Tax Considerations in the Purchase & Sale of an Incorporated Company

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1. Introduction

The purchase and sale of a private incorporated company in Canada raises a variety of important tax considerations. This paper provides an overview and analysis of such considerations and argues that the clear public policy objective of promoting small business in Canada using provisions of the *Income Tax Act*[1] (the **"Act"**) has been undermined by the creation of a regime so (and frequently unnecessarily) complex that business owners face the choice of either incurring significant expense to avoid pitfalls and optimize the purchase and sale transaction or risk an inflated tax bill and potential non-compliance due to ignorance of existing tax provisions. While many of the tax issues discussed also apply to the purchase and sale of public companies, the focus of this paper is on the purchase and sale of privately held corporations.

2. Considerations in Asset Versus Share Purchase & Sale Transactions

A fundamental decision to be made when structuring the purchase and sale of a business is determining whether it will be the company's assets or shares that will be sold. Generally the seller wants to sell shares while the buyer wants to buy assets. Sellers want to sell shares to take advantage of the lifetime capital gains exemption and to provide for a comparatively clean and simple transfer of the corporation and most associated administrative burdens, risks and liabilities. Buyers, however, usually want to buy the corporation's assets rather than its shares to protect against past corporate liabilities, in some instances to facilitate the partial acquisition of a company where some assets are desired while some are not, and, frequently, to get a higher cost base for capital assets, which is advantageous when calculating depreciation and capital gains for tax purposes. This section will examine these considerations in detail.

2.1 Capital Gains & Lifetime Exemption

A seller is often motivated to sell shares rather than assets in order take advantage of the lower rate of taxation on capital gains – only 50% of capital gains are taxed at a taxpayer's tax rate – and, where applicable, to take advantage of the lifetime capital gains exemption, which can provide significant tax savings for the seller of shares in a qualified small business corporation.[2] At the time of writing the lifetime capital gains exemption provides for a lifetime deduction up to one half of $813,600.[3] A seller is eligible for the exemption where each share sold is a "qualified small business corporation share," which requires that:

a) The share is capital stock of a small business corporation (and is therefore a "qualified small business corporation share"), as defined in section 110.6 (1) of the Act, and is owned by the seller, the seller's spouse or a partnership of which the seller is a member;

b) During the period that the shares were owned in the past 24 months the corporation was a Canadian-controlled private corporation (**"CCPC"**), as defined in section 125(7) of the Act, and more than 50% of the fair market value of the assets of the corporation are used in Canada and/or are made up of certain shares or debts of connected corporations; and,

c) With some exceptions, nobody else owned the shares in the 24 months prior to disposition.[4]

Section 248(1) of the Act defines "small business corporation" as, broadly speaking, a CCPC with all or substantially all of the fair market value of its assets used principally in an active business carried out primarily in Canada. Section 125(7) of the Act defines a CCPC as, broadly speaking, a private corporation controlled by resident Canadians.

Where relying on the lifetime capital gains exemption is either not available or not desirable, the seller of a small business corporation can also rely on Section 44.1 of the Act, which permits the deferral of all or some capital gains from the disposition of shares in a small business corporation when the proceeds are used to invest in new small business corporation shares.[5] The section requires that certain criteria be met including that:

a) The common shares were issued directly by the corporation;

b) The issuing corporation was an eligible small business corporation when the shares were issued;

c) The total carrying value of the assets in the corporation does not exceed $50 million immediately before or after the shares were issued;

d) The corporation remains a small business corporation while the shares are held;

e) The shares are held for no less than 185 days from the date of acquisition;

f) The replacement shares have been acquired within the year of disposition or 120 days from the end of that year.[6]

These provisions are examples of a broader public policy of using the Act to encourage investment in new and growing enterprises. They are important because they provide significant incentives for Canadian residents to build value in small business – an engine of job creation and economic growth. The lifetime capital gains exemption incentive is such that an eligible business owner will require a material price adjustment to forego the associated tax savings. Another consideration in determining how to structure a purchase and sale transaction, perhaps of equal importance to capital gains implications, is the apportionment of risk.

2.2 Liability & Business Risk

A common issue in business transactions that can include both tax and non-tax consequences is how potential liability and business risk will be allocated. Risk in the context of a business purchase and sale transaction can take many forms including reassessments of tax liability, creditor and shareholder remedies, tort, civil and statutory claims. During the negotiation process each side will inevitably seek to structure the transaction to allocate the greatest degree of potential risk to the other while minimizing their own. A sale of assets frees the buyer from liabilities associated with the company and limits risk to the future use or operation of the assets purchased. A sale of shares, however, allows an owner/operator to walk away from responsibility for dealing with business liabilities with the exception of certain extraordinary claims such as for fraudulent acts. In either scenario it is likely that the parties will include representations, warranties and other clauses in the underlying purchase and sale agreement that allocate specific risks based on the negotiated terms of the transaction. When allocating risk the resulting complexity of how a transaction is structured should also be taken into account.

2.3 Complexity

Reducing the complexity of a transaction saves time and money. Opting for selling shares rather than assets can in many instances significantly simplify a proposed transaction. The sale of shares involves selling one thing (shares) whereas an asset sale usually involves the sale of many things, each of which can require separate transfer documentation. The transfer of some assets can be involved and require filings, the transfer of licenses or permits and may involve renegotiating or assigning agreements such as leases and permits. In some instances government permits and licenses are not transferable and would have to be re-applied for. Though the additional complexity involved in an asset purchase transaction will vary depending on its particulars, in some instances such additional effort is considered a small price to pay for resulting benefits; for example, when the buyer is motivated to acquire only a portion a company.

2.4 Partial Acquisition

In many instances a buyer is interested in only part of the seller's business. The seller may wish to extract profitable elements while excluding unprofitable elements, it may wish to acquire only elements that complement its existing operations, or it may wish to purchase only part of the business to ensure that the purchasing entity will continue to be considered a small business corporation or a CCPC for tax purposes. A partial acquisition by way of asset purchase will often also have a material affect on the calculation of capital asset depreciation for the business.

2.5 Depreciation

Depreciation is the process of reducing the accounted-for value of an asset over time to reflect a loss in value primarily due to wear and tear. Canada's tax system differentiates between current expenses incurred during the course of business (and deductible as a business expense) and capital expenses that provide a lasting benefit or advantage (that is not deductible but may be depreciable).[7] The Act lists capital property that is depreciable, permitting differing classes to depreciate (and be partially deducted as a current expense in a given year) at different rates. The capital cost allowance is the amount that one is permitted to depreciate and deduct for a capital asset under the Act and its Regulations.[8] The asset's recorded value based on this permitted rate of depreciation (the recorded value consisting of the asset's cost minus the asset's accumulated depreciation or "book value") does not necessarily correspond with the actual value of the capital asset if determined on the open market (the "fair market value").

When the shares of a business are sold the book value continues to be used for the purposes of depreciation. When the assets of a business are sold, however, generally the purchase price is the amount from which future depreciation is calculated. If the fair market value of the good was higher than the book value this can allow for an increase in the cost-base of the asset for future depreciation, resulting in a tax savings for the buyer in comparison to a share purchase and sale. This could result in a tax liability for the seller in the form of "recapture" where the proceeds of sale of a given asset are greater than its book value, however. Allocating tax consequences between the buyer and seller to optimize value should be considered during purchase and sale negotiations. This is equally true when considering accumulated tax losses.

2.6 Tax Losses

Sometimes an acquired company has incurred tax losses that can be deducted against future income. Section 111(1) of the Act permits non-capital losses to be carried back for up to 3 years and forward for up to 20 years.[9] A share purchase transaction allows the buyer to take advantage of the company's tax losses against future income whereas an asset purchase would not allow these tax losses to be used by the buyer. As with accumulated tax losses, the applicability and impact of taxes derived from sources other than income should also be considered.

2.7 Sales & Property Transfer Taxes

Another significant consideration when deciding between a share and asset purchase is the applicability of sales and property transfer taxes. While a share purchase transaction avoids both, an asset purchase can trigger significant tax liabilities. Though the application of sales tax is complicated and differs depending on the Province in which the transaction occurs, sales tax can apply to an asset purchase when only part of a business's assets are sold. Section 167(1) of the *Excise Tax Act*[10] allows for an election to exempt an asset purchase and sale from sales tax only when "all or substantially all of the property that can reasonably be regarded as being necessary for the recipient to be capable of carrying on the business or part as a business [is transferred]."[11] Parties to a transaction must be mindful as to whether they are required to collect and pay sales tax, whether the contemplated asset purchase would otherwise require the collection of sales tax and whether the *Excise Tax Act* section 167(1) election is available.

The applicability of property transfer tax is another significant tax liability that could result from conducting a sale of assets rather than a sale of shares. Land transfer tax can vary widely depending on the jurisdiction in which the land is located. At the time of writing in Toronto, Ontario, for example, pursuant to the Toronto Municipal Code, the land transfer tax is calculated as 0.5% for the first $55,000 of the purchase price, 1% on $55,000 to $400,000, and 2% on any amount over $400,000.[12] Parties to an asset purchase and sale transaction including the sale of real property should consider whether property transfer tax applies.

As discussed in this section, there are numerous, and frequently complex tax issues that must be taken into account when determining whether to structure a purchase and sale transaction as a sale of shares or assets, some which are generally to the benefit of the seller and some which are generally to the benefit of the buyer. Because these considerations are ultimately monetary in nature, either side can, at least in theory, be indifferent to a concession to the other if an appropriate price adjustment is made. In practice, this is most commonly seen in the calculation of a price premium paid to the seller in order to proceed with the sale of assets rather than shares.

3. Asset Purchase Price Premium

The tax implications of the sale of assets rather than shares is highly variable, both due to the particulars of the assets sold and of each party including their respective marginal tax rates. When calculating the asset purchase price premium it is useful to remember that when a business is sold the seller is seeking to maximize after tax proceeds of the sale while the buyer seeks to maximize the net present value (the current value of future cash flows) of the business.[13]

The tax implications for both scenarios for each party must be calculated in order to calculate the indifference price between the sale of assets and shares. Such calculations can be complex and are impacted by the nature and classification of the corporation to be acquired. Such considerations include whether the business has appreciated in value, whether it is bought and sold for cash, whether the business is and will continue to be a going concern, whether the buyer and seller are entering into the transaction as individuals or through other entities such as corporations, whether the business is eligible for the small business tax rate and, consequently, whether individual shareholders will be eligible for the reduced tax rate on dividends. In calculating the tax implications for each party the taxation of different classes of assets must be considered. This includes depreciable assets (including the potential to step up book value in an asset purchase), eligible capital property and the impact of distribution of proceeds to shareholders. [14]

The asset purchase price premium can then be calculated by equating the net present value of each of the shares and assets (since they should be equivalent) and then working backwards, taking the tax implications for both parties into account, to determine what the corresponding purchase price should be. While a thorough review of the applicable formulae and calculations are outside of the scope of this paper, the principle that a price premium can be calculated to make the parties financially indifferent to the nature of the purchase and sale transaction should be remembered during negotiations when either party expresses a strong preference for a given provision.[15]

Deciding whether to structure a transaction as an asset or share sale and what, if any, price premiums should be applied is a major consideration when structuring the purchase and sale of a business. Most transactions, however, will also require the careful consideration of other factors, their suitability and resulting tax impact. Such considerations, like the value of a business' goodwill can even turn conventional assumptions on their head.

4. Goodwill

Goodwill is the excess of a business' purchase price over the fair market value of its assets. It is the intangible value of a company's good reputation. Goodwill is an eligible capital property under the Act because it is a non-depreciable capital asset. Section 20(1)(b) of the Act permits an eligible capital property pool, equaling all amounts spent on acquisitions minus dispositions, to be deducted at the rate of up to 7% of the balance of the pool at the end of each taxation year. A negative balance must be reported as income in most instances. A gain on the disposition of an eligible capital property is treated in a similar manner to a capital gain with only 50% of the total amount taxed as regular business income. The other 50% can be paid out to shareholders tax-free.[16]

When a purchase and sale transaction involves a business with significant value in goodwill it is important to reconsider the conventional assumption that the seller will prefer to sell shares. This is because the combination of the tax rate on dividends (paid out to shareholders after the sale of assets) plus the reduced tax rate on the sale of goodwill at a favorable corporate tax rate can be comparable or preferable to the rate of tax on capital gains from the sale of shares. Notably, differing corporate and individual tax rates between provinces means that the tax implications will vary depending on the applicable jurisdiction.[17]

5. Deferred Payments & Earn-outs

Sometimes a purchaser will not have, nor be able to secure third party financing to raise, enough money to pay the entire purchase price at the time of closing. In such a scenario, and in some others, deferred payments, earn-outs and vender take-backs may be used to facilitate payment and the completion of the transaction. The tax consequences of such arrangements should be considered when structuring the purchase and sale of a business in this fashion.

A deferred payment in the context of a business purchase or sale is a payment that is to be made after the date of closing. The taxation of deferred payments in a purchase and sale transaction is contemplated in the Act. Section 20(1)(n) allows for a reserve for the unpaid purchase price where the amount is not due for a period of at least 2 years, though the reserve is limited to a maximum of 3 years by Section 20(8). Section 40(1)(a) allows for a capital gains reserve over a 5 year period on the sale of capital property.[18] The Canada Revenue Agency (**"CRA"**) takes the position that no reserve is available for either the recapture of depreciation arising on the sale of property,[19] nor for eligible capital property (which is neither depreciable nor capital property and includes assets like goodwill), as the sale of such assets is not "in the course of business."[20]

An earn-out is a deferred payment where the payment or the amount of the payment is contingent on an outcome such as business gross revenues or net profit. An earn-out can be particularly useful when the buyer and seller cannot come to an agreement on the valuation of the business (most accurately assessed as the net present value of future cash-flows) and, consequently, the appropriate purchase price. This is most likely to be the case in start-up or financially distressed businesses where future cash flows are most uncertain. Earn-outs can also act as an incentive for the ongoing participation of the seller where the seller's continued involvement in the company is important.[21]

Section 12(1)(g) of the Act addresses earn-out payments. This section includes as income "any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an installment in the sale price of property…."[22] CRA interpretation bulletin IT-426R[23] states that the receipt of an earn-out payment is generally treated as ordinary income even if it represents a disposition from the sale of capital property because it relates to the performance of the business. The CRA then, however, takes an administrative position that allows for a cost-recovery-method for payments received from the sale of shares, effectively allowing for treatment analogous to capital gains, if certain conditions outlined in bulletin IT-426R are satisfied. Such requirements include that the parties are at arm's length, the earn-out is for no more than 5 years, the seller is a Canadian resident, a copy of the agreement and a letter of request is submitted and the earn-out relates to goodwill value which cannot reasonably be agreed upon as of the date of sale.[24]

Though these provisions attempts to provide clarity on the implications for a commonly used commercial arrangement the rules are sufficiently complex that they defy an intuitive understanding and require careful study. Deferred payments and earn-outs are not unique in this respect. The Act's provisions on restrictive covenants are perhaps one of the most apparent instances where an attempt to clarify has unnecessarily increased complexity and resulting compliance cost and risk.

6. Restrictive Covenants

A restrictive covenant is an agreement to refrain from taking certain action(s). In the context of a purchase and sale transaction, frequently the buyer will require that the seller enter into a non-competition agreement as a term of sale to ensure that the seller does not set up a new business to compete against the purchaser within a period of time after the close of the transaction. Historically such a restrictive covenant was allocated no or little of the purchase price. Two Federal Court decisions, Fortino[25] in 2001 and Manrell in 2003,[26] however, concluded that non-competition payments are not taxable because they are neither income from a source nor capital property. After these rulings allocating greater value to non-compete clauses became more common. In response, in 2003 the Department of Finance introduced legislation to reverse the Court's findings, dealing more broadly with "restrictive covenants."[27]

After a long wait, section 56.4 of the Act was enacted with Bill C-48 on June 26, 2013, though the section generally applies retroactively to amounts paid or payable after October 7, 2003.[28] The provision broadly defines "restrictive covenant" to also include other arrangements such as non-solicitation and non-disclosure agreements and allocates most payments made for restrictive covenants to ordinary income, with some exceptions.[29] For the majority of business owners, the most important exemption from full income inclusion for restrictive covenants is found in section 56.4(3)(c). It applies to arms-length dispositions of an eligible interest (which includes a share of the capital stock of a corporation that carries on a business) in the corporation that carries on the business to which the restrictive covenant relates where, broadly speaking, the following criteria are met:

a) The disposition is to the purchaser;

b) It is as consideration not to compete with the purchaser;

c) It is to maintain the value of the eligible interest disposed of;

d) It is not a redemption of shares under subsection 84(3);

e) The amount is added to the particular taxpayer's proceeds of disposition; and,

f) The parties file an election form.

Section 56.4(3)(c) allows an exemption to the broader section 56.4 rule to the benefit of businesses engaged in a customary purchase and sale transaction. Alarmingly, however, the concern over the non-taxability of non-compete agreements and the desire to exempt customary business transactions from a punitive counter-measure has been carried out with such unnecessary complexity that it has created a trap for the unwary business owner that fails to file the requisite election form. Why a simpler solution such as including a right to compete in the definition of "property" or defining consideration for a covenant as "proceeds of disposition"[30] is not clear. The end result is that a business owner must incur additional expense to retainer professional tax expertise to avoid an unintended and potentially detrimental tax consequence. For small business owners the cost of such a burden is not immaterial. The restrictive covenants provision is a prime example of legislative complexity acting counter to other provisions that very clearly seek to provide tax incentives to promote small business. Another example of additional complexity that risks incurring unintentional tax consequences is the potential for triggering multiple year-ends upon the acquisition of a business.

7. Deemed & Multiple Year Ends

When planning a business purchase and sale transaction one must consider whether acquisition of control or the change in CCPC status deemed year ends will be triggered and, if so, what the tax consequences will be. Section 249(4) of the Act deems a year-end to have occurred immediately prior to the acquisition of control of a corporation by a new party. Its purpose is to create separate tax years for the old and new controlling party. When the purchased corporation either becomes or ceases to be a CCPC, section 249(3.1) also deems a year-end to allow entitlement to CCPC benefits up until the date of change. Otherwise, a corporation would not be eligible for CCPC benefits if at any time in the tax year it was not a CCPC. This provision differs from section 249(4) because CCPC status can change without a simultaneous acquisition of control.

When not fully considered, the interaction between sections 249(4) and 249(3.1) can have unexpected results. When contemplating their impact reference should be made to section 256(9), which deems the timing of the acquisition of control deemed year-end to be the beginning of the day and not at a specific time unless otherwise elected, and section 251(5)(5), defining “Canadian-controlled private corporation” for the purposes of the provisions discussed and, by inference, clarifying the circumstances that would result in the loss of CCPC status. Notably, a corporation will not be a CCPC if a public company or non-resident has a right to acquire control under section 251(5)(b) even if a Canadian resident has actual control, while a corporation will ***not*** be a CCPC for so long as actual control rests with a public company or non-resident even if a Canadian resident has the right to acquire control.[31] Lack of familiarity with these deemed year-end provisions could result in unintended consequences for the unwary business owner. Such potentially simultaneously applying provisions are an example of an instance where prudent drafting could reduce Act complexity and unintended consequences, with an election required to trigger a deemed year-end, and align a core public policy aim in the Act with the costs associated with taxpayer compliance in practice.

8. Conclusion

An overview and analysis of tax considerations in the purchase and sale of a private incorporated company in Canada demonstrates that legislative intent to support and promote small business in Canada through provisions in the Act have been tempered by their undue complexity which increased related tax planning and compliance costs. Specifically, unduly complicating the section 56.4 provision on restrictive covenants and the creation of potential traps like the interaction between sections 249(4) and 249(3.1) demonstrate that policy objectives and their implementation are not sufficiently aligned with respect to the promotion of small business under the Act. Government objects are better met by both including such tax incentives while also working to keep them sufficiently accessible so that small businesses with fewer resources can rely upon them without incurring disproportionate costs due to unnecessary complexity.

9. End Notes

[1] *Income Tax Act, RSC 1985, c 1 (5th Supp).*

[2] Canada Revenue Agency. *Capital Gains Deduction, Which Gains are Eligible?* January 5, 2016. <http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns248-260/254/lgbl-eng.html>. Accessed July 18, 2016.

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[6] Canada Revenue Agency. Capital Gains – 2015. January 3, 2013. <http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-e.html>. Accessed July 21, 2016.

[7] Canada Revenue Agency. *Current expenses or capital expenses?* January 5, 2016. <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/rntl/crcp-eng.html>. Accessed July 18.

[8] See: Canada Revenue Agency. *Classes of depreciable property*. January 5, 2016. <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/dprcbl-eng.html> and Canada Revenue Agency. *Definitions for letter C (Business)*. January 28, 2016. <http://www.cra-arc.gc.ca/tx/bsnss/glssry/c-gn-eng.html#CCA>. Accessed July 18, 2016.

[9] This applies for losses after 2005. Losses from earlier years have a shorter permitted period.

[10] *Excise Tax Act (R.S.C., 1985, c. E-15).*

[11] *Excise Tax Act* Section 167(1).

[12] City of Toronto. *Toronto Municipal Code, Chapter 760, Municipal Land Transfer Tax, Article 760-9*. April 1, 2010. <http://www.toronto.ca/legdocs/municode/1184_760.pdf>. Accessed July 21, 2016.

[13] Amin Mawani. *Managerial Tax Planning – 2016 Course Binder*. In Progress. Page 181.

[14] *Ibid*. Pages 182-184.

[15] *Ibid*. Page 190.

[16] Canada Revenue Agency. IT-123R6 - Transactions Involving Eligible Capital Property. June 1, 1997. <http://www.cra-arc.gc.ca/E/pub/tp/it123r6/it123r6-e.html>. Accessed July 23, 2016.

[17] Bill Vienneau, “Purchase and Sale of a Business,” 2011 Atlantic Provinces Tax Conference, (Halifax: Canadian Tax Foundation, 2011), 2B:1-33. Page 5.

[18] Ron Choudhury and Doug Connell, “Select Issues in the Purchase and Sale of a Business,” 2012 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2012), 11: 1-31. Page 10.

[19] *Odyssey Industries v. R., [1996] 2 C.T.C. 2401 (TCC)*. 2012 OC 11 Footnote-32 Purchase and Sale of a Business (Choudhury, R. & D. Connell). As cited in: Ibid. Page 10.

[20] Interpretation Bulletin IT-123R6, “Transactions Involving Eligible Capital Property” June 23, 1997, paragraph 37; CRA document no. 2007-0250301E5, dated October 18, 2007. As cited in: Choudhury. *Ibid*. Page 10.

[21] *Ibid*. Page 8.

[22] As quoted in *Ibid*. Page 9.

[23] Canada Revenue Agency. Interpretation Bulletin IT-426R. September 28, 2004. <http://www.cra-arc.gc.ca/E/pub/tp/it426r/it426r-e.html>. Accessed July 22, 2016.

[24] Choudhury. *Supra*. Page 9.

[25] *The Queen v. Fortino, [2000] 1 CTC 349 (FCA).*

[26] *Manrell v. The Queen, [2003] 3 CTC 50.*

[27] Choudhury. *Supra*. Page 11.

[28] Parliament of Canada. *First Session, Forty-first Parliament, 60-61-62 Elizabeth II, 2011-2012-2013, Statutes of Canada 2013, Chapter 34*. June 26, 2013. <http://www.parl.gc.ca/HousePublications/Publication.aspx?DocId=6249914>. Accessed on July 21, 2016. As cited in McMillan LLP. *Income Tax Act changes to taxation for restrictive covenants are now confirmed: beware as consequences could be taxing!* 2013. <http://www.mcmillan.ca/will-work-for-free-employers-beware-of-offers-of-free-work-by-unpaid-interns> Accessed July 21, 2016.

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[30] Choudhury. *Supra*. Page 11.

[31] Mark Jadd and Eoin Brady, Structuring the Purchase and Sale of a Business: Some Tips and Traps," 2011 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 2011), 11: 1-33. Page 3.

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