Tax Deferral and the Subsection 85 Rollover

From Sole Proprietor to a Corporation

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It is very common for a new business owner to avoid incorporation, in an effort to minimize start-up costs and to enable initial losses to be offset against personal income. However, once the business starts generating profits, and the sole proprietor is earning more money than he or she requires, the benefits of a corporate structure will often become very attractive. Typically, this is when a sole proprietor will want to convert the business operations into an incorporated entity.

If the sole proprietor accumulated assets that have increased in value (equipment, goodwill, land) while the unincorporated business was operating, how can those assets be transferred to a corporation on a tax-deferred basis?

Generally, when you transfer assets to a corporation, Canada Revenue Agency treats the transaction as if you disposed of those assets at fair market value. Consequently, the sole proprietor may realize a capital gain on which he or she will have to pay tax. That is when the "subsection 85 rollover" planning can be utilized. Subsection 85(1) of the Income Tax Act (Canada) provides a mechanism in which assets can be transferred to a taxable Canadian corporation, on a tax deferred basis.

Assets which are eligible for a tax deferred transfer include:

- Capital property, including depreciable assets and accounts receivable
- Eligible capital property, such as goodwill
- Inventory, including a professional taxpayer's work in progress (excluding real property inventory)
- Canadian resource property and foreign resource property

Assets which are ineligible for a tax deferred transfer include:

- Real property that represents inventory to the taxpayer
- Prepaid expenses

To qualify for a subsection 85(1) rollover, the sole proprietor, otherwise known as the "transferor", will need to receive at least one share in the capital stock of the "purchasing" corporation, as consideration for the transfer of assets. The fair market value of the total consideration received for the assets transferred must equal the fair market value of those assets.

In addition, the transferor and the "purchasing" corporation will both need to complete and file a joint election in the prescribed form with the Canada Revenue Agency. If the prescribed form is filed after the filing deadline, penalties will accrue.

By properly utilizing the subsection 85(1) rollover mechanism, the transferor will not be liable for tax on the transfer of assets to the corporation. Instead, those taxes will be deferred until such time as the corporation disposes of the assets.

It is important to note that this article focuses on income tax only. Provincial sales tax, goods and services tax and land transfer tax may be payable on the transfer of assets.

When considering a transfer of assets to an incorporated entity, and whether your business may benefit from this type of transaction, it is always recommended that you obtain proper legal and accounting advice.

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