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## Issues that Arise in the Context of the Sale of a Business

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December 7, 2005



# Agenda

- “BREAKING NEWS!!” – Department of Finance Release – November 23, 2005
- Restrictive Covenants – new section 56.4
- Effective vs. Closing date
- Earn-outs
- Tax warranties – not discussed today
- GST considerations
- Possible capital gains deduction planning

## “BREAKING NEWS!!”

### Department of Finance News Release – November 23, 2005

- Reduce taxation on “eligible dividends”
- “Eligible dividends” appears to include income of a CCPC that is subject to the general corporate tax rate
- Are bonuses now necessary?
- If not, section 67 risks may disappear
- Likely “surplus tracking” will be necessary
- NWMM still not available for review – “devil will be in the details”

# "BREAKING NEWS!!"

## Department of Finance News Release – November 23, 2005 (cont'd)

		Tax rates	Old rules - bonus	Old rules with no bonus	New Rules - with no bonus
Taxable income			1,000,000	1,000,000	1,000,000
Bonus			700,000	-	-
<b>Taxable income after bonus</b>			<b>\$ 300,000</b>	<b>\$ 1,000,000</b>	<b>\$ 1,000,000</b>
<b>Corporate income tax</b>					
>= \$300,000		16.12%	48,360	48,360	48,360
< \$300,000		33.62%	-	235,340	226,840
<b>Total corporate income tax</b>			<b>\$ 48,360</b>	<b>\$ 283,700</b>	<b>\$ 275,200</b>
<b>Personal income tax</b>					
Bonus			700,000	-	-
Grossed up dividend		125.00%	314,550	895,375	-
Grossed up ineligible dividend		125.00%	-	-	314,550
Grossed up eligible dividend		145.00%	-	-	686,082
<b>Total personal income</b>			<b>\$ 1,014,550</b>	<b>\$ 895,375</b>	<b>\$ 1,000,632</b>
<b>Personal income tax before dividend tax credit</b>		<b>39.00%</b>	<b>395,675</b>	<b>349,196</b>	<b>390,246</b>
Dividend tax credit - ineligible dividend - Federal	2/3 of gross up amount (Note1)	66.67%	41,942	119,389	41,942
Dividend tax credit - ineligible dividend - Alberta	32% of gross up amount (Note 1)	32.00%	20,131	57,304	20,131
Dividend tax credit - eligible dividend - Federal	2/3 of gross up amount (Note1)	66.67%	-	-	141,955
Dividend tax credit - eligible dividend - Alberta	32% of gross up amount (Note 1)	32.00%	-	-	68,135
<b>Total personal income tax</b>			<b>\$ 333,601</b>	<b>\$ 172,503</b>	<b>\$ 118,083</b>
Total tax (personal and corporate)			381,961	456,203	393,283
Net cash flow (income minus total taxes)			618,039	543,797	606,717
<b>Net cash flow after tax per \$ of income</b>			<b>\$ 0.618039</b>	<b>\$ 0.543797</b>	<b>\$ 0.606717</b>
Note 1					
Section 121 of the Federal Income Tax Act					
Section 21 of the Alberta Personal Income Tax Act					

## November 23, 2005 Department of Finance Release

- in the context of a sale of business, why is this relevant?
- can be very relevant – often times the sale of business assets will result in “recapture” – subsection 13(1) income or eligible capital proceeds – subsection 14(1)
- in the right circumstances, such income may be treated as active business income
- in order to preserve integration, “bonuses” are often thought of
- will such bonuses be considered reasonable?

# November 23, 2005 Department of Finance Release Reasonable Bonuses??

September 2001

CTF Conference

- CRA comments on criteria where reasonableness will not be challenged
- Comments subsequently documented in Technical News No. 22 - January 11, 2002

# November 23, 2005 Department of Finance Release Reasonable Bonuses??

## CRA Technical News No. 22

- Paid to shareholders (either direct or indirect shareholders) of a CCPC
- Shareholders/managers are Canadian residents
- Shareholders/managers are actively involved in day-to-day operations
  - Ownership structure does not impact policy
  - Inter-corporate management fees will continue to be challenged

# November 23, 2005 Department of Finance Release

## Reasonable Bonuses??

### Non-active Business Income

- CRA will not challenge bonuses paid from “non-active business income” as long as other criteria met
- What is non-active business income?
- Document No. 2002-0128875 - April 8, 2002 –
- Encompasses all business income, active or otherwise
- Income incidental to active business – active or otherwise including income of specified investment business
- Activity level required – question of fact
- If only activity is investments managed through 3rd party – shareholder not considered active



# November 23, 2005 Department of Finance Release Reasonable Bonuses??

## Capital Gains

- Bonus paid to offset capital gains – acceptable?
- Is this non-active business income?
- Document No. 2002-0128865 - April 10, 2002
- Policy in Technical News No. 22 will not be respected
- Subparagraph 40(1)(a)(i) – salaries not an outlay or expense
- What about payments to trust? No
- Document No. 2001-0114905 - March 20, 2002

# November 23, 2005 Department of Finance Release Reasonable Bonuses??

## Technical News No. 30 – May 21, 2004

- 2003 documents CTF comments
- Clarified intent of policy in Technical News No. 22
- The following remuneration payments/situations beyond intent of policy:
  - major sale of business assets
  - income triggered from above including CCA, 14(1)
  - management fee
  - dividends that have flowed from complex corporate structure
  - see Document No. 2003-0046624-November 7, 2003 regarding further CRA views on disposition of assets and remuneration payments

## November 23, 2005 Department of Finance Release Reasonable Bonuses??

### Technical News No. 30 – May 21, 2004 – Advance Tax Rulings

- CRA will now issue rulings on reasonableness of owner-manager remuneration
- Recently released rulings – see for example 2005 – 0146031R30 – deductibility of bonus paid out of income triggered from the proceeds of a sale of business assets
- See also 2005 – 0146021R3

## November 23, 2005 Department of Finance Release Reasonable Bonuses??

- as stated earlier, given risks involved with bonus payments involved with sale of business assets, consideration should instead be given to paying “eligible dividends”

# Restrictive Covenant Proposals – New Section 56.4

## A Little Background

- Restrictive covenants very common in sale of business
- Fortino v. The Queen – 2000 DTC 6060 (FCA)
- Manrell v. The Queen – 2003 DTC 5225 (FCA)
- Department of Finance News Release – October 7, 2003 – intention to tax amounts received or receivable by a taxpayer for granting a restrictive covenant as full income with certain exceptions

## Restrictive Covenant Proposals – New Section 56.4 A Little Background (cont'd)

- February 27, 2004 – draft proposals released by Department of Finance – new section 56.4 and proposed change to section 68 – very broad implications
- Significant problems with February 27, 2004 proposals including potential for double taxation
- 2nd proposals released July 18, 2005

## Restrictive Covenants – General Overview Of Provisions

- Subsection 56.4(2) – main taxing provision
- Subsection 56.4(3) – exceptions to taxing provisions of subsection 56.4(2) if:
  - *Restrictive covenant amount would have been taxed as employment income by recipient individuals;*
  - *The amount would otherwise be required to be included as CEC proceeds and the taxpayer and purchaser elect in prescribed form to treat the amount as CEC; or*
  - *The amount relates to the taxpayer's disposition of property that is an eligible interest and the taxpayer and the purchaser elect in prescribed form.....*

## Restrictive Covenants - General Overview Of Provisions

- Subsection 56.4(4) – treatment of amount paid by purchaser
- Paragraph 68(c) – deeming provision for amounts that can reasonably be regarded as consideration for the restrictive covenant
- Subsections 56.4(5) – (8) – provisions that contain the conditions when paragraph 68(c) will not apply. Note election in subsection 56.4(7)
- Subsection 56.4(9) – how elections under subsection 56.4(3) and (7) are to be filed



# Restrictive Covenants July 18, 2005 Proposals

## A Little More Detail

- Significant amendments from February 27, 2004 proposals
- New definition in proposed subsection 56.4(1) for “eligible corporation” – means a taxable Canadian corporation of which, at the time, the taxpayer holds not less than 90% of the issued and outstanding share capital (must have voting rights) and 90% of the FMV of all the issued and outstanding shares – relevant for “new” subsections 56.4(5) and (7) which provides an exception to the application of section 68

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- “eligible interest” defined in subsection 56.4(1) as a partnership interest in a partnership or a share of the capital stock of a corporation that carries on a business
- New paragraph (c) added to the definition of “eligible interest” in subsection 56.4(1) – adds that a share of the capital stock of a corporation – 90% or more of the FMV of which is attributable to eligible interests in one other corporation can be an “eligible interest”

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- New definition of “goodwill amount” in subsection 56.4(1) – is an amount that is received or receivable by the taxpayer as consideration for the disposition by the taxpayer of goodwill, and that is required by the description of “E” in the definition of “cumulative eligible capital” in subsection 14(5) to be included in computing the CEC of a business of a taxpayer. Such definition is relevant for “new” subsections 56.4(5) and (7) which provides an exception to the application of section 68
- See subparagraph 56.4(7)(d)(i)

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- Definition of “restrictive covenant” in subsection 56.4(1) is clarified to exclude obligations described in section 49.1 of the Act from being captured in the definition (section 49.1 is usually relevant to the demutualization of insurance corporations)

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- The income inclusion provision of subsection 56.4(2) has been clarified with additional wording to exclude amounts from being taxed in the taxpayer's hands if the amount has been captured into income by the "taxpayer's eligible corporation's income" by virtue of subsection 56.4(2) in the year or a preceding year.
- This wording should help to eliminate otherwise possible double taxation issues for restrictive covenant amounts received by an eligible corporation

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- Subsection 56.4(3) is the provision that can exclude certain amounts from the taxing provisions of subsection 56.4(2)
- Paragraph 56.4(3)(b) has been amended to clarify the wording that a restrictive covenant amount is excluded from subsection 56.4(2) if variable "E" of the definition of "cumulative eligible capital" would otherwise be applicable in computing the taxpayer's CEC and the taxpayer and the purchaser elect in prescribed form to have paragraph (b) apply

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- Paragraph 56.4(3)(c) is also clarified to read that the otherwise restrictive covenant amount is excluded from the taxing provisions of subsection 56.4(2) if the amount directly relates to the taxpayer's disposition of property that is, at the time of disposition, an "eligible interest" in the partnership or corporation that carries on the business to which the restrictive covenant relates or is at that time an eligible interest by virtue of "new" paragraph (c) of the definition "eligible interest"

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- Paragraph 56.4(3)(c) is also amended to add a condition that subsection 84(3) - deemed dividends - cannot apply to the disposition when applying the paragraph
- Minor other wording changes re: clarifying the amount added to proceeds – see subparagraph 56.4(3)(c)(v) – and how to elect to have the paragraph apply – see subparagraph 56.4(3)(c)(vi)



## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- New subsections 56.4(5), (6) and (7) clarify when section 68 does not apply to deem consideration to be received or receivable by the taxpayer for the restrictive covenant. Subsection (6) will be applicable if:
  - the restrictive covenant is granted by an individual to a person with whom the individual deals at arm's length;
  - the restrictive covenant directly relates to the acquisition from one or more other persons by the purchaser of an interest in the individual's employer;
  - the individual deals at arm's length with the employer and the vendor;

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- the restrictive covenant is an undertaking of the individual not to provide property or services in competition with the property or services provided or to be provided by the purchaser in the course of carrying on the business to which the restrictive covenant relates;
- no proceeds are received or receivable by the individual for granting the restrictive covenant; and
- the amount that can reasonably be regarded to be consideration for the restrictive covenant is received or receivable only by the vendors.

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- New subsection 56.4(5) – non-application of section 68 – applies as well if new subsection 56.4(7) applies where:
  - the restrictive covenant is granted by a taxpayer to a person with whom the vendor deals at arm's length;
  - the restrictive covenant is an undertaking of the vendor not to provide property or services in competition with the property or services provided by the purchaser in the course of carrying on the business to which the restrictive covenant relates;

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- no proceeds are received or receivable by the vendor for granting the restrictive covenant;
- the amount that could otherwise reasonably be regarded to be consideration for the restrictive covenant is:
  - included by the vendor in computing a "goodwill amount"; or
  - received or receivable by a corporation that was an eligible corporation of the vendor when the restrictive covenant was granted and is included by the eligible corporation in computing a goodwill amount of the eligible corporation in respect of the business to which the restrictive covenant relates (subparagraph 56.4(7)(d)(ii)).

# Restrictive Covenants July 18, 2005 Proposals

## A Little More Detail (cont'd)

- the restrictive covenant may reasonably be considered to have been granted to maintain or preserve the value of:
  - goodwill acquired by the purchaser from the vendor; or
  - goodwill acquired by the purchaser from the vendor's eligible corporation; and
  - the vendor and the purchaser (or, if subparagraph 56.4(7)(d)(ii) applies, the vendor, the eligible corporation and the taxpayer) jointly elect in prescribed form to have subsection (5) apply

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- New subsection 56.4(8) provides clarifying rules if subsection 56.4(5) applies – i.e. if section 68 does not apply
- New paragraph 56.4(8)(a) states that amounts referred to in paragraph 56.4(6)(f) – that is, the amount received by the vendors other than the taxpayer – are to be included in computing the amount received or receivable by those vendors as consideration for the disposition of the interest referred to in paragraph (6)(b)

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- New paragraph 56.4(8)(b) clarifies that amounts referred to in paragraph 56.4(7)(d) – “goodwill amounts” – are to be included in computing the eligible corporation’s CEC
- New subsection 56.4(9) sets out how the joint elections referred to in subsections 56.4(3) and (7) are to be filed
- Minor wording change in the amendment to section 68 ... now refers to restrictive covenant ... “granted by a taxpayer” instead of “agreed to by a taxpayer”

## Restrictive Covenants July 18, 2005 Proposals A Little More Detail (cont'd)

- “New” subsection 14(5.1) proposed – clarifies that variable ‘E’ of the definition of “cumulative eligible capital” does not apply to an amount that is received or receivable by a taxpayer in a taxation year if that amount is required to be included in the taxpayer’s income because of subsection 56.4(2) – restrictive covenant income inclusion
- However, if subsection 56.4(2) does not apply because of proposed paragraph 56.4(3)(b), then section 14 could apply



# Restrictive Covenants

## Problems with Draft Legislation

- Can election under subsection 56.4(3) ever be done?
- Opening words of subsection 56.4(3) require that the taxpayer who grants the covenant and the person to whom the covenant is granted deal at arm's length
- Would paragraph 251(5)(b) apply to deem the buyer to control the seller prior to closing? If so, in conjunction with subsection 251(2), buyer and seller will be deemed not to deal with each other at arm's length therefore election under subsection 56.4(3) would not be available
- Surely this must be unintended

# Restrictive Covenants

## Problems with Draft Legislation

- Subparagraph 56.4(3)(c)(ii) requires that, in order for election under paragraph 56.4(3)(c) to be valid, that “the amount is consideration for an undertaking by the taxpayer not to provide property or services in competition with the property or services provided or to be provided by the purchaser (or a person related to the purchaser).”
- What if the covenant granted by the vendor was to not compete with the purchaser including acquiring an entity that carries on a similar business?
- Acquisition does not appear to meet conditions of subparagraph 56.4(3)(c)(ii) therefore election would appear to not be available
- Unintended?

# Restrictive Covenants Non-Resident Issues<sup>1</sup>

- If section 68 applies, proposed paragraph 212(1)(i) could apply to deem a withholding tax to be eligible even if the underlying share sale would be not taxable by way of treaty
- Would the restrictive covenant amounts received by a non-resident be “business profits” under a treaty? If so, such business profits would not be subject to Canadian taxation if the non-resident does not have a permanent establishment in Canada

<sup>1</sup> For an excellent discussion on these issues see “Canadian Covenants Not to Compete – Cross Border Traps”, Mark Brender, Richard Tremblay and William J. Corcoran in Tax Management International Journal, November, 2005

# Restrictive Covenants Non-Resident Issues<sup>1</sup>

- Would the non-compete proceeds received by the non-resident be “other income” under the applicable treaty? If so, taxation treatment would need to be considered

1 For an excellent discussion on these issues see “Canadian Covenants Not to Compete – Cross Border Traps”, Mark Brender, Richard Tremblay and William J. Corcoran in Tax Management International Journal, November, 2005

# Restrictive Covenants Non-Resident Issues<sup>1</sup>

- Consider the case where Non-Resident Corp 1 (“NR1”) sells the shares of its wholly owned Canadian subsidiary (“Canco”) to another non-resident corp (“NR2”)
- Proposed paragraph 212(1)(i) should not apply because the payer of the restrictive covenant is non-resident (in order to apply the payer needs to be resident)
- However, proposed paragraph 212(13)(g) may deem NR2 to be Canadian resident for purposes of paragraph 212(1)(i) if certain conditions are met. Accordingly, Canadian withholding tax could apply

<sup>1</sup> For an excellent discussion on these issues see “Canadian Covenants Not to Compete – Cross Border Traps”, Mark Brender, Richard Tremblay and William J. Corcoran in Tax Management International Journal, November, 2005

# Restrictive Covenants July 18, 2005 Proposals

WHEW!

CONFUSED YET?

# Restrictive Covenants – Department Of Finance

## Example 1

### Facts:

- Terence and Isabelle each own 50 common shares of X Ltd. which carries on a business
- The ACB of Terence's and Isabelle's shares of X Ltd. is nil in the aggregate
- In 2004, Y Ltd. – an arm's length corporation to Terence and Isabelle – offers to acquire all of the shares of X Ltd. for \$2M

# Restrictive Covenants – Department Of Finance

## Example 1

- The offer by Y Ltd. stipulates that Terence agrees not to compete with the business of Y Ltd. and X Ltd. after the sale. If no covenant is provided by Terence, the offer by Y Ltd. is reduced to \$1.8M
- Terence and Isabelle agree to the sale with the following considerations:
  - \$1.8M – shares of X Ltd.
  - \$200,000 – Terence's restrictive covenant



# Application Of New Rule Under Section 56.4

## Example 1

- Isabelle
  - Capital gain - \$900,000
  - Restrictive covenant amount - \$nil – since Isabelle did not grant a restrictive covenant therefore section 68 could not apply

# Application Of New Rule Under Section 56.4

## Example 1

### Analysis – Terence

- Shares of X Ltd. Held by Terence and Isabelle will be considered an “eligible interest” – see subsection 56.4(1)
- Given this, an exception to the \$200,000 restrictive covenant amounts to be received by Terence from being fully taxed under subsection 56.4(2) should be available – subsection 56.4(3)
- Paragraph 56.4(3)(c) will be available to Terence but election will need to be jointly filed by Terence and X Ltd.

# Application Of New Rule Under Section 56.4

## Example 1

- Terence
  - a) Capital gain – share disposition - \$900,000
  - b) Portion of restrictive covenant that can be added to proceeds of disposition – subparagraph 56.4(3)(c)(iii):

- Lesser of:

\$200,000 (restrictive covenant receivable)

\$100,000 (value by which Terence's share interest in X Ltd. would increase if covenant were provided for no consideration when compared with a sale in which no covenant is granted) -

$$(50\% \times \$2M) - (50\% \times \$1.8M) = \quad \$ 100,000$$

\$ 1,000,000

- Restrictive covenant (ordinary) income

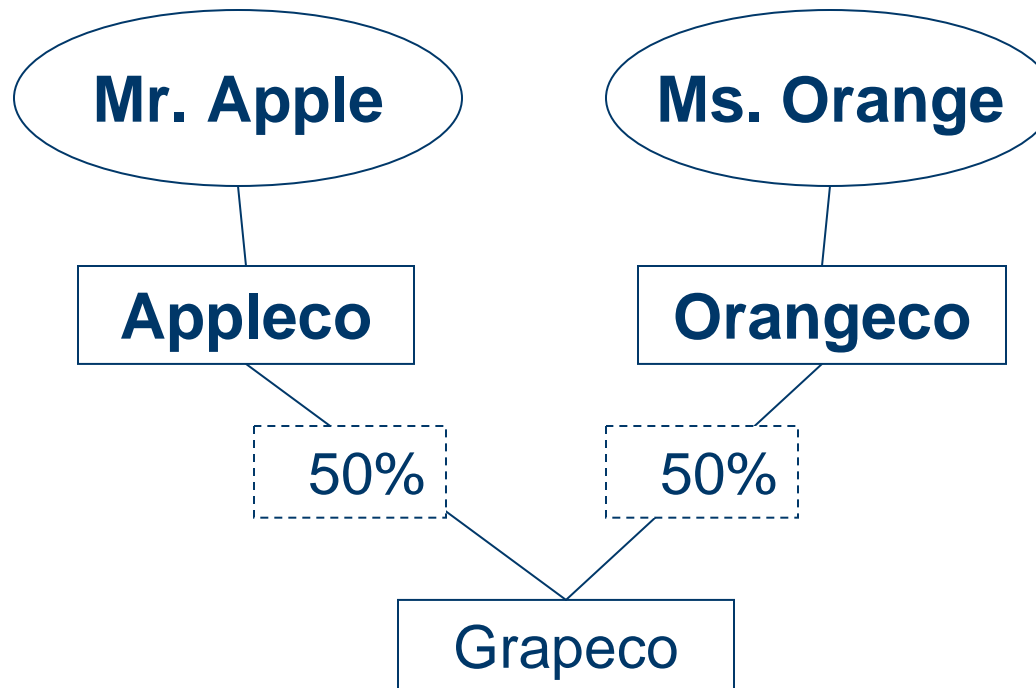
$$(\$200,000 - \$100,000) =$$

\$ 100,000

added to proceeds (subparagraph 56.4 (3)(c)(v))

## Example 2 – Sale Of Business Assets

- Facts – Corporate Structure



# Issues that Arise in the Context of the Sale of a Business

## Example 2 – Sale Of Business Assets

- Assets of Grapeco, mostly goodwill, are sold to an arm's length purchaser – "Purchaseco" for \$30M; Grapeco realizes income under subsection 14(1) of approximately \$15M (ignoring subsection 56.4 issues)
- In order to facilitate the sale, Mr. Apple and Ms. Orange grant restrictive covenants to not compete to Purchaseco for consideration of \$1.00 each

## Example 2 – Sale Of Business Assets

- All parties agree that the restrictive covenant amounts are worth approximately \$2M for each of Mr. Apple and Ms. Orange's covenant – amounts included in purchase price of \$30M to be paid by Purchaseco.

## Example 2 – Sale Of Business Assets

### Analysis:

- Grapeco will not be an “eligible corporation” – see definition under subsection 56.4(1) – of Mr. Apple or Ms. Orange
- Paragraph 68(c) will deem amount of \$2M for each of Mr. Apple and Ms. Orange to be received or receivable by them

## Example 2 – Sale Of Business Assets

- Exception to paragraph 68(c) – subsections 56.4(6) or (7) will not apply
- Accordingly, would subsection 6(3.1) deem each of Mr. Apple and Ms. Orange to have received the \$2M each, in the year the restrictive covenant is granted, as employment income (by virtue of employment) or would the amounts be included in income under subsection 56.4(2)
- Better view is likely subsection 56.4(2)
- Exceptions under subsection 56.4(3) will not apply



## Example 2 – Sale Of Business Assets

- Planning Point – what if the restrictive covenant proceeds were received by Appleco and Orangeco and it could be said that both Appleco and Orangeco were in business?
- Exclusion for section 68 could then apply – see elective provisions of subsection 56.4(7)
- Election under paragraph 56.4(3)(b) could then be made to treat proceeds received by Appleco and Orangeco to be treated as CEC proceeds

## Example 3 – Sale Of Shares

### Facts:

- Ms. Banana owns 100% of the issued shares of Bananaco that operates a business
- Ms. Banana sells all of the issued shares of Bananaco for \$1M to Purchaseco – an arm's length corporation - on December 31, 2005
- Ms. Banana grants a restrictive covenant to Purchaseco to not compete with the business of Purchaseco. If the covenant was not granted, the sale of Bananaco shares would have occurred at a value of \$700,000
- No proceeds are received by Ms. Banana for the granting of the restrictive covenant – the covenant is granted under seal

## Example 3 – Sale Of Shares

### Analysis:

- Shares of Bananaco would meet definition of “eligible interest” and “eligible corporation” – see subsection 56.4(1)
- Exception to subsection 56.4(2) income inclusion of \$300,000 would apply – see paragraph 56.4(3)(c) – joint election required
- Accordingly, \$300,000 would be added to proceeds of disposition of the shares of Bananaco – see subparagraph 56.4(3)(c)(v)
- No election to avoid section 68 is available nor necessary in this case

## Example 4 – Sale Of Shares

- Same facts as Example 3 except shares of Bananaco are wholly owned by the Banana Family Trust – a discretionary inter-vivos personal trust of which Ms. Banana is a trustee and beneficiary
- Many of Ms. Banana's other family members are also discretionary beneficiaries of the trust
- Ms. Banana, like before, grants the restrictive covenant

## Example 4 – Sale Of Shares

### Analysis:

- Bananaco is not an eligible corporation nor are the shares an eligible interest of Ms. Banana
- Paragraph 68(c) will apply to restrictive covenant granted by Ms. Banana
- Exception to subsection 56.4(2) under subparagraph 56.4(3)(c) will not apply – trust is disposing of shares – not Ms. Banana
- Exception to non-application of section 68 will not apply under subsection 56.4(7)
- \$300,000 will be taxable to Ms. Banana under subsection 56.4(2); Trust's proceeds of disposition of shares = \$700,000

## Restrictive Covenants – New Section 56.4

- CRA has posted draft elections on its website
- see [www.cra-arc.gc.ca/tax/business/topics/life-events/selling/restrictive](http://www.cra-arc.gc.ca/tax/business/topics/life-events/selling/restrictive)

## Effective vs. Closing Date

- when is the disposition reported for tax purposes?
- complex question – subject of much litigation.<sup>1</sup>
- the date of disposition is relevant for many purposes including, but not limited to:
  1. recognition of gains/losses
  2. 13(1), 14(1)
  3. CCA claims
  4. GST issues
  5. PST, if applicable

1. Many great papers have been written on this subject. For example, see D. Blair Nixon and Sandra G. Jack, "The Deal: The Price Tag and Adjustment Mechanisms," Report of Proceedings of Fifty-Second Tax Conference, 2000 Tax Conference (Toronto: Canadian Tax Foundation, 2001), 11:1-37

## Effective vs. Closing Date

- “effective date” can often be applicable for various working capital adjustments – often referred to as “adjustment date”.
- “closing date” is often used in the context of the completion/execution of all relevant documentation to complete the transaction and purchase consideration is exchanged.



## Effective vs. Closing Date

- critical —→ when does beneficial ownership pass?
- not always easy to determine.
- definition of “disposition” in subsection 248(1) excludes from the definition “...*any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property....*” [emphasis added]. – see paragraphs (e) and (f) of the definition.

# Effective vs. Closing Date

## Summary of Legal Principles as to When Disposition Occurs<sup>1</sup>

1. For income tax purposes, it is the transfer of beneficial ownership of the target assets that is determinative, not legal title.
2. Care should be taken to ensure that all related actions of the parties (insurance, accounting, income tax and GST filings) are consistent with the intended date of transfer of beneficial ownership.
3. The convergence of legal title can precede or follow the transfer of beneficial ownership.

1. See Nixon and Jacks, pp 5 – 15 for an exhaustive review.

# Effective vs. Closing Date

## Summary of Legal Principles as to When Disposition Occurs<sup>1</sup>

4. Assuming contract is otherwise silent, beneficial ownership will transfer at the earlier of:
  - a) The time the purchaser acquires legal title; and
  - b) The time the purchaser acquires all the “incidents of ownership” (ie. possession, use and risk).
5. True condition precedent must be satisfied or waived before beneficial ownership passes.
6. Beneficial ownership may transfer subject to a condition subsequent.
7. It may be arguable that a disposition can be made effective prior to the date a binding and enforceable contract is in place.

# Effective vs. Closing Date

## CRA's Administrative Comments of Interest

- CPTS Revenue Canada Round Table – June 12, 1991.
- Q25 – Revenue Reporting between Effective Date and Closing Date of a transaction
- CRA states: *"In this situation, the transfer is not legally effective until the closing date, and the vendor is legally liable to report the income between the effective date and the closing date. However, there have been instances where the Department has administratively accepted that the transfer occurred on the effective date where:*
  - *Both parties to the transaction agree that the effective date should be used;*
  - *No significant tax benefit arises from the use of this date.*

*However, if either party does not wish to use this date, the Department will tax the vendor on this income. Revenue Canada would use normal auditing procedures to ensure that all the revenues were reported for tax purposes. These procedures could vary from case to case and would be what is decided to be appropriate by the auditor and supervisor."*

## Effective vs. Closing Date

### CRA's Administrative Comments of Interest (cont'd)

- IT – 170R – Sale of Property – When Included in Income Computation August 25, 1980
- See IT – 437R – Ownership of Property (Principal Residence) – February 21, 1994
- Tech Int. 9616800 – May 9, 1996 – follow - up to 1995 ICAA Round Table where CRA is questioned as follows:

Commonly, the following circumstances exist:

1. *The effective date is selected for administrative ease, rather than being a date when the "deal is done" (sometimes the effective date is a time before negotiations had even commenced);*
2. *The conditions to be met prior to closing and after the effective date are typically such that the parties to the agreement can "back out" if the conditions are not met (often the conditions are simply "escape clauses", such as the need for "Board Approval");*
3. *Usually there is a tax benefit to either the buyer or seller as a result of the effective date being viewed as the transaction date for tax purposes, rather than the closing date.*

If any or all of these circumstances are present, would Revenue Canada's answer to the 1995 Round Table be any different?

## Effective vs. Closing Date CRA's Administrative Comments of Interest (cont'd)

CRA responds:

*Generally speaking, if the purchase and sales agreement is absolute and the incidents of beneficial ownership of the property including possession, use and risk do pass to the purchaser on the effective date, the Department will accept that date as the disposition date to the seller and the acquisition date to the purchaser for tax purposes. An exception to this position would be where the reason for choosing the effective date offends the GAAR set out in section 245 of the Income Tax Act. In the first circumstance described above, it appears the sale is not completed and presumably beneficial ownership does not pass to the purchase on the effective date. Therefore, we will look to the closing date as being the date of disposition and acquisition.*

## Effective vs. Closing Date Summary

- difficult area
- presentation on this subject today has only touched on some of the relevant areas
- review jurisprudence
- ensure that intended result is achieved by very careful drafting of the contracts.

## Earnouts

- if purchase price is payable by way of an “earn-out” arrangement, need to be aware of potential paragraph 12(1)(g) application.
- paragraph 12(1)(g) taxes as income “any amount received by the taxpayer in the year that was dependant on the use of or production from property.....”
- if applicable, otherwise capital treatment can result in full income treatment.
- if paragraph 12(1)(g) applies, reserve under subparagraph 40(1)(a)(iii) will not be available



# Earnouts

## CRA Administration Views

- IT – 426R – shares sold subject to an Earnout Agreement – September 28, 2004
- CRA will accept cost recovery method of reporting the gain or loss on the sale of shares under an earnout agreement where:
  - a) The vendor and purchaser are dealing with each other at arm's length.
  - b) The gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature.
  - c) It is reasonable to assume that the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale.
  - d) The earnout feature in the sale agreement must end no later than 5 years after the date of the end of the taxation year of the corporation (whose shares are sold) in which the shares are sold. For the purposes of this condition, the CRA considers that an earnout feature in a sale agreement ends at the time the last contingent amount may become payable pursuant to the sale agreement.
  - e) The vendor submits, with his return of income for the year in which the shares were disposed of, a copy of the sale agreement. He also submits with that return a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined below.
  - f) The vendor is a person resident in Canada for the purpose of the Act.

## Earnouts

### CRA Administration Views

- if conditions met, the vendor reduces the ACB of the shares as amounts on account of the sale price become determinable.
- any excess is considered a capital gain realized at the time the amount becomes determinable and the ACB is nil.

## Earnouts

### CRA Administration Views

- recent Tech. Int. – 2004 – 0098121E5 – December 16, 2004
- States that goodwill of a business sold pursuant to an earnout is taxable under paragraph 12(1)(g) and not section 14
- relies on the decision of *289018 Ontario Limited* (87DTC 38) in making its comments.
- CRA states that cost recovery method only applicable for sale of shares and not goodwill.
- see *Wright v. R* 2003 DTC 763 for recent decision on paragraph 12(1)(g)

## Acquisition of Control

- Has control been acquired?
- what does control mean – de jure or de facto control?
- normally, in the context of a business sale, one is concerned about de jure control.
- subsection 256(7) can deem control not to have been acquired in certain cases – need to review carefully.

# Acquisition of Control

- non-exhaustive impact of acquisition of control:
  - a) subsection 10(10) – revaluation of inventory for a corporation where the property is inventory of a business that is an adventure or concern in the nature of trade.
  - b) subsections 13(21.2) and (24) – loss on transfer of depreciable properties.
  - c) subsection 14(12) – loss on transfer of eligible capital property
  - d) subsection 18(15)
  - e) sections 18.1 and 37
  - f) “superficial loss” – section 54
  - g) section 55
  - h) section 111 – loss utilization
  - i) subsection 249(4) – taxation year end.
  - j) section 256 – association rules.
  - k) revaluation of capital property – paragraphs 111(4)(c), 53(2)(b.2)
  - l) revaluation of CDA – subsection 89(1.1)
  - m) revaluation of depreciable property – paragraphs 111(4)(e), 13(7)(f)

## Acquisition of Control

- accordingly, given the large impact that an acquisition of control can have, careful and exhaustive planning around the timing of the acquisition of control must be done.

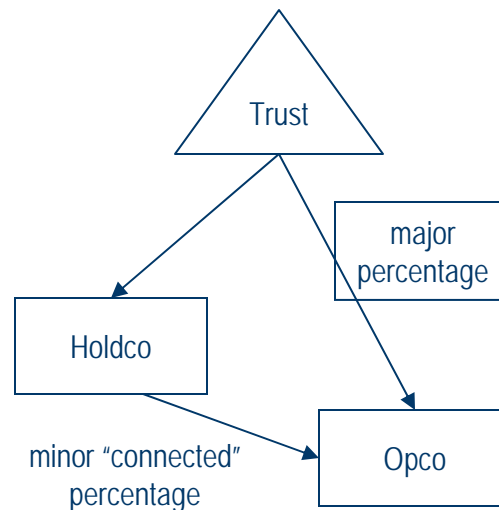
## Various Issues to Consider GST

- In the context of sale of all or substantially all of a business or part of a business, is the section 167 election available?
- Is the sale exempt from GST?
- For example, is the asset being disposed of a financial instrument?
- Is the supply of a restrictive covenant subject to GST?
- Is election under subsection 156(2) available for sales between non-arm's length parties?
- PST issues?

# Various Issues to Consider

## Capital Gains Deduction Planning

- Sale of QSBC shares and QFP (see subsection 110.6(1)), capital gains deduction may be available – see subsections 110.6(2) and/or (2.1)
- QSBC/QFP definitions generally well known.
- In context of qualifying for 50%/90% test, consider continual “bleeding” of excess assets of corporation to connected Holdco.
- In closely held family corporation consider merits of “triangle” structure:





## Various Issues to Consider Capital Gains Deduction Planning

- in context of “24 month” test, consider planning utilizing paragraph 110.6(14)(f)
- for example, if proprietor transfers his/her business to a corporation and receives shares as consideration, 24 month hold may not apply – good planning can occur