 85(1). As an alternative, the property could be transferred to the corporation by selling it at FMV, in which case the terminal loss will be deductible in the year of transfer.

C) ITA 85(1) does not apply. The POD are deemed to be the UCC amount, thereby disallowing the terminal loss. The terminal loss amount will be treated by the seller as separate depreciable property eligible for CCA in future years.

D) This proposed transfer can be completed using ITA 85(1). The terminal loss will be deductible to the transferor as long as the corporation continues to use the machinery to earn income.

Answer: C

Explanation: C) ITA 85(1) does not apply. The POD are deemed to be the UCC amount, thereby disallowing the terminal loss. The terminal loss amount will be treated by the seller as separate depreciable property eligible for CCA in future years.

Type: MC

Topic: Rollovers (ITA 85) - superficial losses

50) Bridget sold land to her wholly owned corporation using ITA 85(1). The land had an ACB of $150,000 and a FMV of $250,000 at the time of the sale. The property was mortgaged for $50,000. As consideration for the sale, Bridget received cash of $200,000 and preferred shares with legal capital of $10,000. The corporation assumed the mortgage. Which one of the following is the elected transfer price (first) and the ACB of the preferred shares (second) as a result of ITA 85(1)?

A) $250,000 and Nil

B) $250,000 and $240,000

C) $260,000 and $50,000

D) $150,000 and Nil

Answer: A

Explanation: A) Elected amount = $200,000 + $50,000 = $250,000 of NSC

ACB = $250,000 - $200,000 - $50,000 = Nil Note: that there is excess consideration in this case since the total FMV of consideration of $260,000 exceeds the FMV of the property transferred of $250,000. The $10,000 excess would be treated as a shareholder benefit under ITA 15(1) which would result in an ACB adjustment of $10,000 to the shares under ITA 52(1). ITA 84(1) would not apply since it requires an increase in PUC. ITA 85(2.1) reduces the PUC by $10,000 to nil.

Type: MC

Topic: Rollovers (ITA 85) - determining the elected amount

51) Using the provisions of ITA 85(1), Marion sold land that is capital property to a corporation in which she owned all of the shares. The ACB of the land was $150,000 and it had a FMV of $225,000. In order to utilize a $25,000 capital loss, she chose an elected amount of $175,000. What is the ACB of the land to the corporation?

A) $175,000.

B) $150,000.

C) $225,000.

D) $162,500

Answer: A

Explanation: A) $175,000.

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

52) Under the provisions of ITA 85(1), Jason sold land that is capital property to a corporation in which he owned all of the shares. The ACB of the land was $120,000 and the FMV was $390,000. The elected amount was $120,000. As consideration, Jason received a promissory note for $60,000, preferred shares with a FMV of $210,000, and common shares with a FMV of $120,000. Which one of the following is the ACB of the preferred shares (first) and the ACB of the common shares (second)?

A) Nil and $60,000.

B) $60,000 and Nil.

C) $38,181 and $21,819.

D) $210,000 and $120,000.

Answer: B

Explanation: B) $60,000 and Nil.

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

53) Under the provisions of ITA 85(1), Marx Stanislawski sells a depreciable property to a corporation in which he is the sole shareholder. The FMV of the property is $500,000, its capital cost of $320,000 and the UCC is $180,000. Marx elects an amount of $180,000. As consideration, he receives cash of $140,000, and common shares with a legal capital of $360,000. What is the required PUC reduction for the common shares?

A) $320,000.

B) $220,000.

C) $180,000.

D) $40,000.

Answer: A

Explanation: A) $320,000 [$360,000 - ($180,000 - $140,000)].

Type: MC

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

54) Harold Warren incorporated Warren Enterprises Ltd. at the beginning of the current year. In addition to a $100,000 cash contribution for common shares, Harold contributed property with an ACB of $100,000 and a FMV of $150,000. In return, he receives 25,000 common shares in the new corporation. If he elects the minimum amount the ACB of all of his common shares will be:

A) $100,000.

B) $150,000.

C) $200,000.

D) $250,000.

Answer: C

Explanation: C) $200,000 ($100,000 + $100,000).

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

55) Barry Hicks owns a building with a capital cost of $200,000, a UCC balance of $150,000, and a FMV of $600,000. This property is sold/transferred to a corporation using the provisions of ITA 85(1). The corporation assumes the $50,000 mortgage on the building. In return for the building, Barry receives a promissory note for $40,000 and preferred shares with a FMV of $510,000. If Barry elects the minimum amount the ACB of the preferred shares is:

A) nil.

B) $60,000.

C) $110,000.

D) $600,000.

Answer: B

Explanation: B) $60,000 ($150,000 - $40,000 - $50,000).

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

56) Daniel Kwok incorporates his business by selling the business properties to a corporation. The total elected amounts for all properties is $678,000. The FMV of the business properties is $1,250,000. Daniel receives the following consideration:

Cash $150,000

Preferred shares of the new corporation with a FMV 500,000

Common shares of the new corporation with a FMV 600,000

How will the elected amount be allocated between: the NSC and the preferred and common shares issued?

A) $150,000; $0; $528,000

B) $150,000; $500,000; $28,000

C) $150,000; $528,000; $0

D) $150,000; $264,000; $264,000

Answer: B

Explanation: B) $150,000; $500,000; $28,000

Type: MC

Topic: Rollovers (ITA 85) - allocating the elected amount (ITA 85(1)(f) & (g))

57) Jason sold land that is capital property to a corporation in which he owned all of the shares using the provisions of ITA 85(1). The ACB of the land was $60,000 and it had a FMV of $120,000 at the time of the sale. In order to utilize a capital loss, Jason elected a transfer price of $105,000. What is the ACB of the land to the corporation? Jason received $120,000 in share consideration.

A) $60,000

B) $82,500

C) $105,000

D) $120,000

Answer: C

Explanation: C) $105,000

Type: MC

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

58) Mary Hanson owns 1,000 shares of Hanson Operations that have an ACB and PUC of $20,000. Their current FMV is $200,000. Electing under ITA 85(1) in a manner that will maximize tax deferral, the shares are sold to Hanson Holdings Inc., in return for $8,000 in cash and 250 Hanson Holdings shares with a FMV of $192,000. The PUC of the Hanson Holdings shares will be:

A) $12,000.

B) $20,000.

C) $192,000.

D) $200,000.

Answer: A

Explanation: A) $12,000. The PUC reduction will be $180,000 [$192,000 - ($20,000 - $8,000)]. This leaves a PUC of $12,000 ($192,000 - $180,000).

Type: MC

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

59) Mr. Fingula sells property to a corporation all of the shares of which are owned by his daughter. In which of the following situations do the gifting rules apply?

A) The property is sold to the corporation at an elected amount that is equal to the FMV of the property and the consideration.

B) The property has a FMV that exceeds the greater of the FMV of the consideration received and the elected amount.

C) The property has a FMV that is less than the greater of the FMV of the consideration received and the elected amount.

D) The property is sold to the corporation at an elected amount that is less than the FMV of the property and Mr. Fingula receives total consideration equal to that FMV.

Answer: B

Explanation: B) The property has a FMV that exceeds the greater of the FMV of the consideration received and the elected amount.

Type: MC

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

60) Ms. Bimo sells a non-depreciable capital property to a corporation in which all of the common shares are owned by her son. The property has a FMV of $150,000 and an ACB of $35,000. Ms. Bimo chooses an elected amount of $35,000 and the corporation issues her a promissory note in the amount of $35,000 and preferred shares with a FMV of $100,000. The ITA 85(1)(e.2) excess amount (i.e. indirect gift) is:

A) $15,000.

B) $115,000.

C) $100,000.

D) $35,000.

Answer: A

Explanation: A) $15,000 [$150,000 - $135,000]

B) $115,000 [150,000 — 35,000]

C) $100,000 [the FMV of the preferred shares]

D) $35,000 [ the amount of the promissory note]

Type: MC

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

61) Bruno owns 75% of the common shares of a corporation. His adult daughter owns the remaining 25%. During the current year, Bruno sells shares from his investment portfolio that had an ACB of $55,000 to the corporation. These shares had a FMV of $85,000 at the time of the sale and Bruno chose an elected amount of $55,000 under the provisions of ITA 85(1). As consideration for the sale, he received a promissory note for $55,000 and preferred shares with a FMV of $20,000. Which one of the following is the minimum elected amount (first) and the ACB of the preferred shares (second)?

A) $55,000 and $20,000

B) $55,000 and $30,000

C) $65,000 and $20,000

D) $65,000 and Nil

Answer: D

Explanation: D) Elected amount = $55,000 + [$85,000 - ($55,000 + $20,000) gift] = $65,000

ACB = $55,000 - $55,000 = Nil The gift does not affect the ACB of share consideration.

Type: MC

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

62) The use of ITA 85(1) to sell property to a corporation would result in a benefit to a shareholder under ITA 15(1) in a situation where:

A) the FMV of the property sold is less than the FMV of the total consideration received.

B) a capital gain is triggered on the transfer resulting in taxable income to the transferor.

C) the elected amount is received entirely in the form of NSC.

D) the FMV of the property sold is greater than the FMV of the consideration received.

Answer: A

Explanation: A) The FMV of the property sold is less than the FMV of the total consideration received.

Type: MC

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

63) Which of the following statements involving ITA 85 rollovers with excess consideration is correct?

A) Only one-half of the shareholder benefit under ITA 15(1) will be added to income.

B) The amount of the shareholder benefit under ITA 15(1) will be added to the ACB of the consideration received by the transferor.

C) The amount of the shareholder benefit under ITA 15(1) will always be added to the ACB of the share consideration received by the transferor.

D) The amount of the shareholder benefit under ITA 15(1) will be added to the PUC of the consideration received by the transferor.

Answer: B

Explanation: B) The amount of the ITA 15(1) benefit will be added to the ACB of the consideration received by the transferor.

Type: MC

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

64) Which of the following conditions is **NOT** required for ITA 84.1 (dividend stripping) to apply?

A) The shares that are disposed of must have been held as capital property.

B) The corporation, the shares of which are sold, must be associated with the purchaser corporation immediately after the disposition of the shares.

C) The share disposition must be made to a corporation with which the taxpayer does not deal at arm's length.

D) The taxpayer who disposes of the shares must be a Canadian resident other than a corporation.

Answer: B

Explanation: B) The corporation, the shares of which are sold, must be associated with the purchaser corporation immediately after the disposition of the shares.

Type: MC

Topic: Dividend stripping - ITA 84.1

65) Jean Hill, a Canadian resident, sells all of the shares she owns in Hill Inc. to a new company, Jean Ltd. The Hill Inc. shares have an ACB and PUC of $100,000, and a FMV of $1,000,000. The transfer is made under the provisions of ITA 85(1) at an elected amount of $850,000. Ms. Hill receives cash of $850,000 and retractable preferred shares with a FMV of $150,000. What are the immediate income tax consequences to Ms. Hill, as a result of the disposition of shares?

A) A capital gain of $900,000.

B) An ITA 84.1(1) deemed dividend of $750,000 and no capital gain.

C) An ITA 84.1(1) deemed dividend of $750,000, plus a capital gain of $150,000.

D) A capital gain of $750,000.

Answer: B

Explanation: B) An ITA 84.1(1) deemed dividend of $750,000. The PUC reduction will be $150,000, leaving the shares with a PUC of nil. Given this, the deemed dividend totals $750,000 ($150,000 + $850,000 - $100,000 - $150,000).

Type: MC

Topic: Dividend stripping - ITA 84.1

66) Which of the following conditions is **NOT** required for ITA 55(2) (capital gains stripping) to apply?

A) There is a disposition of shares by a corporation to an arm's length person.

B) The corporation that has disposed of the shares has received taxable dividends that are deductible under ITA 112(1) as part of a series of transactions which includes the taxable dividend.

C) One of the purposes of the dividend received by the corporation was to significantly reduce a capital gain on the disposition of shares.

D) The corporation selling the shares must be a resident private corporation.

Answer: D

Explanation: D) The corporation selling the shares must be a resident private corporation.

Type: MC

Topic: Capital gains stripping - ITA 55(2)

67) Parent Co. owns 100% of the shares of Son Co. The Son Co. shares have a FMV of $950,000, and an ACB of $75,000. Son Co. has safe income of $60,000. In order to complete a sale of Son Co. to Unrelated Co., an arm's length corporation, Son Co. borrows $875,000 from a bank, and uses the funds to pay a taxable dividend to Parent Co of the same amount. As a result, the FMV of the Son Co. shares drops to $75,000. At this point, the shares are sold to Unrelated Co. for $75,000. Under these circumstances, the income tax consequences to Parent Co. are:

A) a taxable capital gain of $437,500 and no dividends.

B) Taxable dividend of $875,000 and no capital gains.

C) a taxable capital gain of $437,500 and a taxable dividend of $875,000.

D) a taxable capital gain of $ 407,500 and a taxable dividend of $60,000.

Answer: D

Explanation: A) A taxable capital gain of $437,500 [ (1/2)($950,000 - $75,000)]

B) Dividend income of $875,000 [the actual amount paid as a taxable dividend]

C) A taxable capital gain of $437,500 [(1/2)($950,000 - $75,000)] and a taxable dividend of $875,000 [the actual amount paid as a dividend]

D) A taxable capital gain of $ 407,500 and a taxable dividend of $60,000 TCG = (1/2)($950,000 - $75,000 -$60,000) = $407,500] and [safe income amount of $60,000]

Type: MC

Topic: Capital gains stripping - ITA 55(2)

68) Natasha Pulski's carries on a business as a sole proprietor. The business has inventory with a FMV of $47,000 and a tax cost of $55,000. In addition, it has land that is capital property with a FMV of $275,000 and an ACB of $83,000. She intends to sell the land and inventory to a new corporation, taking back $47,000 in cash for the inventories and $122,000 in cash for the land. If she uses ITA 85(1), what is the possible range of amounts that can be elected for the two properties? If, in each case, she elects the lowest amount, what are the income tax consequences for Ms. Pulski?

Answer:

**Inventories -** The $47,000 FMV is the only possible elected amount. The sale would result in a loss of $8,000 ($55,000 - $47,000), an amount that would be fully deductible. Some nominal share consideration would have to be received. Technically cash should be $46,999 and shares for $1 to avoid difficulties.

**Land -** The minimum elected amount would be the NSC of $122,000 and the maximum would be the FMV of $275,000. Electing the minimum amount would result in a taxable capital gain of $19,500 [($122,000 - $83,000)(1/2)]. Some nominal share consideration would also have to be received.

Type: ES

Topic: Rollovers (ITA 85) - determining the elected amount

69) Natalie Bushkin carries on a business as a sole proprietor. The business has land that is capital property with a FMV of $322,000 and an ACB of $147,000. In addition, the business has inventory with a FMV of $23,000 and a tax cost of $25,000. She intends to sell the land and inventory to a new corporation, taking back $160,000 in cash for the land and $23,000 in cash for the inventory. If she uses ITA 85(1) for the sale, what is the possible range of amounts that can be elected for the two properties? If, in each case, she elects the lowest possible amount, what are the income tax consequences for Natalie?

Answer:

**Land -** The acceptable range would be between the NSC of $160,000 and the FMV of $322,000. Electing the minimum amount of $160,000 would result in a taxable capital gain of $6,500 [(1/2)($160,000 - $147,000)].

**Inventories -** The $23,000 amount is the only possible elected amount. Electing this amount would result in a loss of $2,000 ($23,000 - $25,000). Since each property disposition requires that share consideration be received the NSC should be $22,999 and the share consideration $1 to avoid any difficulties with the election.

Type: ES

Topic: Rollovers (ITA 85) - determining the elected amount

70) Ms. Helen Nasser has two depreciable properties - a Class 1 building and Class 8 equipment. The properties are to be sold to a corporation using ITA 85(1). Relevant information on the two properties are as follows:

**Class 1 Class 8**

FMV of the Property $390,000 $15,000

UCC of Class (Last property in Class) 134,000 10,000

Capital Cost 191,000 27,000

FMV of NSC 246,000 11,000

What is the possible range of amounts that can be elected for the two properties? If, in each case, she elects the lowest possible amount, what are the income tax consequences for Ms. Nasser?

Answer:

**Class 1 Property -** The range would be from $246,000 (the FMV of the NSC) to a maximum of $390,000 (FMV). Election of $246,000 would result in recapture of $57,000 ($191,000 - $134,000) and a taxable capital gain of $27,500 [($246,000 - $191,000)(1/2)].

**Class 8 Property -** The range for the Class 8 property would be from $11,000 (the FMV of the NSC) to a maximum of $15,000 (FMV). Electing the minimum amount of $11,000 would result in recapture of $1,000 ($11,000 - $10,000).

Type: ES

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

71) Joan Barkin carries on a business as a sole proprietor. She plans to sell the depreciable properties of her business to a corporation in which she will be the sole shareholder. Relevant information on the properties are as follows:

**Class 1 Class 8**

FMV of the Property $263,000 $46,000

UCC of Class (Last property in Class) 122,000 52,000

Capital Cost 201,000 81,000

FMV of NSC 100,000 46,000

Joan would like to defer as much income tax as possible on the sale. What is the minimum elected amount she can choose for each property? Justify your answers. If she elects the minimum amount, what are the income tax consequences for Joan in each case?

Answer:

**Class 1 Property -** The maximum elected amount would be the FMV of $263,000 and the minimum amount would be the $122,000 UCC. The UCC should be chosen as the elected amount, as there will be no income tax consequences. Note, however, an additional $22,000 ($122,000 - $100,000) in NSC could have been received without resulting in any income tax consequences.

**Class 8 Property -** With respect to the Class 8 property, the FMV is less than the UCC. In this case, ITA 13(21.2) prevents the application of ITA 85(1) and, if the property is sold to the corporation, the POD are deemed to be the UCC amount of $52,000. There will be no income tax consequences associated with the transfer and the corporation will retain the transferor's original capital cost of $81,000.

While a terminal loss could have been recognized if the property had been sold to an arm's length person, it would have been disallowed in this case because Joan's corporation is an affiliated person.

Type: ES

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

72) Using ITA 85(1), Tom Leung sold non-depreciable capital property to a corporation using an elected amount of $86,800. The property has a capital cost and ACB of $86,800 and a FMV of $246,400. As consideration, he receives a promissory note for $71,400, preferred shares with a FMV of $74,200, and common shares with a FMV of $100,800. Indicate the ACB of the consideration received by Mr. Leung.

Answer: The ACB amounts would be calculated as follows:

Elected Amount $86,800

ACB of Promissory Note (FMV) ( 71,400)

Excess Elected Amount $15,400

ACB of Preferred Shares\* ( 15,400)

ACB of Common Shares (Residual) Nil

\*Remainder available as it is less than the FMV of $74,200.

Type: ES

Topic: Rollovers (ITA 85) - allocating the elected amount (ITA 85(1)(f) & (g))

73) Karl Young owns a non-depreciable capital property with an ACB of $220,000 and a FMV of $460,000. He intends to sell the property to a corporation using the provisions of ITA 85(1), using an elected amount of $220,000. As consideration he will receive a promissory note for $110,000, preferred shares with a FMV of $90,000, and common shares with a FMV of $260,000. Indicate the ACB of the consideration received by Karl.

Answer: The ACB would be calculated as follows:

Elected Amount $220,000

ACB of Promissory Note (FMV) ( 110,000)

Excess Elected Amount $110,000

ACB of Preferred Shares (FMV) ( 90,000)

ACB of Common Shares (Residual) $ 20,000

Type: ES

Topic: Rollovers (ITA 85) - allocating the elected amount (ITA 85(1)(f) & (g))

74) Using ITA 85(1), Ms. Robyn Tunney sells non-depreciable capital property to a corporation at an elected amount of $91,200. The property has an ACB of $91,200 and a FMV of $187,200. As consideration, she receives a promissory note for $66,400, preferred shares with a FMV and legal capital of $77,600, and common shares with a FMV and legal capital of $43,200. Indicate the ACB of all consideration received and the PUC of the preferred and common shares that were issued as consideration to her.

Answer: The ACB would be calculated as follows:

Elected Amount $91,200

ACB of Promissory Note (FMV) ( 66,400)

Excess Elected Amount $24,800

ACB of Preferred Shares\* ( 24,800)

ACB of Common Shares (Residual) Nil

\*Remainder available as it is less than the FMV of $77,600.

The total PUC reduction would be calculated as follows:

Increase in Legal Capital ($77,600 + $43,200) $120,800

Less the excess of:

Elected Amount ($91,200)

Over the FMV of NSC 66,400 ( 24,800)

PUC Reduction $ 96,000

Note that this reduction is equal to the deferred gain on the election of $96,000 ($187,200 - $91,200). The PUC reduction would be allocated on the basis of relative FMV as follows:

Preferred Shares [($96,000)($77,600 ÷ $120,800)] $61,669

Common Shares [($96,000)($43,200 ÷ $120,800)] 34,331

Total PUC Reduction $96,000

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

**Preferred Shares Common Shares**

Legal Capital $77,600 $43,200

PUC Reduction (From Preceding) ( 61,669) ( 34,331)

Total PUC $15,931 $ 8,869

Note that the sum of these two amounts totals $24,800 ($15,931 + $8,869), the total ACB of the preferred and common shares, as well as the difference between the elected amount of $91,200 and the FMV of the NSC of $66,400.

Type: ES

Topic: Rollovers (ITA 85) - allocating the elected amount & PUC/PUC reduction

75) Christine Rue sells a non-depreciable capital property to a corporation, using the provisions of ITA 85(1). The property has a FMV of $342,000 and an ACB of $111,000. She uses an elected amount of $111,000. As consideration she receives:

• Cash of $21,000.

• Preferred shares with a FMV of $50,000.

• Common shares with a FMV of $271,000.

Indicate the ACB and the PUC of the preferred shares and common shares that were issued to Christine.

Answer: The ACB amounts would be calculated as follows:

Elected Amount $111,000

FMV of Non-share consideration (Cash) ( 21,000)

Excess Elected Amount $ 90,000

ACB of Preferred Shares (FMV) ( 50,000)

ACB of Common Shares (Residual) $ 40,000

The total PUC reduction would be calculated as follows:

Increase in Legal Capital ($50,000 + $271,000) $321,000

Less The excess of:

Elected Amount ($111,000)

Over the FMV of NSC 21,000 ( 90,000)

PUC Reduction $231,000

Note that this reduction is equal to the deferred gain on the election of $231,000 ($342,000 - $111,000). The PUC reduction would be allocated on the basis of relative FMVs as follows:

Preferred Shares [($231,000)($50,000 ÷ $321,000)] $ 35,981

Common Shares [($231,000)($271,000 ÷ $321,000)] 195,019

Total PUC Reduction $231,000

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

**Preferred Shares Common Shares**

Legal Capital $50,000 $271,000

PUC Reduction (From Preceding) ( 35,981) ( 195,019)

Total PUC $14,019 $ 75,981

Note that the sum of these two amounts equals $90,000 ($14,019 + $75,981), the total ACB of the preferred and common shares, as well as the difference between the elected amount of $111,000 and the FMV of the NSC of $21,000.

Type: ES

Topic: Rollovers (ITA 85) - allocating the elected amount & PUC/PUC reduction

76) Jack Wild owns a depreciable property with a capital cost and ACB of $120,000 and a FMV of $180,000. It is the only property in its CCA class and the UCC balance for the class is $98,000. He uses ITA 85(1) to set the amounts for income tax purposes and sells this property to a new corporation at an elected amount of $160,000. In return for the property, he receives a promissory note for $160,000, in addition to common shares with a FMV of $20,000.

What are the income tax implications of this transaction for both Jack Wild and the corporation? Include in your answer the ACB and PUC of the shares.

Answer: The income tax consequences to Mr. Wild and the corporation can be described as follows:

• Mr. Wild will have a taxable capital gain of $20,000 [(1/2)($160,000 - $120,000)].

• Mr. Wild will have recapture of CCA of $22,000 ($120,000 - $98,000).

• The shares issued as consideration will have an ACB of nil (elected amount of $160,000, less the FMV of NSC of $160,000). The PUC of the shares would also be nil (legal capital of $20,000, less a PUC reduction of $20,000).

• The corporation will have a depreciable property with an ACB of $160,000 and a deemed capital cost for CCA and recapture purposes, of $140,000 [$120,000 + (1/2)($160,000 - $120,000)]. The corporation will retain the capital cost of $180,000 and be deemed to have claimed CCA of $40,000.

Type: ES

Topic: Rollovers (ITA 85) - elected amount (income tax consequences)

77) Darlene Saunders has carried on a business as a sole proprietor for over 10 years. The business has been very successful and has now reached a point where it is producing more income than she requires for her personal needs. Given this, she would like to incorporate the business to a new corporation, using the provisions of ITA 85(1).

On January 5, 2022, the sale date, the tangible property of the business have total tax costs of $375,000. The combined FMV is $1,190,000. In addition, because of the success of the business, it is estimated that the business has goodwill the FMV of which is $320,000. At the transaction date, business liabilities are $115,000.

The elected amount for the transfer will equal the tax costs of $375,000. The corporation will assume the $115,000 in business liabilities. In addition, Darlene will receive:

• A promissory note of $85,000.

• Preferred shares with a FMV of $100,000.

• Common shares with a FMV of $1,210,000.

Any taxable dividends paid by the corporation will be non-eligible.

**Required**: Determine the following:

1. The ACB of each type of consideration received by Darlene.

2. The PUC of each class of shares issued as consideration by the new corporation.

3. The income tax consequences to Darlene if the new preferred shares are redeemed at their FMV.

Answer:

**Part 1 -** The ACB of the consideration received will total the elected amount of $375,000. It will be allocated as follows:

Elected Amount $375,000

FMV of NSC ($115,000 + $85,000) ( 200,000)

Excess Elected Amount $175,000

ACB of Preferred Shares (FMV) ( 100,000)

ACB of Common Shares (Residual) $ 75,000

**Part 2 -** The PUC of the shares issued must be reduced as follows:

Increase in Legal Capital ($100,000 + $1,210,000) $1,310,000

Less The excess of:

Elected Amount ($375,000)

Over The FMV of NSC 200,000 ( 175,000)

PUC Reduction $1,135,000

This PUC reduction would be split between the preferred shares and the common shares on the basis of their relative FMVs:

Preferred Shares [($100,000/$1,310,000)($1,135,000)] $ 86,641

Common Shares [($1,210,000/$1,310,000)($1,135,000)] 1,048,359

Total PUC Reduction $1,135,000

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

**Preferred Shares Common Shares**

Legal Capital $100,000 $1,210,000

PUC Reduction (From Preceding) ( 86,641) ( 1,048,359)

Total PUC $ 13,359 $ 161,641

**Part 3 -** The income tax consequences of the preferred share redemption would be as follows:

Proceeds of Redemption $100,000

PUC ( 13,359)

ITA 84(3) Deemed Dividend (Non-Eligible) $ 86,641

Proceeds of Redemption $100,000

Less: ITA 84(3) Deemed Dividend ( 86,641)

Modified POD $ 13,359

ACB ( 100,000)

Capital Loss ($ 86,641)

Inclusion Rate 1/2

Allowable Capital Loss ($ 43,321)

The grossed up non-eligible dividend of $99,637 [(115%)($86,641)] would qualify for a federal dividend tax credit of $8,997 [(9/13)(15%)($86,641)]. The allowable capital loss is disallowed (ITA 40(3.6)) and would be added to the ACB of the remaining shares (e.g. the common shares).

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

78) Samuel Rosen incorporates a new corporation, arranging to have all of its common shares issued to his adult daughter for cash of $500. Mr. Rosen then sells, using ITA 85(1), non-depreciable capital property with an ACB of $67,500 and a FMV of $87,750. The transfer is made at an elected amount of $67,500. As consideration for this property, the corporation gives Mr. Rosen a promissory note for $67,500 and preferred shares with a FMV and a legal capital of $20,250. A CRA reassesses on the basis that the actual FMV of the property transferred is $100,000. Mr. Rosen reluctantly accepts the reassessment. There is no price adjustment clause (PAC) in the purchase and sale agreement.

After the reassessment, Mr. Rosen and his daughter sell their shares for their FMV.

Describe the income tax consequences of these transactions for both Mr. Rosen and his daughter. How would these income tax consequences differ if Mr. Rosen had simply sold the non-depreciable capital property for its post-reassessment FMV of $100,000?

Answer: As Mr. Rosen sold property with a post-reassessment FMV of $100,000 and received consideration with a FMV of $87,750 ($67,500 + $20,250), he has made a gift to his daughter of $12,250 ($100,000 - $87,750). The income tax consequences for Mr. Rosen and his daughter are as follows:

Deemed Elected Amount = Deemed POD

($67,500 + $12,250) $79,750

ACB ( 67,500)

Capital Gain $12,250

Inclusion Rate 1/2

Taxable Capital Gain $ 6,125

Elected Amount (Original) $67,500

FMV of NSC ( 67,500)

ACB of Preferred Shares Nil

The required PUC reduction and resulting PUC would be calculated as follows:

Increase in Legal Capital $20,250

Less excess of:

Revised Elected Amount ($79,750)

Over FMV of NSC 67,500 ( 12,250)

PUC Reduction $ 8,000

PUC of Preferred Shares ($20,250 - $8,000) $12,250

The FMV of the common shares is $12,750 ($100,000 + $500 - $67,500 - $20,250).

The sale of the shares for their FMV would result in the following:

**Preferred Common**

POD (FMV) $20,250 $12,750

ACB Nil ( 500)

Capital Gain $20,250 $12,250

Inclusion Rate 1/2 1/2

Taxable Capital Gain $10,125 $ 6,125

If the property had simply been sold for its $100,000 post-reassessment FMV, there would have been a $16,250 [(1/2)($100,000 - $67,500)] taxable capital gain. With the effect of ITA 85(1) there is a $6,125 taxable capital gain, along with a $10,125 taxable capital gain on the sale of the preferred shares. This is the same $16,250 amount that would have occurred on the direct sale of the non-depreciable capital property.

Unfortunately, because the common shares have increased in value by the amount of the gift with no corresponding increase in the ACB, there is an additional $6,125 taxable capital gain (one-half the amount of the gift) on the sale of the daughter's common shares.

Type: ES

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

79) Derek Blunt wishes to sell non-depreciable capital property to a corporation that is owned by his adult daughter. The corporation is a newly incorporate company in which $100 in cash was invested for common shares. Derek's daughter owns all of the common shares of this new corporation.

At the time of the sale to the corporation, the non-depreciable capital property has an ACB of $250,000 and an estimated FMV of $400,000. The sale is made at an elected amount of $250,000, with Derek receiving a promissory note for $250,000 and preferred shares with a legal capital and FMV of $150,000. The CRA reassessed on the basis that the actual FMV was $475,000. Mr. Blunt reluctantly accepts this value and does not object to the reassessment. There is no price adjustment clause (PAC) included in the purchase and sale agreement.

After the reassessment, Derek and his daughter both sell their shares in the new corporation for the FMV.

Describe the income tax consequences of these transactions for both Mr. Blunt and his daughter. How would these income tax consequences differ if Mr. Blunt had simply sold the non-depreciable capital property for its post-reassessment FMV of $475,000?

Answer: As Mr. Blunt sold property with a post-reassessment FMV of $475,000 and received consideration with a FMV of $400,000 ($150,000 + $250,000), he has indirectly made a gift to his daughter of $75,000 ($475,000 - $400,000). The income tax consequences to Mr. Blunt and his daughter are:

Revised Elected Amount = Revised POD

($250,000 + $75,000) $325,000

ACB ( 250,000)

Capital Gain $ 75,000

Inclusion Rate 1/2

Taxable Capital Gain $ 37,500

Elected Amount (Original) $250,000

FMV of NSC ( 250,000)

ACB of Preferred Shares Nil

The required PUC reduction and resulting PUC would be calculated as follows:

Increase in Legal Capital $150,000

Less excess of:

Revised Elected Amount ($325,000)

Over FMV of NSC 250,000 ( 75,000)

PUC Reduction $ 75,000

PUC of Preferred Shares ($150,000 - $75,000) $75,000

The FMV of the common shares is $75,100 ($475,000 + $100 - $250,000 - $150,000).

The sale of the shares for their FMV would result in the following:

**Preferred Common**

POD (FMV) $150,000 $75,100

ACB Nil ( 100)

Capital Gain $150,000 $75,000

Inclusion Rate 1/2 1/2

Taxable Capital Gain $ 75,000 $37,500

If the property had simply been sold for its post-reassessment FMV of $475,000, there would have been a $112,500 [(1/2)($475,000 - $250,000)] taxable capital gain. With the effect of ITA 85(1) there is a $37,500 taxable capital gain on the disposition, along with a $75,000 taxable capital gain on the sale of the preferred shares. This is the same $112,500 amount that would have occurred on the direct sale of the non-depreciable capital property.

Unfortunately, because the common shares have increased in value by the amount of the gift with no corresponding increase in the ACB, there is an additional $37,500 taxable capital gain (one-half the amount of the gift) on the sale of the daughter's common shares.

Type: ES

Topic: Rollovers (ITA 85) - the gifting rule (ITA 85(1)(e.2))

80) In 2021, Mrs. Jeanne Keanings uses ITA 85(1) to set the tax amounts on the sale of non-depreciable capital property to a CCPC in which she is the sole shareholder. The ACB of the property is $136,000 and she believes that it has a FMV of $283,000. In consideration for this property, Mrs. Keanings receives a promissory note for $283,000 and preferred shares with a nominal value.

In 2022 Jeanne is reassessed by the CRA on the basis that the FMV of the transferred property was only $224,000. She accepts the reassessment without objection. There is no price adjustment clause (PAC) in the purchase and sale agreement.

Describe the income tax consequences of the transfer and the reassessment. Indicate the ACB of the consideration, and the ACB and PUC of the preferred shares after the reassessment.

Answer: On the original sale in 2021, Jeanne would have recognized a taxable capital gain of $73,500 [(1/2)($283,000 - $136,000)]. Based on the original estimate of the FMV of the property sold, there was no mismatch in value that would have led to a ITA 15(1) shareholder benefit.

With the value of the property reassessed at $224,000, there is excess consideration and an ITA 15(1) shareholder benefit.

FMV of Consideration $283,000

Reassessed FMV of Property ( 224,000)

ITA 15(1) Shareholder Benefit $ 59,000

With the FMV of the property reassessed to $224,000 the elected amount cannot exceed that amount. This would result in a revised capital gain, calculated as follows:

Revised elected amount $224,000

ACB ( 136,000)

Capital Gain $ 88,000

Inclusion Rate 1/2

Capital Gain After Reassessment $ 44,000

As a result of the reassessment, income for 2021 is increased by $29,500 as shown in the following table:

Shareholder Benefit $59,000

Taxable Capital Gain after Reassessment 44,000

Reversal of Reported Taxable Capital Gain ( 73,500)

Total Addition to Net Income $29,500

The ITA 15(1) benefit of $59,000 would be added to the ACB of the NSC, resulting in the following revision:

Revised Elected Amount $224,000

Add: ITA 15(1) Shareholder Benefit 59,000

ACB of NSC $283,000

Both the ACB and the PUC of the preferred shares would be nil.

Type: ES

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

81) In 2021, Martha Stuart sells a non-depreciable capital property to a CCPC in which she is the sole shareholder using the provisions of ITA 85(1). The ACB of the property is $270,000 and it has an estimated FMV of $550,000. In return for this property, Ms. Stuart receives a promissory note for $550,000 and preferred shares with a nominal value.

In 2022, Martha is reassessed by the CRA on the basis that the FMV of the transferred property was only $415,000. She accepts the reassessment without objection. There is no price adjustment clause (PAC) written into the purchase and sale agreement.

Describe the income tax consequences of the sale and the reassessment. Indicate the ACB of the consideration, and the ACB and PUC of the preferred shares after the reassessment.

Answer: On the original sale in 2021, Martha would have recognized a taxable capital gain of $140,000 [(1/2)($550,000 - $270,000)]. Based on the original estimate of the FMV of the property sold, there would not have been any ITA 15(1) shareholder benefit.

When the FMV of the property is reassessed at $415,000, there is excess consideration and an ITA 15(1) benefit.

FMV of Consideration $550,000

Reassessed FMV of Property ( 415,000)

ITA 15(1) Shareholder Benefit $135,000

With the FMV of the property reassessed to $415,000, there would be a revised capital gain as follows:

Revised Elected Amount $415,000

ACB ( 270,000)

Capital Gain $145,000

Inclusion Rate 1/2

Taxable Capital Gain after Reassessment $ 72,500

As a result of the reassessment, 2021 Net Income will be increased by $67,500 as shown in the following table:

Shareholder Benefit $135,000

Revised Taxable Capital Gain after Reassessment 72,500

Reversal of Reported Taxable Capital Gain ( 140,000)

Total Revision to 2021 Net Income $ 67,500

The ITA 15(1) benefit of $135,000 would be added to the ACB of the promissory note, resulting in the following ACB:

Elected Amount $415,000

Add: ITA 15(1) Shareholder Benefit 135,000

ACB of the promissory note $550,000

Both the ACb and PUC of the preferred shares would be nil.

Type: ES

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

82) Mr. Marshal Stack owns 100% of the outstanding shares of Stack Ltd., a corporation whose shares qualify for the capital gains deduction. The shares have a PUC and an ACB of $132,000 and a FMV of $699,000. The Company has no balance in its GRIP account. On January 31, 2022, Mr. Stack uses ITA 85(1) to sell these shares to Stack's Investments Ltd., at an elected amount of $699,000. As consideration, he receives a promissory note for $390,000 and preferred shares with a FMV and a legal capital of $309,000. Mr. Stack owns all of the shares of Stack's Investments Ltd. and has made no previous use of the capital gains deduction.

What are the income tax consequences of this transaction to Mr. Stack? Include in your answer the ACB and the PUC of the newly issued preferred shares.

Answer: Mr. Stack (an individual) has sold shares of a corporation to a second corporation, a corporation in which he does not deal at arm's length, and the two corporations are connected subsequent to the sale. As a consequence, ITA 84.1 applies. Given this, the income tax consequences of this transaction to Mr. Stack are as follows:

Increase in Legal Capital $309,000

Less Excess, if any, of:

Greater of PUC and ACB of shares sold ($132,000)

Over the FMV of NSC 390,000 Nil

PUC Reduction $309,000

PUC of New Shares ($309,000 - $309,000) Nil

Increase in Legal Capital $309,000

FMV of NSC 390,000

Total $699,000

Less The sum of:

Greater of PUC and ACB of shares sold ($132,000)

PUC Reduction ( 309,000) ( 441,000)

ITA 84.1 Deemed Dividend (Non-Eligible) $258,000

Elected POD for Subject Shares $699,000

Less: ITA 84.1 Deemed Dividend ( 258,000)

Modified POD $441,000

ACB of Subject Shares ( 132,000)

Capital Gain $309,000

Inclusion Rate 1/2

Taxable Capital Gain $154,500

ACB of New Shares ($699,000 - $390,000) $309,000

The grossed up non-eligible dividend of $296,700[(115%)($258,000)] would qualify for a federal dividend tax credit of $26,792 [(9/13)(15%)($258,000)]. In addition, there would be a taxable capital gain of $154,500 that would be eligible for the capital gains deduction. If Mr. Stack claims the deduction, he may need to pay alternative minimum tax (AMT).

Type: ES

Topic: Dividend stripping - ITA 84.1

83) Foral Inc., a Canadian public company, owns 80% of the outstanding shares of Matlin Ltd. Matlin Ltd. is also a Canadian public company. The shares of Matlin Ltd. have an ACB of $125,000 and a FMV of $940,000. The safe income of Matlin Ltd. is $285,000.

Foral Inc. wishes to dispose of these shares, and Sored Company, an arm's length corporation, is interested in purchasing them. In order to accomplish this goal, the Matlin Ltd. shares are transferred to Sored, using the provisions of ITA 85(1), at an elected amount of $125,000. As consideration for the transferred shares, Foral Inc. receives redeemable voting preferred shares issued by the Sored Company that have a FMV of $940,000. The ACB and PUC of these shares are equal to the elected amount of $125,000. Foral Inc. redeems these shares immediately. Describe the income tax consequences to Foral Inc. of the redemption.

Answer: In the absence of ITA 55(2), the results for Foral would be as follows:

Proceeds Of Redemption $940,000

Less: PUC of Preferred Shares ( 125,000)

ITA 84(3) Deemed Dividend $815,000

POD $940,000

Less: ITA 84(3) Dividend ( 815,000)

Modified POD $125,000

ACB ( 125,000)

Capital Gain Nil

As the ITA 84(3) dividend is deductible under ITA 112(1) the Company would have succeeded in disposing of the Martin shares without income tax consequences even though shares were sold at FMV to an arm's length person.

However, as the redemption was in conjunction with a disposition to an arm's length purchaser, ITA 55(2) alters this result. ITA 55(2) would deem $587,000 ($815,000, less $228,000, 80% of the Safe Income of $285,000) of the ITA 84(3) dividend to not be a dividend ITA 55(2) would then deem the $587,000 to be POD. The result for Foral would be a capital gain determined as follows:

Modified POD $125,000

Add: Deemed POD 587,000

Total POD $712,000

ACB ( 125,000)

Capital Gain $587,000

Inclusion Rate 1/2

Taxable Capital Gain $293,500

There would be a tax free taxable dividend equal to the Safe Income of $228,000 [(80%)($285,000)] and a taxable capital gain of $293,500.

Type: ES

Topic: Capital gains stripping - ITA 55(2)

84) Several years ago, Ms. Fox acquired a small apartment building for $950,000 ($225,000 for the land and $725,000 for the building).

The property has a current FMV $1,200,000 ($300,000 is attributable to the land and $900,000 to the building). Ms. Fox would like to incorporate the property using ITA 85(1) to minimize the income tax implications. At the beginning of the current year, the building had a UCC of $582,000. The elected amount chosen is $807,000 ($225,000 for the land + $582,000 for the building). The consideration paid by the corporation to Ms. Fox for the property is 12,000 common shares.

Shortly after the rollover is completed, Ms. Fox sells all of the common shares she received to to Mr. Hound, an arm's length person, for POD of $1,200,000.

**Required:**

A. Describe the income tax consequences for Ms. Fox of using ITA 85(1) and selling the common shares.

B. How do these results compare with the income tax consequences of simply selling the building directly to Mr. Hound for $1,200,000?

Answer:

***Part A - Sale using ITA 85(1)***

As the $807,000 elected amount was equal to the tax costs of the property, there would be no income tax consequences associated with the rollover. The income tax consequences of selling the common shares would be calculated as follows:

Total Elected Amount $ 807,000

FMV of NSC Nil

ACB - Common Shares (Residual) $ 807,000

POD $1,200,000

ACB - Common Stock ( 807,000)

Capital Gain $ 393,000

Inclusion Rate 1/2

Taxable Capital Gain $ 196,500

***Part B - Direct Sale (No ITA 85(1) Rollover)***

The income tax consequences of selling the property directly would be as follows:

**Land Building**

POD $300,000 $900,000

ACB ( 225,000) ( 725,000)

Capital Gain $ 75,000 $175,000

Inclusion Rate 1/2 1/2

Taxable Capital Gain $ 37,500 $ 87,500

Based on these calculations, the overall tax effect of the direct sale would be as follows:

Taxable Capital Gain on Land $ 37,500

Taxable Capital Gain on Building 87,500

Recapture on Building ($725,000 - $582,000) 143,000

Total additional income $268,000

The reason for the difference lies in the type of income that the two approaches produce. The total amount of income, before consideration of preferential treatment, that you would expect on this transaction is $393,000 ($1,200,000 - $807,000). When ITA 85(1) is used, this full amount is received as a capital gain, resulting in an income inclusion of $196,500. In contrast, with the direct sale, only $250,000 ($75,000 + $175,000) of the total income is received as a capital gain, with the remaining $143,000 ($393,000 - $250,000) being received as fully taxable recapture. The result is a higher amount included in income under the direct sale alternative.

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem (direct sale vs indirect sale with use of ITA 85(1))

85) The following three **independent** cases involve sale/transfer of property to a corporation using ITA 85(1).

**Case One -** Land with a cost of $423,000 and a FMV of $647,000 is sold to a corporation in exchange for $47,000 in NSC and $600,000 in preferred shares (FMV and legal capital).

**Case Two -** Inventories with a FMV of $87,400 and a cost of $63,200 are sold in exchange for $70,000 in NSC and $17,400 in common shares (FMV and legal capital).

**Case Three -** Depreciable property with a FMV of $124,000, an ACB and capital cost of $115,000, and a UCC of $52,992, is sold for NSC of $100,000, preferred shares with a FMV and legal capital of $10,000, and common shares with a FMV and a legal capital of $14,000.

**Required**: For each of the three Cases provide the following information:

A. The minimum and maximum elected amount under the provisions of ITA 85.(1)

B. Assuming the minimum elected amount is chosen, the amount of capital gain or business income to be included in the income of the seller.

C. Again assuming that the minimum elected amount is chosen, determine the ACB and PUC of the preferred share and common share consideration. Your answer should include the determination of any shareholder benefit under ITA 15(1) or deemed dividend under ITA 84(1) that will arise on the sale, or explain why there is no shareholder benefit or deemed dividends.

Answer:

***Case One - Land***

A. The acceptable range of elected amounts is between the ACB of $423,000 and the FMV of $647,000.

B. Using the minimum elected amount of $423,000 would result in no additional income.

C. The ACB of the preferred shares would be calculated as follows:

Elected Amount $423,000

FMV of NSC ( 47,000)

ACB - Preferred Shares $376,000

The PUC reduction would be calculated as follows:

Increase in Legal Capital $600,000

Less The excess, if any, of:

Elected Amount ($423,000)

Over FMV of NSC 47,000 ( 376,000)

PUC Reduction $224,000

This would leave the PUC of the preferred shares at $376,000 ($600,000 - $224,000).

There are no deemed dividends under ITA 84(1) or shareholder benefits under ITA 15(1) since the FMV of the property sold equals the FMV of the consideration received.

***Case Two - Inventories***

A. The range of values would be between the $70,000 in FMV of NSC and the FMV of $87,400.

B. Using the minimum $70,000 elected amount would result in business income of $6,800 ($70,000 - $63,200).

C. The ACB of the common shares would be calculated as follows:

Elected Amount $70,000

Less: FMV of NSC ( 70,000)

ACB - Common Shares Nil

The PUC reduction would be calculated as follows:

Increase in Legal Capital $17,400

Less the excess, if any, of:

Elected Amount ($70,000)

Over the FMV of NSC 70,000 ( Nil)

PUC Reduction $17,400

This would leave the PUC of the common shares at nil ($17,400 - $17,400).

There are no deemed dividends under ITA 84(1) or shareholder benefits under ITA 15(1) since the FMV of the property sold equals the FMV of the consideration received.

***Case Three - Depreciable Property***

A. The range would be between the FMV of the NSC of $100,000 and the FMV of $124,000.

B. Using the $100,000 elected amount would result in business income (recapture) of $47,008 ($100,000 - $52,992).

C. The ACB of the preferred shares and common shares would be calculated as follows:

Elected Amount $100,000

Less: FMV of NSC ( 100,000)

ACB - Preferred Shares and Common Shares Nil

The PUC reduction on the preferred and common shares would be calculated as follows:

Increase in Legal Capital ($10,000 + $14,000) $24,000

Less the excess, if any, of:

Elected Amount ($100,000)

Over the FMV of NSC 100,000 ( Nil)

PUC Reduction $24,000

The PUC of both the preferred and common shares would be nil ($24,000 - $24,000).

There are no deemed dividends under ITA 84(1) or shareholder benefits under ITA 15(1) since the FMV of the property sold equals the FMV of the consideration received.

Type: ES

Topic: Rollovers (ITA 85) - short cases [determining the elected amount & tax consequences]

86) Janice Tabor has a depreciable property that she wishes to sell to a new corporation using ITA 85(1). The property has an ACB and capital cost of $450,000, a UCC of $225,000, and a FMV of $675,000. The transfer will take place at an elected amount of $400,000.

Ms. Tabor is considering the following alternative forms of consideration:

**Alternative**

**One Two Three**

Promissory Note $150,000 $375,000 $300,000

Preferred Shares 150,000 300,000 Nil

Common Shares 375,000 Nil 375,000

Total $675,000 $675,000 $675,000

All of the amounts in the preceding table are shown at their respective FMVs.

**Required:**

A. For each of the three alternatives, determine the ACB of the consideration received.

B. For each of the three alternatives, determine the legal capital and PUC of the share consideration.

Answer:

***Part A - ACB of Consideration***

The ACB of the consideration, under the three alternatives, would be calculated as follows:

**Alternative**

**One Two Three**

Elected Amount $400,000 $400,000 $400,000

Less: FMV of NSC ( 150,000) ( 375,000) ( 300,000)

Available for Share Consideration $250,000 $ 25,000 $100,000

Less: ACB - Preferred Stock ( 150,000) ( 25,000) N/A

ACB - Common Stock (Residual) $100,000 N/A $100,000

The ACB of the NSC is equal to its FMV.

***Part B - Legal Capital and PUC***

The legal capital for the two classes of shares would be as follows:

**Alternative**

**One Two Three**

Preferred Shares $150,000 $300,000 Nil

Common Shares 375,000 Nil $375,000

Total Legal Capital $525,000 $300,000 $375,000

The required PUC reduction would be calculated as follows:

**Alternative**

**One Two Three**

Increase in Legal Capital

- All Shares (A) $525,000 $300,000 $375,000

Elected Amount ($400,000) ($400,000) ($400,000)

FMV of NSC 150,000 375,000 300,000

Elected Amount, Less NSC (B) ( $250,000) ($ 25,000) ($100,000)

Required PUC Reduction (A - B) $275,000 $275,000 $275,000

**Alternative One -** In Alternative One, the PUC reduction would have to be split between the two classes of shares on the basis of their relative FMVs. The relevant calculation would be as follows:

Preferred Shares: [($275,000)($150,000 ÷ $525,000)] = $78,571

Common Shares: [($275,000)($375,000 ÷ $525,000)] = $196,429

This would leave PUC of $71,429 ($150,000 - $78,571) for the preferred shares, and PUC of $178,571 ($375,000 - $196,429) for the common shares.

**Alternative Two -** In Alternative Two, the entire PUC reduction of $275,000 would be allocated to the preferred shares, leaving PUC of $25,000 ($300,000 - $275,000).

**Alternative Three -** In Alternative Three, the entire PUC reduction of $275,000 would be allocated to the common stock, leaving PUC of $100,000 ($375,000 - $275,000).

Type: ES

Topic: Rollovers (ITA 85) - PUC and the PUC reduction (ITA 85(2.1))

87) Paul Kwan owns a rental property that he purchased years ago for $780,000. Of this total, $280,000 was for the land and $500,000 for the building.

An appraiser has estimated that the current FMV of the land is $425,000 and the current FMV of the building is $775,000. The current UCC of the building is $391,000.

Mr. Kwan wishes to use ITA 85(1) when he sells this property to a new corporation, Kwan Ltd. in which he will be the sole shareholder.

**Case A -** Mr. Kwan elects to sell the property at an elected amount of $280,000 for the land and $391,000 for the building. In return, he receives shares in the new corporation with a FMV and legal capital of $1,200,000 ($425,000 + $775,000).

**Case B -** Mr. Kwan elects to sell the property at an elected amount of $425,000 for the land and $391,000 for the building. The consideration consists of shares in the new corporation with a FMV and legal capital of $1,200,000.

**Case C -** Mr. Kwan elects to sell the property at an elected amount of $425,000 for the land and $391,000 for the building. The consideration consists of a promissory note for $816,000 and shares in the new corporation with a FMV and legal capital of $384,000.

**Required:** For each of the preceding three independent cases, determine:

• The immediate income tax consequences of the sale.

• The tax costs of the land and building to the corporation.

• The ACB of the share consideration.

• The PUC of the share consideration.

Answer:

***Case A***

**Immediate Income Tax Consequences -** As the elected amounts for the land and building equal their respective tax costs, there are no immediate income tax consequences resulting from the sale.

**Tax Cost of the Land and Building -** The tax cost of the land (ACB) would be the elected amount of $280,000. The tax cost of the building (UCC) would be the elected amount of $391,000. Note, however, the new corporation would retain the old capital cost of $500,000, with the $109,000 difference being treated as deemed CCA.

**ACB of Shares -** The ACB of the shares issued by the corporation would be calculated as follows:

Elected Amount ($280,000 + $391,000) $671,000

Less: FMV of NSC Nil

ACB of Shares $671,000

**PUC Of Shares -** The required PUC reduction and resulting PUC would be calculated as follows:

Legal Capital of Shares $1,200,000

Less Excess, if any, of:

Elected Amount ($671,000)

Over FMV of NSC Nil ( 671,000)

PUC Reduction $ 529,000

PUC of Shares ($1,200,000 - $529,000) $ 671,000

***Case B***

**Immediate Income Tax Consequence**s - As the elected amount for the land of $425,000 exceeds the $280,000 ACB of the land, there is a taxable capital gain of $72,500 [(1/2)($425,000 - $280,000)]. As the elected amount of the building is equal to its tax cost, there are no immediate income tax consequences for the disposition of the building.

**Tax Cost of the Land and Building -** The tax cost of the land (ACB) would be the elected amount of $425,000. The tax cost of the building (UCC) would be the elected amount of $391,000. Once again, the new corporation would retain the old capital cost of $500,000, with the $109,000 difference being treated as deemed CCA.

**ACB of Shares -** The ACB of the shares issued by the corporation would be calculated as follows:

Elected Amount ($425,000 + $391,000) $816,000

Less: FMV of NSC Nil

ACB of Shares $816,000

**PUC of Shares -** The required PUC reduction and resulting PUC would be calculated as follows:

Legal Capital of Shares $1,200,000

Less Excess, if any, of:

Elected Amount ($816,000)

Over FMV of NSC Nil ( 816,000)

PUC Reduction $ 384,000

PUC of Shares ($1,200,000 - $384,000) $ 816,000

***Case C***

**Immediate Income Tax Consequence**s - As the elected amount for the land of $425,000 exceeds the $280,000 ACB of the land, there is a taxable capital gain of $72,500 [(1/2)($425,000 - $280,000)]. As the elected amount of the building is equal to its tax cost, there are no immediate income tax consequences with respect to the disposition of the building.

**Tax Costs of the Land and Building -** The tax cost of the land (ACB) would be the elected amount of $425,000. The tax cost of the building (UCC) would be the elected amount of $391,000. Note, however, that the new corporation would retain the old capital cost of $500,000, with the $109,000 difference being treated as deemed CCA.

**ACB of Shares -** The ACB of the shares issued by the corporation would be calculated as follows:

Elected Amount ($425,000 + $391,000) $816,000

Less: FMV of NSC ( 816,000)

ACB of Shares Nil

**PUC of Shares -** The required PUC reduction and resulting PUC would be calculated as follows:

Legal Capital of Shares $384,000

Less Excess, if any, of:

Elected Amount ($816,000)

Over the FMV of NSC 816,000 Nil

PUC Reduction $384,000

PUC of Shares ($384,000 - $384,000) Nil

Type: ES

Topic: Rollovers (ITA 85) - comprehensive 3 cases with depreciable property

88) During the current year, Mr. Thomas Nelson sold a depreciable property to a new corporation in which he is the sole shareholder. The taxation year of the corporation is December 31.

The depreciable property was the only remaining property in its CCA class. It had been purchased several years ago for $225,000. Because of increasing difficulty in purchasing this type of property, it's FMV os now $316,000. At the time of the sale, the balance in the UCC class was $189,600.

In order to offset a $40,000 capital loss on a sale of investments in the current year, Mr. Nelson elects an amount of $265,000 ($225,000 + $40,000).

As consideration, Mr. Nelson receives a promissory note for $150,000, preferred shares with a FMV of $50,000, and common shares with a FMV of $116,000.

**Required:** Describe the income tax implications resulting from this transaction. Your answer should include both current income tax implications, and the determination of tax attributes (ACB, Capital cost, PUC etc) that will have future tax implications.

Answer:

***Income as a result of the sale/transfer***

This transaction will affect Mr. Nelson's current year income as follows:

UCC for Class $189,600

Dispositions - Lesser of:

• Capital Cost = $225,000

• POD (Elected Amount) = $265,000 ( 225,000)

Negative Balance ($ 35,400)

Recapture 35,400

UCC Nil

POD (Elected Amount) $265,000

ACB ( 225,000)

Capital Gain $ 40,000

Inclusion Rate 1/2

Taxable Capital Gain $20,000

Allowable Capital Loss on Investments [(1/2)($40,000)] ( 20,000)

Net Taxable Capital Gain Nil

Mr. Nelson will have business income of $35,400, the recapture of CCA. The $20,000 taxable capital gain will be completely offset by the $20,000 allowable capital loss on the sale of investments, resulting in no addition to current year net income.

***ACB of Consideration***

The ACB of the consideration received by Mr. Nelson would be as follows:

Elected Amount $265,000

ACB of NSC ( 150,000)

Available for Share Consideration $115,000

ACB of Preferred Shares ( 50,000)

ACB of The Common Shares (Residual) $ 65,000

***Capital Cost of Transferred Depreciable Property***

The capital cost, for CCA and recapture purposes, would be calculated as follows:

Capital Cost to Transferor $225,000

POD $265,000

ACB ( 225,000)

Excess $ 40,000

Fraction 1/2 20,000

Capital Cost to Corporation for CCA Purposes (ITA 13(7)(e)) $245,000

The ACB of the property for capital gains purposes is the elected amount of $265,000.

***Paid Up Capital (PUC)***

The total PUC for the two classes of shares would be calculated as follows:

Increase in Legal Capital ($50,000 + $116,000) $166,000

Less Excess of:

Elected Amount ($265,000)

Over the FMV of NSC 150,000 ( 115,000)

PUC Reduction $ 51,000

The PUC reduction would be allocated on the basis of relative FMVs as follows:

Preferred Shares [($51,000)($50,000 ÷ $166,000)] $15,361

Common Shares [($51,000)($116,000 ÷ $166,000)] 35,639

Total PUC Reduction $51,000

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

**Preferred Shares Common Shares**

Legal Capital $50,000 $116,000

PUC Reduction (From Preceding) ( 15,361) ( 35,639)

Total PUC $ 34,639 $ 80,361

Note that the total PUC of $115,000 ($34,639 + $80,361) is equal to the total ACB of $115,000 ($50,000 + $65,000).

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

89) Several years ago, Ms. Katrina Bond acquired a business location that included land and a building for a total of $950,000. At the time, it was estimated that the FMV of the land was $220,000 and the FMV of the building was $730,000.

Ms. Bond carried on the business for several years as a sole proprietor and, during this period, CCA was claimed on the building. As there were years in which she experienced losses, she did not always claim the maximum amount of CCA.

Ms. Bond has agreed to take your advice and incorporate the business. She will use ITA 85(1) to sell the land and building to the new corporation in January of 2022. At the time of the sale, the building had a UCC of $625,000. Other relevant amounts were as follows:

**Elected**

**Property Tax Cost FMV Amount**

Land $220,000 $ 510,000 $220,000

Building 625,000 980,000 730,000

Total $845,000 $1,490,000 $950,000

There is a $400,000 mortgage on the property that will be assumed by the new corporation. In addition, the new corporation will issue a $500,000 promissory note to Ms. Bond. The remaining consideration will be in the form of common shares with a FMV and legal capital of $590,000. The new corporation does not have a balance in its GRIP account in any of the taxation years under consideration.

**Required:**

A. What are the income tax consequences of making this sale at an elected amount of $950,000? Your answer should include amounts to be included in Ms. Bond's income as a result of the sale, as well as the corporation's tax costs for the land and building.

B. Compute the ACB of the consideration that Ms. Bond has received from the corporation.

C. Compute the PUC of the common share consideration.

D. What amounts would be included in Ms. Bond's 2022 net income if, in 2022, she sells the common shares for $650,000?

E. What amounts would be included in Ms. Bond's 2022 net income if, in 2022, the corporation redeems the common share consideration for $650,000?

Answer:

***Part A - Income Tax Consequences of Sale***

With respect to the land, the $220,000 elected amount will be both the POD to Ms. Bond and the ACB to the corporation. As the elected amount is equal to Ms. Bond's ACB, there will be no income tax consequences resulting from the sale of the land.

The elected amount and POD for the building is its original cost, an amount that is in excess of its UCC. This will result in Ms. Bond having to include recapture of $105,000 ($730,000 - $625,000) in her 2022 income. However, with the elected amount at Ms. Bond's original cost for the building, both the capital cost and the UCC will be equal to the elected amount of $730,000.

***Part B - ACB of Consideration***

The ACB of all consideration received by Ms. Bond will be the total elected amount of $950,000. It will be allocated as follow:

Elected Amount $950,000

FMV of NSC

($400,000 Assumed Debt + $500,000 Promissory Note) ( 900,000)

ACB of Common Shares $ 50,000

***Part C - PUC of the Share Consideration***

The calculation of PUC would be as follows:

Increase in Legal Capital (FMV) $590,000

Less Excess of:

Elected Amount ($950,000)

Over the FMV of NSC 900,000 ( 50,000)

PUC Reduction $540,000

The PUC of the common shares would be reduced to $50,000 ($590,000 - $540,000).

***Part D - Sale of Common Shares***

The increase in 2022 net income from a sale of the shares received as consideration for $650,000 would be as follows:

POD $650,000

ACB ( 50,000)

Capital Gain $600,000

Inclusion Rate 1/2

Taxable Capital Gain $300,000

***Part E - Tax Consequences of Redemption***

The income tax consequences of a redemption of the shares issued as consideration for $650,000 would be as follows:

Proceeds of Redemption $650,000

Less: PUC ( 50,000)

ITA 84(3) Deemed Dividend (Non-Eligible) $600,000

There would be no capital gain on this redemption as shown in the following calculation:

Redemption Proceeds $650,000

Less: ITA 84(3) Deemed Dividend ( 600,000)

Modified POD $ 50,000

ACB ( 50,000)

Capital Gain Nil

The amount to be included in 2022 would be $690,000, the $600,000 deemed non-eligible dividend grossed up by 15%.

There would also be a federal dividend tax credit of $62,308 [(9/13)(15%)($600,000)].

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

90) Griffeth Enterprises is the registered name of a business carried on as a sole proprietorship by Sol Griffeth. As Mr. Griffeth has outstanding management skills, the business has grown rapidly. Since he no longer needs all of the income that is generated by the business, he would like to incorporate the business to a new corporation in which he will be the sole shareholder. The new corporation would be named Griffeth Ltd. and would have a December 31 taxation year end.

On January 1, 2022, the tax attributes (ACB, UCC etc) and FMV of the assets and liabilities reported by the accountants for Griffeth Enterprises are as follows:

**Tax Cost FMV**

Accounts Receivable $ 168,000 $ 161,000

Temporary Investments 58,000 49,000

Inventory 310,000 326,000

Furniture and Fixtures 71,000 87,000

Machinery (Capital Cost = $302,000) 275,000 384,000

Land 210,000 432,000

Building (Capital Cost = $656,000) 579,000 713,000

Goodwill Nil 275,000

Total $1,671,000 $2,427,000

Liabilities ( 104,000) ( 104,000)

Net Business Assets (Owner's Equity) $1,567,000 $2,323,000

The sale of the Griffeth Enterprises' business properties to Griffeth Ltd. will take place on January 1, 2022, and the provisions of ITA 85(1) will be used to minimize any income tax implications of the incorporation of the business. Griffeth Ltd. will assume the liabilities of Griffeth Enterprises and, in addition, will issue $1,120,000 of a promissory note to Mr. Griffeth. With respect to share consideration, the new Company will issue preferred shares with a FMV of $300,000 and common shares with a FMV of $903,000.

All of the shares issued by Griffeth Ltd. as part of this rollover will be issued to Mr. Griffeth. Griffeth Ltd. does not have a balance in its GRIP account for any of the taxation years under consideration.

**Required:**

A. Determine whether the Accounts Receivable and Temporary Investments should be sold using the provisions of ITA 85(1). Explain your conclusion and, if you recommend that ITA 85(1) should not be used, indicate the appropriate alternative treatment.

B. Without regard to your conclusions in Part A, assume that all of the business properties are sold to the new corporation using the provisions of ITA 85(1). Indicate the minimum elected amounts for each property.

C. Assume the sale of all of the properties of the business is made using the provisions of ITA 85(1), and that Mr. Griffeth will elect the amount that you have determined in Part B. Determine the ACB of the consideration received by Mr. Griffeth. In addition, determine the PUC of the share consideration.

D. Indicate the income tax consequences to Mr. Griffeth if the preferred shares and common shares received as consideration were:

1. immediately sold for their FMVs; or alternatively

2. immediately redeemed by the new corporation at their FMV.

Answer:

***Part A - Accounts Receivables and Temporary Investments***

If the Accounts Receivable are sold using ITA 85(1), no election can be made under ITA 22. As a result, the $7,000 ($168,000 - $161,000) loss will be a capital loss, which will be disallowed under ITA 40(2)(g) because the transfer is to a corporation controlled by the seller (an affiliated person). The appropriate treatment would be to exclude the Accounts Receivable from the ITA 85(1) election. This would permit the use of the ITA 22 election that would allow the $7,000 loss to be treated as a fully deductible loss. As ITA 22 is a joint election, the corporation would have to include the $7,000 in income, but could then deduct actual doubtful debt reserves and bad debts as they occur. If the ITA 22 election is not made, the tax cost of the accounts receivables to the corporation will be their FMV. If a different amount is collected, the result will be either a capital gain or a capital loss.

With respect to the Temporary Investments, ITA 40(2)(g) would deny the $9,000 ($58,000 - $49,000) capital loss on a transfer to a controlled corporation (an affiliated person), without regard to whether the sale is made using ITA 85(1). This means that there is no point in selling these investments to the corporation. Mr. Griffeth could continue to own the investments personally or, alternatively, sell them to an arm's length person. The allowable capital loss on such a sale would be immediately deductible, provided that Mr. Griffeth has available sufficient taxable capital gains. If he does not, he might wish to structure the ITA 85(1) rollover in such a fashion that $9,000 in capital gains are realized on the rollover through an elected amount that triggers the required capital gains.

***Part B - Minimum Elected Amounts***

The minimum elected amounts would be as follows:

Accounts Receivable $ 161,000

Temporary Investments 49,000

Inventories 310,000

Furniture and Fixtures 71,000

Machinery 275,000

Land 210,000

Building 579,000

Goodwill 1

Total Elected Amounts $1,655,001

***Part C - ACB of Consideration***

The ACB of the NSC would be its FMV which, in the case of debt, would be FMV of $1,224,000 ($1,120,000 promissory note, plus $104,000 in assumed debt). Given this, the ACB of the share consideration would be as follows:

Total Elected Amount $1,655,001

Less: FMV of NSC ( 1,224,000)

Available for Share Consideration $ 431,001

Less: ACB of Preferred Shares (FMV) ( 300,000)

ACB of Common Shares (Residual) $ 131,001

**(The following paragraph is not required.)**

As Mr. Griffeth will control the new corporation, the capital losses of $7,000 on Accounts Receivable and $9,000 on Temporary Investments will be disallowed under ITA 40(2)(g). The disallowed losses will be added to the tax cost of the those properties to Griffeth Ltd.. This means the Accounts Receivable will have an ACB of $168,000 and the Temporary Investments will have an ACB of $58,000. Any bad debts on the Accounts Receivable will be treated as capital losses.

***Part C - PUC of the Preferred Shares and Common Shares***

The PUC calculation would begin with the legal capital of the shares. These were $300,000 for the preferred shares and $903,000 for the common shares. ITA 85(2.1) would require a PUC reduction in this total as follows:

Total Increase in Legal Capital of Shares

($300,000 + $903,000) $1,203,000

Less Excess of:

Total Elected Amounts ($1,655,001)

Over the FMV of the NSC 1,224,000 ( 431,001)

PUC Reduction $ 771,999

The PUC reduction would be allocated on the basis of relative FMVs as follows:

Preferred Shares [($771,999)($300,000 ÷ $1,203,000)] $192,518

Common Shares [($771,999)($903,000 ÷ $1,203,000)] 579,481

Total PUC Reduction $771,999

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

**Preferred Shares Common Shares**

Legal Capital $300,000 $903,000

Less: PUC Reduction ( 192,518) ( 579,481)

PUC $107,482 $323,519

The total PUC of $431,001 ($107,481 + $323,519) is equal to the difference between the elected amounts of $1,655,001 and the FMV of the NSC of $1,224,000. It is also equal to the total ACB of the two classes of shares ($300,000 + $131,001).

***Part D(1) - Income Tax Consequences of a Share Sale***

The income tax consequences for Mr. Griffeth on the sale of the preferred and common shares would be as follows:

**Preferred Common**

**Shares Shares**

POD $300,000 $903,000

ACB (Part C) ( 300,000) ( 131,001)

Capital Gain Nil $771,999

Inclusion Rate N/A 1/2

Taxable Capital Gain Nil $386,000

***Part D(2) - Income Tax Consequences of Share Redemptions***

The income tax consequences for Mr. Griffeth on the redemption of the preferred shares and common shares would be as follows:

**Preferred Common**

**Shares Shares**

Proceeds of Redemption $300,000 $903,000

Less: PUC (Part C) ( 107,482) ( 323,519)

ITA 84(3) Deemed Dividend (Non-Eligible) $192,518 $579,481

Redemption Proceeds $300,000 $903,000

Less: ITA 84(3) Deemed Dividend ( 192,518) ( 579,481)

Modified POD $107,482 $323,519

ACB ( 300,000) ( 131,001)

Capital Gain (Loss) ($192,518) $192,518

Mr. Griffeth would have a deemed non-eligible dividend of $771,999 ($192,518 + $579,481). This is also the amount of the gain that was deferred through the use of ITA 85(1) ($2,427,000 - $1,655,001).

The grossed up non-eligible dividend of $887,799 [(115%)($771,999)] would qualify for a federal dividend tax credit of $80,169 [(9/13)(15%)($771,999)].

There is a net capital gain of nil ($192,518 - $192,518).

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

91) Karla Manson purchased a commercial property consisting of land and a building 2 years ago for $920,000. At the purchase date, it was estimated that the FMV of the land on which the building was situated was $175,000 and the building $745,000. The purchase was financed with a mortgage of $420,000.

She had intended to begin business operations immediately. However, health problems required her to defer beginning operations for over a year. Since she expects the business to be profitable immediately, she decides to sell the land and building to a new corporation in which she will be the sole shareholder.

The sale will take place on January 1, 2022 and, at that time, relevant facts about the property are as follows:

**Land Building**

FMV $300,000 $1,100,000

ACB 175,000 745,000

UCC\* N/A 690,000

Mortgage Balance N/A 375,000

\*As the building was used periodically to earn income, Ms. Manson has claimed CCA.

Ms. Manson will choose an elected amount for the land of $300,000 and $700,000 for the building.

The corporation will assume the $375,000 mortgage on the building and, in addition, will issue a promissory note to Ms. Manson for $625,000. The corporation will also issue common shares to Ms. Manson with a FMV of $400,000 and legal capital of $400,000.

The new corporation does not have a balance in its GRIP account in any of the taxation years under consideration.

**Required:**

A. What are the income tax consequences of making this sale at the elected amount of $1,000,000? Your answer should identify amounts to be included in Ms. Manson's income as a result of the sale, as well as the corporation's tax costs of the properties.

B. Determined the ACB of the consideration received from the corporation.

C. Calculate the PUC of the common share consideration.

D. What amounts would be included in Ms.Manson's income if, in 2022, she sells her common shares for $400,000?

E. What amounts would be included in Ms.Manson's income if, in 2022, the corporation redeems her common shares for $400,000?

Answer:

***Part A - Income Tax Consequences of the Sale***

With respect to the land, the $300,000 elected value will be both the POD to Ms. Manson and the ACB to the corporation. As the elected amount exceeds the ACB there is a taxable capital gain of $62,500 [(1/2)($300,000 - $175,000)].

The elected amount and POD for the building is $700,000, an amount that is less than its capital cost of $745,000, but more than its UCC of $690,000. This will result in Ms.Manson having to include recapture of $10,000 ($700,000 - $690,000) in her income. The corporation's ACB is $700,000. However, the corporation will retain the original capital cost of $745,000 for recapture purposes and will be deemed to have claimed CCA of $45,000.

***Part B - ACB of the Consideration***

The ACB of all consideration received by Ms. Manson will be the total elected amount of $1,000,000 ($300,000 + $700,000). It will be allocated as follow:

Total Elected Amount $1,000,000

Less: FMV of NSC

($375,000 Assumed Mortgage + $625,000 New Debt) ( 1,000,000)

ACB of Common Shares Nil

***Part C - PUC of the Share Consideration***

The calculation of PUC would be as follows:

Increase in Legal Capital (FMV) $400,000

Less excess of:

Elected Amount ($1,000,000)

Over the FMV of NSC 1,000,000 Nil

PUC Reduction $400,000

The PUC of the common shares would be reduced to Nil ($400,000 - $400,000).

***Part D - Sale of Common Shares***

The increase in income from a sale of the shares for $400,000 would be as follows:

POD $400,000

ACB Nil

Capital Gain $400,000

Inclusion Rate 1/2

Taxable Capital Gain $200,000

As taxable income consequences are not required, the effect of the capital gains deduction was not considered.

***Part E - Income Tax Consequences of Redemption***

The income tax consequences of a redemption for $400,000 would be as follows:

Proceeds of Redemption $400,000

Less: PUC Nil

ITA 84(3) Deemed Dividend (Non-Eligible) $400,000

There would be no capital gain on this redemption as shown in the following calculation:

Proceeds of Redemption $400,000

Less: ITA 84(3) Deemed Dividend ( 400,000)

Modified POD Nil

ACB Nil

Capital Gain Nil

The amount to be included in 2022 net income would be the grossed up amount of $460,000 [(115%)($400,000)]. There would also be a federal dividend tax credit of $41,538 [(9/13)(15%)($400,000)].

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

92) For the last six years, Ms. Sarah Delmor has carried on the business (called Delmor Industries) as a sole proprietor. The business has been very successful and, as a consequence, has experienced rapid growth. Given this situation, Ms. Delmor has concluded that in order to enhance her ability to raise additional capital, the business should be incorporated to a new corporation, Delmor Inc. in which she will be the sole shareholder.

On July 1, 2022, the tax costs (ACB, Capital cost or UCC) and FMV of the properties and liabilities of the business as reported by the accountants are as follows:

**Tax Cost FMV**

Accounts Receivable $ 120,000 $ 112,000

Temporary Investments 42,000 37,000

Inventories 220,000 231,000

Depreciable Property - CCA Class 8 (Note One) 53,000 61,500

Machinery (Note Two) 197,000 273,000

Land 150,000 311,000

Building (Note Three) 416,000 523,500

Goodwill Nil 200,000

Total $1,198,000 $1,749,000

Liabilities ( 72,000) ( 72,000)

Net (Owner's Equity) $1,126,000 $1,677,000

**Note One -** There are two properties in Class 8. Property A has a capital cost of $27,000 and a FMV of $32,500. Property B has a capital cost of $33,000 and a FMV of $29,000.

**Note Two -** The capital cost of the Machinery is $212,500.

**Note Three -** The capital cost of the Building is $472,000.

The sale of the Delmor Industries' properties to Delmor Inc. will take place on July 1, 2022, and an election will be filed under ITA 85(1). Delmor Inc. will assume the liabilities of Delmor Industries and, in addition, will issue $800,000 in new debt (a promissory note) to Ms. Delmor. With respect to share consideration, the new Company will issue preferred shares with a FMV of $200,000 and common stock with a FMV of $677,000.

Any shares issued by Delmor Inc. as part of this rollover will be issued to Ms. Delmor. Delmor Inc. does not have a balance in its GRIP account in any of the taxation years under consideration.

**Required:**

A. Determine whether the Accounts Receivable and Temporary Investments should be sold using the provisions of ITA 85(1). Explain your conclusion and, if you recommend that ITA 85(1) should not be used, indicate the appropriate alternative treatment.

B. Without regard to your conclusions in Part A, assume that all of the properties are sold to the new corporation using the provisions of ITA 85(1). Indicate the minimum amounts that can be elected for each property. Explain how the election would apply to Property A and B in Class 8.

C. Assume the sale of the business properties to Delmor Inc. is going to be made using the provisions of ITA 85(1). Ms. Delmor will elect the minimum amounts determined in Part B, and sell all of the properties of Delmor Industries (whether or not appropriate). Determine the ACB of the consideration received by Ms. Delmor. In addition, determine the PUC of the preferred share and common share consideration.

D. Determine the income tax consequences to Ms. Delmor if the preferred share and common share consideration were immediately redeemed by the new corporation at FMV.

Answer:

***Part A - Accounts Receivables and Temporary Investments***

If the accounts receivable are sold using ITA 85(1), no election can be made under ITA 22. As a result, the $8,000 ($120,000 - $112,000) loss on the receivables will be a capital loss, which will be disallowed under ITA 40(2)(g) because the sale is to a corporation controlled by the transferor (an affiliated person). The appropriate treatment would be to exclude the Accounts Receivable from the ITA 85(1) election. This would permit the use of the ITA 22 election that would allow the $8,000 loss to be treated as a fully deductible business amount. As ITA 22 is a joint election, the corporation would have to include the same $8,000 in income, but could then deduct actual doubtful debt reserves and bad debts as they occur with respect to the purchased receivables.

With respect to the temporary investments, ITA 40(2)(g) would also deny the $5,000 ($42,000 - $37,000) capital loss on a sale to a controlled corporation, without regard to whether the sale is made under the provisions of ITA 85(1) because of the affiliated person connection. This means that there is no point in selling the investments to the corporation. Ms. Delmor could continue to personally own the investments or, alternatively, sell them to a non-affiliated person. The allowable capital loss on such a sale would be immediately deductible, provided that Ms. Delmor has available sufficient taxable capital gains. Another option is to structure the ITA 85(1) rollover to include an elevated elected amount to generate additional capital gains to offset the capital losses.

***Part B - Minimum Elected Amounts***

The minimum elected amounts would be as follows:

Accounts Receivable $ 112,000

Temporary Investments 37,000

Inventory 220,000

Class 8 Depreciable Property (See Note) 53,000

Machinery 197,000

Land 150,000

Building 416,000

Goodwill 1

Total Elected Amounts $1,185,001

**Note -** The minimum elected amount for depreciable property, under ITA 85(1)(e), is the least of the UCC for the class, the cost of the individual property, and the FMV of the individual property. For the two Class 8 properties, these amounts would be as follows:

Property A (Least of $53,000, $27,000, and $32,500) $27,000

Property B (Least of $53,000, $33,000, and $29,000) 29,000

Total $56,000

If this amount is used, the result will be recapture of $3,000 ($56,000 - $53,000). However, ITA 85(1)(e.1) allows the properties to be sold one at a time in order to avoid this result. Therefore, if Property A is sold first, the UCC balance will be $26,000 ($53,000 - $27,000). This means that when Property B is sold, the least amount will be the UCC of $26,000 and, when this is subtracted, the UCC balance will be nil and there will be no recapture.

***Part C - ACB of the Consideration***

The ACB of the NSC would be its FMV which, in the case of debt, would be $872,000 ($800,000 in new debt, plus $72,000 of old debt assumed). Given this, the allocations to the share consideration would be as follows:

Total Elected Amount $1,185,001

Less: FMV of NSC ( 872,000)

Available for Share Consideration $ 313,001

ACB of Preferred Shares (FMV Maximum) ( 200,000)

ACB of Common Shares (Residual) $ 113,001

**(The following paragraph is not required.)**

As Ms. Delmor will control the new corporation, the capital losses of $8,000 on Accounts Receivable and $5,000 on Temporary Investments will be disallowed under ITA 40(2)(g). The disallowed losses will be added to the tax cost of those properties to the corporation. This means the Accounts Receivable will have a tax cost of $120,000 and the Temporary Investments will have a tax cost of $42,000 for Delmor Inc. Any bad debt losses on the Accounts Receivable will be capital losses.

***Part C - PUC of the Preferred Shares and Common Shares***

The PUC calculation begins with the legal capital. These were $200,000 for the preferred shares and $677,000 for the common shares. ITA 85(2.1) would require a PUC reduction as follows:

Total Increase in Legal Capital

($200,000 + $677,000) $877,000

Less Excess of:

Total Elected Amount ($1,185,001)

Over the FMV of NSC 872,000 ( 313,001)

PUC Reduction $563,999

The PUC reduction would be allocated on the basis of relative FMVs as follows:

Preferred Shares [($563,999)($200,000 ÷ $877,000)] $128,620

Common Shares [($563,999)($677,000 ÷ $877,000)] 435,379

Total PUC Reduction $563,999

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be:

**Preferred Shares Common Shares**

Initial PUC (Legal Capital) $200,000 $677,000

Less: PUC Reduction (From Preceding) ( 128,620) ( 435,379)

PUC $ 71,380 $241,621

The PUC of $313,001 ($71,380 + $241,621) is equal to the difference between the elected amount of $1,185,001 and the NSC of $872,000. It is also equal to the ACB of the two classes of shares ($200,000 + $113,001).

***Part D - Income Tax Consequences of Redemption***

The income tax consequences for Ms. Delmor on the redemption of the preferred common shares would be as follows:

**Preferred Common**

**Shares Shares**

Redemption Proceeds $200,000 $677,000

Less: PUC (Part C) ( 71,380) ( 241,621)

ITA 84(3) Deemed Dividend (Non-Eligible) $128,620 $435,379

Redemption Proceeds $200,000 $677,000

Less: ITA 84(3) Deemed Dividend ( 128,620) ( 435,379)

Modified POD $ 71,380 $241,621

ACB ( 200,000) ( 113,001)

Capital Gain (Loss) ($128,620) $128,620

Ms. Delmor would have a deemed non-eligible dividend of $563,999 ($128,620 + $435,379). This is also the amount of the gain that was deferred through the use of the rollover ($1,749,000 - $1,185,001). The grossed up non-eligible dividend of $648,599 [(115%)($563,999)] would qualify for a federal dividend tax credit of $58,569 [(9/13)(15%)($563,999)].

There is a net capital gain of nil ($128,620 - $128,620).

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem

93) Ms. Bess Chadwick carries on a business as a sole proprietor. The business has been extremely successful and is now worth several million dollars. While she is only 32 years old, she would like to retire. She has developed a taste for luxury travel and would like to spend the next two years pursuing that interest before settling down to a life of leisure in Canada.

Her common-law partner for the last four years has been Biff Banner. Bess would like to sell the business and its future growth of the business to Biff.

In order to implement the decision to sell the business to Biff, she has arranged for Biff to incorporate a new corporation and by investing $5,000 in its newly issued common shares. At the time of incorporation, the cash investment of $5,000 is the only corporate property and Biff owns the only common shares. The new corporation is named Bannerr Executive Services and Supplies (BESS) and will have a December 31 taxation year end.

On January 1, 2022, Ms. Chadwick will sell most of the business properties to BESS. On that date, the tax costs (UCC, capital cost and ACB) and estimated FMVs are as follows:

**Tax Cost FMV**

Inventory $1,200,000 $ 1,250,000

Depreciable Properties - CCA Class 8 (Note One) 3,650,000 3,850,000

Land 1,870,000 2,600,000

Building (Note Two) 3,100,000 4,800,000

Total $9,820,000 $12,500,000

Liabilities ( 850,000) ( 850,000)

Net (Owner's Equity) $8,970,000 $11,650,000

**Note One -** The capital cost of the properties in Class 8 on January 1, 2022 is $4,100,000.

**Note Two -** The capital cost of the Building is $3,600,000.

The Accounts Receivable of the business will be sold using ITA 22 rather than ITA 85(1). Also, a business valuation has indicated that Ms. Chadwick's business does not have any goodwill.

Ms. Chadwick will sell the business properties at an elected amount of $9,820,000. The new corporation will assume all of the $850,000 of business liabilities and issue a promissory note to Ms. Chadwick in the amount of $7,150,000. She will also receive redeemable preferred shares with a FMV and legal capital of $4,500,000.

On review, the CRA issues a reassessment in August, 2022 which increases the FMV of the land to $3,100,000, an increase of $500,000. Ms. Chadwick does not plan to appeal this reassessment as she had been pressed for time and had decided on the $2,600,000 value without any professional consultation. There is no price adjustment clause (PAC) written into the purchase and sale agreement.

**Required:** Ignore the capital gains deduction in your solution.

A. Taking into consideration the reassessment, determine the income tax consequences to Ms. Chadwick that result from the sale of her business properties to BESS. Your answer should include amounts to be included in Ms. Chadwick's income as a result of the sale, as well as the ACB and PUC of her preferred shares.

B. Determine the income tax consequence to Ms. Chadwick if BESS subsequently redeems her preferred shares for $4,500,000.

C. In early December of 2022 Biff sells his BESS shares to a non-affiliated person for $550,000. Determine the income tax consequences of the share for Biff.

Answer:

***Part A***

As the FMV of the consideration received by Ms. Chadwick was less than the reassessed FMV of the properties sold, the result would be that she has indirectly made a gift to a related person, Biff. given that the value of his common shares would have increased by the gift amount.

ITA 85(1)(e.2) requires that any gift amount be added to the elected amount with the total being used as the deemed POD without any increase in the ACB of any share consideration received.

The amount of the gift and the income tax consequences of the sale to Ms. Chadwick would be calculated as follows:

FMV of Properties Sold

($12,500,000 + $500,000) $13,000,000

Less The greater of:

• FMV of Consideration Received = $12,500,000

($850,000 + $1,150,000 + $6,000,000 + $4,500,000)

• Elected Amount = $9,820,000 ( 12,500,000)

Gift Amount $ 500,000

Based on the reassessment, the $500,000 will be added to the cost of the land resulting in a taxable capital gain calculated as follows:

Revised Elected Amount = Revised POD

($9,820,000 + $500,000) $10,320,000

Tax Costs of Properties sold ( 9,820,000)

Capital Gain $ 500,000

Inclusion Rate 1/2

Taxable Capital Gain $ 250,000

The ACB of the preferred shares received by Ms. Chadwick would be calculated as follows:

Elected Amount (Original) $9,820,000

FMV of NSC ($850,000 + $1,150,000 + $6,000,000) ( 8,000,000)

ACB of Preferred Shares $1,820,000

The required PUC reduction and resulting PUC for the preferred shares received by Ms. Chadwick would be calculated as follows:

Increase in Legal Capital $4,500,000

Excess, If any of:

Revised Elected Amount

($9,820,000 + $500,000) ($10,320,000)

Over FMV of NSC 8,000,000 ( 2,320,000)

PUC Reduction $2,180,000

PUC of Preferred Shares ($4,500,000 - $2,180,000) $2,320,000

***Part B***

The income tax consequences to Ms. Chadwick of a share redemption would be as follows:

Proceeds of Redemption $4,500,000

Less: PUC of Shares ( 2,320,000)

ITA 84(3) Deemed Dividend $2,180,000

This deemed dividend would be grossed up to $2,507,000 [(115%)($2,180,000)] and will generate a federal dividend tax credit of $226,385 [(9/13)(15%)($2,180,000)].

In addition to the ITA 84(3) deemed dividend, there will also be a taxable capital gain calculated as follows:

POD $4,500,000

Less: ITA 84(3) Deemed Dividend ( 2,180,000)

Modified POD $2,320,000

ACB ( 1,820,000)

Capital Gain $ 500,000

Inclusion Rate 1/2

Taxable Capital Gain $ 250,000

***Part C***

If Biff Bangor sells his shares for $550,000, the income tax consequences would be as follows:

POD $550,000

ACB ( 5,000)

Capital Gain $545,000

Inclusion Rate 1/2

Taxable Capital Gain $272,500

***Economic Analysis (Not Required)***

If Ms. Chadwick had simply sold her business properties for their reassessed FMV, she would have had a combination of business income and capital gains totalling $3,180,000 ($13,000,000 - $9,820,000). Using ITA 85(1), the result has the same $3,180,000 ($500,000 capital gain on the sale, plus the deemed dividend of $2,180,000 resulting from the redemption, plus the $500,000 capital gain also resulting from the redemption). While the composition of the income is different, the overall result is the same.

However, there is an impact on Biff. The $500,000 gift increased the FMV of his shares with no corresponding increase in the ACB of the shares. In effect, this has become a component of the $545,000 capital gain. The result is that this same amount has been included in the income of both Bess and Biff. This result could have been avoided by a properly structured with the addition of a Price Adjustment Clause (PAC).

Type: ES

Topic: Rollovers (ITA 85) - comprehensive problem with gifting

94) In 2021, Mr. Mark Graber sells non-depreciable capital property to an existing corporation in which he is the sole shareholder. The sale is made using the rollover provisions of ITA 85(1). The corporation has a December 31 taxation year end.

The property has an ACB of $342,000 and Mr. Graber believes that it has a FMV of $560,000. Reflecting this view, he takes back a promissory note with a FMV of $560,000 and one preferred share with a nominal value. He reports a taxable capital gain of $109,000 [(1/2)($560,000 - $342,000)] in his 2021 income tax return.

In 2022, the CRA reassesses on the basis that the FMV of the property was only $475,000 at the time of the sale. Mr. Graber accepts this reassessed value and does not file an objection. There was no price adjustment clause (PAC) written into the purchase and sale agreement.

**Required:**

A. Determine the income tax consequences to Mr. Graber that will result from the sale of the property to the corporation in 2021 and the subsequent reassessment in 2022.

B. Indicate the tax cost of the consideration received subsequent to the reassessment.

Answer:

***Part A***

The original amount used in the sale resulted in a taxable capital gain of $109,000. The reassessment value of $475,000 identifies a situation in which there is excess consideration. In other words he took too much from the corporation on the disposition of the non-depreciable capital property, resulting in the following ITA 15(1) benefit:

FMV of Consideration Received $560,000

Less: FMV of Property Given Up ( 475,000)

ITA 15(1) Shareholder Benefit $ 85,000

With the value of the transferred property reassessed at $475,000, the elected amount cannot exceed this amount. Based on this, there would be a revised taxable capital gain on the transfer, calculated as follows:

Revised Elected Amount $475,000

ACB ( 342,000)

Revised Capital Gain $133,000

Inclusion Rate 1/2

Revised Taxable Capital Gain $ 66,500

The net effect of the reassessment would be calculated as follows:

Revised Taxable Capital Gain $ 66,500

Shareholder Benefit 85,000

Reversal of Initial Taxable Capital Gain ( 109,000)

Change in 2021 Net Income $ 42,500

***Part B***

Because a $85,000 benefit will be included in Mr. Graber's income as a result of a property acquisition, ITA 52(1) requires that this amount be added to the ACB of the consideration. Given this, the ACB of the consideration (e.g. the promissory note) would be as follows:

Revised Elected Amount $475,000

Add: ITA 15(1) Shareholder Benefit 85,000

ACB of Consideration (Promissory Note) $560,000

Type: ES

Topic: Rollovers (ITA 85) - shareholder benefit ITA 15(1)

95) Mr. Doug Johnston is the sole shareholder of Johnston Home Furnishings, a CCPC involved in the sale of retail products for the home. He has managed the business of the Company for the last 20 years, in most years earning satisfactory profits.

As of December 31, 2022, relevant information as to the FMV of the Company and therefore the FMV of his shares are as follows:

Initial Investment (PUC) $ 478,000

FMV - December 31, 2021 $3,985,000

Mr. Johnston is nearing retirement and wishes to gradually wind down the corporate business. In preparation for retirement, he has enrolled in a variety of courses at a local college. One of these courses, Taxation 405, has introduced him to the concept of selling property to a corporation using a rollover under ITA 85(1). In reviewing this provision, it has occurred to him that, by selling the shares of Johnston Home Furnishings to a new company, he could avoid income tax on the appreciation in the value of his shares of $3,507,000 - the difference between his initial investment of $478,000 and the current FMV of $3,985,000. In 2022 his available capital gains deduction is $500,000.

In view of his analysis of the situation, he has plans to sell all of the shares of Johnston Home Furnishings to a new company, Johnston Investments in January of 2022. The sale/transfer will be made using the provisions of ITA 85(1) and an elected amount of $978,000 will be chosen. In return for the shares of Johnston Home Furnishings, Mr. Johnston will receive a promissory note for $978,000 and 10 common shares of the new company. These shares have a legal capital and a retraction value of $3,007,000.

The promissory note will be due in one year and Mr. Johnston anticipates that, as a result of dividends received from Johnston Home Furnishings, Johnston Investments will have sufficient cash to pay the entire amount at that time.

Neither of the Companies have a GRIP balance in any of the taxation years under consideration.

**Required:**

A. In the absence of ITA 84.1, determine the income tax consequences of the sale of the shares of Johnston Home Furnishings to Johnston Investments.

B. Determine whether ITA 84.1 would apply. Assuming that ITA 84.1 does apply, calculate the deemed dividend that would arise on the sale. In addition, indicate the net economic effect that would result from this transfer combined with a redemption of the Johnston Investments shares at their FMV of $3,007,000 ($3,985,000 - $978,000).

Answer:

***Part A - Absence of ITA 84.1***

Without ITA 84.1, Mr. Johnston could sell the shares in Johnston Home Furnishings (JHF, hereafter) on a rollover basis to Johnston Investments (JI, hereafter) at the elected amount of $978,000, receiving NSC for this full amount. This would result in a capital gain of $500,000 ($978,000 - $478,000), all of which could be offset by the capital gains deduction. In the absence of ITA 84.1, there would be no income tax consequences as a result of the sale of the shares.

***Part B - Application of ITA 84.1***

Mr. Johnston is a Canadian resident and JHF is a corporation resident in Canada. In addition, Mr. Johnston does not deal at arm's length with JI (the purchaser corporation), and JI is, immediately after the sale of the JHF shares, connected with JHF therefore ITA 84.1 applies. This means that there will be a PUC reduction of the JI shares, calculated under ITA 84.1(1)(a) as follows:

Increase in Legal Capital of JI $3,007,000

Less the Excess, if any, of:

Greater of PUC and ACB of JHF Shares $ 478,000

Over the FMV of NSC ( 978,000) Nil

ITA 84.1 PUC Reduction $3,007,000

PUC After Reduction ($3,007,000 - $3,007,000) Nil

There would also be a deemed dividend, calculated under ITA 84.1(1)(b) as follows:

Increase in Legal Capital of JI $3,007,000

Add: FMV of NSC 978,000

Total $3,985,000

Less:

PUC of JHF Shares ($ 478,000)

PUC Reduction ( 3,007,000) ( 3,485,000)

ITA 84.1(1)(b) Deemed Dividend (Non-Eligible) $ 500,000

The ACB of the JI shares would be calculated as follows:

Elected Amount $978,000

Less: FMV of NSC ( 978,000)

ACB - JI Common Shares Nil

As shown in the following calculation, there would be no capital gain or loss on the disposition of JHF shares:

Elected Amount $978,000

Less: ITA 84.1 Deemed Dividend ( 500,000)

Modified POD $ 478,000

ACB ( 478,000)

Capital Gain Nil

If the JI shares were later redeemed at their FMV of $3,007,000 ($3,985,000 - $978,000), the results would be as follows:

Redemption Proceeds $3,007,000

Less: PUC Nil

ITA 84(3) Deemed Dividend (Non-Eligible) $3,007,000

Redemption Proceeds $3,007,000

Less: ITA 84(3) Deemed Dividend ( 3,007,000)

Modified POD Nil

ACB Nil

Capital Gain Nil

The overall economic effect of all of these transactions would be as follows:

ITA 84.1(1)(b) Deemed Dividend $ 500,000

ITA 84(3) Deemed Dividend 3,007,000

Total Deemed Dividends $3,507,000

The deemed non-eligible dividends would result in taxable dividends of $4,033,050 [(115%)($3,507,000)], which would qualify for a federal dividend tax credit of $364,188 [(9/13)(15%)($3,507,000)].

***(The following paragraphs are not required.)***

If Mr. Johnston had simply sold the original JHF shares for their FMV to a person other than a non-arm's length corporation, the sale would have resulted in a capital gain of $3,507,000 ($3,985,000 - $478,000). However, the application of ITA 84.1 on the rollover to JI and the subsequent redemption of the share consideration has resulted in this full amount being characterized as a deemed dividend. The effective substitution of a dividend for a capital gain eliminates the ability to use the capital gains deduction which remains available for another day.

Type: ES

Topic: Dividend stripping - ITA 84.1 comprehensive problem

96) Shipley Inc. is a CCPC that is an investment holding corporation that has owned 100% of the outstanding shares of Shapley Ltd. a CCPC that is an subsidiary company that carries on an extensive business. The ACB and PUC of the Shapely shares owned by Shipley are both $895,000. The FMV its shares in the subsidiary is $2,450,000. The subsidiary has $462,000 in safe income that is attributable to the shares owned by Shipley

Shipley does no balance in either of its RDTOH accounts and neither company has a positive GRIP account balance.

**Required:** Indicate the income tax consequences to Shipley Inc. in both of the following **independent** situations:

A. Shapley Ltd. obtains a bank loan in the amount of $1,555,000 and uses all of this amount to pay a taxable dividend to Shipley Inc. Subsequent to the payment of the taxable dividend, Shipley Inc. sells the Shapley shares to Ms. Arden, an arm's length person, for $895,000.

B. Using ITA 85(1), Shipley sells the Shapley shares to Arden Ltd., an arm's length corporation. The elected amount is $895,000. As consideration, Shipley receives Arden Ltd. preferred shares with an ACB and PUC of $895,000 and a redemption value of $2,450,000. Immediately after the sale, Arden Ltd. redeems the preferred shares for $2,450,000.

Answer:

***Part A***

In the absence of ITA 55(2), the entire $1,555,000 taxable dividend would be deducted in the determination of Shipley's taxable income. However, as a taxable inter-corporate dividend has been paid in conjunction with a disposition of property to an arm's length person, ITA 55(2) applies. As a result, the following calculation is required for the dividend received by Shipley:

Dividends Received from Shapley $1,555,000

Dividend Attributable to Safe Income ( 462,000)

Amount Deemed by ITA 55(2) not to be a Dividend

and by ITA 55(2) to be a Capital Gain $1,093,000

Inclusion Rate 1/2

Taxable Capital Gain $ 546,500

As shown, $462,000 of the funds would be received by Shipley as a taxable dividend from safe income and could be claimed as a taxable income deduction under ITA 112,(1) resulting in no Part I tax cost. However, the remainder would be converted to a taxable capital gain of $546,500. We would add that this also results in an increase of the same amount to the company's capital dividend account (CDA).

***Part B***

In the absence of ITA 55(2), the results for Shipley would be as follows:

Proceeds of Redemption $2,450,000

PUC of Preferred Shares ( 895,000)

ITA 84(3) Deemed Dividend $1,555,000

Proceeds of Redemption $2,450,000

Less: ITA 84(3) Dividend ( 1,555,000)

Modified POD $ 895,000

ACB ( 895,000)

Capital Gain Nil

As the ITA 84(3) taxable dividend can be claimed as a taxable income deduction, the Company would have succeeded in disposing of the Shapley shares without income tax consequence.

However, as the redemption was in conjunction with a disposition of corporate property to an arm's length purchaser, ITA 55(2) applies to deem $1,093,000 ($1,555,000, less the safe income of $462,000) of the ITA 84(3) dividend not to be a dividend. ITA 55(2)(b) would then deem the $1,093,000 to be POD. The result would be a capital gain determined as follows:

Modified POD $ 895,000

Plus: Deemed POD (ITA 55(2)) 1,093,000

POD $1,988,000

ACB ( 895,000)

Capital Gain $1,093,000

Inclusion Rate 1/2

Taxable Capital Gain $ 546,500

The overall result would be the same as in Part A. That is, that $462,000 of the taxable dividend distribution is free of Part I tax and the remainder is characterized as a capital gain. There would also be an addition to the company's CDA of $546,500.

Type: ES

Topic: Capital gains stripping - ITA 55(2)