TAX PLANNING FOR THE SALE OF YOUR BUSINESS

If you own a corporation that carries on an active business, you may be in a position at some point to consider the sale of your business.

This Reference Guide sets out some of the important tax issues that you should consider.

SHARE SALE VS. ASSET SALE

The sale of an incorporated business can be accomplished either through the sale of the corporation's assets or the sale of shares of the corporation. The *asset sale* versus *share sale* decision requires consideration of many tax and non-tax issues. However, tax will generally play a significant role in the decision.

As a general rule, the vendor of an incorporated business would prefer to sell shares, while the purchaser would prefer to buy assets. For the vendor, the tax cost will generally be less in the case of a share sale. For the purchaser, an asset purchase will result in a greater cost base for the underlying assets of the business, and therefore a greater cost base on which to claim depreciation. In addition, with an asset purchase, the purchaser can recognize and depreciate for tax purposes any goodwill associated with the business.

A non-tax reason that a purchaser would rather purchase assets is the potential liabilities that may exist in the corporation, which would remain if the purchaser acquired the *shares* of the corporation. By buying the assets of an existing corporation instead, and carrying on the business in a new corporation, the purchaser will only inherit those liabilities that it specifically assumes. This would be of particular concern if the nature of the business were such that it could give rise to significant potential unrecorded liabilities (e.g. liability with respect to environmental damage.) However, it should be noted that an asset sale may be subject to sales tax, GST and land transfer tax, which would be payable by the purchaser. In addition, an asset purchase can be a more complex transaction to implement, because each asset must be transferred and registered in the name of the purchaser.

In either case, whether on a sale of shares or assets, there are opportunities for the vendor to minimize tax.

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MINIMIZING TAX ON A SHARE SALE

There are several methods to reduce or defer the tax that the vendor will pay on a sale of shares.

Capital Gains Exemption

Many sale transactions are structured around the vendor's ability to claim the $750,000 enhanced lifetime capital gains exemption in respect of the disposition of shares of a qualified small business corporation ("QSBC shares").

The enhanced capital gains exemption is available only to individuals who are resident in Canada throughout the year. It is reduced to the extent that capital gains exemptions were claimed in previous taxation years[1]. The amount of the exemption that may be claimed may also be reduced by any net capital losses claimed by the individual for the year, any allowable business investment losses claimed by the individual and the individual's cumulative net investment loss at the end of the year.

Additionally, certain rules provide that the exemption may be denied where it can reasonably be concluded that a significant part of an individual's capital gain results from the fact that the shares (other than certain prescribed shares) have paid low or no dividends or that dividends paid were less than 90% of the annual rate of return that a prudent investor would expect to receive. These rules prevent the conversion of dividends into exempt capital gains through the use of shares with attributes designed specifically to yield capital gains by not paying dividends where dividends could reasonably be expected.

<u>QSBC Share</u>

In order to qualify for the enhanced capital gains exemption, an individual must dispose of a share of a qualified small busines corporation or "QSBC". A QSBC share of an individual is defined to be a share of the capital stock of a corporation that meets the following criteria:

- *Determination Time Asset Test:* At any time (the "Determination Time") it is a share of a "small business corporation" owned by the individual. In order to qualify as a "small business corporation", it is required that the corporation be a Canadian-controlled private corporation ("CCPC"), all or substantially all of the fair market value of the assets of which were used in an active business carried on primarily in Canada by the corporation or a related corporation, or certain shares and indebtedness of a connected small business corporation,

[1] The enhanced capital gains exemption available upon the disposition of QSBC shares may be reduced to the extent that the individual has previously used the "general exemption" of $100,000, which was repealed in 1994, or any capital gains exemption previously claimed related to QSBC shares or certain qualified farm property.

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or any combination of such assets. The Canada Revenue Agency ("CRA") has generally interpreted the phrase "all or substantially all" to mean 90%;

- *24 Month Ownership Test:* In the 24 months preceding the Determination Time, the share was not owned by anyone not related to the individual; and

- *24-Month Asset Test:*

  - Where the situation involves only one corporation (i.e., *not* a situation in which a holding company owns an operating company), in the 24 months preceding the Determination Time, the share was a share of a CCPC, more than 50% of the fair market value of the assets of which must have been attributable to assets used principally in an active business carried on primarily in Canada by the corporation or a related corporation, or certain shares or indebtedness of a connected corporation, or any combination of such assets.

  - Where the share being considered is a share of a holding corporation (i.e., where there is a tiered structure, with the individual directly owning shares in a holding company, which in turn holds shares in the operating company), additional considerations apply, and the 24-month business asset test may be more stringent. If 90% or more of the holding company's assets are either active assets and/or investments in connected CCPCs, then the connected company or companies need only meet the 50% test. However, if the holding company does not meet this 90% test, then the connected company or companies must meet the 90% test throughout the 24 month period and the holding company must meet the 50% test. Essentially, it will be necessary for either the holding corporation or its connected subsidiary or subsidiaries to meet the 90% threshold throughout the 24-month period preceding the disposition of the shares.

Non-eligible Assets - Purification of a Corporation

Given the above asset tests, ownership by a corporation of non-eligible assets such as significant reserves of cash or investment assets may therefore disqualify the shares of a corporation as QSBC shares. This would occur if those non-eligible assets exceed 10% of the fair market value of all assets of the corporation at the time of disposition, or 50% of the fair market value of all assets of the corporation during the 24 months preceding the time of disposition (assuming the subsidiary company meets the 90% test throughout the 24-month period).

The determination as to whether assets are eligible active business assets or non-eligible assets for the purposes of the tests described above must be made in light of all the facts and requirements of the specific business, in consultation

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with professional advisors. In a seasonal business, for example, the proportion of cash or investment assets required in the business activities may be higher than in a non-seasonal business.

If a corporation does not meet the 24-month asset test, there are various strategies available to "purify" the corporation for the purposes of the enhanced capital gains exemption by removing excess non-eligible assets. However, it can take two years or more for the shares to meet the QSBC definition after "purification". It is therefore important to begin reviewing the status of your corporation's shares sooner rather than later. This would be an efficient strategy prior to the sale of a business. It would also be important to examine this issue as part of the planning of an estate freeze.

Use of Multiple Exemptions

An additional planning technique available to a vendor of shares is to introduce children and other family members as shareholders of the corporation, typically through the use of a family trust and a corporate reorganization. If the shares of the corporation rise in value and are later sold, the family members will incur a capital gain proportionate to the value of the shares they hold, and may potentially shield the gain by using their own lifetime capital gains exemption.

Since the newly introduced shareholders will only incur gains (and thereby utilize the capital gains exemption) to the extent that the fair market value of their shares increases after they became shareholders, utilization of this technique requires planning well in advance of a contemplated share sale.

Share Sale to a Non-Arm's Length Corporation

Note that special rules can apply when an individual sells shares to a corporation with which the individual does not deal at "arm's length" under the income tax legislation. If applicable, the rules will deem a vendor to receive proceeds in the form of "deemed dividends" instead of capital gains, which would prevent the vendor from being able to claim the enhanced capital gains exemption to shield gains from taxation. Careful planning considerations are therefore involved in any situation where an individual proposes to sell shares to a non-arm's length corporation.

Payments from Available Tax Pools

Another method of minimizing tax is to remove value from the corporation prior to the sale where the tax cost of the removal is less than the tax cost of the capital gain that would otherwise arise. The following are some examples of how this might be accomplished:

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Shareholder Loans

Amounts owing by a corporation to its shareholders can be repaid without tax. These amounts should be repaid prior to a sale. This payment should have no effect on the purchase price, as it would result in a decrease in both the assets (i.e. cash) and the liabilities of the corporation in an equivalent amount.

Capital Dividend Account

The balance in the corporation's capital dividend account ("CDA") may be distributed to its shareholders without triggering personal tax. A CDA arises from three possible sources: the tax-free portion of any capital gains realized by the corporation (reduced by capital losses); life insurance proceeds received by the corporation; and capital dividends received by the corporation.

A vendor should extract the balance of the CDA account by paying out capital dividends prior to selling shares of the corporation. This would reduce the value of the corporation, which would in turn reduce the purchase price subject to tax.

Safe Income

"Safe Income" represents the earnings of a corporation that can be extracted and passed on to another corporate entity (by way of an inter-corporate dividend) without incurring tax at the corporate level. Tax on these earnings is deferred until they are extracted from that corporation and paid to the individual shareholders. A vendor would consider paying a "safe income" dividend if the vendor intends to leave funds in a remaining corporation to achieve a tax deferral.

It should be noted that to pay a "safe income" dividend, costs would be incurred in the calculation of safe income as well as a corporate reorganization (if necessary). An estimate of those costs should be obtained from your professional advisors, in order to assess whether the benefits of this strategy outweigh the potential costs.

Retiring Allowance

Another strategy used to defer tax (and, if the deferral is long enough, to save tax) is to have the corporation pay to the vendor(s) a retiring allowance prior to the sale. The payment of a retiring allowance would decrease the value of the corporation and would therefore decrease the purchase price that would be subject to tax.

If the vendor was employed by the corporation prior to 1996, a portion of the retiring allowance received by the vendor may be transferred to an RRSP, and would then not be subject to tax until withdrawn from the RRSP. That portion is calculated as follows:

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- $2,000 for every year of employment prior to 1996, plus

- $1,500 for every year of employment prior to 1989 with respect to which employer contributions to a registered pension plan or deferred profit sharing plan had not vested.

In order for the payment to constitute a retiring allowance, the vendor(s) would have to actually cease employment with the corporation and could not remain on as consultants. However, the vendor could still remain as a director, provided the compensation is nominal.

Capital Gain Rollover

Under the income tax legislation, an individual can defer all or a portion of a capital gain when the individual disposes of shares of an eligible small business corporation and uses the proceeds to invest in new shares of another eligible small business corporation (sometimes referred to as "replacement shares"). This deferral is effected by the cost base of the replacement shares being *reduced* by the amount of the capital gain deferred.

An investment in an eligible small business corporation, whether being sold or acquired, must generally have the following characteristics:

- The investment must be, or must have been, in the form of common shares issued from treasury (that is, acquired directly from the corporation, not purchased from a shareholder);

- At the time the shares are issued and throughout the period that they are held, the corporation is a CCPC with 90% or more of its assets either:

  - used principally in carrying on an active business in Canada, or

  - being shares of a related eligible small business; and

- Before and after the time the investment is made, the total carrying value of its assets and those of related corporations does not exceed $50,000,000. (The carrying value refers to the value arrived at in accordance with generally accepted accounting principles used in Canada.)

In order for the gain to be deferred, the shares must be owned by the individual throughout the 185-day period immediately prior to the disposition. In addition, the purchase of replacement shares must be made either in the year of disposition of the previous investment, or within 120 days after the end of that year. The replacement shares must also be designated as such in the individual's tax return.

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The maximum capital gain that can be deferred is based on the proportion of the proceeds received from the disposition that are reinvested in eligible investments.

If you have plans to reinvest any of the proceeds from the sale of a business in another business venture, you should discuss this potential deferral with your professional advisors.

Defer Payment of the Purchase Price

Deferral of payment of the purchase price is another way to defer tax. Note, however, that to the extent that a vendor agrees to defer the receipt of the purchase price, the vendor is financing the acquisition. In such cases, the vendor should ensure that any unpaid amounts are properly secured.

Capital Gains Reserve

As a general rule, tax is payable when the business is sold, regardless of when the purchase price is paid. However, in certain circumstances, a reserve may be available to the vendor. The effect of the reserve is to spread out the capital gain over more than one taxation year.

In a typical situation, the vendor and purchaser will fix the purchase price and agree that it will be payable in annual installments. If the sale agreement is properly structured, the proceeds generally will not be taxable until they are actually received (subject to a maximum deferral of five years).

Rollover for Shares

Subsection 85(1) of the Income Tax Act provides for a rollover when the vendor receives consideration that includes shares of the purchaser (where the purchaser is a corporation). This is, in effect, a deferral of payment, since the vendor would receive no cash until the shares are sold or redeemed. If the vendor receives freely tradable shares of the purchaser corporation, the tax liability would be realized when the vendor sells the shares on the open market (if they are shares of a public company) or as the shares are redeemed by the purchaser corporation.

MINIMIZING TAX ON AN ASSET SALE

There are a few methods to reduce the tax that the vendor (in this case, the corporation) will pay on an asset sale.

Allocation of Purchase Price

When an asset sale is contemplated, the allocation of the purchase price will be a key issue. For the purchaser, it will be important to maximize the tax cost basis

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for the assets it is purchasing, so that it can obtain the most beneficial write-off of this basis over time. The purchaser may therefore place greater emphasis on obtaining cost base for depreciable property (such as buildings or equipment) rather than non-depreciable items (such as land) or assets with a slower write-off (such as goodwill). However, the most beneficial position for the vendor from a tax perspective may differ significantly depending on the nature of the assets being sold.

Any allocation, however, cannot be driven solely by the tax considerations of either party. It is important that any allocation consider the regulations applicable to this issue under the Income Tax Act. Since this is a complex area, professional advisors should be consulted in determining the most appropriate allocation based on your circumstances.

Defer Payment of the Purchase Price

The methods discussed above for deferring the payment of the purchase price on a share sale will also apply to the corporate vendor on an asset sale.

CONCLUSION

As outlined in this Reference Guide, there are several tax planning opportunities when you are considering a sale of your business. There may be additional strategies beyond those discussed here, depending on the particular circumstances of the vendor and the purchaser. In all cases, professional legal and accounting advice, as well as proper planning and documentation, are essential.

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