EXCHANGE OF SHARES IN AN INTERNAL REORGANIZATION – SECTION 86

- Section 86 is used when a shareholder of a corporation exchanges all of his shares in one class for newly authorized shares in another class
- In addition to taking back another class of shares, the shareholder can also take back some non-share consideration (i.e. boot)

Technical Calculations

In an exchange of shares two things happen:

1. The Issuance of "new shares" by the corporation

PUC of New Shares	ACB of New Shares
PUC of new shares = PUC of old shares - Boot	ACB of new shares = ACB of old shares - Boot

2. Redemption of the "old shares" by the corporation:

Deemed Dividend	Capital Gain
Deemed Dividend = Proceeds – PUC of old shares *Proceeds = boot + PUC of new shares*	Capital Gain = Adjusted Proceeds – ACB *Adjusted Proceeds = boot + ACB of new shares – Deemed Dividends*

There will be no deemed dividend or capital gains as long as the **Boot is less than** the **minimum of:**

a) PUC of old shares; and
b) ACB of old shares

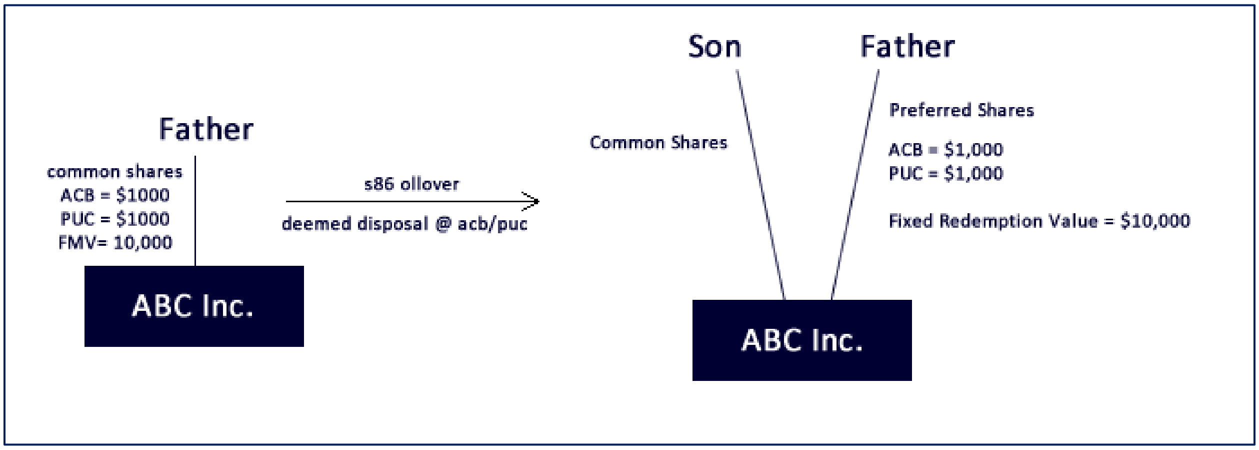
Suppose PUC of old shares = ACB of Old Shares = $10, and in an internal exchange of shares I take back boot = $15

- New PUC = 10-15 = $NIL (cannot be negative)
- New ACB = 10-15 = $NIL (cannot be negative)
- Deemed Dividends = (15+0)-10 = $5
- Capital Gain = (15+0-5)-10 = $NIL

Therefore, there will be a deemed dividend of $5

Application of Section 86

- Section 86 Rollover is used in an Estate Freeze
- Example of Estate Freeze using Section 86



- The Father owns all the common shares of ABC Inc. He is nearing retirement and wants to pass on the future growth of the company to his son.

- **Step 1:** To make this happen, he exchanges his common shares for preferred shares (he does not take back any boot/non-share consideration)
  - **The ACB of the Preferred Shares** = old ACB – Boot = $1,000-0 = $1,000
  - **The PUC of the Preferred Shares** = old PUC – Boot = $1,000-0 = $1,000
  - **Deemed Dividends** = boot+ new PUC – Old PUC = (0+1000)-1000= NIL
  - **Capital Gain** = boot + new ACB – Deemed Dividend – old ACB = (0+1,000-0)-1,000 = $NIL

- The fixed redemption value will always equal to the fair market value of the common shares at the time the exchange took place = $10,000
  - This means that when the father ultimately disposes his shares (or upon his death) the proceeds will be $10,000; he will have an accrued (unrealized) capital gain of $9,000
  - Note how this capital gain is fixed; therefore his growth is "frozen"

- **Step 2:** ABC Inc. then issues common shares to his son for a **nominal amount**
  - The future growth of the company will not flow to the Son
  - The Father will be no longer on the hook for future growth for tax purposes; when he disposes or redeems his shares; he will only be on the hook for the $9,000 gain that is frozen

Criteria for Section 86

1. The shares must be capital property (cannot be used to earn business income – see business income vs. capital gains notes)
2. The shareholder (i.e. the father) must transfer all shares owned in a particular class
    - If the shareholder owns class A common shares and plans on exchanging it for preferred shares; for s 86 to apply, he must transfer all shares he owns in Class A
        - note that other shareholders do not need to dispose their class A shares for this rollover to apply

3. The transferor (i.e. the father) must receive at least one share in return

Tips on Avoiding Disputes with CRA

Note that in our example, the father took back some preferred shares with a redemption value (fair value) of $10,000. ABC Inc. must ensure that the preferred shares issued represents the redemption value. To ensure that you do that:

1. The preferred shares must be redeemable at the option of the shareholder (i.e. the father)
2. The preferred shares should pay dividends at a reasonable rate – this is done to protect the fair value of the preferred share and to ensure that a benefit isn't being conferred to the common shareholder (in essence CRA wants to know that the FV is protected)
3. The corporation needs to have a policy stating that it would not pay dividends to other classes of shares if doing so would jeopardize the corporation from redeeming preferred shareholder due to insufficient net assets
4. When the FMV of the net assets of the company becomes less than the redemption value; the preferred shares must become cumulative preferred shares

Other Common Uses of Section 86

- When the shareholder **does not have a suitable family member** to be the successor; often owner-managers choose a successful employee to be the successor
- A section 86 rollover can be used in this situation whereby the shareholder will exchange his shares for preferred shares; the employee will then purchase common shares issued by the corporation
- The shareholder can provide support to the new owner by being a preferred shareholder; note that the preferred shares can also have normal voting rights
- when the shareholder is ready, he can redeem his preferred shares