SALE AND ROLLOVER OF SHARES
(Notes)

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1.00 PURPOSE OF THE OPERATION

When a taxpayer assigns his shares to a legal person under his control, if the proceeds of disposition of such shares is higher than the cost of purchase of the latter (the fiscal cost of purchase is known as the "adjusted cost base"), the assignment will consequently create a taxable capital gain. Such taxable capital gain may cause problems for the assignor, as the consideration received for the assignment may not allow for the payment of the taxes due pursuant to such assignment.

To avoid punishing a taxpayer who merely wishes to reorganize its business, the law allows the taxpayer to delay the payment of any tax due pursuant to such assignment, subject to several conditions. The operation used to delay such tax payment is known as a "rollover." The legal bases for such rollover are found in section 85(1) of the *Income Tax Act* (Canada) and in section 518 of the *Taxation Act* (Quebec).

2.00 REQUIRED INSTRUMENTS

To perform a rollover operation, three different legal instruments shall be used:

(a) the share capital structure of the assignee legal person;

(b) the sale and rollover of shares agreement; and

(c) the rollover forms.

2.01 Share Capital Structure

If the taxpayer wishes to avail himself of the rollover mechanism, the legal person which purchases his shares must issue shares in its capital stock as the total or partial consideration for the assignment.

To isolate the rollover operation from the rest of the share capital, we recommend using a specific class of shares, created solely for the purpose of such rollover.

Ideally, this class of share will have all characteristics required for the purpose of the rollover operation. For examples of such characteristic, please refer to the class "B" shares described in documents A07.120 (Quebec) and A07.125 (Canada) of the *Business Precedents*.

The two sample classes of shares mentioned hereinabove are intended for internal financing purposes. They are used by the holders of class "A" shares to finance part of the activities of the legal person. As such financing may take various shapes, this class of shares was designed to fit in various scenarios. Since the rollover of shares operation is similar to internal financing, shares of this class may be used as consideration for the shares subject to rollover. The law treats rollover shares as ordinary shares for redemption purposes. Consequently, prior to issuing such shares, the issuer must fulfil the requirements of the solvency tests provided in section 123.53 and 123.54 of the *Companies Act* (if the issuer is a Quebec company) or of section 36 of the *Canada Business Corporations Act* (if the issuer is a federal corporation).

We will now analyze the most important characteristic of said class of shares, to explain how they make a rollover operation possible.

As specified in section 2.01, the shares of this class do not grant voting rights to their holder. Consequently, the holder of such share is not entitled to participate in the control of the legal person, unless he also holds shares of another class which does grant voting rights.

Furthermore, pursuant to section 2.02, the holders of shares of this class are entitled to a preferred dividend, usually at a fixed rate instead of at a discretionary rate, as is the case for the class "A" shares.

In the event of liquidation of the legal person, the class "B" shares of the aforementioned share capital structure are entitled, pursuant to section 2.03, to repayment, prior to repayment of the class "A" shares, of their redemption value as determined according to the fair market value of the shares received in consideration for the class "B" shares at the date of their assignment to the legal person.

In addition, pursuant to section 2.04, the class "B" shares are not participating, which means they are not entitled to the profits of the business beyond the dividend granted to such class in section 2.02. This is due to the fact that the rollover shares are usually issued to allow the taxpayer to crystallize the value of the assigned shares.

Finally, section 2.06 of the share capital creates an adjustment mechanism for the redemption value of the shares should the tax authorities re-evaluate the fair market value of the shares, either upward or downward.

2.02 Sale and Rollover of Shares Agreement

This second instrument is essentially a sale of shares agreement, to which specific clauses regarding the rollover operation have been added. Document Y04.700 of the *Business Precedents* is an example of such a document.

It is important to note that, since the sale takes place between closely related persons, the representations and warranties found in the document have been simplified, as they are not as essential as in other agreements.