Income Tax Issues in the Purchase and Sale of Assets

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Scope of Paper

This paper canvasses the income tax issues most frequently encountered where a transaction is structured as a purchase and sale of the assets of a business. It is not intended to be an exhaustive review of all of the tax issues arising out of or requiring consideration in the context of the purchase and sale of assets. In addition, the issues that are reviewed are not dealt with in a detailed, comprehensive manner.

This paper assumes a purchase and sale of the assets of a business as a going concern that is owned by a Canadian corporation ("SellerCo") that is a taxable Canadian corporation within the meaning of the *Income Tax Act*.[2] The sole shareholder of SellerCo is an individual who is also a resident of Canada.[3] It is assumed that SellerCo's business is carried on exclusively in Canada. Except where it is otherwise indicated, it is assumed that the purchaser (the "Purchaser") is an individual who is a resident of Canada and who deals at arm's length with SellerCo's shareholder.

This paper is based on the provisions of the Act in force on April 30, 2010, specific proposals to amend the Act publicly announced by the Minister of Finance up to April 30, 2010 (the "Technical Amendments") and the regulations enacted pursuant to the Act. It is also based on the published positions of the Canada Revenue Agency ("CRA") in respect of the administration of the Act and relevant judicial interpretations. The Goods and Services Tax and retail sales tax implications of the purchase and sale of the assets of a business will be dealt with elsewhere during this programme.[4]

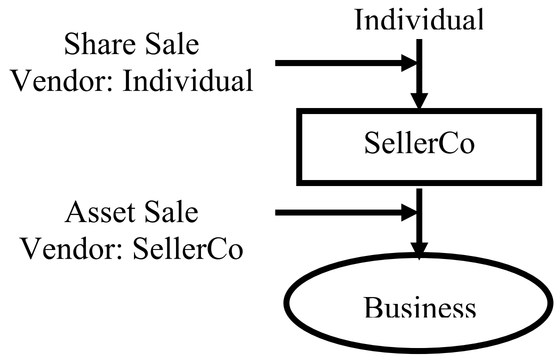
This paper is divided into six parts:

1. Who is selling?
2. The Decision to Buy and Sell Assets

1. Who is Selling?

There are two basic alternative structures to the purchase and sale of a business that is owned and operated by SellerCo: SellerCo's shareholder(s) may sell the SellerCo shares; or SellerCo may sell the assets and distribute the after-tax proceeds of sale[5] to the shareholder(s).

Where the subject matter of the purchase and sale is assets, the Vendor is SellerCo. Any profit realized on the sale of assets will be subject to tax in SellerCo at a combined federal provincial tax rate of approximately 33%.[6] The taxes payable in respect of a sale of assets will depend on the nature of the gain realized by SellerCo (recapture of CCA, eligible capital amounts, income, capital gains), the manner in which amounts are distributed to SellerCo's shareholder (repayment of debt, return of capital, bonus, taxable dividends, capital dividends), the status of SellerCo and its shareholder for Canadian income tax purposes, and the rates of tax payable by them. SellerCo's after-tax proceeds will be distributed to SellerCo's shareholder and, depending on the form of the distribution, may be subject to tax.



By way of contrast, where the subject matter of the sale is shares, the Vendor is SellerCo's shareholder. Any gain will likely be a capital gain, one-half of which will be subject to tax.[7] Depending on the circumstances, all or a portion of the gain may be offset by the $750,000 capital gains exemption available in respect of qualified small business corporation shares ("QSBC Shares").[8]

2. The Decision to Buy and Sell Assets[9]

The tax consequences to both the Vendor and the Purchaser arising out of the sale will usually determine the structure of the transaction as a purchase and sale of either assets or shares, the price the Vendor will ask to be paid and the price that the Purchaser will be prepared to pay. That being said, there may be non-tax reasons which will dictate the structure of the transaction including, for example, licensing or regulatory considerations and the existence of contingent liabilities.

a. Purchaser's Preference

The Purchaser will usually prefer to purchase the assets of the business.

If the purchase is structured as a share transaction, the Purchaser will acquire all of SellerCo's assets and inherit SellerCo's liabilities (both disclosed and undisclosed, actual or contingent) including tax liabilities and tax history.

In a share transaction, the tax cost of the assets to SellerCo will generally be the same as when SellerCo was controlled by the Vendor.[10] The purchase price allocated to the shares will become the adjusted cost base of the shares to the Purchaser. The adjusted cost base will generally have a benefit only on a subsequent sale of the SellerCo shares.

In a purchase transaction structured as a purchase and sale of assets, the Purchaser will purchase only the assets that are essential to the business as it will be carried on by the Purchaser. The Purchaser will have a tax cost in the purchased assets equal to the purchase price allocated to them.[11] The assets may generate deductions which can be used to reduce the Purchaser's income from the business in the years subsequent to sale. Any assets not purchased by the Purchaser will be left with the Vendor. As with the purchased assets, the Purchaser can choose which of SellerCo's liabilities, if any, will be assumed.

b. **Vendor's Preference**

The Vendor will usually prefer to sell shares. On a sale of the shares, the Vendor will realize a capital gain, one-half of which will be subject to tax with the result that approximately $23 of each $100 of gain will be paid in income tax.[12] The gain realized on the sale of shares may be offset in full or in part by the $750,000 capital gains exemption available in respect of QSBC Shares, thereby increasing the after-tax yield to the individual Vendor.[13]

An asset sale is less attractive to the Vendor on the basis that there will be two levels of tax: first in SellerCo and then in respect of distributions made by SellerCo to its shareholder.[14] In addition, the assets comprising the business are often not disposed of at one time with the result that the Vendor will be forced to sell assets remaining after the sale to the Purchaser to a third party (likely at a less favourable price).

For the balance of this paper, it is assumed that the purchase and sale of the business will be structured as a purchase and sale of assets by SellerCo.

3. Calculation of the Vendor's After-Tax Proceeds

a. Required Information

Once it has been determined that the transaction will be structured as a sale of SellerCo's assets and a global purchase price for those assets has been established, the amount that will be available for distribution to SellerCo's shareholder(s) can be determined.[15]

A starting point for determining the amount that will be available for distribution to SellerCo's shareholders is confirming the tax consequences to SellerCo arising out of the sale of assets.

There are four steps in determining SellerCo's after-tax proceeds in respect of a sale of assets:

1. Categorize the assets from a tax perspective.

2. Allocate the global purchase price among the assets.

3. Determine the income or gain arising as a result of the allocation of the purchase price among the assets.

4. Determine the taxes payable by the Vendor in the year of sale and subsequent years.

To provide a context for the analysis of the tax issues in the purchase and sale of a business, consider the following balance sheet.

SELLER CO
Balance Sheet as at December 31, 2009

	Assets	
Cash	$ 18,575	
Accounts Receivable	183,560	
Prepaid Expenses	171,330	
Inventory	248,048	
Shares of Subsidiaries	6	
Land	500,000	
Fixed Assets	815,274	$1,936,793
	Liabilities	
Accounts Payable	$115,991	
Long Term Debt	248,571	
Due to Shareholder	173,311	
	Shareholders' Equity	
Stated Capital	$ 45,000	
Retained Earnings	1,353,920	$1,936,793

b. **Financial Statements and Tax Returns**

To analyze the tax consequences to SellerCo on the purchase and sale of its assets, a review of SellerCo's financial statements and tax returns for at least the immediately preceding fiscal period should be undertaken.[16] This exercise will provide useful background for preparing the asset purchase agreement (the "Agreement").

(i) Financial Statements

The financial statements are useful in the course of undertaking the due diligence exercise; however, they rarely provide the detailed information necessary to properly analyze an asset purchase transaction from a tax perspective. Common reasons for this include:

1. Financial statements may be presented on a consolidated, rather than entity, basis. Corporations with several operating divisions isolated in separate companies or entities (such as partnerships)[17] will present one consolidated financial statement to the public. As a consequence of the consolidation, key indicators of profitability, loss, intercorporate transactions and tax costs will inevitably be lost. While some of this information may be gleaned by a careful reading of the notes or a review of the consolidation working papers, where the assets of an entity are the subject matter of the sale, the only relevant financial information is "entity" financial information.

2. The financial statements presented may not be complete. The balance sheet may be presented without the notes or other supporting schedules.

3. A balance sheet is a snap-shot in time. It will not reflect transactions before or after that time. It is quite possible that the snap shot is not particularly relevant for the transaction that is being analyzed.

4. Many items on a balance sheet are stated at historical cost from an accounting perspective. The marketable net worth of the business can be understated. For example, land originally purchased 20 years ago for $1,000 would continue to be valued on a balance sheet as $1,000 even though the realizable market value of the land may currently be $10,000 as at the date of the balance sheet.

5. The financial statements do not reflect off-balance sheet assets and liabilities. For example, the goodwill associated with the business may not be noted on the financial statements. Similarly, important contracts to the business may not be disclosed in the financial statements.

6. The financial statements are prepared using generally accepted accounting principles ("GAAP"). To determine the entity's tax position, it is necessary to review its tax returns.

(ii) Tax Returns

As tax advisors to SellerCo and its shareholder(s), it will be necessary to collect information relating to SellerCo's tax position. The information can be found in SellerCo's federal and provincial tax returns and notices of assessment/reassessment and would include:

√ a determination of SellerCo's effective tax rate -- is it eligible for the small business deduction? the reduced manufacturing and processing tax rates?

√ are there non-capital or net capital loss carryforwards which can be used to offset any income that will be subject to tax?

√ what is the tax cost of the assets to SellerCo relative to the estimated purchase price? Have there been tax elections filed in respect of the assets?

√ is there debt that will be repaid as a result of the sale? Are there unamortized financing expenses that have not been deducted for tax purposes?

√ what is the paid-up capital of SellerCo's shares?

√ is there a capital dividend account balance?

√ is there refundable dividend tax on hand?

The tax returns should be reviewed for significant issues or transactions. It may be necessary to review the working papers behind them. Any notices of assessment/reassessment should also be reviewed. To complete the picture, GST and retail sales tax returns should also be reviewed.

Although a review of the tax returns provides information about SellerCo's tax position and its compliance with tax statutes, the information can be limited. Certain schedules of the tax returns will provide useful information as to the tax cost to SellerCo of certain of its assets. These schedules reflect SellerCo's assets as at year end. They will not reflect additions or disposals after that time. There may be a review of SellerCo's tax returns by a taxation authority that is in progress that will not be reflected in the tax returns. Thus, while SellerCo's tax returns are an important starting point, the due diligence exercise will have to go beyond them.

c. Overview of Taxation of Specific Assets

As a general matter, the sale of a business in its entirety is a capital transaction.[18] This generalization has been displaced by specific provisions of the Act that dictate the tax consequences to the Vendor of the sale of certain assets in the course of a sale of the business as a going concern.

i. **Cash** ($18,575)

Although cash may appear on the balance sheet, a Purchaser would be unlikely to purchase the cash utilized in a business.

ii. **Accounts Receivable** ($183,560)

(1) *General*

Generally, the accounts receivable on the balance sheet will be the difference between the amount of the accounts receivable shown on the invoice and the allowance claimed by SellerCo in respect of accounts receivable that it determines may not be collectible in the near-term or at all. The accounts receivable will typically be purchased by the Purchaser for an amount equal to their book value; however, the purchase price may be reduced if, on review, it is determined that the allowance for doubtful or bad debts claimed by SellerCo is inadequate.

(2) *Taxation of Accounts Receivable*

To understand how the accounts receivable are to be subject to tax on a sale, it is useful to review how accounts receivable are generally subject to tax.

At the time that an invoice is rendered for goods sold or services rendered, the supplier of the goods or services is required to include the invoiced amount in income.[19] This is the case notwithstanding the fact that all or part of the amount may not be paid until after the end of the year.[20]

If it is determined at the end of a year that the collection of a particular account receivable is doubtful, a reserve (or deduction) may be claimed in respect of that account receivable[21] with the result that no tax will be payable in respect of that account receivable. To be able to claim a doubtful debt reserve or a bad debt deduction, the business must be carried on for profit at the end of the year. In the next year, the amount claimed as a reserve in the previous year must be brought back into income.[22] If at the end of that year ("Year 2"), the account receivable has not been collected, a doubtful debt reserve may be claimed again, or, if it is determined that the account receivable is not collectible, the taxpayer may claim a deduction in respect of the bad debt.[23] Should the accounts receivable for which a doubtful debt deduction has been claimed be collected, the amount previously deducted as a bad debt must be included in income.[24]

(3) *Sale of Accounts Receivable Absent Section 22 Election*

On the sale of accounts receivable, there are two tax consequences. First, the Vendor will be required to include an amount in income in respect of amounts previously claimed as doubtful debts.[25] No doubtful debt deduction would be available for the year of sale since one of the conditions of paragraph 20(1)(l), (that the business must be carried on for profit <u>at the end of the year</u>), will not have been met where the accounts receivable and the business have been sold.[26] Second, the Vendor may realize a capital gain or capital loss. A sale of accounts receivable in the course of selling a business generally gives rise to a capital gain or a capital loss depending on the relationship between the purchase price allocated to the accounts receivable and the cost amount of the accounts receivable to the Vendor (that is, the face amount).[27]

From the Purchaser's perspective, should a purchased receivable be determined subsequently not to be collectible, the Purchaser will not be entitled to a deduction in computing income in respect of doubtful debts or bad debts in respect of that receivable on the basis that the technical requirement of paragraphs 20(1)(l) and 20(1)(p)[28] will not have been met. Specifically, no amount in respect of the accounts receivable would have been included in the Purchaser's income in the year or a previous year. In addition, any loss the Purchaser sustains by virtue of not collecting the accounts receivable will be a capital loss, one-half of which can be applied only against taxable capital gains. In circumstances where the purchase price allocated to the accounts receivable is low, any amount collected in excess of that allocation will generate a capital gain.

The tax consequences to the Vendor and the Purchaser on a sale and purchase of accounts receivable can be unattractive to both parties. The remedy is to have the parties file an election under section 22 of the Act.[29]

(4) *Sale of Accounts Receivable Pursuant to Section 22 Election*

A section 22 election is available where a person who has been carrying on a business in a taxation year sells accounts receivable[30] as part of a transaction where "all or substantially all" of the assets of the business are sold to a Purchaser who proposes to carry on the business which the Vendor had been carrying on. The Vendor and the Purchaser must execute a joint election in prescribed form to have section 22 apply.

The election is made by filing form T2022, a copy of which can be found in the Appendix to these materials. The Act does not prescribe a time limit for filing the form. The CRA's administrative position is that the election should be filed with the tax return for the year in which the business is sold.[31]

Subsection 22(2) provides that the election is to include a statement by the Vendor and the Purchaser, jointly, as to the consideration paid for the accounts receivable. Subject to subsection 69(1), the statement as to consideration is binding on the Vendor and Purchaser insofar as it is relevant in respect of any matter arising under the Act.

(5) *Section 22: Tax Consequences to SellerCo and Purchaser*

Where the election is made, the tax consequences for the year in which the business is sold are as follows:

1. SellerCo should be able to claim a deduction equal to the difference between the face value of the accounts receivable and the amount of the purchase price allocated to them.[32] Where the accounts receivable are sold at a discount from the face amount, SellerCo should be entitled to claim a deduction equal to the amount of the discount. The effect of the election is to enable SellerCo to deduct an amount that would otherwise have been deductible under paragraphs 20(1)(l) or 20(1)(p) had the accounts receivable not been sold.

2. The Purchaser will be required to include an amount in income equal to the difference between the face amount of the accounts receivable and the allocated portion of the purchase price paid to acquire them.[33] This amount will generally be equal to the amount that would have been deducted by the Vendor (that is, SellerCo). The accounts receivable will be deemed to have been included in the Purchaser's income in the year or a previous year. Accordingly, the Purchaser should be able to claim a deduction in the year of acquisition on account of doubtful or bad debts associated with the purchased accounts receivable pursuant to either paragraph 20(1)(l) or paragraph 20(1)(p), other than amounts claimed by SellerCo as a bad debt in respect of those accounts receivable.[34] Moreover, any amounts deducted by SellerCo in computing its income under paragraph 20(1)(p) shall be deemed, for purposes of paragraph 12(1)(i), to have been deducted by the Purchaser.

(6) *Technical Requirements for Section 22 Election*

Although a covenant to file a section 22 election is present in almost every agreement of purchase and sale, the section 22 election is not available in every case. The following five technical requirements must be met for a valid section 22 election:

1. the Vendor (SellerCo) must have been carrying on a business in Canada to which the receivables relate or the Vendor (SellerCo) must have been subject to tax in Canada on the income generated by the receivables that are the subject matter of the sale;[35]

2. the Vendor (SellerCo) must be selling "all or substantially all" of the property of the business used in carrying on the business;

3. the assets being sold must include debts that have been or will be included in computing the Vendor's income for the year or a previous year and are still outstanding;[36]

4. the Purchaser must propose to continue the business previously carried on by the Vendor; and

5. the Vendor and the Purchaser must make and file a joint election on form T2022.[37]

(7) *Selected Legal Issues*

A number of legal issues can arise in respect of the availability of a section 22 election:

1. Is the Vendor carrying on a business?

2. Do the assets that are being sold constitute "all or substantially all" of the property used in carrying on the business? The CRA's administrative position is that "all or substantially all" means property representing 90 per cent or more of the fair market value of the business assets.[38]

3. Is the business that is being sold separate from other businesses carried on by the Vendor?[39] If the "business" is a division, does the Vendor account

for it from a financial statement and tax perspective as a separate business?

4. Does the Purchaser propose to continue the business which the Vendor has been carrying on? If the Purchaser proposes to reorganize the business after closing, is the Purchaser's business <u>the business</u> that had been carried on by the Vendor?

5. Do the assets that are the subject matter of the sale include all of the accounts receivable of the Vendor outstanding at the time of the sale?

(8) *Business Issue*

If the section 22 election is found not to be available because the conditions of that section have not been met, who bears the risk? This may be the subject matter of the indemnity provisions of the Agreement.

(9) *Section 22 - Documentation*

The Agreement should include a covenant to file the section 22 election.

<u>Sample Clause</u> The parties shall, pursuant to section 22 of the *Income Tax Act* (Canada), jointly elect to have the provisions of section 22 apply to the purchase and sale of receivables.[40]

Where there are issues as to the technical requirements of section 22, the representations and warranties should include representations to meet those technical requirements.

<u>Sample Clause</u> The Business is a separate business from other businesses carried on by the Vendor. The Purchased Assets comprise all or substantially all of the property used by the Vendor in carrying on the Business. The Accounts Receivable as at the Closing Date constitute all of the outstanding debts of the Vendor in respect of the Business that were included in the Vendor's income in respect of the Business in the year of sale or a previous year.

iii. Prepaid Expenses ($171,330)

SellerCo may have prepaid certain expenses (for example, rent, royalties, insurance, services to be rendered after the end of the year, or parts or supplies to be used in a subsequent year). Taxpayers are not permitted to deduct the prepaid expenses in the year that they are incurred, rather, the Act requires that a deduction may be claimed only in the year in which the taxpayer realizes the benefit of the expense.[41]

Administratively, an amount received by the Vendor in respect of prepaid expenses is included in income. The amount paid by the Purchaser is considered to be a prepaid expense to the Purchaser. Accordingly, the Purchaser should be able to deduct the prepaid expense in the year the Purchaser realizes the benefit of those expenses.

iv. Inventory ($248,048)

The inventory of a business is comprised of either the products held for sale or the material which the business processes, manufactures or assembles into products for sale. The value of the inventory may be very difficult to determine. Certain of the inventory may be obsolete or not saleable. It is not uncommon for inventory to be sold for a price equal to its book value.

Section 23 of the Act applies to a sale of all or part of the inventory of a business.[42] It applies where the Vendor disposes of or ceases to carry on a business or a part of a business and in connection with that, part or all of the inventory of the business is sold. Where section 23 applies, the inventory that is sold is deemed to have been sold in the course of carrying on the business. Thus, any gain realized on the sale (that is, the difference between the purchase price and the cost of the inventory) will be on income account. Unlike the case with accounts receivable, there is no requirement that all of the inventory be sold in order for section 23 to apply.

The Purchaser will not be entitled to a deduction in computing income equal to the portion of the purchase price paid for the inventory. As the inventory is sold, however, the Purchaser will be entitled to a deduction in computing income equal to the cost of the inventory that was sold[43].

v. Capital Property

Capital property is defined to mean (i) depreciable capital property and (ii) any property the disposition of which will give rise to a capital gain or capital loss.[44]

(1) *Non-depreciable Capital Property – Shares of Subsidiaries ($6), Land ($500,000)*

Examples of non-depreciable capital property are shares and land.

On a sale of non-depreciable capital property, the Vendor will realize a capital gain (or loss) equal to the amount by which the purchase price exceeds (or is exceeded by) the adjusted cost base of the capital property to the Vendor.[45] One-half of the capital gain is included in income and subject to tax.[46] Because SellerCo is a CCPC, twenty per cent (20%) of the taxable capital gain will be added to SellerCo's refundable dividend tax on hand ("RDTOH").[47] SellerCo will also pay a refundable tax equal to 6-2/3% of the gain.[48] This amount will also be added to SellerCo's RDTOH and will be refunded on the basis of $1 for every $3 of dividends paid.[49] The non-taxable portion of the capital gain will be added to SellerCo's capital dividend account.[50] Assuming the appropriate elections are made, the balance of the capital dividend account can be paid out to the shareholders of SellerCo as a tax-free capital dividend.[51]

If, in a taxation year, the capital losses exceed the capital gains, one-half of the excess is a net capital loss which may be carried back up to three years and offset only against taxable capital gains of those prior years. Net capital losses remaining may be carried forward indefinitely and be applied against taxable capital gains.[52] Certain losses realized on the sale of shares and debt of corporations that are "small business corporations" within the meaning of the Act, may be an "allowable business investment loss"[53] and may be used to offset income from sources other than capital gains.

From the Purchaser's perspective, the purchase price paid for the non-depreciable capital property becomes the adjusted cost base of the non-depreciable capital property to the Purchaser. Any benefit associated with the allocation of the purchase price will be realized only when that asset is sold.

If the non-depreciable capital property is land, generally speaking, land transfer tax will be payable.

(2) *Depreciable Capital Property ($815,274)*

Depreciable capital property is property in respect of which the taxpayer is entitled to claim capital cost allowance ("CCA").[54] Examples of depreciable capital property include buildings, machinery and equipment.

The Regulations to the Act divide depreciable capital property into a number of classes with different rates of CCA ranging from 4% to 100%. When a depreciable capital property is acquired, the cost of that asset is added to a "class" for CCA purposes.[55] Where a corporation carries on more than one business, separate classes are maintained for each business.[56] The rate for the class is applied against the aggregate capital cost of the class to determine the amount of the deduction available on account of CCA.[57] Generally, only one-half of the CCA that is otherwise available is deductible in the year an asset is acquired.[58] Once CCA is claimed in a year, the difference between the capital cost and the CCA claimed is called "undepreciated capital cost" ("UCC").[59]

To analyse the tax consequences to the Vendor on the disposition of depreciable assets, reference should be made to the T2SCH8 which is included in the corporate tax return. A T2SCH8 is included in the Appendix to these materials. It must be noted that the T2SCH8 is prepared at a particular point in time. It does not reflect additions or disposals after that time.

Although the financial statements will include assets that have been depreciated under "generally accepted accounting principles" or "ordinary principles of commercial trading", the rate of depreciation and the depreciated balance for financial statement purposes may not be the same as the CCA claimed in a year or the UCC for income tax purposes. The reason for this are numerous, and include the following:

1. For accounting purposes, the rate of depreciation is designed to allocate the original cost of the assets over the asset's useful life. The CCA rates for tax purposes may reflect an incentive under the Act. For example, machinery and equipment used directly or indirectly for the purpose of manufacturing and processing may be depreciated on a 40-year declining-balance basis for financial statement purposes; however, for tax purposes, the CCA rate is 50 per cent.[60]

2. Financial reporting may require that an asset be depreciated on a straight-line basis. That is, the cost of the asset is depreciated evenly over the life of the asset. For tax purposes, with a very few exceptions, assets are depreciated on a declining-balance basis.[61]

3. Depreciation is a mandatory deduction for financial statement purposes. CCA is a discretionary deduction. In other words, the taxpayer may choose whether or not CCA is to be claimed as a deduction for tax purposes in a year. A taxpayer may choose not to claim CCA, for example, in years where the taxpayer realizes a loss for tax purposes. If the taxpayer chooses not to claim CCA in year, it is not possible to "double up" the deduction in future years.

4. The CCA available in the year in which an asset is acquired for use is one-half of the CCA otherwise available.[62] This rule reflects the fact that the taxpayer is entitled to claim CCA in respect of an asset regardless of when the asset was acquired in the year.

In order to appreciate the tax consequences arising on the purchase and sale of depreciable capital property, it is important to note the following features of the CCA system:

1. CCA is calculated on a class, rather than individual asset basis.[63] The UCC is adjusted upwards and downwards as the taxpayer acquires or disposes of assets.

2. Properties acquired for the purpose of gaining or producing income from a business fall into a class for that particular business.[64] If the taxpayer carries on more than one business, separate classes are to be maintained.[65] A sale of the assets of one business may give rise to recaptured depreciation notwithstanding the fact that there is a UCC balance for another business.

3. Where a taxpayer has a taxation year of less than 365 days, the CCA must be prorated to the number of days in the taxation year.[66]

4. CCA cannot be claimed in respect of an asset until such time as the asset is available for use.[67]

5. CCA is claimed only if the asset is owned at the end of the year. If the asset is not owned at the end of the year, no CCA can be claimed.

6. When the assets of a particular class are sold, CCA claimed in prior years will be required to be brought into income to the extent that the purchase price exceeds the UCC of the class but only to the extent of the original capital cost. In other words, the CCA previously claimed will be recaptured. Any amount in excess of the original capital cost is subject to tax as a capital gain.

7. Where there are several assets in a class and one is sold, the CCA claimed in respect of the class will be recaptured to the extent that the proceeds of disposition exceed the UCC of the class. If the sale proceeds for the asset

exceeds the original capital cost of that asset, that amount will be taxed as a capital gain, one-half of which must be included in income.

8. Where all of the assets of a particular class have been disposed of and there is still a UCC balance in the class, that amount may be claimed as a terminal loss[68] which may be deducted against income of any source. The sale of depreciable capital property does not give rise to a capital loss.

9. Recapture is determined at the end of the year. Accordingly, it may be possible to defer the recognition of recapture by adding other assets to the class. Since CCA is determined on a business-by-business basis, recapture can be avoided only if the assets are added to the class maintained for the particular business.

10. The amount to be included in income as recapture must be included in income in the year of sale notwithstanding that a portion of the purchase price is deferred. No reserve can be claimed in respect of that portion of the sales proceeds attributable to depreciable assets. In the future, where it is clear that a portion of the purchase price will not be paid, a bad debt deduction may be claimed under subsection 20(4) of the Act. This deduction is available only where the debt is uncollectible (that is, a bad debt), not when it is doubtful.

In summary, on the sale of a depreciable capital property used by a Vendor in the business, the Vendor will credit the proceeds to the relevant class but only up to the amount of the particular asset's capital cost. If, at the end of a particular year, there is a credit balance in the particular class, this amount must be included in income as recaptured CCA. The recaptured CCA is treated as business income[69] and thus may be eligible for the small business deduction subject to the conditions of that deduction. If the purchase price is less than the UCC and there are no assets in the class, the difference may be deducted from income in the year of sale as a terminal loss.[70] If the purchase price exceeds the capital cost, the excess will be treated as a capital gain of which one-half will be included in income.

Where a portion of the purchase price is allocated to depreciable capital property that is tangible personal property, retail sales tax may be payable.[71]

From the Purchaser's perspective, the amount of the purchase price that is allocated to the depreciable capital property must be added to the appropriate class. The class of a particular asset may change upon the acquisition of the asset by the Purchaser. For example, the asset may be included in Class 43 (30%) to the Vendor only to be Class 29 (50%) to the Purchaser since it was acquired by the Purchaser after March 18, 2007.

The amount of the purchase price that is allocated to the depreciable capital property will form the basis of the CCA deductions that will be available to the Purchaser in future years. As noted above, the Purchaser generally will only be entitled to claim one-half of the CCA otherwise available in the year of purchase.[72] A short taxation year may, however, cushion the effect of the half-year rule. For example, if the Purchaser is a newly-incorporated company, it may select a taxation year end shortly after the completion of the purchase of the assets. In the short year, the half-year rule will apply. In the new taxation year following, the half-year rule will have no effect. If the Purchaser has a taxation year of less than 365 days, the amount of CCA claimed in the year will have to be pro-rated.

vi. Eligible Capital Property

An eligible capital property is an outlay or expense made on account of capital for the purpose of gaining or producing income from a business; with certain exceptions. In order to qualify as an eligible capital property, an outlay or expense must meet the following conditions:[73]

1. the expenditure must be in respect of a business of the taxpayer. Eligible capital property, like CCA, is determined on a business-by-business basis;

2. the expenditure must be as a result of a transaction occurring after 1971;

3. the expenditure must be on account of capital;[74] and,

4. the expenditure must be for the purpose of gaining or producing income from a business or property.

Most intangibles would qualify as eligible capital property other than an intangible that is a depreciable capital property. Examples of eligible capital property include goodwill, intellectual property and related assets, business names, customer lists, trademarks, licenses, patents, copyrights and trade secrets.[75] Goodwill is the price over and above the value of specific assets which the Purchaser is prepared to pay to acquire the business.

From a tax perspective, three-quarters of an eligible capital expenditure is the eligible capital amount.[76] Seven per cent of that amount is available as a deduction in computing income.[77] The balance remaining is called the cumulative eligible capital (or CEC). The CEC balance at the end of a year is found in T2SCH10, a copy of which can be found in the Appendix to these materials.

On a sale of eligible capital property, the Vendor will be required to include two-thirds of the gain in income.[78] The effect of the two-thirds factor is to convert the three-quarters inclusion rate to one-half -- which is equivalent to capital gains rates.

Subsection 129(4) deems taxable proceeds from the sale of eligible capital property used to earn active business income not to be investment income. Since the taxable portion of the eligible capital is not investment income, it does not attract the 6-2/3 refundable surtax. Also, the gain would be subject to tax as business income and would be eligible, if all of the conditions were met, for the small business deduction. Where the Vendor is a private corporation, one-half of the gain realized on the sale of eligible capital property will be added to the corporation's capital dividend account at the year end.[79] Although 20% of the taxable portion of a capital gain is added to RDTOH, there is no such addition with respect to the taxable portion of eligible capital.

If the purchase price allocated to the eligible capital property is less than the CEC balance, the Vendor has ceased to carry on the business and owns no property that was eligible capital property in respect of the business, the Vendor will be entitled to a deduction in computing income in respect of the CEC balance remaining in the first year after it ceases to carry on the business.[80]

Subsection 14(1.01) of the Act permits a taxpayer to elect to report a capital gain on the disposition of an eligible capital property in respect of which the taxpayer can verify the eligible capital expenditure in respect of a particular eligible capital property.[81] The election is made in the taxpayer's return for the year of the disposition, or with an election under subsection 83(2) of the Act, filed on or before the taxpayer's filing due date for the taxation year. This allows a taxpayer to consider the resulting capital gain when making a capital dividend election.

A subsection 14(1.01) election might be made if the Vendor has capital losses[82] since the capital losses can be used to offset capital gains. In addition, the subsection 14(1.01) election will allow a taxpayer to claim a reserve under paragraph 40(1)(a)(ii) if all or a part of the consideration allocated to the property is due after the end of the year. As a final advantage, the making of the election can enable the taxpayer to add the portion of the capital gain to the capital dividend account rather than having to wait to add that amount after the end of the taxation year. On the other hand, consideration should be given to the tax payable in respect of business income as opposed to the capital gain. It is important to review each transaction in detail to determine whether a subsection 14(1.01) election is appropriate to the particular facts and circumstances.

In circumstances where the corporation is dealing not at arm's length with the transferor of the property and the eligible capital expenditure of the transferor to acquire the property cannot be determined, subsection 14(1.03) of the Act and subsection 14(1.02) of the Act[83] precludes a taxpayer from making an election under those subsections in respect of eligible capital property that is goodwill. Subsection 14(1.03) also precludes an election by a corporation under those subsections for property acquired in circumstances where an election was made under subsection 85(1) or (2) of the Act, if the amount agreed on as the corporation's cost under those subsections was less than the fair market value of the property at the time it was so acquired.[84]

From the Purchaser's perspective, only three-quarters of the cost of the eligible capital property will be added to the CEC and can be amortized at the rate of 7 per cent per year for an effective rate of 5.25%. However, if the Purchaser's tax year is less than 12 months, the deduction will be prorated.[85]

d. Allocation of Purchase Price

A fundamental issue from a tax perspective in the context of a purchase and sale of asset is the allocation of the purchase price among the purchased assets. The allocation of the purchase price will determine the taxes payable by the Vendor in the year of sale. It may affect the provincial retail sales tax, land transfer tax and GST payable. It will determine the deductions available to the Purchaser in calculating its taxable income in future years.

The Vendor's objective in allocating the purchase price is to allocate the purchase price to assets which will give rise to no or little income in the year of sale or income that is subject to tax at less than full rates. The Purchaser's objective in allocating the purchase price is to allocate the purchase price to assets that will give rise to deductions in computing income in the future. If the allocation of the purchase price results in little or no taxes payable by the Vendor, it is likely that the Purchaser will have limited ability to deduct those costs in the future. The following table illustrates the tension between the Vendor's objectives and the Purchaser's objectives.

Description of Asset	Vendor's Preference (in order)	Purchaser's Preference (in order)
Non-depreciable capital property - only one-half of any gain will be included in income	1	4
Depreciable capital property where there will be little or no recapture of CCA	2	2 allocation first to assets with high CCA rate.
Eligible capital property since only two-thirds of the sale proceeds will be deducted from the CEC and the excess will be included in income	3	3
Depreciable capital property where there will be a recapture of CCA	4	2 allocation first to assets with high CCA rate.
Inventory and other assets which give rise to a full income inclusion	5	1

As a practical matter, Purchasers and Vendors often resist the allocation of the purchase price in the Agreement. This reluctance is based on the general feeling that each party should report the allocation in its own tax return on its own terms. That notwithstanding, it is important that the Vendor and the Purchaser agree to an allocation of the purchase price. In the event that they do not, there is a risk that the CRA would force an allocation of the purchase price using section 68 of the Act. A CRA-forced allocation is not likely to satisfy the objectives of either the Vendor or the Purchaser. As a general matter, an agreed-upon allocation of the purchase price between Vendor and Purchaser will be respected by the CRA where there has been hard bargaining, the Agreement is not a sham or subterfuge and none of the parties is indifferent to the allocation.[86]

When might a party be indifferent to an allocation? A vendor who has substantial non-capital losses or is a tax exempt may be indifferent to the allocation of the purchase price since there will be no or little taxes payable on the sale. A purchaser who is also a tax exempt may be indifferent to the allocation of the purchase price since the purchaser will have no need to claim deductions (CCA, for example) in the year of sale or thereafter.

The Agreement should include a schedule detailing the allocation of the purchase price among the assets (including an allocation between the classes of depreciable assets) and services contemplated by the Agreement and a covenant of the parties to prepare their respective tax returns on the basis of the agreed-upon allocation. Consistency in filing is an indicator of hard bargaining and consensus.

<u>Sample Clause</u> For the purposes of this Agreement, the Purchase Price shall be allocated as set forth in Schedule ●. The Vendor and the Purchaser agree to file their tax returns and filings on a basis that is consistent with the allocations in such Schedule.

e. **Allocation of Consideration**

As noted previously, the Vendor's goal is to minimize the tax consequences in the year of sale and the Purchaser's goal is to minimize the tax consequences after the sale. This necessarily results in tension in the negotiation.

The consideration for the purchase of assets may include cash, shares, an assumption of liabilities and unpaid purchase price. It is the unpaid purchase price which may give rise to a deferral of taxes payable by the Vendor.

A number of provisions of the Act provide for a deferral of taxes payable by a Vendor over a period of years where certain conditions have been met, as follows:

1. The amount must be due after the end of the year. A portion of the purchase price that is payable on the second anniversary of the closing date meets this requirement. A demand promissory note does not meet the requirement that an amount be due after the end of the year.[87]

2. A reserve in respect of capital property cannot exceed five years.[88] This means that in order to get the maximum benefit of the reserve, the term of a promissory note should not exceed five years.

3. A reserve in respect of inventory cannot exceed three years.[89] This means that in order to obtain the benefit of the reserve, the term of the promissory note should not exceed three years.

4. Unless an election is made pursuant to subsection 14(1.01) of the Act, a reserve is not available in respect of eligible capital property.[90] Therefore, a promissory note should not be allocated to an asset that is an eligible capital property.

5. A reserve is not available to defer the taxes payable in respect of the recapture of CCA. Therefore, a promissory note should not be allocated to depreciable capital property.

6. As a general rule, cash or near cash consideration should be allocated to an asset in respect of which a reserve is not available. If cash or near cash is allocated to an asset in respect of which a reserve is available, ideally it should be equal to the adjusted cost base and the tax payable in the year of sale. In this way, the cost of the asset to the Vendor is recovered and the taxes payable in the first year by the Vendor are funded.

The Agreement should be drafted carefully to ensure that the Vendor will have maximum entitlement to reserves.

Unpaid purchase price in a transaction between arm's length parties may have an interest component. There is no requirement from an income tax perspective that interest be imposed. However, section 16 of the Act may result in an imputation of interest if it is determined that the purchase price allocated to a particular property was greater than its fair market value. Any interest component would be fully taxable to the Vendor.

4. Distribution of After-Tax Proceeds

As noted previously, the sale of assets by SellerCo will result in two levels of tax: first, when SellerCo sells the assets and second, when the after-tax proceeds are distributed to its shareholder (assumed to be an individual).

The assets of SellerCo having been sold, SellerCo's shareholder will want to minimize the personal taxes payable in respect of distributions from SellerCo. In this connection, the shareholder will need to determine an ongoing strategy for SellerCo - will SellerCo purchase a new business,[91] operate as an investment holding company, or will it be wound-up?

Regardless of the shareholder's objectives concerning SellerCo, the shareholder will be motivated to extract the maximum funds possible from SellerCo on a tax-free basis. In this connection, SellerCo's shareholder should consider the following:

1. repayment of shareholder loans and advances;
2. return of paid-up capital;[92] and,
3. payment of a capital dividend.[93]

Once these steps have been taken, the shareholder would consider the payment of taxable dividends in order to generate a dividend refund in SellerCo. To the extent that SellerCo spreads out the payment of taxable dividends over time, a deferral of tax can be achieved.

5. Documentation and Compliance Matters Generally[94]

a. Representations and Warranties

In some cases, the tax consequences to the Vendor and to the Purchaser may depend on certain factual matters. For example, the section 22 election requires that "all or substantially all" of the assets of the business carried on by the Vendor including the accounts receivable are the subject matter of the sale. It is critically important to include in the representations and warranties of the Agreement, sufficient representations that deal with these matters.

b. Allocation of Consideration

It is recommended that the Agreement includes a schedule that details, with some particularity, the allocation of the purchase price among the assets and the allocation of the consideration. It is also recommended that the Agreement includes a covenant on the part of the parties to file their tax returns on the basis that it is consistent with the allocation.

c. Elections

The tax consequences to the Vendor and/or the Purchaser may be dependent on the filing of an income tax designation or election.[95] The Agreement should include a covenant to file the designations and/or elections within the time prescribed by the Act.

d. **Subsection 20(24) Reserve**

The transaction may include an assumption by the Purchaser of obligations of the Vendor to deliver goods or perform services in the future for which the Vendor has already received payment. Absent an election under subsection 20(24), the tax consequences would be as follows:

1. No deduction would be allowed to the Vendor as no outlay of an expense would have been incurred;

2. The outlay made by the Purchaser in connection with the goods or services would be considered to be a capital outlay made in connection with the purchase of the business;

3. The Purchaser purchasing the business or service obligations would treat the assumed amount as part of the consideration paid for the business. Accordingly, no amount could be brought into the Purchaser's income under paragraph 12(1)(a) of the Act as these obligations would have arisen in connection with the capital transaction; and

4. The Purchaser would not be allowed to deduct any costs incurred to render the related services or to provide the required goods as the outlay would be incurred in connection with the capital obligation acquired in the purchase transaction (that is, they would not be expenses laid out to earn income).

The effect of subsection 20(24) is to allow the Vendor to deduct the amount paid to the Purchaser to assume its liabilities.[96] This would have the effect of replacing that deduction under paragraph 20(1)(m) for goods and services to be supplied after the end of the year in which the Vendor would have been able to claim the deduction if the Vendor had not sold the business. The Purchaser is deemed to have received an amount described in paragraph 12(1)(a)[97] thereby allowing the Purchaser to claim a paragraph 20(1)(m) reserve and permitting the deduction of the expense of providing these goods or services an expense of the business in the year in which it has incurred. This would be the case even though the assumption of the future obligations reduces an outlay that Purchaser otherwise would have made on account of capital. Whether making the election is in the Purchaser's interest will depend upon the relationship between the amount of the income inclusion and the period over which the deductions may be made.

The subsection 20(24) election is to be made in the tax return for the year of transfer. There is no prescribed form. Presumably, a letter or attachment to the tax return setting out the parties and the amount of the payment is sufficient.

6. Consulting Arrangements

The transaction could include having the Purchaser enter into a consulting agreement with the Vendor for a period of time. Payments made pursuant to a consulting contract may generate a better tax result for the Purchaser than having an amount allocated as part of the purchase price for assets. The advantage of this arrangement to the Purchaser is that the Purchaser would be entitled to deduct amounts paid pursuant to the consulting agreement provided that they are reasonable in the circumstances. The reasonableness of the payment will depend on a number of factors, including the services provided by the consultant.

Payments made pursuant to a consulting contract may generate a better tax result from the Purchaser's perspective than having an amount allocated as part of the purchase price for assets. This is because amounts paid as purchase price for assets would be added to cost amount of the assets. Generally speaking, the Purchaser would realize the benefit of the cost additions over time (for example, through the CCA system) or when the assets are sold.

The recipient will be required to include the consulting revenues in income at full rates (as opposed to capital gains rates, for example); however, to the extent that the consulting arrangement extends over a period of time, some element of deferral may be achieved.

In *Foresbec Inc. v. Queen*[98], the deductibility of payments made pursuant to a consulting contract was considered. The shares of Foresbec were held by a holding company that was controlled by Guy Boisse. Mr. Boisse was also the President of both the holding company and Foresbec. The Foresbec shares were sold to a company ("Multi") controlled by Mr. L'Esperance who became the chairman of Foresbec's board of directors. Difficulties ensued between Mr. Boisse and Mr. L'Esperance and, as a result, the holding company repurchased the shares of Foresbec for a purchase price equal to the unpaid purchase price for the Foresbec shares. As part of the consideration, Multi was granted a $150,000 contract for the consulting services of Mr. L'Esperance.

The $150,000 was deducted by Foresbec pursuant to either subsection 9(1) or paragraph 18(1)(a) of the Act. The Minister disallowed the deduction on the basis that the $150,000 did not represent a payment for consulting services. The Minister's position was that the $150,000 payment was part of the purchase price for the repurchase of the Foresbec shares that the parties had sought to disguise as payment for consulting services. The Minister also determined that the statute-barred taxation years were open to reassessment pursuant to subsection 152(4) on the basis that the appellants had made an intentional misrepresentation in their tax returns; assessed a penalty under subsection 163(2) of the Act on the basis that the taxpayers knowingly made false statements in their tax returns; and, assessed a shareholder benefit under subsection 15(1) of the Act on the basis that Foresbec paid $150,000 of the purchase price for the buy-back of its shares.

The taxpayer argued that the agreements should be given their legal effect for tax purposes. The share purchase agreement and the consulting contract were entered into between arm's length parties that created legally enforceable rights. The consulting contract was in line with standard commercial practices and it was reasonable that Foresbec would want to ensure that it had the co-operation of the outgoing owner, who was also a director.

The Court dismissed the taxpayer's appeal on the basis that the consulting agreement was a "sham" insofar as it did not reflect the true legal reality of the rights and obligations between the taxpayers. First, no consulting services were ever performed by Mr. L'Esperance. Second, the existence of the consulting agreement was questionable. The primary reason for the repurchase of the Foresbec shares was due to the questionable business decisions and conduct of Mr. L'Esperance. Finally, the holding company did not have the funds to complete the purchase of the Foresbec shares. The effect of the consulting agreement was to defer payment of the purchase price. Accordingly, the $150,000 was treated as consideration for the purchase of shares rather than a business expense for consulting services, the holding company was required to include the payment in income as a shareholder benefit, and the otherwise statute-barred years were open for reassessment and the penalty under subsection 163(2) was sustained.

Conclusion

This paper has canvassed, in a general way, the income tax issues most frequently encountered in a transaction structured as a purchase and sale of assets.

It is my hope that this paper provides you with the background you need as you structure asset purchases and sales and either draft or review the documentation that implements them.

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Endnotes

1. This paper is an update of the paper prepared and presented by the author at the 1998 to 2009 Tax Law for Lawyers course. It is based, in part, on the paper prepared by Robin MacKnight and presented at this course in 1996. There are many excellent papers on this topic: see, for example, Manon Thiverge, "Planning for the Purchase and Sale of a Business", *Report of the Proceedings of the Fifty-Seventh Tax Conference*, 2005 Tax Conference (Toronto: Canadian Tax Foundation, 2006), 10:1-10:34, Jasen F. Kwong, "Exit Strategy Planning Issues", 2004 British Columbia Tax Conference (Vancouver: Canadian Tax Foundation, 2004), 18:1-37, Lori A. Mathison, "Selling a Business: Minimizing the Vendor's Tax", *Report of Proceedings of Fifty-Fourth Tax Conference*, 2002 Tax Conference (Toronto: Canadian Tax Foundation, 2003), 41:1-21, Joseph C. Monaco, "Tax Clauses in Acquisition Agreements/Price Adjustment Clauses", 2002 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2002), 8:1-38, Robert R. Hagerman, "Purchase and Sale Checklist for CCPCs; Tax Treatment of Non-Compete Payments; Retiring Allowances", 2002 Prairie Provinces Tax Conference (Toronto: Canadian Tax Foundation, 2002), 8:1-31, D. Blair Nixon and Sandra E. Jack, “The Deal: The Price Tag and Adjustment Mechanisms”, *Report of the Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001). Rodney C. Bergen, “Purchase and Sale of Assets: An Update” in *Income Tax and GST Planning for the Purchase, Sale and Canada-U.S. Expansion of a Business*, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), David Forster, “The Purchase and Sale of Assets of a Business: Selected Tax Aspects” in *Selected Income Tax and Goods and Services Tax Aspects of the Purchase and Sale of a Business*, 1990 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1991), 2:1-36, Wallace M. Howick, “Purchase and Sale of Assets” in *Selected Income Tax Aspects of the Purchase and Sale of a Business*, 1984 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1984), 156-202.

2. *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, as amended (referred to in this paper as the “Act”), section 89.

3. SellerCo and the individual are sometimes referred to in this paper collectively as the “Vendor”.

4. See W. Jack Millar, “GST and PST Issues Affecting Corporate Reorganizations, Business Sales and Partnerships" which appears elsewhere in these materials.

5. The after-tax proceeds are calculated not only with reference to federal and provincial income tax but also Goods and Services Tax, provincial retail sales tax and other taxes.

6. An approximate combined federal and Ontario provincial corporate tax rate for income other than income eligible for the manufacturing and processing rate and assuming that the Ontario surtax designed to claw back the provincial small business deduction does not apply.

7. Assuming that the shares are held by the individual as capital property.

8. Within the meaning of subsection 110.6(2.1) of the Act.

9. This issue has been canvassed in a number of papers: see, for example, Edwin G. Kroft, “Some Tax Aspects of Buying or Selling Assets or Shares” in Income Tax and GST Planning for the Purchase, Sale and Canada-U.S. Expansion of a Business, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996) 1:1-55, Wallace M. Howick, “Assets versus Shares: An Approach to the Alternatives,” in Selected Income Tax and Goods and Services Tax Aspects of the Purchase and Sale of a Business, 1990 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1991), 1:1-35.

10. Except in circumstances where there has been a write-down of the asset required where control of a corporation has been acquired by a person or group of persons. See subsection 111(4) of the Act.

11. Except in certain cases where the Purchaser deals not at arm’s length with the Vendor. See, for example, paragraph 13(7)(e) of the Act.

12. Depending on the Vendor’s province of residence and subject to the availability of the $750,000 capital gains exemption available in respect of QSBC shares.

13. Where there are multiple vendors and the gain may be offset by the $750,000 capital gains exemption, the bias toward a sale of shares will be more pronounced. For more information see Douglas A. Cannon, “Purchase and Sale of a Business / Share Sales”, which appears elsewhere in these materials.

14. If the Vendor is a Canadian-controlled private corporation within the meaning of the Act and there is full integration, the tax burden borne by the corporation and its shareholder is not materially different than the tax burden borne by an individual on a sale of assets.

15. The due diligence exercise will go beyond tax matters. For a discussion of this topic, see John van Ogtrop, “Tax Due Diligence in Commercial Transactions” in Report of the Proceedings of the Fiftieth Tax Conference, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999) p. 9:1-9:20.

16. SellerCo will be required to file a federal T2 corporate tax return and a provincial corporate tax return for each province in which it has a permanent establishment. In fact, the due diligence exercise will span a period greater than the immediately preceding year; however, this is a good starting point. The most recent financial statements will provide information about SellerCo’s recent history.

17. To provide liability protection or to meet other commercial objectives.

18. See the discussion in Bergen, supra footnote 1, at 3:2-3 and in Kwong, supra footnote 1, at p. 2.

19. Paragraph 12(1)(b) of the Act.

20. Subparagraph 12(1)(b)(ii) of the Act provides that an amount may be deemed to have become receivable on the day the account would have been rendered had there been no undue delay in rendering the account.

21. Paragraph 20(1)(l) of the Act. See IT-442R "Bad debts and reserves for doubtful debts" (September 6, 1991). See also Cloverdale Paint Inc. [2007] 2 C.T.C. 2024 (TCC).

22. Paragraph 12(1)(d) of the Act.

23. Paragraph 20(1)(p) of the Act.

24. Paragraph 12(1)(i) of the Act.

25. Paragraph 12(1)(d) of the Act.

26. However, the Vendor may be able to claim a bad debt deduction under paragraph 20(1)(p) of the Act. See paragraph 7 of Interpretation Bulletin IT-188R.

27. See Rodney C. Bergen, supra footnote 1. It is very unlikely that the sale of accounts receivable would give rise to a capital gain.

28. The amount must have been included in income on account of the goods sold or services rendered for the preceding year.

29. See IT-188R "Sale of accounts receivable" (May 22, 1984).

30. Accounts receivable include debts arising from loans made where the ordinary course of the business is the lending of money.

31. See IT-188R, supra note 29, at para. 4. The CRA has indicated that it will accept an election before a notice of assessment for the year is issued or before the expiry of the time the taxpayer can object to the assessment for the year. Technical Interpretation 9632646, October 8, 1996.

32. Paragraph 22(1)(a) of the Act.

33. Paragraph 22(1)(b) of the Act.

34. Paragraph 22(1)(c) of the Act.

35. The vendor may be a non-resident of Canada; however, the vendor must be carrying on a business in Canada the income of which is subject to tax under subsection 2(3) of the Act.

36. The election is not available in respect of the disposal of assets by way of gift.

37. The election must specify the consideration paid for the accounts receivable and loans. The amount is final for tax purposes and is binding on the Vendor and the Purchaser. It is not

necessarily binding on the CRA. If the Vendor and the Purchaser deal not at arm's length and the fair market value of the accounts receivable is different than the amount paid for them, paragraphs 69(1)(a) or (b) could apply.

38. It is likely, however, that a court would resolve this issue based on the facts of the particular situation rather than a fixed percentage. See for example, Wood v. MNR, 87 DTC 312 (TCC), Keefe v. R., 2003 DTC 1526 (TCC), and Watts v. R., 2004 D.T.C. 3111(TCC).

39. Whether a business is comprised of more than one business is a question of fact. For CRA's views as to separate businesses, see IT-206R "Separate businesses" (October 29, 1979), IT-188R, supra note 29, IT-442R "Bad debts and reserves for doubtful debts" (September 6, 1991).

40. Edwin G. Kroft, "Tax Clauses in Acquisition Agreements" in Selected Income Tax and Goods and Services Tax Aspects of the Purchase and Sale of a Business, 1990 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1991), 9:1 at 9:88.

41. Subsection 18(9) of the Act.

42. See IT-287R2 "Sale of inventory" (January 30, 1999).

43. Subsection 10(1) of the Act allows the purchaser to value the inventory at the lower of cost or market. Regulation 1801 allows inventory to be valued at fair market value.

44. Section 54 of the Act "capital property".

45. Some consideration should be given to the cost of the asset. If the asset was acquired before 1972, reference must be made to the Income Tax Application Rules. Any gains accrued on capital properties before 1972 will be tax-free to the Vendor on a winding-up as pre-1972 capital surplus on hand.

46. Paragraph 38(a) of the Act.

47. Subsection 129(3) of the Act.

48. Section 123.3 of the Act.

49. Subsection 129(1) of the Act.

50. Subsection 89(1) of the Act "capital dividend account".

51. See the requirements in subsection 83(2) of the Act.

52. Paragraph 111(1)(b) of the Act.

53. Paragraph 39(1)(c) of the Act.

54. Subsection 13(21) of the Act “depreciable property”.

55. There are a number of complex provisions of the Act which determine the class to which assets be added for CCA purposes.

56. Regulation 1101. Separate classes for CCA purposes would be an indication that the business is a separate business. See the discussion concerning accounts receivable.

57. Paragraph 20(1)(a) of the Act.

58. Regulation 1100(2) of the Act.

59. Subsection 13(21) of the Act “undepreciated capital cost”.

60. Class 29 of Schedule II of the Draft Regulations for property acquired after March 18, 2007.

61. The straight-line basis is generally available only in respect of leasehold improvements, timber rights and limited life intangibles.

62. Regulation 1100(2).

63. One notable exception is for buildings having a capital cost exceeding $50,000.

64. For a discussion on replacement properties, see Adam Shapiro, "The Replacement Property Rules: A Bit More Than Before" in "Personal Tax Planning," (2002), vol. 50, no. 6 Canadian Tax Journal, 2141-2165 and Kwong supra footnote 1 at p.7. Also see IT-259R4 "Exchange of Property" (September 23, 2003).

65. Regulation 1101(1).

66. Regulation 1100(3).

67. Subsections 13(26) to (29) of the Act.

68. Subsection 20(16) of the Act. Where the depreciable capital property being disposed of is a building and land adjacent to or immediately contiguous to and necessary for the use of the building, the amount of the terminal loss otherwise realized on the disposition of the building will be reduced to the extent of the capital gain on the disposition of the land. See subsection 13(21.1) of the Act.

69. Subsection 129(4) of the Act provides that income pertaining or incident to an active business carried on by a company will not be investment income and will presumably have a source as active business income.

70. A capital loss will not arise as a result of the specific provisions of paragraph 39(1)(b) of the Act.

71. See Jack Millar's paper, supra footnote 4.

72. Pursuant to Regulation 1100(2). Note the exception to the half-year rule contained in Regulation 1100(2.2) for non-arm’s length transactions.

73. Subsection 14(5) of the Act "eligible capital expenditure".

74. That is, permitted by subsection 18(1)(b) of the Act.

75. Where intellectual property has a limited life, it may be a depreciable asset under Class 14. See IT-386R “Eligible capital amounts” (October 30, 1992), IT-143R3 “Meaning of eligible capital expenditure” (August 29, 2002).

76. Subsection 14(5) of the Act "cumulative eligible capital". Although the inclusion rate has been changed for capital gains and the amounts to be included in income on a disposition of eligible capital property, three-quarters of the purchase price payable for eligible capital property will be depreciated.

77. Paragraph 20(1)(b) of the Act.

78. Subsection 14(1) of the Act.

79. Paragraphs 89(1)(c.1) and (c.2) of the Act “capital dividend account”.

80. Section 24 of the Act.

81. In other words, the election is not available for internally generated eligible capital property. For a criticism of subsection 14(1.01) not applying to internally-developed eligible capital property, see Doug Frost & Sheryl Mapa, "ECP Election Inequity", 11(3) Canadian Tax Highlights (Canadian Tax Foundation, March 2003).

82. Note that capital losses would also affect the amount to be added to the capital dividend account.

83. Dealing with an election regarding property acquired with pre-1972 outlays or expenditures.

84. The exclusion from electing for property acquired in a rollover prevents the conversion of property with no determinable cost into property with a cost that is determinable for tax purposes.

85. Paragraph 20(1)(b) of the Act.

86. Queen v. Golden, 86 DTC 6138 (SCC), aff’g 83 DTC 5138 (FCA), rev’g 80 DTC 6378 (FCTD).

87. The Queen v. Derbecker, 84 DTC 6549 (FCA).

88. Paragraph 40(1)(a) of the Act. Note that a 10-year reserve is available in very limited circumstances under subsection 40(1.1) of the Act.

89. Paragraph 20(1)(n) and subsection 20(8) of the Act.

90. Subsections 14(1) and (5) of the Act. Subsection 14(1) provides that where, at the end of a taxation year, the cumulative eligible capital account has a negative balance, the negative balance is required to be included in the taxpayer's income for the year from that business. Pursuant to "E" of the definition of "cumulative eligible capital" in subsection 14(5), the amount the taxpayer "may become entitled to receive" in respect of the disposition of eligible capital property reduces the amount of the taxpayer's cumulative eligible capital. (As discussed above under "eligible capital property", with certain types of eligible capital property and in certain situations the Vendor may elect under subsection 14(1.01) to report a capital gain on the disposition of an eligible capital property. The CRA's administrative position is that a reserve may be available under subparagraph 40(1)(a)(iii) in these circumstances. See Technical Interpretation 2002-0133797 "Eligible capital property gains election" dated April 18, 2002, Technical Interpretation 2002-0122675 "Election quotas" dated May 1, 2002, and M. Thivierge, supra, fn.1.

91. If SellerCo purchases a new business, it is possible that the replacement property rules in the Act would apply to defer taxes payable on the sale.

92. Caution should be exercised since the return of capital impacts on the adjusted cost base of the shares to the Vendor and may result in a capital gain.

93. Assuming the requirements of subsection 83(2) of the Act are satisfied. See Stuart Hoegner, "The Best Things in Life are (Tax-) Free: A Current Look at the Capital Dividend Account" in "Personal Tax Planning," (2002), vol. 50, no. 4 Canadian Tax Journal, 1426-1457. Also see IT-66R6 "Capital Dividends" (May 31, 1991).

94. See Graham Turner, “Tax Issues in Acquisition Agreements” in Income Tax and GST Planning for the Purchase, Sale and Canadian-U.S. Expansion of a Business, 1996 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 8:1 and Jennifer Babe, "Sale of a Business" 5th ed. (Markham: LexisNexis, 2004) at 9.470.

95. For example, a section 22 election in respect of accounts receivable.

96. Paragraph 20(24)(a) of the Act. See Ron Choudhury, "Non-Resident Issues in Acquisition Transactions", *Report of the Proceedings of the Fifty-Sixth Tax Conference*, 2005 Tax Conference (Toronto: Canadian Tax Foundation, 2006), 42:1-42:14.

97. Paragraph 20(24)(b) of the Act.

98. Foresbec Inc. v. Queen, 2003 DTC 5455 (FCA), aff’g 2001 DTC 180 (TCC). See Bill Maclagan, "Foresbec: The "Sham Doctrine"", (2002) British Columbia Tax Conference.