Select Tax Issues in the Purchase and Sale of a Business

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Buying and Selling a Business

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SELECT TAX ISSUES IN THE PURCHASE AND SALE OF A BUSINESS

Introduction

This paper will focus on select tax issues and opportunities in structuring the purchase and sale of a business. It is not an exhaustive survey of all of the relevant tax issues, but rather is intended to highlight some of those that may be of most interest to commercial practitioners.

Traditionally, the purchase and sale of an incorporated business has been structured as either an asset sale or a share sale. It has been generally understood, both for tax and commercial reasons, that vendors prefer to sell shares and that purchasers prefer to buy assets. This paper will review the considerations relevant to the decision to structure the sale as assets or shares, as well as certain tax issues that may arise. This paper will also discuss how the vendor can plan ahead and prepare for a sale in order to maximize after-tax return, including qualifying for the capital gains exemption. In addition, this paper will discuss how to bridge the gap between buyer and seller by structuring the purchase and sale as a hybrid transaction. Finally, this paper will review the restrictive covenant rules, which are of concern in nearly every purchase and sale of a business.

Assets or Shares - Non-tax Considerations

Some of the most important non-tax factors that may impact the choice of buying and selling assets or shares are listed below.

First, in a share sale the purchaser acquires all of the assets, liabilities and obligations of the business. This can include significant liabilities that are unknown at the time of purchase. An asset sale allows the purchaser to avoid assuming those liabilities it does not wish to assume. Likewise, an asset sale allows the purchaser to avoid purchasing those assets it is not interested in owning.

Second, a purchaser may prefer an asset sale because it only is required to deal with one corporate vendor, rather than several shareholders. This can be exacerbated where there are minority shareholders that are intransigent and do not wish to sell.

Third, there may be regulatory issues involved. For example, if a special business license is in the name of the corporation, it may be difficult and cumbersome to transfer the license to the purchaser.

Assets or Shares - Tax Considerations

Generally, where the Lifetime Capital Gains Exemption (LCGE) on shares of a Qualified Small Business Corporation (QSBC) is available, a share sale will result in a significant tax advantage for

the vendor. The more LCGEs that are utilized, the greater the advantage. Likewise, if capital losses are available or there is significant adjusted cost base in the shares, the vendor will prefer a share sale. If none of these is available, then there may little or no tax advantage to selling shares. In fact, if the vendor retains the proceeds in the corporation, there may be a deferral advantage to the vendor of an asset sale.

For the purchaser, generally the principal tax advantage of an asset purchase is the ability to generate current deductions by acquiring depreciable capital assets (including goodwill). While a share purchase will generate adjusted cost base in the acquired shares, the benefit of this tax attribute is only realized upon a subsequent sale of the shares, and therefore usually of only minor value to the purchaser.

Asset sale – Allocation of purchase price

In an asset sale, it is important to allocate the purchase price among the acquired assets, as it can be an important driver of the tax treatment of the transaction. This can be a source of difference between the vendor and purchaser. Generally, the purchaser will want to maximize its tax pools by allocating more of the purchase price to assets that create tax shield, such depreciable capital assets with high depreciation rates. On the other hand, the vendor will generally wish to reduce recapture by allocating more of the purchase price to favourably taxed assets such as non-depreciable capital property or goodwill. Because the allocation can have important tax implications, it should be subject to careful consideration and negotiation. The purchase price allocation should be explicitly made, documented and used by both parties to the agreement.

It is important to note that any allocation of the purchase price will be subject to section 68 of the Income Tax Act[1], the purpose of which is to prevent unreasonable allocations. Section 68 allows CRA to reallocate the purchase price if the consideration is unreasonably allocated between the respective assets, services, and the grant of a restrictive covenant. Such reallocation will be made irrespective of the legal form or effect of the contract between the parties. This provision applies to both arm's-length and non-arm's-length transactions.

Since the Supreme Court of Canada's 1986 decision in *The Queen v. Golden*[2], the courts have held that when a purchase price allocation has been made between arm's-length parties, it is given considerable weight in determining the reasonable allocation for the purposes of section 68. As a

[1] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as the "Tax Act"). Unless otherwise stated, statutory references in this article are to the Tax Act.
[2] [1986] 1 SCR 209; aff'g. *Golden v. The Queen*, 80 DTC 6378 (FCTD); rev'g. 83 DTC 5138 (FCA).

result, failure to explicitly document the allocation gives CRA greater scope to challenge any allocation claimed by either party.

The CRA summarized the case law as follows:

> Even where a value is specified in an agreement for each class or kind of property or service and the total consideration for the whole sale is reasonable, a re-allocation of the consideration between the various kinds or classes of property or services, may, nevertheless, be made by the Department if some or all of the values specified are considered unreasonable. Where, however, the parties to the agreement are dealing at arm's length, the agreement is prima facie evidence of the reasonableness of the allocation specified therein. The taxpayer's allocation is further supported where there is evidence of hard bargaining between the parties involved in arriving at that allocation.[3]

The Federal Court of Appeal's 2012 decision in *TransAlta Corporation v. Canada*[4] has provided important clarity on how Section 68 should be applied to purchase price allocations.

In 2002, TransAlta sold its electricity transmission business to AltaLink, an arm's length third party. The agreement explicitly allocated $190 million of the total $818 million purchase price to goodwill. Extensive supporting documentation was prepared in support of this allocation. CRA reassessed pursuant to section 68 to reallocate $190 million from goodwill to depreciable property. This resulted in significant recapture to TransAlta.

The Federal Court of Appeal reversed the CRA reassessment, finding in favour of the taxpayer. In doing so the Court made, *inter alia*, the following points:

1. An allocation agreed between the parties to an arm's length transaction is an important factor to consider for the purpose of section 68 of the Tax Act. However, the weight to be given to such an agreement will vary according to the circumstances. An agreement where the parties have strong divergent interests concerning the allocation will be given considerable weight, while an agreement where one of the parties is indifferent, or where both parties' interests are aligned as regards the allocation, will be given less weight.[5]

2. The fact that the parties have agreed to an allocation does not trump the reasonableness test under section 68 of the Tax Act.[6]

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[3] Interpretation Bulletin IT-220R2, dated May 25, 1990, para. 5
[4] 2012 FCA 20; rev'g. (in part) 2010 TCC 375
[5] *TransAlta* para. 77
[6] Id. at para. 78