

Section 44.1 Versus Section 110.6: Is the Deferral Worth the Pain?

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The replacement property rules in section 44 and subsection 13(4) , regarding the voluntary or involuntary disposition of land, buildings, and other capital property, are well known and commonly used, but a second set of replacement property rules in section 44.1 is less well known. Section 44.1 allows a taxpayer to defer a capital gain when certain shares of a company ("the target company") are sold, provided that the proceeds are invested in shares of another company ("the replacement company") and certain conditions are met.

Although this concept appears simple, a planner must carefully review the conditions of section 44.1 in order to ensure that all of them are met. The concepts used in section 44.1 are similar to those associated with qualified small business corporation (QSBC) shares as defined in subsection 110.6(1) , but there are several important distinctions: section 44.1 includes many terms and phrases that are all defined specifically for the purposes of that particular section.

The Vendor

In order to meet the conditions set out in section 44.1, the vendor of the shares of the target company must be an individual, pursuant to the preamble in the definition of "qualifying disposition" in subsection 44.1(1) . In contrast to the rules for QSBC shares, the vendor cannot be a trust for the purposes of section 44.1.

Status of Target Company

At the time of sale, the target company must be an eligible small business corporation (ESBC), as defined in subsection 44.1(1), which states that an ESBC is

- a corporation that is a CCPC all or substantially all of the FMV of the assets of which is
 - used principally in an active Canadian business of the corporation or of a related ESBC,
 - shares or debt owing by other related ESBCs, or
 - a combination of the two foregoing.

The definition of an ESBC is very similar to the definition of "small business corporation" (SBC) in subsection 248(1), but there are subtle differences in phrasing. It is unknown whether this distinction was made deliberately in order to narrow the range of companies that would qualify under section 44.1.

There is also a specific exclusion from the ESBC definition. Pursuant to subsection 44.1(10), neither the target company nor the replacement company can be one of the following:

- a professional corporation;
- a specified financial institution;
- a corporation whose principal business is leasing, rental, development, or sale, or any combination thereof, of real property; or
- a corporation of which more than 50 percent of the FMV of its property is real property (net of any debts incurred to acquire the property).

No similar exclusions exist for the purposes of subsection 110.6(1), which means that section 44.1 is narrower in scope than subsection 110.6(1).

Holding Period Test

Pursuant to paragraph (c) of the definition of "qualifying disposition" in subsection 44.1(1), the vendor must hold the shares for 185 days before the sale. Thus, this holding period test is much less stringent than the 24-month holding period test for QSBC shares. Furthermore, subsections 44.1(6) and (7) provide for a "continuity rule" in the event of a reorganization of the shares, thus allowing the new shares to maintain the attributes of the old ones provided that certain conditions are met. The rules set out in these two subsections are similar to the continuity rules in paragraph 110.6(14)(f).

Classification of Shares of the Target Company

The shares of the target company that are disposed by the vendor must be common shares throughout the period in which they are owned by the vendor, pursuant to paragraph (b) of the definition of "qualifying disposition" in subsection 44.1(1). Note also that common shares are defined under subsection 44.1(1) to be those that meet the conditions of regulation 6204. Thus, if the vendor holds preferred shares of the target company, section 44.1 may not be available.

Asset Test

Paragraph (b) of the definition of "qualifying disposition" requires the shares disposed of to be shares (and indeed, as mentioned above, common shares) of an active business corporation (ABC). An ABC is defined in subsection 44.1(1) to be a taxable Canadian corporation all or substantially all of the FMV of whose assets is

- used principally in an active business of the corporation or of a related ABC,
- shares or debt owing by other related ABCs, or
- a combination of the two foregoing.

The definition above is modified by subsection 44.1(9) so as to require the active business to be carried on in Canada for at least 730 days during the period of ownership or, if the period of ownership constitutes fewer than 730 days, for the whole of that shorter period.

It is important to note also that a corporation, in order to meet the definition of an ABC in subsection 44.1(1), must use all or substantially all of the FMV of its assets in an active business, and this condition must be maintained throughout the period during which the individual owned the shares, pursuant to paragraph (b) of the definition of "qualifying disposition." Thus, the target company is required to meet the "90 percent asset test" throughout the period in which it is owned by the individual. This is much

more stringent than the "50 percent asset test" required for QSBC shares. Thus, if the target company holds a substantial amount of excess cash or other redundant assets, the shares may not qualify for section 44.1 treatment.

Size of the Target

The term "small business corporation" can be a misnomer because its definition does not restrict the size of the target, but an ESBC and all related companies cannot have assets with a carrying value of greater than \$50 million immediately before and immediately after the issuance of an ESBC share. "Carrying value" is defined in subsection 44.1(1) to be the amount presented on the balance sheet for generally accepted accounting principles (GAAP). In 2011, GAAP was repealed as Canada's accounting standards framework and replaced by accounting standards for private enterprises (ASPE) and international financial reporting standards (IFRS). Presumably the CRA would accept financial statements prepared under ASPE or IFRS, but there is no guidance on this point. It also raises a question: Would the CRA accept financial statements prepared under compilation engagements, since such statements are not required to be prepared under either accounting framework? It is also interesting to note that the relevant definition refers to a valuation method other than FMV. It should be noted, too, that the restriction on size applies only at the time immediately before and immediately after the issuance of the share but at no other time.

Compliance

Pursuant to the definition of "replacement share" in subsection 44.1(1), the following conditions apply:

- The proceeds must be invested in the replacement company in the same year as the disposition of the old shares, or within 120 days of the end of the year in which the disposition occurred.
- The vendor is required to make a designation, in its return for the year, that the acquired ESBC share is a replacement share. This is analogous to the requirement in subsection 110.6(6) whereby the capital gains exemption is denied if the corresponding gain is not reported and it is determined that gross negligence occurred.

The ACB of the replacement share is correspondingly reduced by the amount of the deferred gain, pursuant to paragraph 44.1(2)(b). Note that there is no corresponding reduction of PUC, meaning that the replacement shares could conceivably have PUC that is significantly higher than ACB. This creates a trap: PUC that is withdrawn at a later date would reduce the ACB pursuant to subparagraph 53(2)(a)(ii) and therefore could create a capital gain to the extent that the ACB goes negative, pursuant to subsection 40(3).

As noted above, the only restriction on the replacement shares is that the shares must be ESBC shares immediately before and immediately after issuance. The replacement company faces no legislative restrictions or requirements to meet any type of asset or holding period test. The CRA concurred on this matter in document no. 2009-0339151E5 (May 11, 2010). It is important to note, however, that if the replacement company were in a startup phase, it would be a question of fact as to whether or not the company's assets were being used in an active business at the time of their issuance, as required by the definition of "ESBC share." The CRA alluded to this point in document no. 2004-0057171E5 (May 6, 2004).

Conclusion

As commonly occurs in the Act, a fairly simple concept has developed into a terribly complicated one. The capital gains exemption regime in section 110.6 is much more generous than the regime in section 44.1 in that it allows taxpayers a permanent reduction in tax while section 44.1 offers only a deferral. Thus it is unclear why the rules in section 44.1 are much more stringent than those in section 110.6. It would seem that the intended result of section 44.1 could be achieved by using the same concepts as in section 110.6. This is yet another example of how complicated the CCPC tax regime has become and why a comprehensive review of the entire income tax system is long overdue.

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BIBLIOGRAPHIC INFORMATION

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