CI ASSANTE
PRIVATE CLIENT

REFERENCE GUIDE

WEALTH PLANNING GROUP

TAX PLANNING FOR THE SALE OF YOUR BUSINESS

CI Assante Private Client, a division of CI Private Counsel LP

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 when selling your business.

Share sale vs. asset sale

The sale of an incorporated business can be accomplished either through the sale of the corporation's assets, the sale of shares of the corporation or through a hybrid sale of both assets and shares. A hybrid sale is beyond the scope of this guide. The asset sale versus share sale decision requires consideration of many tax and non-tax factors, as both play a significant role in the decision.

As a general rule, the vendor of an incorporated business prefers to sell shares. Generally, because the sale of shares is simpler, corporate liabilities stay with the corporation post-sale and the lifetime capital gain exemption may be available thus resulting in less tax. Conversely, the purchaser prefers to acquire the business assets rather than corporation shares because an asset purchase will usually result in an increase to the cost base of the assets of the business thereby providing a greater cost base upon which depreciation may be claimed for tax purposes.

However, while an asset purchase is usually more appealing to a purchaser, it should be noted that an asset sale may be subject to sales tax (GST or HST) 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.

From a risk perspective, buying the assets of an existing corporation and carrying on the business in a new corporation generally means the purchaser will only inherit liabilities that it specifically assumes with the operating assets. 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.)

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

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 share sale transactions are structured around the vendor's ability to claim the capital gains exemption (CGE) in respect of the disposition of shares of a qualified small business corporation (QSBC). The lifetime exemption limit for an individual is currently set at $913,630 for 2022 and

is annually indexed for inflation. An individual shareholder could shelter between $203,000 and $247,000 of tax, depending on the province or territory of residence of the individual, from using their CGE.

The 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 (ABIL) claimed by the individual and the individual's cumulative net investment loss (CNIL) at the end of the year.

Care should be taken if capital losses, such as on personal non-registered investment assets, are realized in the same year that a capital gain eligible for the capital gains exemption is realized. As the allowable capital losses must first be offset against eligible capital gains realized in the year, this can result in situations where the gain is shielded by the current losses rather than the capital gains exemption.

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.

Alternative minimum tax (AMT) is often applicable where a taxpayer claims a preferential tax deduction such as the CGE. The AMT was introduced to deal with the perception that many high-income taxpayers were paying little tax due to preferential sources of income, such as capital gains and dividends from private corporations, and claiming large deductions such as the CGE. Minimum tax paid can be recovered in the next seven years to the extent that regular tax exceeds the AMT. The AMT formula is very complex and beyond the scope of this reference guide.

QSBC share

In order to qualify for the capital gains exemption, an individual must dispose of a share of a qualified small business corporation (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 (SBC) owned by the individual. In order to qualify as an SBC, 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

[1] The lifetime 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 or fishing property.

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, 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.
- **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 will 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 passive 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 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 capital gains exemption by removing excess non-eligible passive 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.

A discussion with your professional tax advisor of certain tax rules that target surplus stripping is necessary whenever planning which involves inter-corporate dividends is being considered to avoid unintended adverse tax consequences.

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 as a part of a corporate reorganization or estate freeze. If the shares of the corporation rise in value after an estate freeze and are later sold, the family members will incur a capital gain proportionate to the value of the shares they hold either directly or indirectly through a family trust and may potentially shelter any tax otherwise payable on the capital gain by using their own CGE.

Utilization of this technique requires planning well in advance of a contemplated share sale. Refer to our reference guide on estate freezes and speak with your professional tax advisor for more details about how to use multiple CGEs.

Share sale to a non-arm's length corporation

Note that specific tax rules can apply when an individual sells shares to a corporation with which the individual does not deal at arm's length. 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 their CGE on the sale. New legislation was introduced on June 29, 2021, to provide tax relief for legitimate transfers to a child or grandchild whereby the proceeds would not be converted into a deemed dividend. There is some uncertainty with these new rules and amended legislation is forthcoming to provide clarity.

It is important to discuss planning considerations with your professional tax advisor prior to undertaking any sales to avoid triggering unintended tax consequences.

PAYMENTS FROM AVAILABLE TAX POOLS

Another method of minimizing tax is to remove value from the corporation in a more tax-efficient manner prior to the sale. . The following are some examples of how this might be accomplished:

Shareholder loans

Amounts owing by a corporation to its shareholders can be repaid without tax. These amounts should always be repaid prior to a sale, if possible. While these repayments have no effect on the purchase price (i.e., they result in an equal decrease in both the assets and liabilities of the corporation), they provide the shareholders with additional cash on a tax-free basis.

Capital dividend account

The balance in the corporation's capital dividend account (CDA) may be distributed to its shareholders on a tax-free basis. CDA generally arises from three possible sources: the tax-free portion (50%) of any net capital gains realized by the corporation, 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 electing in prescribed form to declare and pay dividends from the CDA of the corporation prior to its sale. 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 tax-paid retained earnings of a corporation that can be extracted and paid to another particular corporation by way of an inter-corporate dividend without exposing the particular corporation to the anti-surplus stripping rules.

Typically, inter-corporate dividends within a related group are paid on a tax-free basis[2]. However, . the anti-surplus stripping rules would function to re-characterize an inter-corporate tax-free dividend as proceeds of disposition thereby resulting in a capital gain to the recipient corporation unless those dividends are paid from available safe income of the payor corporation.

A vendor will generally consider paying a safe income dividend if the vendor intends to leave funds within the corporate structure to achieve a tax deferral.

It should be noted that to pay a safe income dividend, costs would be incurred to calculate the safe income on hand of the corporation 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 to defer tax is to have the corporation pay an individual vendor a retiring allowance prior to the sale, if possible. The payment of a retiring allowance would decrease the value of the corporation thereby decreasing the purchase price ultimately subject to tax.

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[2] Dividends between connected corporations are tax-free in the sense that there will be no Part I income tax in respect of the dividend. Depending on the refundable dividend tax-on-hand balance of the dividend payor corporation, the dividend recipient corporation may be subject to Part IV 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 may not be subject to tax until withdrawn from the RRSP in the future. The portion of the retiring allowance that can be transferred to an RRSP is calculated as follows:

- $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 would have to actually cease employment with the corporation meaning they may not continue to work in any capacity for the corporation (not even as a consultant). However, the vendor may be a director of the corporation provided the compensation is nominal.

CAPITAL GAIN ROLLOVER

The Canadian tax legislation allows an individual to defer all or a portion of a capital gain realized by an individual who disposes of shares of an eligible small business corporation (ESBC) and uses the proceeds to invest in new shares of another ESBC (referred to as replacement shares). The cost base of the replacement shares is reduced by the amount of the capital gain deferred.

An investment in an ESBC, 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 ESBC; 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.

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

Deferring the payment and receipt 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, thus allowing the capital gain to be included into income 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 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 in most situations, or ten years in certain cases involving dispositions of qualifying private corporation shares, family farm or fishing property by a parent to a child).

Rollover for shares

The *Income Tax Act (Canada)* provides for a tax-deferred rollover when the vendor receives consideration that include at least one share of a Canadian purchaser corporation[3]. The result is a deferral of payment since the vendor would receive no cash consideration until the shares are sold or redeemed.

In order for the transaction to be tax-deferred, the vendor and purchaser must jointly elect in prescribed form to transact at the lesser of the FMV and tax cost of the shares transferred.

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.

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[3] The rollover is also available when a vendor transfers property to a Canadian partnership and in return receives consideration that includes at least one unit of the partnership.

ALLOCATION OF PURCHASE PRICE

When an asset sale is contemplated, the allocation of the purchase price amongst the assets being sold/acquired is a key issue. For the purchaser, it will be important to maximize the tax cost of the assets being purchased so that it can obtain the most beneficial write-off of this tax cost over time via tax depreciation. The purchaser may therefore place greater emphasis on obtaining tax cost base for depreciable property (such as buildings or equipment) rather than non-depreciable items (such as land). However, the most beneficial position for the vendor from a tax perspective may differ significantly depending on the nature of the assets being sold. A vendor will ultimately want to allocate the purchase price towards assets that trigger capital gains alone (such as land and goodwill) versus ones that also trigger recapture depreciation (such as most depreciable property).

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

TAX ON SPLIT INCOME (TOSI)

The Canadian tax system is one that is based on the income of the individual, not the family unit as a whole. A family with one individual earning $100,000 of income will pay more tax than two individuals earning $50,000 of income. Income splitting has been used to shift income from one taxpayer in a higher tax bracket to one or more family members in a lower tax bracket, thus resulting in less overall tax otherwise payable on that income.

In order to prevent families from income splitting through the use of a private company, the Federal government significantly expanded the TOSI legislation to include more sources of income (including capital gains), as well more family members. The rules are essentially designed to dissuade you from paying dividends or capital gains to other family members. Note that while they don't prevent you from paying dividends or capital gains, doing so will result in severely adverse tax consequences.

Under the legislation, income caught by the TOSI rules is taxed at the highest marginal tax rate for that particular individual unless a specific exemption within the legislation applies to that particular individual. The rules are complex, and a thorough understanding of the pertinent facts for each situation must be reviewed in conjunction with the legislation before any conclusions are reached.

Refer to our TOSI reference guide for more details but ensure to speak with your tax professional prior to undertaking any income splitting measures, or when planning for an estate freeze, in general.

Conclusion

As outlined in this reference guide, there are several tax planning opportunities when considering a sale of your business. There may be additional strategies beyond those discussed above, 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.

For more information, we encourage you to speak to your advisor or visit us at assante.com

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