BASIC COMPANY LAW - 1985

CHAPTER 9

TAX CONSIDERATIONS - SALE OF A BUSINESS

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CHAPTER 9

TAX CONSIDERATIONS - SALE OF A BUSINESS

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1. GENERAL

1.01 These notes are intended to highlight some of the more usual tax implications relating to the sale of a business. They are not exhaustive; and are limited to sales involving a small business or, as may be more consistent with the definitions in the Income Tax Act, a Canadian controlled private Corporation engaged in active business, also known as a CCPC generating ABI, that is:

(a) a corporation resident in Canada or held 50% by Canadian residents;

(b) a corporation which is not public, that is not traded on a prescribed stock exchange, nor controlled by public corporations;

(c) a corporation engaged in business activities as opposed to merely holding property or holding an investment portfolio.

Usually such a corporation would be a small, one to three person operation engaged in a business generating net income of less than $200,000 per year. These are the assumptions for the purpose of these notes.

1.02 References:

Sections 125(7)(b), 251(5)

IT-458, Canadian Controlled Private Corporation

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2. SALE OF A BUSINESS

2.01 The sale of a business will usually be effected by way of one of two methods:

(a) the sale of the assets used in carrying on the business by the Vendor Corporation to the Purchaser, which may also involve the assumption of the liabilities formerly of the Vendor Corporation by the Purchaser; or

(b) the sale of the shares of the Corporation by the Vendor Shareholder(s) of the Corporation to the Purchaser.

These methods are not mutually exclusive. There are hybrids which could involve both the sale of assets and the sale of shares. These variations will not be discussed in these notes; however, for those interested in these aspects, reference should be made to the excellent papers referred to in the bibliography.

2.02 Many factors are determinative of purchase price, and therefore, should be considered by the Vendor and Purchaser <u>prior</u> to fixing the purchase price. Not the least of these factors is the amount of tax to be paid or deferred. It would not be uncommon in the case of a sale of a business involving a purchase price of $500,000 for the total tax payable by the Vendor to vary from $100,000 to $150,000 depending on the structuring of the transaction, that is, whether it be by way of sale of assets or sale of shares. In other words, by considering the tax implications and structuring the transaction in the manner best suited to the Vendor that structuring could save, or at least defer, for the Vendor $50,000 in income or other taxes.

2.03 Most Vendors will be disappointed in the final price tag if after entering into the agreement of purchase and sale their tax advisors determine that the net proceeds to the Vendor will be significantly less than the figure the Vendor had in mind. Those calculations must be made prior to the final determination of the purchase price so as to ensure that the net proceeds to the Vendor are within a range acceptable to the Vendor.

2.04 The Purchaser will also wish to know in advance the net cost after taxes of any increase in the purchase price, which may be requested by the Vendor in the course of negotiations. Tax advisors to the Purchaser will want to calculate in advance the present value of future tax write-offs for the Purchaser. These calculations are necessary to estimate the Purchaser's future tax position so as to assess the incremental cost of an increase in the purchase price. In many circumstances the tax to be paid by the Vendor and the future tax savings to the Purchaser will be the final factors dictating the purchase price.

<u>General Rule:</u>

2.05 A knowledgeable Vendor prepared to take $500,000 for a straight share sale will frequently require significantly more in the case of a sale of assets of the Vendor Corporation owned by the Vendor. The Purchaser, on the other hand, will usually be prepared to pay more to purchase assets from the Corporation than to purchase shares from the Vendor Shareholder of the Corporation.

2.06 The purchase price should vary depending on whether the sale will be by way of assets or shares, and if by assets, will vary depending on the allocation of the purchase price to the several kinds of assets involved and will further vary depending on whether the purchase price will be paid on closing or over time.

May 1985 Budget:

2.07 Prior to the introduction of the Budget on May 23, 1985, the Purchaser for reasons outlined further in these notes would generally prefer to purchase assets rather than shares. The Vendor in many circumstances would prefer the sale of shares to assets; although, the Vendor could usually be persuaded to agree to an asset sale with some compensating increase in the purchase price.

2.08 The positions of the Vendors and Purchasers have been significantly altered by the recent Budget. The Budget proposes to exempt capital gains otherwise taxable to individuals to a lifetime cumulative limit of $500,000 in 1990. This amendment will be implemented in a transitional manner with $20,000 capital gains or $10,000 of net taxable capital gains exempted in 1985, $25,000 of net taxable capital gains in 1986, $50,000 in 1987, $100,000 in 1988, $150,000 in 1989, and the full $250,000 net taxable capital gains or $500,000 in capital gains in 1990.

2.09 Therefore a Vendor Shareholder, who is an individual, that sells shares of a Corporation having a capital gain of $500,000 or less will have a tax free transaction in circumstances where a sale of shares previously by the Vendor could result in tax in the order of $100,000 to $125,000. The Purchaser, who in the past has generally been able to persuade the Vendor to agree to an asset sale with some compensating increase in the purchase price will now find that the Vendor is not so cooperative and will insist on a share sale or a very substantial increase in the purchase price to cover the income tax payable on an asset sale.

Examples:

I. Sale by Shares for $500,000 (Pre Budget 1985)

Vendor Shareholder

Proceeds	$500,000
Adjusted Cost Base ($1.00)	Nil
Capital Gain	500,000
Taxable Capital Gain	250,000
Tax (@ 50%)	(125,000)
Net Proceeds to Shareholder	$375,000
Total Tax to Revenue Canada	$125,000

II. Sale by Shares for $500,000 (Post Budget 1985)

Vendor Shareholder

Proceeds	$500,000
Adjusted Cost Base ($1.00)	NIL
Capital Gain	500,000
Exempted Capital Gain	(500,000)*
Taxable Capital Gain	0
Net Proceeds to Shareholder	$500,000
Total Tax to Revenue Canada	0

*Assume year 1990; cumulative capital gain to date is nil; and Vendor Shareholder is an individual.

References:

Notice of Ways and Means Motion to amend the Income Tax Act proposed May 23, 1985, Paragraph 1.

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3. TAX CONSIDERATIONS IN THE SALE OF ASSETS

General Rule

3.01 The Purchaser will generally prefer to acquire a business by purchasing the assets from the Vendor

Corporation rather than the shares of the Corporation from the Vendor Shareholders. In this manner, the Purchaser acquires an increased cost base for tax purposes of the assets acquired equivalent to the fair market value or purchase price paid by the Purchaser to the Corporation for the assets. As a result, the capital cost allowance available against future taxable income of the Purchaser will be greater. In addition, although of lesser importance, the cost base of any assets acquired will be greater, such that should the Purchaser decide in a future year to sell those assets the capital gain will be less.

3.02 The Vendor Corporation will in many instances dislike a sale of assets because the Vendor Corporation will have expensed capital cost allowance against taxable income in past years, with the result that the undepreciated capital cost of the assets is low and will generate recapture for the Vendor Corporation at the time of disposition of the assets.

Other Considerations

3.03 The tax impact on the Vendor of an asset sale is more immediate. The Vendor will usually be required to pay the income tax in the year of disposition; on the other hand, the Purchaser's tax deferral will be realized over several years. The present value of the Purchaser's future tax savings or deferrals must be measured against the actual tax dollars to be paid presently by the Vendor.

3.04 Any comparison between the purchase price for an asset sale and the purchase price for a share sale must recognize that where a Corporation disposes of assets, receives the purchase price into the corporate coffers, and pays corporate income tax, that there is still additional tax to be paid in order to get the funds out of the corporate coffers into the hands of the Shareholders. The 12½% Corporations Distribution Tax pursuant to Section 181 of the Income Tax Act will be imposed on any income generated from the asset sale subject to the small business rate, otherwise known as the preferred earnings amount. There will also be income taxes to be paid by the Shareholders on any taxable dividends received from the Corporation. These costs of distribution must be factored into the determination of purchase price.

3.05 The additional income tax which must be paid by the Vendor Shareholder as a result of selling assets and then distributing or dividending the proceeds from the Corporation to the Vendor Shareholder, may be adequately

compensated by an increase in purchase price such that the Vendor is prepared to dispose of assets rather than shares. The Vendor may even prefer an asset sale in the case of a CCPC engaged in active business, if a major asset of the CCPC is goodwill, and the tax rate for the Corporation is 25% or less, since the total tax payable by the Corporation and the Vendor Shareholder may be less.

3.06 The Purchaser will have to consider the cost of any health services tax which may be payable on the acquisition of assets by it from the Corporation. Any assets to be used or consumed by the Purchaser will, unless otherwise exempted under the Health Services Tax Act, attract a 10% sales tax payable on closing to the Province.

3.07 Any realty involved in an asset sale will result in deed transfer tax payable by the Purchaser. The amount varies from municipality to municipality, but generally falls within the range of ½% to 1½% of the fair market value of the realty transferred.

3.08 The agreed allocation of the purchase price to the various assets transferred will also affect the net proceeds to the Vendor and may be sufficiently important to cause the Vendor to reconsider and authorize only a share sale if an acceptable allocation cannot be agreed upon. Refer to Section 4 for the considerations affecting the allocation of the purchase price.

3.09 The Purchaser may prefer a share sale (or at least not care) if the purchase price is less than the depreciated cost of the assets of the business. The Purchaser will be entitled to claim CCA only to the extent of the purchase price of the assets. If this is less than the undepreciated capital cost of the assets, the Purchaser would be better advised to buy the shares of the Corporation and acquire the Corporation's UCC with the result that the future CCA would be higher than if the purchase occurred by way of asset sale.

3.10 The Vendor may prefer an asset sale if the proceeds can be retained in the Corporation for future business enterprises, and the Vendor does not require cash, or at least cash in excess of the tax free distribution from the capital dividend account,** immediately.

<u>Examples:</u>

The following examples illustrate the tax implications to the Vendor of a sale with a fixed purchase

price of $500,000 regardless of whether it proceeds as an asset sale or share sale. The examples also assume the Vendor Shareholder is in a marginal tax bracket of 50% and the Vendor Corporation is entitled to the small business rate of 25% on active business income.

III. Sale by Shares for $500,000 (Pre Budget 1985)

Vendor Shareholder

Proceeds	$500,000
Adjusted Cost Base ($1.00)	Nil
Capital Gain	500,000
Taxable Capital Gain	250,000
Tax (@ 50%)	(125,000)
Total Proceeds to Shareholder	$375,000
Total Tax to Revenue Canada	$125,000

IV. Sale of Land only for $500,000 by the Corporation

Vendor Corporation

Proceeds	$500,000
Adjusted Cost Base	100,000
Capital Gain	400,000
Taxable Capital Gain	200,000
Tax (@ 50%)	(100,000)
Net Proceeds to Corporation	$400,000
Refundable Tax to Corporation	33,000*
Available for Distribution	433,000
Distributed Tax Free	$200,000**
Taxable Dividend	$233,000
Gross Up	116,500
TOTAL Grossed Up	349,500
Tax @ 50%	174,750
Dividend Tax Credit	116,500
Tax on Distribution	58,250
Total Proceeds to Vendor	200,000
Shareholder	174,750

	$374,750
Total Tax to Revenue Canada	$100,000
	($33,000)
	58,250
	$125,250

* See Section 129 of the Income Tax Act. This Section enables a CCPC which has paid income tax on certain types of income, including capital gains, to recover a portion of that tax when it pays a taxable dividend. The purpose is to ensure no more tax is paid by a Corporation on capital gains realized by that Corporation and subsequently distributed to the Vendor Shareholder than would be paid if an individual Shareholder had realized the capital gain directly The effect, if any, as a result of May 1985 Budget remains to be seen.

** Sections 83(2) and 89(1)(b) of the Income Tax Act permit the tax free distribution of an amount to Shareholders equivalent to the taxable capital gain from the disposition of capital property or the non-taxable proceeds from the sale of eligible capital property.

V. Sale of Depreciable Property only for $500,000 by the Corporation

Vendor Corporation

Proceeds	$500,000
Original Capital Cost	100,000
Undepreciated Capital Cost	50,000
Capital Gain	400,000
Taxable Capital Gain	200,000
Tax (@ 50%)	(100,000)
Refundable Tax to Corporation	33,000
Recapture	50,000
Tax @ 25%	12,500
Net Tax to Revenue Canada	$79,500
Available for Distribution	$420,500

Distributed Tax Free	$200,000
Taxable Dividend	220,500
Gross Up	110,750
TOTAL Grossed Up	332,250
Tax @ 50%	166,125
Dividend Tax Credit	110,750
Tax on Distribution	$ 55,375
Total Tax to Revenue Canada	$100,000
	(33,000)
	12,500
	55,375
	$134,875
Total Proceeds to Vendor Shareholder	$200,000
	165,125
	$365,125

May 1985 Budget:

In addition to the decided preference the 1985 Budget will give an individual Vendor Shareholder to sell shares, the Budget also proposes changes for transfers of depreciable property where the Vendor and the Purchaser do not deal at arm's length to discourage transactions intended primarily to step up the cost base of depreciable property for purposes of claiming greater amounts of CCA. In effect, the Purchaser in a non-arm's length transaction shall be deemed for CCA purposes to have acquired the depreciable property at the Vendor's cost for tax purposes.

References:

Notice of Ways and Means Motion to amend the Income Tax Act proposed May 23, 1985, paragraph 7.

4. ALLOCATION OF GLOBAL PURCHASE PRICE

General Rule

4.01 The net proceeds after tax to the Vendor Corporation and available for distribution to the Vendor Shareholder will vary according to the allocation of the purchase price to the various Sale Assets as agreed with the Purchaser. Generally the Vendor will prefer to have the sale proceeds allocated so as to incur tax on a capital gain or another tax preferred item, rather than income by virtue of recapture of capital cost allowance on depreciable property. Therefore, the Vendor will want to allocate most of the purchase price to land and goodwill.

4.02 The Purchaser, on the other hand, will prefer to have the proceeds allocated to the Sale Assets which will maximize future tax deductible expenses for the Purchaser. The Purchaser's preferred allocation will probably result in the greatest tax burden to the Vendor. For example, the Purchaser will want to allocate to depreciable property and inventory not to goodwill and definitely not to land. The Purchaser will want early tax relief, that is depreciable property with high capital cost allowance maximums.

Examples:

4.03 To illustrate, take the following examples which do not take into consideration the tax cost of distributing the net proceeds of the Corporation to its Shareholder.

VI. Assume a CCPC having a 25% tax rate on ABI and 50% on Other Income

	Capital Gain (Land)	Recapture (Depreciable Property)	Eligible Capital Property (Goodwill)
Proceeds	$500,000	$500,000	$500,000
Taxable Proceeds	250,000	500,000	250,000
Taxes	125,000	125,000	62,500
Refundable Tax	(41,500)		
Total Tax to Revenue Canada	$83,500	$125,000	$62,500
Net Proceeds to Vendor Corporation	$416,500	$375,000	$437,500

Capital Dividend Account	$250,000	nil	$250,000

VII. Assume a CCPC having a 15% tax rate on ABI and 50% on Other Income

	Capital Gain (Land)	Recapture (Depreciable Property)	Eligible Capital Property (Goodwill)
Proceeds	500,000	500,000	500,000
Taxable Proceeds	250,500	500,000	250,000
Taxes	125,000	75,000	37,500
Refundable Tax	(41,500)		
Total Tax to Revenue Canada	$83,500	$75,000	$37,500
Net Proceeds to Vendor Corporation	$416,500	$425,000	$462,500
Capital Dividend Account	$250,000	nil	$250,000

4.04 In the case of a Corporation taxed at the rate of 25% on active business income the least amount of tax will be paid on the dollars of purchase price allocated to goodwill, followed by dollars allocated to capital property, and lastly, dollars allocated to depreciable property, resulting in recapture.

4.05 In the case of a CCPC having a tax rate of less than 25%, as for example in the manufacturing and processing sector, the most favourable tax treatment is still accorded goodwill; however, recapture is then preferable to straight capital gains.

4.06 The additional advantage resulting from an allocation of the purchase price to goodwill and to capital property is the creation of the capital dividend account which permits the tax free dividending of corporate income to the shareholders.

Other Considerations

4.07 The foregoing examples assume the Vendor Corporation's active business income remains under the limit of $200,000 per year. If not, then the excess income would

be taxed at the rate of 50% and in such a situation capital gains would generally be preferred, followed by goodwill and then recapture.

4.08 If the Vendor Corporation's taxable income is approaching the $200,000 limit, the Vendor Corporation could consider selling assets early in the fiscal year to keep the active business income in that year low, or deferring the proceeds for goodwill over several years to retain the entitlement to the active business rate in all years. This is referred to later.

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5. RULES REGARDING THE ALLOCATION OF PURCHASE PRICE

General Rule

5.01 Because of the traditional conflict regarding the allocation of the purchase price between the Vendor and Purchaser, Revenue Canada generally will accept an allocation as agreed by parties because usually the parties negotiate at arm's length and the allocation results from "hard bargaining".

Other Considerations

5.02 Where the sale involves the disposition of real property, such as land and building, it is not sufficient to simply allocate a portion of the purchase price to the real property. This may be adequate for deed transfer tax purposes; however, for income tax purposes, the allocation must be further divided as between land and building.

5.03 Hard bargaining may not occur, even where the parties are at arm's length if the Vendor Corporation does not care about the allocation, as for example, if the Vendor Corporation has loss carry forwards about to expire or where the Vendor or Purchaser is tax exempt.

5.04 Hard bargaining does not require the parties to arrive at the fair market value nor does it require independent appraisals.

References:

Sections 13(21.1), 68

IT-220R, Capital Cost Allowance - Proceeds of Disposition of Depreciable Property, Para. 5, 10-13

Golden v. The Queen, [1983] C.T.C. 112 (F.C.A.), judgment reserved S.C.C. May 1985

Herb Payne Transport Limited v. M.N.R. 63 D.T.C. 1075 (Ex. Ct.)

Klondike Helicopters Limited v. M.N.R. 65 D.T.C. 5253 (Ex. Ct.)

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6. ACCOUNTS RECEIVABLE

General Rule

6.01 The Vendor and Purchaser will usually agree on the advisability of preserving continuity in their tax treatment for accounts receivable. An election should be made pursuant to Section 22 of the Income Tax Act to ensure that any uncollectible accounts receivable may be written off by the Purchaser as a fully tax deductible expense under Sections 21(1)(l) or 21(1)(p). Otherwise a loss incurred by the Purchaser on a written-off receivable would be treated as a capital loss which would simply offset capital gains.

6.02 The Vendor claiming the reserve deduction for doubtful accounts in the preceding year (Section 20(1)(l)) must include the amount in income (Section 12(1)(d)) in the year of disposition and is entitled to claim as a bad debt by virtue of the Section 22 election, an amount equivalent to the difference between the face value of the accounts receivable,and the fair market value or purchase price paid by the Purchaser for them.

Other Considerations

6.03 If the Purchaser is a trader in receivables, the Purchaser will get income treatment on the write-offs without an election.

6.04 The Purchaser must include in income the amount equal to the Vendor's deduction by virtue of the Section 22 election; but may claim a reserve under Section 20(1) or 20(1)(p).

6.05 When can a Section 22 election be made?

(a) The Vendor is carrying on business;
(b) The Vendor is selling substantially all of the assets of the business;
(c) All the receivables relating to the assets are being sold;
(d) The Purchaser continues the business;
(e) A joint election pursuant to Section 22 is made; and
(f) The receivables are short-term, that is created in the Vendor's current year, or the previous tax year.

References

Section 12(1)(d), 20(1)(1), 20(1)(p) and 22

IT-206R - Separate Businesses

IT-188R - Sale of Accounts Receivable

IT-442 - Bad Debts and Reserves

Frankel Corporation Limited v. M.N.R. 59 D.T.C. 1161 (S.C.C.)

Burnaby Paperboard Limited v. M.N.R. 68 D.T.C. 12 (T.A.B.)

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7. **INVENTORY**

General Rule

7.01 An election should be made pursuant to Section

23(1), otherwise the disposition of inventory in the course of selling a business (which is not in the ordinary course of business) will be treated as the disposition of capital property.

7.02 Provided an election is properly made, the disposition will generate taxable income for the Vendor and the cost of inventory will be treated in the usual manner as a business expense for the Purchaser.

Other Considerations

7.03 The Vendor and not the Purchaser will get the 3% inventory allowance on "inventory at commencement of the fiscal year". However, if a Purchaser acquires shortly before its fiscal year end this disadvantage can be minimized. The 3% inventory allowance should be prorated if the Vendor's fiscal year is less than 365 days.

7.04 When is Section 23 available?

(a) When the Vendor disposes of or ceases to carry on all or part of the business;
(b) When the Vendor sells all or part of the inventory of that business.

The test for the inventory election is less stringent than that for the accounts receivable election.

References:

Sections 20(1)(gg), 20(1)(m), 20(1)(n) and 23(1)

Frankel Corporation Limited v. M.N.R. 59 D.T.C. 1161 (S.C.C.)

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8. NON-DEPRECIABLE CAPITAL PROPERTY

General Rule

8.01 The Vendor will wish to allocate the greatest amount possible of the purchase price to land, because any excess of the purchase price over the cost base for tax

purposes of the land will be treated as a capital gain. Land being a non-depreciable asset, will not generate recapture.

8.02 The Purchaser, on the other hand, will wish to minimize the amount of the purchase price attributable to the land, because land is not a depreciable item, and hence there will be no current expense related to it. The only benefit to the Purchaser would be a future benefit if the Purchaser intends to dispose of the land, and there is a resulting reduction in capital gain.

Other Considerations

8.03 For Canadian controlled private Corporation or CCPC paying less than 25% tax on active business income recapture is preferable over capital gains. See Example VII, and therefore the Vendor would likely agree on an allocation to depreciable property rather than to capital property.

8.04 Section 13(21.1) will limit the Vendor's terminal loss resulting from the sale of realty by reducing the allocation of purchase price to the building, in favour of generating a gain on land contiguous to the building. The loss on the class involving the building will be reduced to the extent of any capital gain on the land.

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9. **DEPRECIABLE CAPITAL PROPERTY**

General Rule

9.01 The Vendor will wish to allocate the least amount of the purchase price to depreciable property since it will result in recapture and hence taxable income as opposed to the tax preferred treatment accorded to capital gains and eligible capital proceeds.

9.02 The Purchaser will want to increase its cost for depreciable property so that it may take CCA, being a tax deductible expense in future years. Therefore, the Purchaser will wish to allocate the largest part of the proceeds to depreciable property, and of that, the largest portion to depreciable property with the highest rate of CCA.

Other Considerations

9.03 The purchase price must not only be allocated to depreciable capital property, but to each class of depreciable capital property.

9.04 The Vendor may have taken very little CCA and therefore have very little recapture generating taxable income. This could occur where the Vendor has had business losses in the past and has not required maximum CCA to reduce income, or where the Vendor has just acquired assets and has only taken the first half year of CCA.

9.05 Once the allocation of the purchase price exceeds the recapture which will be recognized by the Vendor, the Vendor may no longer care about the allocation since the capital gains treatment will be the same whether generated from the allocation of proceeds to depreciable property or non-depreciable property.

9.06 The Vendor may have several assets in a class, only one or two of which are being disposed of, in which event, because assets are treated by class, there will usually be no recapture until the last asset is disposed of. In the interim, the result will be capital gains treatment.

9.07 The Vendor may have untilized business loss carry forwards from previous years to be used against any taxable income created by recapture. In addition, those business loss carry forwards may be due to expire, in which event the Vendor will be readily persuaded to utilize those expiring losses against taxable income, and to create taxable income for that purpose.

9.08 A capital gain may be preferable only if in the 25% plus bracket, but if taxed at less than 25% then recapture is no worse, or at least not significantly worse, than capital gain.

9.09 The Vendor could elect pursuant to Regulation 1103(1) to put all assets presently in Classes 2 - 12 of Schedule II into Class 1 of Schedule B. Class 1 has a 4% capital cost allowance. This could eliminate recapture and would therefore be preferable where the Vendor is disposing of all but perhaps one asset, and that asset has a low rate of CCA, as for example, a building at 5%. The Vendor would first move all assets to Class 1, subsequently dispose of the assets leaving the building in the class, and as a consequence show no recapture. This is only an acceptable alternative if the assets remaining will shelter the

recapture, and if the CCA rate is not too much lower than would otherwise be available. This is especially attractive if the Vendor proposes to retain and lease the building as opposed to selling the building with the business. An election must be made by registered letter attached to the return, and such election should be made prior to the disposal of the assets to the Purchaser.

9.10 The Purchaser will have to pay health services sales tax, usually 8% to 10% on most depreciable assets, and may wish, therefore, to keep the allocation down and hence, its current expenditure by way of sales tax.

9.11 The Purchaser will also have to pay deed transfer tax which varies from ½% to 1½%, and again may wish to keep the allocation of the purchase price to realty (both land and buildings) down. In some municipalities the sale of leasehold interests are excluded from deed transfer tax. Therefore, the Purchaser could consider a 99-year Lease.

9.12 The Purchaser might not need the CCA because of loss carry forwards presently available to the Purchaser and therefore may not press to maximize its CCA by maximizing the allocation to depreciable property.

9.13 On the transfer, the class of the assets may change such that the rate deteriorates so that the Purchaser will allocate less to that class, to the advantage of the Vendor. The reverse situation can also occur, where the CCA rate to the Purchaser improves.

9.14 There will be preferences amongst the classes of depreciable property since maximum CCA rates vary. In other words the Purchaser and Vendor having agreed on the amount of the purchase price to allocate to depreciable property would still debate the further allocation of that amount amongst the various classes of assets constituting depreciable property.

References

Regulations 1100 - Acquisition Year Rule

Part XI, Schedule II, III, IV, V and VI

IT-220R Capital Cost Allowance - Proceeds of Dispositions of Depreciable Property

GHC Investments Limited v. M.N.R. 61 D.T.C. 1120

Health Services Tax Act, R.S.N.S. 1967, c.126, as amended

Deed Transfer Tax Act, S.N.S. 1968, c.10, as amended

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10. ELIGIBLE CAPITAL PROPERTY

General Rule

10.01 Taxable proceeds from the sale of eligible capital property qualify as active business income. This category will be preferred by the Vendor since only one half of the proceeds will be taxed as income, and then at the lesser rate of 25%.

10.02 The Purchaser will generally wish to minimize the allocation to eligible capital property since the Purchaser may claim as a tax allowed expense, only one half of the purchase price and then on a 10% declining balance basis. Goodwill will be preferred by the Purchaser only over land or other non-depreciable items.

Other Considerations

10.03 Restrictive covenants can also be regarded by Revenue Canada as eligible capital property. It is advantageous to the Vendor to allocate a portion of the purchase price to restrictive covenants for that reason. The Vendor Corporation must covenant however to cause its officers and employees not to compete. Consideration must move from the Vendor Corporation.

10.04 Not all intangibles are eligible capital property. Some may be depreciable. This will be important to the Purchaser. For example, patents, franchises or licences for a limited time are depreciable property under Class 14.

10.05 Customer lists sold as part of a business will be treated as eligible capital property; however, if sold separately, the purchase price for such lists is fully deductible to the Purchaser as a business expense.

10.06 Eligible capital proceeds may not be available for reserves. Revenue Canada's position is set out in

IT-123R4. Therefore, any portion of the purchase price being paid up front should be first allocated to eligible capital property. However, reference should be made to the Timagami case which permitted reserves for eligible capital proceeds in an unrestricted fashion although the court did not deal specifically with the issue.

References

Sections 14(1), 14(5), 20(1)(b), 20(1)(n)

IT-386, Eligible Capital Amounts and Similar Receipts

IT-123R4, Dispositions of Eligible Capital Property

IT-187, Customer Lists and Ledger Accounts

The Queen v. Timagami Financial Services Limited 82 D.T.C. 6268 (F.C.A.)

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11. DEFERRING THE PURCHASE PRICE

A. INSTALMENT PAYMENTS

General Rule

11A.01 Tax deferred equals tax saved by the Vendor. The Vendor must ensure however that the savings by virtue of deferring tax are not outweighed by the opportunity cost of foregoing payment in cash of the purchase price on closing. Tax payable by the Vendor may be deferred within limits until payment is actually received by the Vendor from the Purchaser; however, an indefinite tax deferral is not available.

Other Considerations

11A.02 In the case of inventory or income reserves, the Vendor is permitted a two year reserve which can be as much as a 35 month reserve with appropriate timing of the disposition to the fiscal year end of the Vendor. Therefore, whether or not the Vendor has received full

payment for the inventory by the end of the two year period, the Vendor will have to bring the amount fully into income and pay tax. Therefore, allocate notes payable within two years to inventory or income items.

11A.03 For capital property the Vendor can postpone the payment of tax on the disposition, based on a reasonable reserve, but, in any event, at least one fifth of the tax that would otherwise be paid, must be paid in each year such that by the end of the fifth year all tax must be paid, whether the Vendor has been paid in full or not. Often the cash is not otherwise available to the Vendor to cover the tax payable. Therefore instalment payments of the purchase price during the first five years should cover at least the tax to be paid by the Vendor.

11A.04 Consideration should be allocated to the assets disposed of as, for example, where there may be several promissory notes due at different dates, each note should be allocated the different kinds of assets disposed of, that is, as amongst non-depreciable, depreciable and eligible capital property.

11A.05 There is some question whether a reserve is allowed for eligible capital property. Refer to the Timagami case and IT-123R4. Therefore, any cash on closing should be allocated to eligible capital property.

11A.06 Income reserves are not available for recapture. Therefore, allocate cash on closing to depreciable property classes generating greatest recapture.

11A.07 Interest need be computed only if the payments over the term are greater than the fair market value of the assets being sold (Section 16(1)).

11A.08 A promissory note should not be simply demand, but should be for a term or demand plus some period of time due to the recent decision of the Court in the case of Derbecker, which would have the effect of eliminating the Vendor's reserves where the Notes are simply demand.

11A.09 There are special rules recognized by Revenue Canada on reserves for properties acquired and involving an assumption of existing mortgages. See No. 703 case.

11A.10 To prolong the time period for reserves, the transaction can be restructured using redeemable or retractable preference shares. These alternatives should be considered if the time for full payment is uncertain or exceeds 5 years. Generally, such structuring will allow the

tax payable to be postponed until the proceeds or cash is actually received by the Vendor.

11A.11 Reserves will delay the crystallization of additions to the capital dividend account. See Section 89(1)(b).

References

Sections 16(1), 20(1)(n), 40(1)(a)(iii), 89(1)(b)

IT-152R3 Special Reserves - Sale of Land

IT-265R2 Payments of Income and Capital Combined

IT-436R Reserves-Promissory Notes

IT-123R3 Dispositions of Eligible Capital Property

R. v. Derbecker, [1984] C.T.C. 606 (F.C.A.)

R. v. Timagami Financial Services Limited, [1982] C.T.C. 314 (F.C.A.)

No. 703 v. M.N.R. 60 D.T.C. 1237 (T.A.B.)

Example

VIII. Assume Sale of Shares for $500,000 by Vendor Shareholder. The Purchaser pays $50,000 in cash Closing, $50,000 in years 2, 3, 4, and 5, and th balance of $250,000 in year 6. The instalment payments are evidenced by 5 Promissory Note issu by the Purchaser to the Vendor on Closing.

Sale Proceeds	$500,000
ACB ($1.00)	0
Capital Gain	500,000
Taxable Capital Gain	250,000
Total Tax (50%)	$125,000

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Proceeds Received	$50,000	$50,000	$50,000	$ 50,000	$ 50,000	$250,0
Tax Paid Equals the greater of:						
Reasonable Allocation Rule	12,500	12,500	12,500	12,500	12,500	62,5
One-fifth Rule	25,000	25,000	25,000	25,000	25,000	
Tax Paid	$25,000	$50,000	$75,000	$100,000	$125,000	

The Shareholder is required to pay the total tax of $125,000 Year 5 although $250,000 of the purchase price is not receiv until Year 6. This indicates how tax may be required to be paid under the One-Fifth Rule despite the postponement of the receipt of a significant portion of the proceeds until after the five year limitation period.

May 1985 Budget

11A.12 The cumulative lifetime capital gains exemption for individuals proposed will exclude capital gains realized prior to 1985 but reserved for years 1985 and subsequent.

11A.13 The possibility of circumventing the time limitations imposed on reserves by the Vendor taking redeemable or retractable shares of the Purchaser Corporation may be affected by the proposed avoidance rules. These are intended to prevent Shareholders from converting what would otherwise be a deemed dividend at the time of redemption or retraction into a capital gain so as to make the receipt tax free.

B. LEASING OF VENDOR'S REALTY TO PURCHASER

General Rule

11B.01 The Vendor may prefer a lease with a purchase

option to the Purchaser because this structuring will not cause a disposition of the realty, and therefore no triggering of recapture and capital gain. The Purchaser can deduct fully the lease payments against taxable income as a business expense as opposed to the slower CCA expense.

Other Considerations:

11B.02 The lease payments will usually be taxable income to the Vendor Corporation subject to the small business rate and hence involved in the preferred earnings account. In the preferred earnings account they will be subject to Part II tax on distribution.

11B.03 Ensure the option to the Purchaser included in the lease is at a price equal to the fair market value of the property at the time the option is exercised, otherwise the cost to the Purchaser of the property is increased by the lesser of the fair market value, or the total lease payments to that date, and the excess is deemed to have been CCA. IT-233R will result in eventual recapture to Purchaser of lease payments deducted.

References

Section 49(1)

IT-233R, Lease Option Agreement Sale, Leaseback Agreements

C. EARNOUTS

General Rule

11C.01 "Earnout" refers to the payment of the purchase price over time, generally with a down payment at Closing and always with future payments based on earnings, whether gross or net. "Reverse Earnout" was in part created to mitigate the tax disadvantages of straight Earnouts. The total purchase price is paid at closing, with abatements or adjustments on the basis of the business's failure to attain financial projections.

11C.02 Straight Earnouts will result in the future payments received by the Vendor being treated as taxable income, even though the payments may result exclusively from the sale of capital property. To compound the problem, such payments are not tax deductible against income by the Purchaser. A Reverse Earnout is not considered an income transaction to the Vendor.

Other Considerations

11C.03 From a strictly tax cost-benefit analysis the Purchaser will not care whether the purchase is structured as a straight Earnout or a Reverse Earnout, because, in any event, the Purchaser will not get an income deduction, but must allocate the total purchase price with subsequent payments or adjustments to the capital cost of the various assets.

11C.04 Section 42 limits a capital loss on a Reverse Earnout to payments by the Vendor to the Purchaser within six years.

References

Sections 12(1)(g), 42

IT-426 Shares Sold Subject to an Earnout Agreement

IT-462 Payments Based on Production or Use

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12. **FISCAL YEAR END**

General Rule

12.01 The Purchaser usually will prefer to acquire late in its fiscal year, due to the one half year CCA rule in the year of acquisition which prevents the Purchaser from claiming more than one half the CCA maximum otherwise allowed.

12.02 The Vendor will usually want to sell early in its next fiscal year to defer taxes as long as possible.

Other Considerations

12.03 If there is an advantage to the Purchaser it acquires in the last month and has one month's income against which it may deduct up to six months' CCA.

12.04 If the Vendor is likely to have taxable income in excess of $200,000, it will want to sell early in the fiscal year, before it exceeds that number and moves into higher corporate tax bracket.

12.05 If the Vendor is claiming income reserves, it will want to sell early in fiscal year to maximize reserves.

12.06 The 3% inventory allowance is not available to Purchaser because the Purchaser must have inventory at commencement of year. Purchaser will want to acquire shortly before year end.

References

IT-179 Change of Fiscal Period

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13. TAX CONSIDERATIONS IN THE SALE OF SHARES

General Rule

13.01 The Vendor will usually prefer to sell shares being capital property, hence no recapture, particularly if shares have a significant cost base (for example, if the Vendor had previously acquired the business through the purchase of shares). Also the sale of shares leaves the proceeds in the Vendor's hands personally, without the distribution costs involved where the funds are received by the Vendor Corporation on an asset sale and must be flowed out to the Shareholder.

Other Considerations

13.02 If the Purchaser is buying shares, the Purchaser should be a Corporation, so that the Purchaser Corporation can borrow funds to finance the acquisition of the shares, and receive dividends from the target company as tax free inter-corporate dividends, and therefore repay the financing

out of pre-tax dollars rather than after tax dollars. Whereas if the Purchaser is an individual and borrows to buy the shares, the interest on the loan is still deductible, but must be repaid out of after-tax dollars. The dividends by the target Corporation to the shareholder are taxable, unlike tax free inter-corporate dividends. The purchasing entity should also have sufficient taxable income to fully utilize the interest expense deduction.

13.03 The Purchaser will buy shares where the fair market value of the Vendor Corporation's assets is less than the undepreciated capital cost.

13.04 If there is substantial goodwill, the Vendor may prefer a sale of assets because the total tax payable by the Vendor Corporation and the Vendor Shareholder would be less than that payable by the Vendor Shareholder on a sale of shares.

13.05 The Vendor Corporation may wish to pay out as dividends the post-1971 earnings to reduce the value of the Corporation by an amount equivalent to its liquid surplus so that the Purchaser obtains only the operating assets of the business and no additional or redundant assets. The avoidance provisions of Section 55 should be reviewed to ensure compliance prior to carrying out such a "strip".

13.06 The Vendor should consider paying out all tax free surplus accounts, such as the capital dividend account prior to the sale of the shares to the Purchaser.

References

Sections 20(1), 55, 87, 88

1T80 Interest on Money Borrowed to Redeem Shares or Pay Dividends

IT315 Interest Expense Incurred for the Purpose of Winding-Up or Amalgamation

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14. DEDUCTIBILITY OF LEGAL AND ACCOUNTING FEES

General Rule

14.01 The overriding test is whether legal, accounting and other professional fees are expenses incurred in

connection with a matter of an income nature and, therefore, paid for the purpose of earning income or whether incurred on account of capital.

14.02 Generally legal and accounting fees incurred by the Purchaser in the acquisition of shares or assets will be added to the cost base of the shares or assets; however, certain costs may be deductible such as those costs associated with certain advance tax rulings.

Reference:

Section 20(1)(cc)

IT-99R2 Legal and Accounting Fees

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15. MANAGEMENT CONSULTING

General Rule

15.01 The Purchaser will prefer to pay the Vendor Corporation management fees to make available the principal shareholder of the Corporation on a consulting basis until the Purchaser is fully underway. Such expenses to the Purchaser would be fully tax deductible as current expense and therefore very attractive from a tax point of view. The Vendor on the other hand would have the same treatment as recapture. This would be totally taxable income. In many instances, this will not be preferred over capital gains treatment. See Examples VI and VII.

Other Considerations

15.02 The Vendor may be persuaded to take management fees because the incremental allocation would in any event go to recapture which would also be taxable income.

15.03 This frequently is a method of splitting income over several years in the case of a sale of shares by the Vendor Shareholder, so that the Vendor is in a lower marginal tax bracket in the years of receipt than it otherwise would be as a result of one lump sum payment on closing.

Provided the disposition proceeds in accordance with the Certificate, the Purchaser is exonerated from tax liability of the Vendor arising from the disposition.

17.02 If the Vendor is a non-resident, any payments pursuant to the financing will be subject to withholding tax to the extent of interest.

17.03 Where the Vendors are about to change residence, as for example, retiring to Florida, you will want to ensure that Canadian residency is maintained until closing.

Other References

Sections 115(1)(b), 116, 212(1)(b)

IT-150R2

IT-176R, Taxable Canadian Property

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