

COMMERCIAL LAW

SOME TAX ASPECTS OF BUYING OR SELLING ASSETS OR SHARES

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Chapter 7

Some Tax Aspects of Buying or Selling Assets or Shares¹

[§7.01] Introduction

Tax considerations often determine many aspects of commercial transactions. In buy/sell transactions the tax consequences often are the “tail that wags the commercial dog”. For example, different tax results flow from the sale of assets or shares. Consequently, the lawyer for both the buyer and seller must know how to assess the tax effects of these two types of transactions properly, both from a seller’s and a buyer’s point of view.

Tax consequences usually affect the price that a seller will command or the buyer will pay for particular assets. Obviously, the more tax a seller has to pay, the more the seller may ask as the sale price. However, the impact may not be reflected in the price itself. The seller may be successful in obtaining more favourable payment terms (for example, more cash “up front”) or may be relieved from providing certain onerous and non-tax-related covenants to the buyer. If the buyer, on the other hand, is not satisfied with the tax consequences of the deal, the buyer may look to the seller for a lower purchase price, favourable financing terms, or certain representations and warranties as compensation.

[§7.02] Common Client Situations

The “seller” is the sole owner of the shares of a Canadian-controlled private corporation (“CCPC”). The seller wants the corporation to sell the business and dispose of its assets. Alternatively, the seller may be willing to sell the shares in the corporation as a means of selling the business. The seller seeks your advice on what to do. Another person (the “buyer”) wants to acquire a business and is uncertain whether to buy assets or shares. The buyer seeks your advice.

This chapter sets out a general framework for analyzing the significant tax considerations for either party and how each party should approach the negotiations. The chapter focuses on income tax, though it does mention the impact of other taxes such as property transfer tax, retail sales taxes, and the goods and services tax (“GST”). All statutory references are to the *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.) unless otherwise noted.

[§7.03] Assets or Shares - General “Non-Tax” Comments

Although tax considerations are often critical to the decision of whether to buy or sell assets or shares, there also are compelling non-tax reasons for favouring either an asset or a share deal.

Generally, the buyer in an asset deal acquires only those assets that are the subject of the agreement and any liabilities that he or she has agreed to assume. In a share transaction, however, the buyer acquires all the assets and the liabilities of the corporation.

The following are some of the commercial factors that may affect the parties’ choice of an asset or share transaction. (See also Chapter 2.)

1. A buyer favours an asset deal when undisclosed actual or contingent liabilities of the target corporation may exist. If the buyer suspects that the corporation has significant liabilities, which have not been disclosed in its financial statements (such as a potential product warranty claim), the buyer may prefer to purchase assets rather than shares.
2. An asset purchase gives the buyer the chance to buy only those assets that he or she wants to acquire. By contrast, a share deal gives the buyer the assurance that he or she is acquiring all of the assets of the corporation (including assets which are sometimes difficult to identify such as a trade name or logo).
3. The existence and intransigence of minority shareholders may prevent a share transaction. A buyer of shares usually wants to acquire all of the outstanding shares and minority shareholders may not want to sell their minority interests. In this instance, an asset purchase may be preferable (or perhaps the only alternative). The majority shareholders could pass a special resolution authorizing the sale of assets by the corporation without the approval of all of the minority shareholders (subject to the possible exercise of statutory rights by the minority shareholders).
4. The buyer might prefer an asset sale because he or she only has to deal with one seller, the corporation, rather than several.
5. Choosing between an asset or share deal may be affected by the costs involved and the necessary consents to the transfer. Agents’ commissions and conveyancing fees will usually only be payable in an asset transaction. “Due diligence” and professional costs, however, may be higher in a share sale. A sale of shares rather than assets may enable a buyer to avoid certain consents when it is not possible to transfer licenses and

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permits (that is, a timber license or liquor license) and rights under a lease without the consent of the regulatory body or lessor.

[§7.04] Methodology for the Required Tax Analysis by Each Party

Assuming there are no compelling commercial or corporate reasons for favouring either an asset or share deal, the first step in the tax analysis is to determine the tax impact and net after-tax yield (or cost) of selling (or buying) assets or shares. In other words, which route will minimize the amount of tax dollars leaking away from the parties to taxation authorities including the Canada Revenue Agency (“CRA”)? Next, you must consider other tax factors that are relevant only to the seller or the buyer.

[§7.05] Role of Accountants

Most of the initial work in the transaction will centre around the financial statements and the seller’s tax returns. The seller’s auditors or accountants must be consulted and, if they have not done so already, they should get involved and prepare, often in conjunction with the seller’s tax lawyer, a comparative analysis of the tax consequences of a share versus an asset deal. Subject to the scope of the lawyer’s retainer, the lawyer usually will not perform the calculations, but the lawyer at least must understand the legal basis underlying the computations. This background will be essential for:

- (a) preparing the purchase agreement and the various warranties, covenants, representations and indemnities contained within it;
- (b) acquiring a thorough understanding of the nature and the reasons for the type of transaction as well as the possible permutations; and
- (c) negotiating the price.

[§7.06] The Seller’s Position - Assets vs. Shares

1. Two Tiers of Income Tax (Corporate & Personal) in an Asset Deal

When a corporation sells its assets, a liability may arise for provincial retail sales tax (SST) and GST as well as for federal and provincial income tax. In most transactions, the seller will realize income (such as recapture of depreciation, referred to as capital cost allowance or “CCA”) or capital gains, on the disposition of the assets and will be liable for income tax. The net after-tax proceeds to the corporation will be taxed again when the proceeds are distributed to the seller shareholders. The amount of this second tier of income tax will be a function of the particular assets sold, the manner in

which the distribution is effected, and the individual characteristics of the seller (for example, resident or non-resident, high or low income tax bracket).

2. Share Sale - One Tier of Tax

An incorporated business can be transferred or sold through a sale of shares. This method may seem simpler than and preferable to an asset sale because there is only one asset to transfer. Yet, from an income tax perspective, the seller of shares must compute any taxable gain and any tax on the taxable gain, and then compare the net yield from the sale with the after-tax amount remaining after the two levels of taxation in an asset deal.

Individuals often prefer share deals when selling because of the \$750,000 lifetime capital gains exemption available on the disposition of “qualified small business corporation shares”. This exemption greatly enhances the net yield to a seller of shares. This will be discussed later under the tax effects of a share deal.

3. General Anti-Avoidance Rule

The purchase and sale of a business, whether by way of a purchase of assets or shares, may involve one or more transactions that are designed to increase the net after-tax proceeds of the seller or reduce the effective purchase price of the buyer. Such transactions may be affected by the general anti-avoidance rules (“GAAR”) set out in s. 245(2) of the *Income Tax Act* and s. 274 of the *Excise Tax Act*, R.S.C. 1985, c. E-15. The provisions may apply to deny the seller and/or the buyer a tax benefit resulting directly or indirectly from a transaction or series of transactions, unless the transaction can reasonably be characterized as undertaken primarily for bona fide business purposes, or if it does not directly or indirectly result in an “abuse or misuse” of the *Income Tax Act* or *Excise Tax Act*.

4. Computing the Seller’s After-Tax Proceeds from an Asset Deal vs. a Share Deal

Step 1— Review Income Tax Status of Assets

You must undertake a detailed review of each asset restating its accounting basis into equivalent income tax “cost amounts”. For accounting purposes, the assets are presented on an historical cost basis, while the relevant cost amounts for tax purposes are a function of V-Day (market value on December 31, 1971), undepreciated capital cost (“UCC”), written-down cost, etc. The following assets generally will not require restatement from accounting to income tax values (that is, they generally will yield the same gain both for tax and accounting purposes):

- (a) Cash,
- (b) Accounts receivable,
- (c) Inventory,
- (d) Prepaid expenses,
- (e) Current liabilities,
- (f) Long-term debt.

The following assets will require special attention:

- (a) Non-depreciable capital property (for example, land),
- (b) Depreciable capital property (for example, buildings and equipment), and
- (c) Eligible capital property (for example, goodwill).

The “tax-free accounts” of the corporation must be reviewed. Any gains that accrued on capital properties before V-Day will be tax-free to the corporation on disposition and will be available for tax-reduced distributions to the seller shareholder on a winding-up of the corporation. One-half of any gains accruing past V-Day will generally be subject to tax at ordinary corporate rates, while the remaining one-half will also be tax-free on disposition (from the “capital dividend account”). The corporation may also have a balance in its “refundable dividend tax on hand account” available for distribution as a taxable dividend. Paid-up capital can also be regarded as a “tax-free account” in that it can be returned to shareholders on a tax-free basis.

Step 2—Allocation of Purchase Price

The proposed or assumed selling price must be allocated among the various assets.

The CRA may attempt to use s. 68 of the *Income Tax Act* to reallocate the price in accordance with what it concludes is commercially reasonable. However, because of the inherent tension between a seller and a buyer (that is, for minimizing tax on sale versus obtaining a higher cost base on which to claim CCA), the agreed-upon allocation of the purchase price between parties dealing with each other at arm’s length generally will not be challenged by the CRA, even if the allocation minimizes income for one party, provided that the agreement is not a “sham or subterfuge”.

Step 3—Asset-by-Asset Tax Calculation

The resulting capital gains and recaptured income or loss must be computed for each asset to be sold by comparing the restated (tax) cost of the asset with the respective allocated portion of the purchase price, and taking into account the existence of any “tax-free accounts” available for each asset.

Step 4—Net After-Tax Yield to Corporation

The net after-tax proceeds to the corporation can then be calculated by deducting the total tax payable on the capital gains and recapture (less deductible losses) on the sale of the assets from the proposed or assumed selling price. The effective tax rate to the corporation will vary depending on the type of income realized. In 2009, the combined Federal and BC rate on active business income will be 30% declining to 25% by 2012. The 2009 rate on investment income (including taxable capital gains) will be 45.67%.

Step 5—Net After-Tax Yield Following a Distribution to Seller

After computing the net after-tax proceeds to the corporation (that is, net distributable proceeds), the net after-tax yield to the seller must be calculated. This involves determining the best way in which to effect the distribution of net proceeds from the corporation to the seller. The considerations include such things as: the existence of “tax-free accounts” available for distribution to the seller shareholder free of tax; the timing of dividends to obtain a payout over time (there may be a tax deferral advantage as well as overall tax savings); the possibility of winding-up the corporation and distributing the proceeds; and the exigibility of withholding taxes if the seller is a non-resident of Canada.

Upon completion of this step, the total income tax liability and net yield to the seller can be calculated; that is, the effective overall tax cost of the asset deal.

Step 6—Tax Effect of Share Deal

The computation of the net yield to the seller from an asset deal must be compared with the yield from a share deal. This chapter assumes that the shares are “capital property” to the seller. If the shares are not capital property, any gains realized on their disposition will be fully taxable and will reduce the net after-tax yield to the seller.

Excluding the individual capital gains exemption, the income tax effect of a share deal is a fairly straightforward calculation. Assuming the shares have a cost to the seller for tax purposes of \$100,000 and the sale price is \$500,000, the net after-tax yield to the seller would basically be as follows:

Proceeds of disposition	\$500,000
Less: cost	100,000
Capital gain	400,000
Taxable capital gain (1/2)	200,000
Tax liability (at, for example, 40%)	80,000

Net after-tax yield \$420,000

This net after-tax yield may increase significantly if the seller is a Canadian resident individual other than a trust. This increase will result from the use of the capital gains exemption for dispositions of “qualified small business corporation shares”. This increased exemption is available to offset \$750,000 of capital gains (\$375,000 of taxable capital gains).

A “qualified small business corporation share” is defined as a share of the capital stock of a Canadian-controlled private corporation that meets three separate tests, a point-in-time fair market value test, a holding period test, and an asset use test.

(a) Fair Market Value Test

At the time of sale of the shares, all or substantially all (generally interpreted by the CRA to mean 90%) of the fair market value of the assets of the corporation must be used in an active business carried on primarily (interpreted to mean 50%) in Canada and/or shares or debt of “connected” corporations that carry on an active business primarily in Canada.

(b) Holding Period Test

The shares must not have been owned by anyone other than the seller, or a person or partnership related to the seller, throughout the 24 months preceding the sale.

(c) Asset Use Test

Throughout the 24-month holding period, more than 50% of the fair market value of the assets of the corporation must have been used in an active business carried on primarily in Canada by the corporation or a related corporation and/or shares or debt of “connected” corporations. Where the corporation holds shares or debt in “connected” corporations (that is, the corporation is a “holding company” for shares or debt of an “operating company”), throughout the 24-month holding period more than 50% of the fair market value of the assets of both the holding company and the operating company and all or substantially all of the assets of either the holding company or the operating company must have been used in an active business carried on primarily in Canada and/or shares or debt of “connected” corporations that

carry on an active business primarily in Canada.

The \$750,000 capital gains exemption is a permissive deduction (in computing taxable income) which offsets the net eligible taxable capital gains included in the seller’s income for the year.

The capital gains exemption can only be claimed by the seller to the extent that net taxable capital gains of the seller exceed the balance of the seller’s “cumulative net investment losses” account at the end of the year. This account is the aggregate of the seller’s investment expenses for the year and prior years ending after 1987 less the aggregate of his or her investment income for such years.

A seller of a proprietorship or partnership business may be encouraged to transfer the business to a corporation and sell the shares of the corporation in order to take advantage of the capital gains exemption.

A sale of shares can be complicated by additional planning intended to defer or eliminate all or some of the tax on the disposition of shares by structuring the transaction to take advantage of the capital gains exemption or to otherwise reduce the amount of the capital gain on the sale through the use of “capital gains stripping” techniques. The general anti-avoidance rules and other legislation may prohibit or restrict if and how these techniques can be used.

A seller who is an individual must also consider the impact of the alternative minimum tax (“AMT”). AMT is calculated as an alternative to the regular income tax. After computing his or her “adjusted taxable income” (which includes the entire amount of capital gains and losses), the seller must deduct his or her basic exemption of \$40,000 and must multiply the remainder by 15% to reach the AMT. To the extent AMT exceeds the income tax otherwise payable, it may be carried forward for seven years and refunded. AMT may have a significant impact upon the ability of a seller to claim an exemption from capital gains on a sale of shares.

Subject to these factors, the seller will plan to minimize any tax otherwise exigible on the share sale. To the extent that the seller has only deferred tax (for example, by streaming dollars tax-free into a holding company), he or she may or may not wish to share this advantage with the buyer by reducing the sale price of the shares.

[§7.07] The Buyer's Position - Assets vs. Shares

1. Assets

From the buyer's point of view, an asset transaction has the following advantages:

- (a) the buyer does not inherit the seller's tax problems;
- (b) the seller keeps the problems of distributing the net after-tax proceeds out of the corporation;
- (c) the buyer can write-off any goodwill inherent in the purchase price;
- (d) the buyer can offset or add to the profits or losses of the buyer, the profits or losses of the new business (subject to certain rules which will be discussed later);
- (e) the buyer can be selective in choosing the assets to be acquired; and
- (f) the buyer can write up assets to their fair market value, giving a higher depreciable base (subject to certain anti-avoidance rules).

Of course, the advantages to the buyer often are offset by corresponding disadvantages to the seller. Therefore, the seller may ask a higher price to compensate for the higher taxes payable on the sale of the assets and distribution of surplus out of the corporation. At the same time, the buyer may be willing to pay more for assets than shares because he or she may obtain a higher cost base on which to claim CCA. Thus, when assessing the seller's "asking price" or otherwise in negotiating the price, the buyer should consider the present value of future CCA claims for the assets being purchased.

There are many other tax factors that both parties must take into account in the purchase of a business (ranging from a determination of the tax costs of winding up the corporation to the incidence of other taxes). Nevertheless, the calculation of the taxes payable by the seller on an asset purchase and the calculation of the value to the buyer of the step-up in cost base usually prove to be an integral part of price negotiations and the determination whether to proceed by way of an asset or share deal.

Against this general background, the buyer should review each asset to be purchased, checking the points noted below under "Assets—Specific Considerations".

2. Shares

The tax aspects of a share deal are more difficult to assess than an asset deal because the acquiring shares indirectly involves the acquiring the assets and liabilities of the corporation. The buyer must

first analyze each of the corporation's underlying assets. A review and appraisal must then be done of each of the corporation's "tax-free accounts", loss carryforwards (if any) and tax status (for example, as a CCPC). The steps involved in the buyer's analysis could be as described below.

Step 1—Tax Status of Assets

Review the market value of all underlying assets to be purchased in the share deal in order to determine the loss of a (potential) increase in cost base (because shares rather than assets are being purchased). Depreciable property and eligible capital property (for example, goodwill) are two common types of assets in which a buyer's failure to obtain a step-up in cost base will result in lower future deductions for the company (and hence higher potential tax costs). Furthermore, if the buyer acquires no step-up in the cost base of depreciable properties, CCA previously claimed by the seller may later be recaptured and included in income of the company when ultimately the assets are disposed of. As well, the disposition of these properties and all other capital property may result in capital gains being realized.

If the buyer is a taxable Canadian corporation that acquires at least 90% of the outstanding shares of each class of the corporation, the underlying assets can be distributed on a "rollover" basis at tax values to the buyer on a winding-up of the corporation (s. 88(1)). The buyer might then be able to attribute some of the cost of the shares of the corporation to its underlying non-depreciable property such as land.

Step 2—Review Tax Accounts

Review and appraise the corporation's "tax-free accounts", loss carryforward balances, and tax credit carryforward balances (for example, investment tax credits). This includes a review of the ability of the buyer to use these benefits as discussed below under the Step 4.

Step 3—Small Business Deduction

Analyze the corporation's entitlement to the small business deduction and hence the ability to pay corporate tax in BC at the low rate of approximately 13.5% on the first \$400,000 of active business income annually. The small business deduction is available only to CCPCs that carry on an active business in Canada. In 2009 any remaining active business income will be subject to a 30% rate with rates scheduled to fall to 25% by 2012. Where the buyer is a public corporation or non-resident, CCPC status and the entitlement to the small business deduction will be lost once the shares of the target corporation have been acquired and "control" has passed to the buyer.

The \$400,000 annual limit must be shared among “associated corporations”. A series of complex rules determine whether two or more corporations are “associated” for tax purposes. In very general terms, two corporations are associated if they are directly or indirectly controlled by the same person or corporation or group of persons or corporations. “Control” may even include de facto or economic control. Moreover, a CCPC’s entitlement to the small business deduction is eliminated if its taxable capital employed in Canada in the preceding year exceeds \$10 million.

Step 4—Loss Carryforwards

To the extent the corporation has a loss carryforward position or unused investment tax credits, the losses or credits may “fall off the table” because “control” of the corporation has been acquired as a result of purchase of the shares.

In general, non-capital losses may be carried back three taxation years and forward ten taxation years, and are deductible against any income sources. Net capital losses may be carried back three taxation years and forward indefinitely but are only deductible against taxable capital gains. Farm losses are also deductible in certain circumstances. Unused investment tax credits have a 20 year carryforward.

A series of rules also prevent the sale of unusable loss carryforwards, scientific research deductions, foreign exchange losses, and investment tax credits by one corporation to an unrelated corporation. These rules are generally applicable and should be carefully reviewed whenever there has been an “acquisition of control” of a corporation (that is, whenever more than 50% of the voting shares of a corporation have been sold).

In general terms, these rules provide the following principal consequences upon an acquisition of control of the corporation:

- (a) the taxation year of the corporation is deemed to end immediately before the change in control. A new taxation year commences at this time (s. 249(4)). A relieving provision provides that where the corporation has a taxation year that ends within seven days of the change in control, the corporation can elect in its tax return for the year to extend its taxation year so that it ends immediately before the acquisition of control.

The shortened taxation year of the corporation gives rise to all the consequences that normally follow a taxation year-end, such as the requirement to file the corporation’s tax return and pay any taxes due. This may result in the accelerated payment of taxes, the proration of certain deductions and the abbreviation of time

otherwise available for using deductions and credits or the mandatory inclusion of amounts into income.

- (b) all depreciable property which has been acquired by the corporation within 12 months preceding the change in control and which has not been used, or acquired for use, by the corporation, in a business carried on before that period, is treated as not having been acquired by the corporation until immediately after the change in control (s. 13(24)).
- (c) the net capital losses of the corporation expire and there is a deemed realization of all unrealized losses on all non-depreciable capital property owned by the corporation (that is, where the cost base for tax purposes of the non-depreciable property exceeds its fair market value at the time of the change or control). The corporation may elect to be deemed to have disposed of some or all of its capital property in order that capital gains realized by the election may be used to offset these capital losses (s. 111(4)).
- (d) the non-capital losses that relate to a business and farm losses of the corporation may be carried forward by the buyer to subsequent taxation years only if the business is carried on by the buyer throughout the year and only to the extent of the income from that business or a similar business. However, the buyer cannot deduct such non-capital losses against taxable capital gains for taxation years ending after the change in control, nor can he or she carry forward or back losses from property as non-capital losses (s. 111(5)).
- (e) the corporation’s pool of undeducted scientific research and experimental development expenditures is reduced to nil. If the business to which the expenditures relate is carried on by the buyer with a reasonable expectation of profit in a subsequent taxation year, then the buyer’s pool of expenditures will be reinstated to the extent of the buyer’s income for the year from the business or a similar business (s. 37(6.1)).
- (f) various restrictions affecting the buyer’s ability to use any unused investment tax credits of the corporation will apply (s. 127(5)).
- (g) an anti-avoidance provision prevents the seller from disposing of property as part of a series of transactions for less than fair market value (that is, under a rollover provision) to enable the buyer to offset capital gains realized upon a subsequent disposition of the property with

carried forward losses or other tax credits (s. 69(11)).

Step 5—Tax Liabilities

Analyze the corporation's potential tax liabilities and adjust the purchase price accordingly. This will include the following:

- (a) reviewing prior tax payments to ensure that payments, instalments, collections and remittances are up to date for all federal, provincial and foreign taxes including retail sales taxes, GST, withholding taxes, capital taxes, employee withholdings (including CPP, EI) and other taxes;
- (b) ensuring all tax returns and tax elections have been filed to date;
- (c) determining any exposure to uncertain or contingent tax liabilities in connection with "open years" (up to three or six years after an original assessment for Canadian-controlled private companies, four or seven years for other corporations, and without limitation in the event of fraud or misrepresentation) as well as existing or proposed assessments;
- (d) ensuring unpaid amounts for which the corporation has previously claimed a tax deduction are dealt with (failure to pay such amounts will result in an income inclusion to the corporation).

These and other items often are the subject of extensive representations and warranties in a share purchase agreement.

Step 6—Structure and Financing

Consider the structure that the buyer will use for acquiring the share. For example, the buyer may choose to acquire the shares of the corporation through the use of a holding company. Financing of the purchase price also requires careful consideration and will have a significant influence on the purchase price negotiated between the parties. For example, the seller may need to assist the buyer in the financing of the purchase price. Alternatively, the parties may negotiate an earn-out or reverse earn-out arrangement whereby the selling price will be dependent on future profits from the business sold. In any event, the buyer will seek to deduct any financing costs including interest. The seller may also request payment for any non-competition clause requested by the buyer. The amount received will be fully taxable except in limited situations.

[§7.08] Assets - Specific Considerations

The following is a representative list of comments and concerns affecting the seller corporation and, by implication, the buyer, with respect to the various tax elements involved in an asset sale. The list is by no means exhaustive.

1. Accounts Receivable

Section 22(1) applies where a taxpayer has sold all or substantially all of the property used in carrying on a business, including accounts receivable that have been or will be included in computing his or her income. In the case of a non-resident corporation, the business must have been carried on in Canada. The section requires the filing of a joint election (Form T2022) by the buyer and the seller corporation in prescribed form. Without this election, the buyer would have to treat any subsequent gain or loss on the receivables as a capital item (because the purchase of a business is a capital transaction).

Where the election is made, s. 22(1) will apply to:

- (a) allow the seller corporation to deduct from income the difference between the face value of the receivables transferred and the sale price;
- (b) treat the receivables as having been included in computing the buyer's income for the taxation year or a previous taxation year so that the buyer may claim an allowance for doubtful accounts or a bad debt write-off in respect of them; and
- (c) if the buyer recovers any bad debts previously written off by the seller corporation, the buyer will have to include the amount recovered in his or her income.

Section 22(1) does not apply to taxpayers filing on a cash basis. Such taxpayers must include in income the amounts received for receivables as they are collected.

In some cases the seller will be asked to guarantee the realizable value of its accounts receivable. If the seller has to make compensating payments to the buyer, there is some question as to the deductibility of these payments to the corporation. Unless the CRA has given some assurance by way of a ruling, the corporation may wish to consider retaining the accounts receivable if there is a doubt as to the quality of those receivables.

2. Inventories

Section 23(1) deems the sale of inventory as part of the purchase and sale of a business as having occurred in the course of carrying on the business.

No special election need be filed. This section does not require the sale of all inventory. The effect is to include in the corporation's income any amounts received as consideration for the sale of inventory (which, for tax purposes, can be valued at either the lower of cost or market or all at market). The corporation may benefit from an instalment sale of the inventory, thereby permitting the claiming of a reserve under s. 20(1)(n).

To avoid future problems with the CRA, the transfer price of the inventory should be clearly set out in the contract of purchase and sale. In an arm's length transaction any allocation agreed upon by the parties presumably would represent "fair market value", unless it was so unreasonable as to constitute a sham.

The buyer may prefer to allocate a large portion of the purchase price to inventory as this will result in a rapidly deductible amount for tax purposes.

3. Prepaid Expenses

Section 18(9) provides that expenditures made or incurred by prepaid rent, interest, insurance, taxes and for services to be rendered in a subsequent taxation year are not deductible until the year to which they relate. If prepaid expenses are being transferred, it may be best in some cases to obtain a ruling that they are transferable. The CRA administrative practice has generally been to include any payments to the seller for prepaid expenses in the income of the seller. The buyer will benefit from a corresponding deduction with the timing of the deduction subject to s. 18(9).

4. Non-Depreciable Fixed Assets

The seller corporation will likely want as much of the price as possible to be attributed to non-depreciable fixed assets (that is, land). Non-depreciable fixed assets will result in income taxable only at capital gains rates to the extent that the consideration received exceeds the cost base of the assets for tax purposes. By contrast, proceeds attributed to depreciable fixed assets will result in income taxable at full rates to the extent of any recaptured CCA.

The buyer will usually want as little as possible of the total consideration attributed to non-depreciable fixed assets because no CCA deductions will be available for them in future years to offset income.

The buyer must also consider property tax legislation, which may impose a tax on the purchase of real property. In BC, property tax is payable under the *Property Transfer Tax Act* at the rate of 1% of the first \$200,000 and 2% of the remainder of the fair market value of real property purchased. This tax is generally payable when the transfer of the property is registered in the Land Title Office.

5. Depreciable Fixed Assets

The seller usually wants to minimize the consideration attributable to depreciable fixed assets to minimize recaptured CCA. The seller therefore will usually want more of the consideration allocated to goodwill or non-depreciable capital property, because this will result in less tax payable.

Where the seller is entitled to claim the small business deduction for the tax payable on "recaptured CCA", he or she may accept an additional allocation of a portion of the price to depreciable property.

The seller also should review s. 13(21.1) on the sale of a building and underlying land if a terminal loss is realized on the disposition of the building and a capital gain on the land. This section will deny the terminal loss to the extent of any capital gain realized on the sale of the land.

The seller may consider revising its prior years' claims for CCA before the sale so as to reduce any non-capital loss carryforwards that the seller may not be able to use.

The buyer generally will want to attribute a high portion of the price to depreciable assets. Also, within the depreciable category, the buyer will generally want to attribute as much as possible of the proceeds to those which are depreciable at high rates as opposed to those which are depreciable at low rates.

Buyers of assets should realize that CCA is limited to one-half the normal rate in the year an asset is acquired. Assets contained in certain classes are not affected by this rule. For depreciable property owned before November 13, 1981, the half-year depreciation rule will not apply on a subsequent transfer to a related party. The rule will also not apply in certain circumstances, provided the transferor had owned the property for at least 364 days.

An “available for use” rule also applies to purchases of assets after 1989. This rule provides that CCA, as well as research and development expenditures and investment tax credits, may not be claimed by a buyer until the earlier of:

- (a) the date the asset becomes available for use for the purpose of earning income, and
- (b) two years from the date the asset was acquired from the seller.

Where the two-year rule applies, CCA claims are not further restricted by the half-year rule discussed earlier.

Where the taxation year is less than 12 months (for example, because the year is the initial year of a corporation or because it is cut short by an amalgamation or a change of fiscal period), the CCA which may be claimed on most depreciable assets must also be pro-rated on the basis of the number of days in the taxation year.

The buyer should calculate the present value of the tax savings generated by CCA claims as a source of funds as follows (the formula assumes the assets are available for use):²

$$\text{Present value of tax savings} = \frac{C \times T \times R}{R + i}$$

Where

- C = cost
- T = tax rate
- R = maximum rate of CCA
- i = interest

Where the half-year rule applies to the acquisition, the present value must be multiplied with:

$$\frac{1 + i/2}{1 + i}$$

The buyer should determine whether it is purchasing separate businesses and therefore separate pools of depreciable assets within each class. The sale of separate businesses may also impact on the seller in the form of recapture and terminal losses.

The buyer must review whether the acquisition of depreciable property results in a change of classification. That is, an asset of one class to the seller may be appropriately characterized as of another class to the buyer. A s. 85 rollover and election, discussed later, may be used to avoid undesirable changes in classification.

The buyer and the seller should ensure that the prices attributed to various categories of fixed assets are clearly stipulated in the sale documents. The basis for determining the value should be retained on file, particularly where the buyer and the seller are not dealing at arm’s length.

The buyer also must not overlook the exigibility of provincial retail sales tax and GST on purchases of tangible personal property. Provincial retail sales tax and GST will generally be payable by buyers of assets but not of shares. In BC, social service tax is payable under the *Social Service Tax Act* at the rate of 7% on tangible personal property purchased. The GST is discussed in §7.09.

6. Goodwill

If the business involves customer lists, the buyer may forego non-competition covenants by the seller. This may render the buyer’s cost of acquiring the lists deductible as a business expense, otherwise, the cost will generally be treated as an eligible capital expenditure, three-quarters of which will be deductible at 7% per year (on a declining balance basis).

7. Bonds, Debentures, Notes

The seller will have to include in its income interest accrued to the date of transfer. Amounts paid for accrued interest are deductible by the buyer in the year in which the accrued interest is included in income. This can create a “timing problem” for the buyer.

Where an obligation such as a bond, debenture, note or mortgage that has been issued after June 18, 1971 by one taxpayer has been assumed by another in connection with the sale of property or otherwise, neither the original issuer of the debt obligation nor the person who assumed the debt is entitled to a deduction in respect of any discount on the debt.

8. Existing Tax Reserves

Tax reserves often pose serious difficulties in asset sales. The existence of such reserves can usually be detected by reviewing the reconciliation of income on the seller’s financial statements with the taxable income shown on its tax return. The most common types of reserves are for goods and services to be provided, prepaid rents, returnable containers, property (that is, real estate inventory) sold in the course of business and capital property (that is, real estate).

² From Howick, Wallace M., 1983 *Corporate Management Tax Conference Report*, pp. 168-169.

The problem arises because of the mechanics of reserve calculations. A prior year's reserve is added to income, while the current year's reserve is deducted. If the assets to which the reserves apply are transferred, the opening reserve is brought into income, but the seller obtains no closing reserve. Furthermore, the buyer also receives no reserve in respect of the assets purchased because no amount has been included in his or her income in respect of such assets.

9. Payment Arrangements

If the purchase price proceeds are not due in the year of sale, reserves for tax purposes may be claimed in these "instalment sales".

For dispositions of property that give rise to ordinary income, the deduction of a reserve in respect of proceeds due in a later year is limited to a maximum of three years. The reserve must be calculated in a "reasonable" fashion, which suggests that "profit" and "return of cost" be recognized proportionately.

A five-year reserve mechanism is provided for taxable capital gains arising on dispositions of capital property. At least one-fifth of the taxable capital gain must be brought into income for each of the five years. A ten-year reserve is available in limited circumstances for gains realized on the disposition of certain farm property, shares of a family farm corporation, an interest in a family farm partnership and shares of a "small business corporation" to a child of the seller.

Where the seller has taken back a demand promissory note for the deferred portion of the purchase price as "conditional payment", the CRA permits the seller to claim a reserve. Demand notes must at least be drafted as term demand notes (that is, due 2, 10, 20 or 366 days after demand has been made), because of the Federal Court of Appeal decision in *Derbecker v. R.* (1984), 84 D.T.C. 6549. However, it is still unclear whether even a term demand note will permit the seller to claim a reserve in law if it is in the seller's discretion when to make a demand.

In summary, if the purchase price is to be paid in instalments, the seller should negotiate the payment of instalment consideration to maximize the reserves that can be claimed. At a minimum, a seller should receive enough cash to pay his or her tax.

10. Tax-Deferred Transfers

The seller may dispose of its assets on a tax-deferred or "rollover" basis, provided the buyer is a corporation and the seller receives shares of the buyer corporation under the sale. In this way, the seller may postpone realization of gains, losses or income until later. These rollover transactions generally involve the seller disposing of assets for shares of the buyer corporation pursuant to s. 85. In doing so, the seller may also strive to convert other taxable gains into tax-free returns (inter-corporate dividends). Certain anti-avoidance rules seek to restrict such practices.

The buyer may only decide to use shares as a form of payment if it does not want or is not able to obtain the financing required to pay the seller. "Rollover" transactions are not attractive to the buyer because the buyer for tax purposes usually gets no increase in the cost base of the assets acquired and must therefore bear the latent tax liabilities inherent in these assets.

There also are rules that permit inter-affiliate transfers without payment of goods and services tax (see §7.09).

[§7.09] Goods and Services Tax ("GST")

1. General Scheme

The GST is a tax at the rate of 5% on most goods (including real and intangible property) and services (collectively termed "supplies") made or supplied in or imported into Canada.

The GST is similar to a provincial retail sales tax (in BC, the BC social service tax) in that the ultimate consumer of the good or services bears the tax. However, the GST system is different in the way in which the tax is collected. Sellers who provide "taxable supplies" must charge the recipient of the supply GST at the rate of 5% of the fair market value or price of the supply. A "taxable supply" includes any disposition of property and any provision of a service, unless specifically exempted. Buyers acquiring taxable supplies in the course of carrying on a "commercial activity" (that is, for the purpose of making taxable supplies) are therefore required to pay GST on the value of the consideration paid or payable for the supply. However, to ensure that the ultimate consumer bears the tax, buyers are entitled to an "input tax credit" for the GST paid to the extent that the goods and services were acquired for use in a commercial activity. Each reporting period, those engaged in a commercial activity are obliged to remit the excess of GST collected over the amount of input tax credits claimable for that period to the CRA. If

input tax credits exceed the GST payable over a period, a refund may be claimed to the extent of this excess.

In summary, when a seller sells goods or provides services of carrying on a commercial activity, it generally will be obliged to collect and remit GST collected from the customer. A buyer also will be required to pay GST on its purchases of most goods and services, unless a specific exemption is available. However, the buyer will be able to claim an input tax credit for the GST which it has been required to pay, thereby effectively passing on the GST to its customers.

2. Purchase of a Business

The sale or transfer of shares will not trigger any GST since shares are an exempt supply. This treatment applies whether the shares are capital property, inventory or property held in the nature of trade to the seller or the buyer.

The GST also contains specific provisions for the winding-up of a 90% or more subsidiary of the transfer of assets. These specific provisions treat the subsequent winding-up or amalgamation as a non-taxable event.

The primary concern for a buyer of shares is the GST liabilities being acquired along with the other liabilities of the target company. To the extent that the target company did not file returns and did not remit GST, the buyer will be held responsible. Buyers of shares should conduct a due diligence review of the target company and ensure that the seller gives appropriate warranties and indemnities.

Where the buyer acquires assets, the buyer and the seller may make the “all or substantially all” election to have the transaction exempted from GST: this is a joint election. The original purpose of this election was to relieve the buyer of the financing costs associated with paying the GST and then claiming it back through an input tax credit, as these financing charges can be substantial in an asset purchase agreement. The election takes its name from the original requirement that the assets constitute all or substantially all of the assets of a business carried by the seller. As a result of amendments to the GST, the election is now available where the assets constitute all or substantially all of the assets that the buyer requires to carry on the business. A covenant to make this joint election has quickly become a standard in asset purchase agreements.

When the GST was first enacted, the “all or substantially all” election only could have been made where both the seller and the buyer were engaged in commercial activities. Where a buyer

was engaged in making exempt supplies (such as a doctor) the election could not be made. In those cases, the GST represented a hard cost to the buyer. This was perceived to be unfair because the seller may also have paid and not recovered the GST. As a result of the amendments to the GST, the “all or substantially all” election now is available for sale of all business except where the seller is engaged in a commercial activity and the buyer is not.

Amendments also exempt from the tax the transfer of goodwill in connection with the sale of the business. This amendment removes the burden of the GST where the “all or substantially all” election is not or cannot be made.

Buyers and sellers are also generally entitled to claim an input tax credit for GST paid on purchases related to the transfer of a business, such as legal and accounting fees.

The legislation also provides a related corporation election. Corporations that are “related” can elect not to have GST apply on any inter-corporate supplies. For two corporations to be “related”, a degree of share ownership between them of at least 90%, both in terms of votes and value, is generally required.

[§7.10] Section 116 of the Income Tax Act and Non-Residents

1. General

The purpose of s. 116 of the *Income Tax Act* is to secure, through the prepayment of tax, any income tax which may be payable by a non-resident on the disposition by the non-resident of “taxable Canadian property”.

Section 116 provides a system by which a non-resident seller (the “Seller”) of “taxable Canadian property” is required to report the disposition or proposed disposition of such property to the CRA either before the disposition or within ten days thereafter, and prepay tax on account of the actual income tax payable as a result of the disposition. This is accomplished either by the Seller making the estimated prepayment of tax, in which case a certificate of compliance (“Clearance Certificate”) is issued by the CRA certifying that this has been done, or by the buyer withholding an amount from the proceeds paid to the Seller on account of such tax. Payments of tax sent to the CRA by the Seller or the buyer, as the case may be, are credited to the account of the Seller until the Seller files an income tax return for the year in accordance with s. 115. Where the provisions of s. 116 are not satisfied, the buyer may be liable for the unpaid tax. Accordingly, the buyer is well advised to withhold

sufficient amounts from the proceeds paid to the seller until the buyer receives a copy of a Clearance Certificate certifying that the seller has prepaid the required amount of tax. Where no Clearance Certificate is forthcoming, the buyer will be obliged to remit the required amount to the CRA on behalf of the Seller's tax liability.

2. "Taxable Canadian Property"

Section 116 applies to the disposition by a Seller of "taxable Canadian property". "[T]axable Canadian property" is defined (s. 248) as including:

- (a) real property situated in Canada (mortgages and hypothecs are not considered by the CRA to be interests in real property, yet options are (s. 115(3));
- (b) capital property used by the Seller in carrying on a business in Canada;
- (c) a share of the capital stock of a corporation resident in Canada (other than a public corporation);
- (d) a share of the capital stock of a public corporation where, at any time during the last five years, not less than 25% of the issued shares of any class belonged to the Seller or to persons with whom the Seller did not deal at arm's length;
- (e) a capital interest in a trust (other than a unit trust) resident in Canada; and
- (f) an interest in a partnership if, at any time during the last 12 months, the fair market value of taxable Canadian property held by the partnership was not less than 50% of the aggregate of the fair market value of all property owned by the partnership.

Overall, the definition of "taxable Canadian property" includes real property as well as interests in corporations, trusts and partnerships that can hold real property. Units or interests in trusts resident in Canada are included.

3. Tax Treaty

A tax treaty between Canada and the non-resident's country of residence may eliminate the Canadian income tax liability that otherwise arises on the sale of shares or assets.

[§7.11] Reductions in the Purchase Price

Purchasers of assets of shares may pay amounts to a vendor in lieu of the actual purchase price with a view to obtaining more optimal tax relief. Such payments may be structured as retiring allowances and/or non-compete payments. The taxability to the recipient, in whole or part, must be carefully considered, as must the current and long-term deductibility to the payor.

[§7.12] Drafting Agreements and Special Tax Clauses

Agreements documenting the purchase and sale of shares or assets can be quite complex because they contain the fundamental terms of the business deal and the promises made by both parties which support the value ascribed to the property being sold. In a typical agreement, the parties will make certain representations and warrant their accuracy. Alternatively, they might indemnify one another in respect of certain contingent liabilities. Frequently there will be contractual provisions drafted that have a tax content. For a more thorough discussion, see:

Edwin G. Kroft, "Tax Clauses in Acquisition Agreements" in *1990 Corporate Management Tax Conference Report* (Canadian Tax Foundation).

[§7.13] Bibliography

The tax considerations of an asset sale and a share sale are discussed in more depth in these sources:

Edwin G. Kroft, "Some Tax Aspects of Buying or Selling Assets or Shares" in *1996 Corporate Management Tax Conference* (Canadian Tax Foundation).

Edwin G. Kroft, "Tax Clauses in Acquisition Agreements" in *1990 Corporate Management Tax Conference Report* (Canadian Tax Foundation).

Howard J. Kellough and Peter E. McQuillan, "Taxation of Private Corporations and Their Shareholders", (3rd. ed.) (Canadian Tax Foundation, 2000).

Lori Mathison, "Selling a Business: Minimizing the Vendor's Tax" in *2002 Annual Conference Report* (Canadian Tax Foundation).

Len Glass, "Sale of a Business—Purchaser and Vendor Issues" in *1999 BC Tax Conference Report* (Canadian Tax Foundation).