Purchase and Sale of a Business – Share Sales

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Planning the Transaction

- Individuals are generally subject to a combined Ontario/federal tax rate of 26.57% on eligible dividends and at a rate of 23.21% on capital gains.

- Dividends from a CCPC are generally subject to tax in Ontario at a rate of 32.57%.

Planning the Transaction

- An eligible dividend is taxable dividend received by person resident in Canada, paid after 2005 by corporation resident in Canada and designated as such.

- CCPC's are able to pay dividends eligible for the enhanced dividend tax credit to the extent that their income (other than investment income) is subject to tax at the general corporate income tax rate.

Planning the Transaction

- Non-CCPC's may pay eligible dividends only after paying ineligible dividends up to low rate income pool ("LRIP"), i.e. taxable income subject to small business deduction.

- Corporations that make excessive eligible dividend designations are liable to a tax equal to 20% or 30% of excessive designation.

Planning the Transaction

- Corporations, other than CCPC's, are currently subject to combined Ontario / federal tax at 16% on capital gains. After July 1, 2010, this rate will be reduced to 15%.

- CCPC's are currently subject to combined Ontario / federal tax at 24.35% on capital gains. After July 1, 2010, this rate will be reduced to 23.35%.

Planning the Transaction

- Generally, corporations are not subject to tax on dividend income, but may pay a refundable tax at the rate of 33.33% under Part IV.

Planning the Transaction

- 26⅔% of a CCPC's taxable capital gains are included in its RDTOH account.

- When taxable dividends are paid to shareholders, a dividend refund equal to the lesser of 33⅓% of the dividends paid or the balance in the RDTOH account is refunded to the corporation.

Vendor Tax Considerations

- Consideration offered by the purchaser should take into account the vendor's tax position.
- Tax Status of Vendor
    - Non-Resident
    - Treaty or Non-Treaty
    - Resident
    - Non-Taxable or Taxable

Vendor Tax Considerations

- Vendor’s cost base exceeds value of shares
- Value of shares exceeds vendor’s cost base
- Significant cost base in shares, but less than value

Deferral of Gain-Debt Consideration

- A reasonable reserve is generally available where the consideration includes debt of the purchaser.
- Vendor must be a resident of Canada.
- Must recognize at least 20% of gain in the year of disposition and each of the following four years.

Deferral of Gain-Share Consideration

- Section 85 allows a vendor of shares to transfer them to a corporation and defer all or part of the gain where the consideration received includes shares of the purchaser corporation.

- Non-share consideration (boot) can be received without the deferral being lost if its value does not exceed the vendor's cost base.

Deferral of Gain-Share Consideration

- Elections must be filed between each vendor and the purchaser corporation; provincial elections may be required.
- Costly and administratively cumbersome in a takeover of a widely held corporation.
- The transferor under s.85 can be a resident or a non-resident.

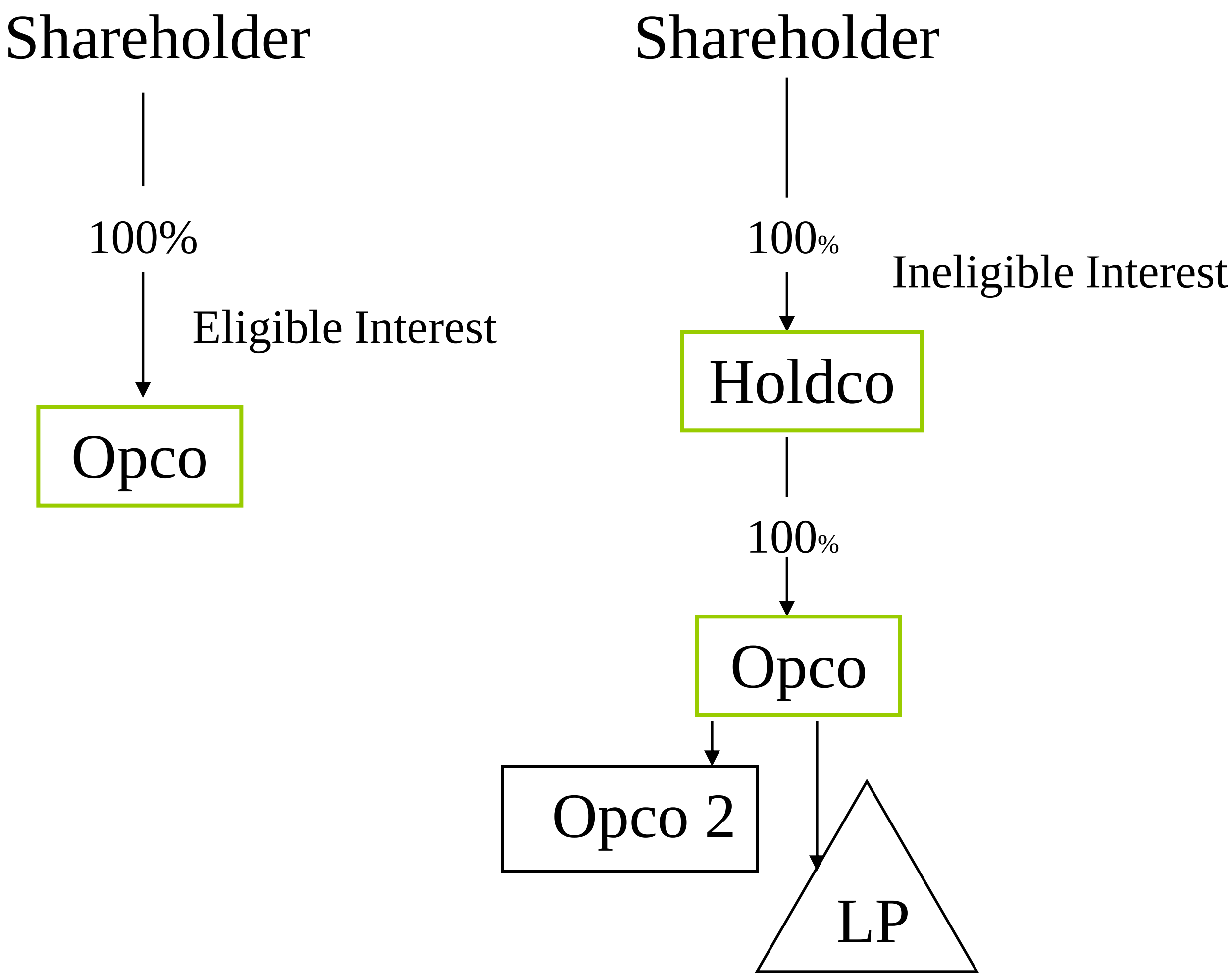
Non-Compete Payments

- *Manrell* and *Fortino* held non-compete payments to be non-taxable receipts.
- Proposed subsection 56.4(2) requires a taxpayer to include in income amounts in respect of restrictive covenants that are received or receivable in the year by the taxpayer or a non-arm’s length person.

Non-Compete Payments

- Joint election for capital gain treatment for amounts related to the disposition of an “eligible interest”
- Shares of a corporation that carries on a business to which the restrictive covenant relates or shares of a holding corporation where 90% of their value is attributable to eligible interests in one other corporation.

Non-Compete Payments



Non-Compete Payments

- Proposed section 68 to apply where consideration is in part for a taxpayer's agreement to be bound by a restrictive covenant.
- 3 exceptions exists.
- Proposed subsections 56.4(5) and (8) - section 68 not applicable if the covenant is integral to a written agreement under which the vendor disposes of shares of a target corporation to an arm's length purchaser.

Non-Compete Payments

- Proposed paragraph 212(1)(i) - Part XIII withholding tax on restrictive covenant payments made to non-residents.
- CRA's position is that non-compete payments are already subject to withholding tax under paragraph 212(1)(d)(iv).
- Proposed amendment to subparagraph 212(1)(d)(iv) – Subparagraph 212(1)(d)(iv) does not apply where 212(1)(i) applies.

Vendor Tax Considerations

Shareholder

100%

A Co.

- Adjusted Cost Base $1
- Retained Earnings $600,000
- Fair Market Value $1,000,000

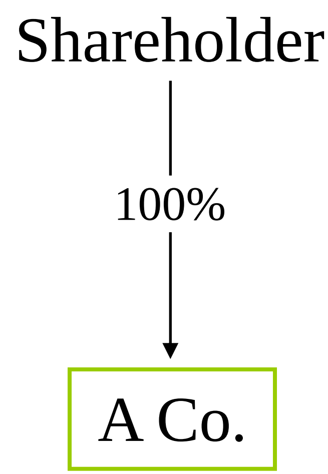
Capital Gains / Dividends

- Sale of Shares of A Co.
  - Capital gains of $1,000,000 subject to tax at 23.21% (i.e. taxes of $232,100)
- Deemed Dividend of $1,000,000 to increase ACB of Shares of A Co and sale for no gain.
  - Dividend of $1,000,000 subject to tax at 32.57% (i.e., taxes $325,700)

Capital Gains / Safe Income Strips

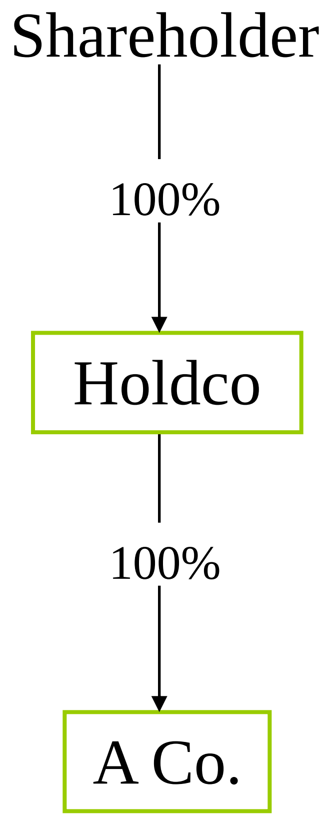
- Implement a safe income strip.
- Transfer of shares of A Co. to Holdco and file an election under section 85 to effect on a rollover basis.

Safe Income Strips



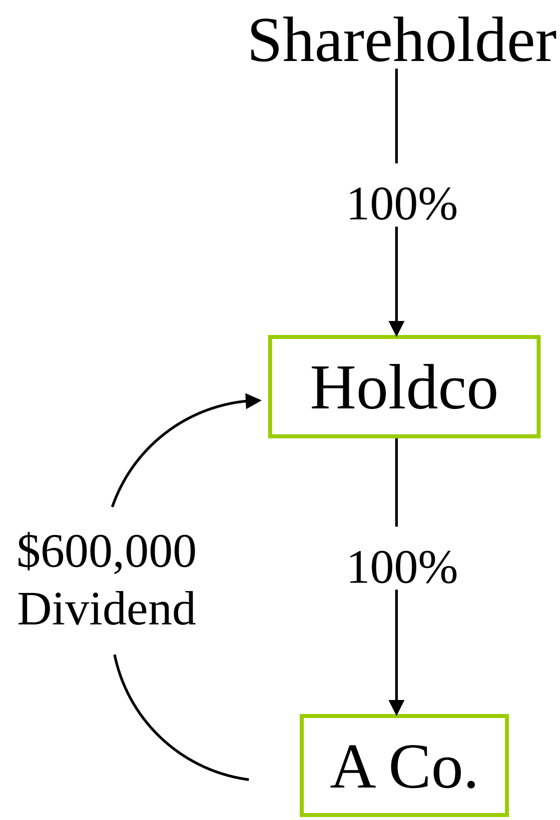
➢Adjusted Cost Base	$1
➢Retained Earnings	$600,000
➢Fair Market Value	$1,000,000

Safe Income Strips



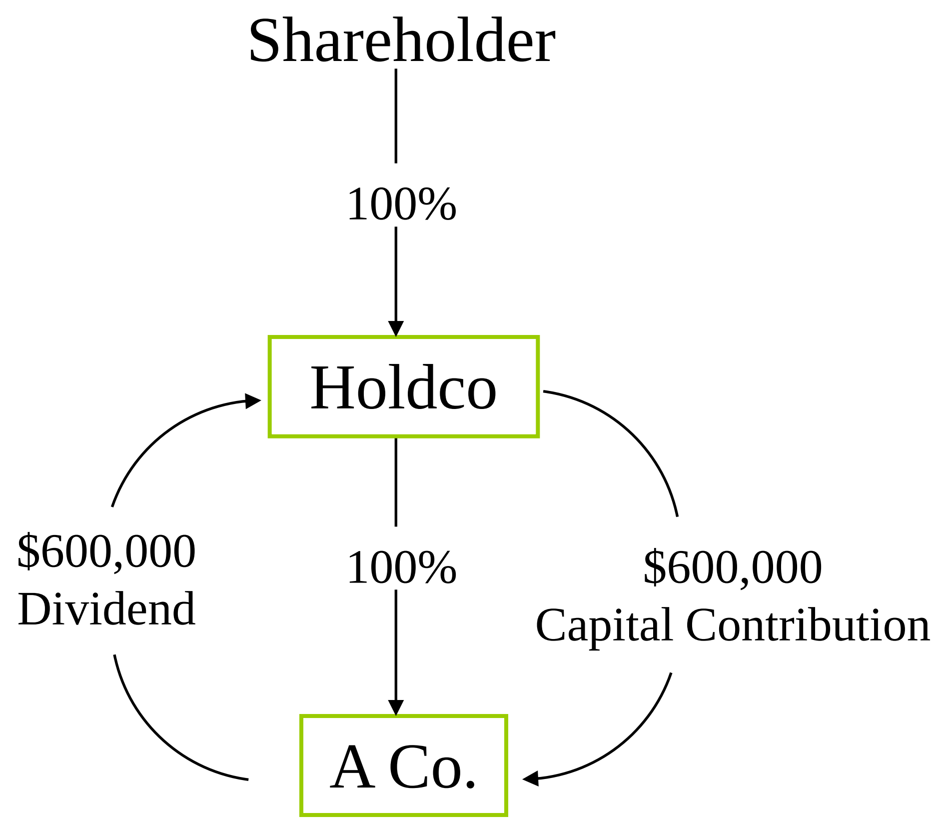
- Adjusted Cost Base $1
- Fair Market Value $1,000,000

Safe Income Strips



- Adjusted Cost Base $1
- Fair Market Value $400,000

Safe Income Strips



- Adjusted Cost Base $600,001
- Fair Market Value $1,000,000

Safe Income Strips

- Safe income dividend of $600,000 paid to Holdco.
  - No tax in Holdco on dividend income.
- Reinvestment of $600,000 in A Co. and sale of shares of A Co. for $1,000,000.
  - Increases ACB by $600,000 and the $399,999 capital gain taxed at 24.35% (i.e., tax of $97,400), with a portion being refundable.

Safe Income Strips

1. Deemed Dividend by Increase in Paid-Up Capital – s. 84(1)
   - Adjusted Cost Base Increase –
     s. 53(1)(b)
   - Not available where converting contributed surplus (see proposed s. 53(1)(b))

2. Actual Dividend followed by Capital Contribution
   - Adjusted Cost Base Increase –
     s. 53(1)(c)

3. No ACB increase with Stock Dividends

Safe Income Strips

Why stop at the retained earnings?

1. Dividend in excess of “safe income” is deemed to be a capital gain or proceeds of disposition under subsection 55(2).
2. Series of dividends vs. paragraph 55(5)(f) designation.

Non-Resident Income Strip

- Where Canco shares are held by a US resident and they derive value principally from real estate, the taxable capital gain will be subject to tax at normal corporate rates.
- U.S. corporation owning at least 10% of Canco voting shares subject to 5% withholding tax on dividends.
- Consider CRA position on GAAR.

Capital Gains Deduction - QSBC

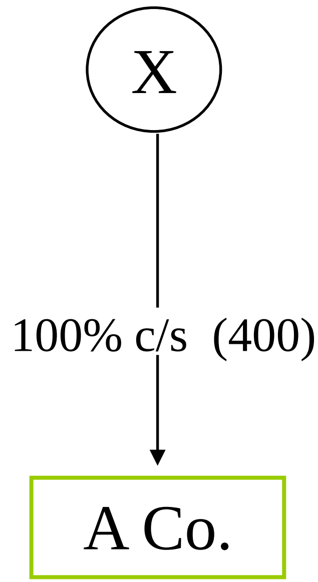
- Individual resident in Canada is entitled to an exemption from tax on $750,000 of capital gains realized on the disposition of shares of a "qualified small business corporation."

- Deduction is provided in s. 110.6.

Capital Gains Deduction - QSBC

- A QSBC share must meet three tests:
  - the small business corporation test;
  - the holding period ownership test; and
  - the holding period asset test.

Combined Strip/Exemption



➢Fair Market Value	$1,000,000
➢Safe Income	$600,000
➢Adjusted Cost Base	$1

Capital Gains/Safe Income Strips

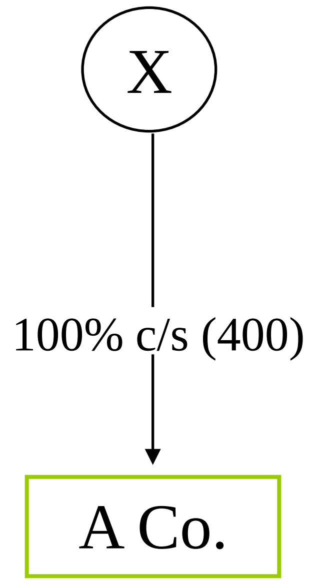
- Sale of shares for $1,000,000 would result in the individual incurring a tax liability of $232,100.

- If the shares qualify for the capital gains exemption, the tax liability would be $58,025.

Capital Gains / Safe Income Strips

- Hybrid Transaction
  - X reorganizes the share capital of A Co. and exchanges 100 of the 400 outstanding common shares for 100 Class B Non-Voting Common Shares –
    s. 51 or s. 85
  - X transfers 100 Class B Non-Voting Common Shares of A Co. to a new holding corporation (“Holdco”) in exchange for shares of Holdco and elects under s. 85

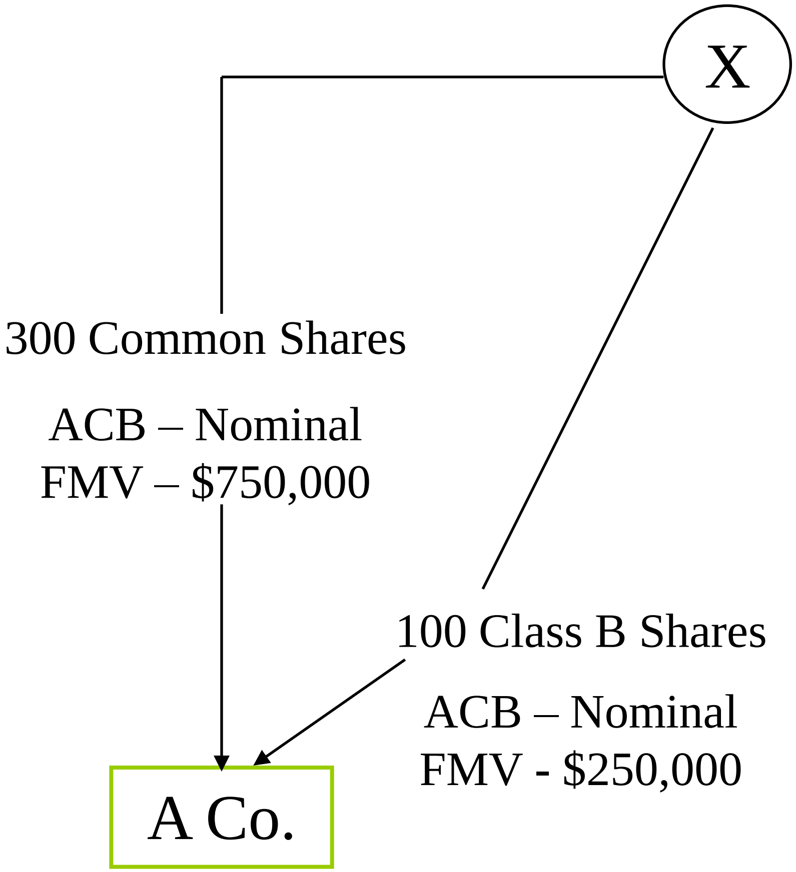
Combined Strip/Exemption



- Fair Market Value $1,000,000
- Safe Income $600,000
- Adjusted Cost Base $1

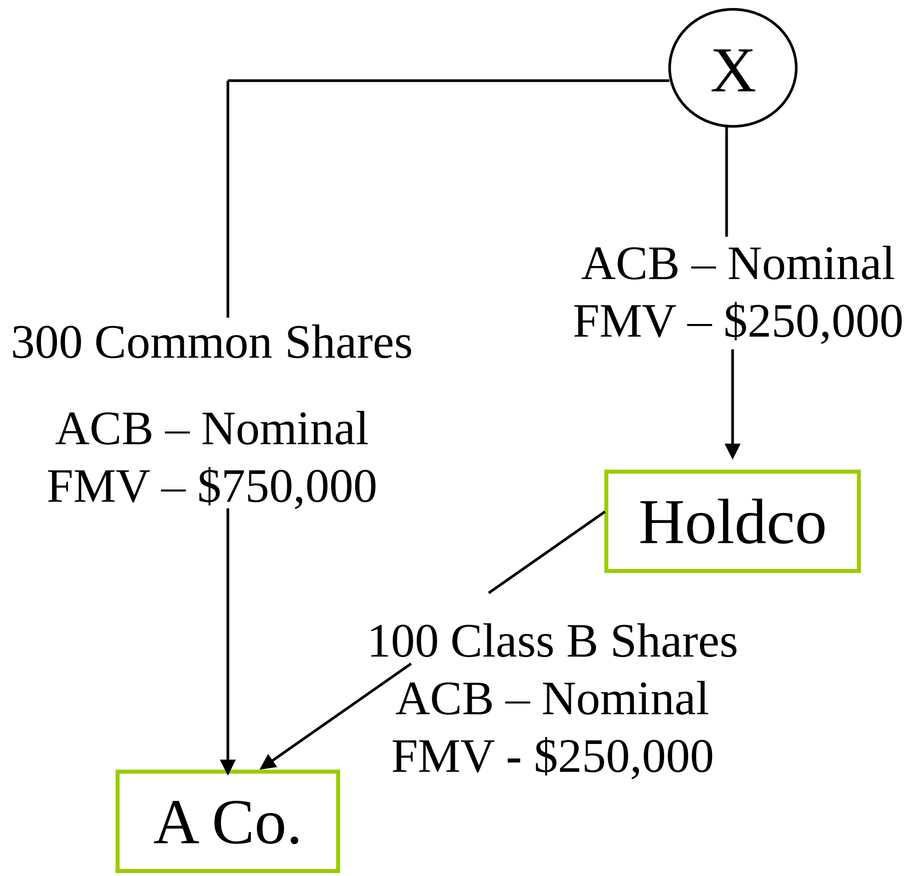
Capital Gains / Safe Income Strips

Hybrid Transaction



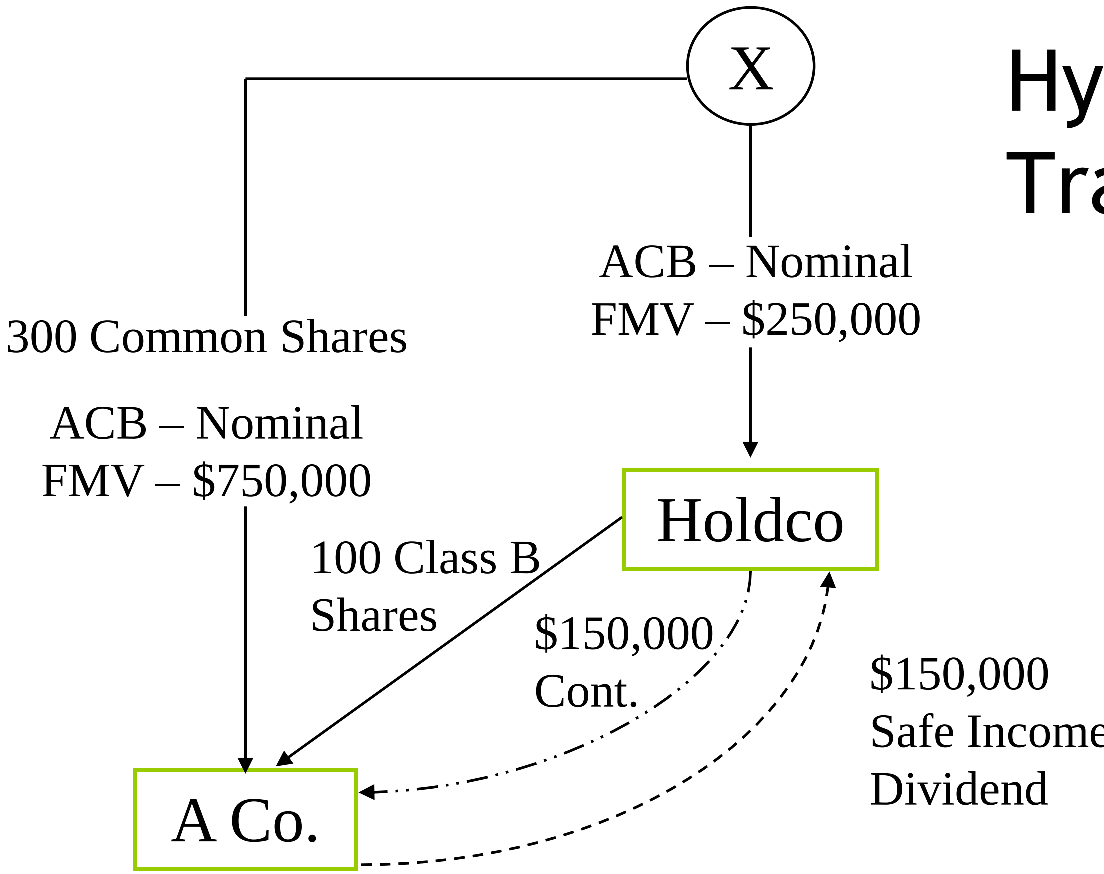
Capital Gains / Safe Income Strips

Hybrid Transaction



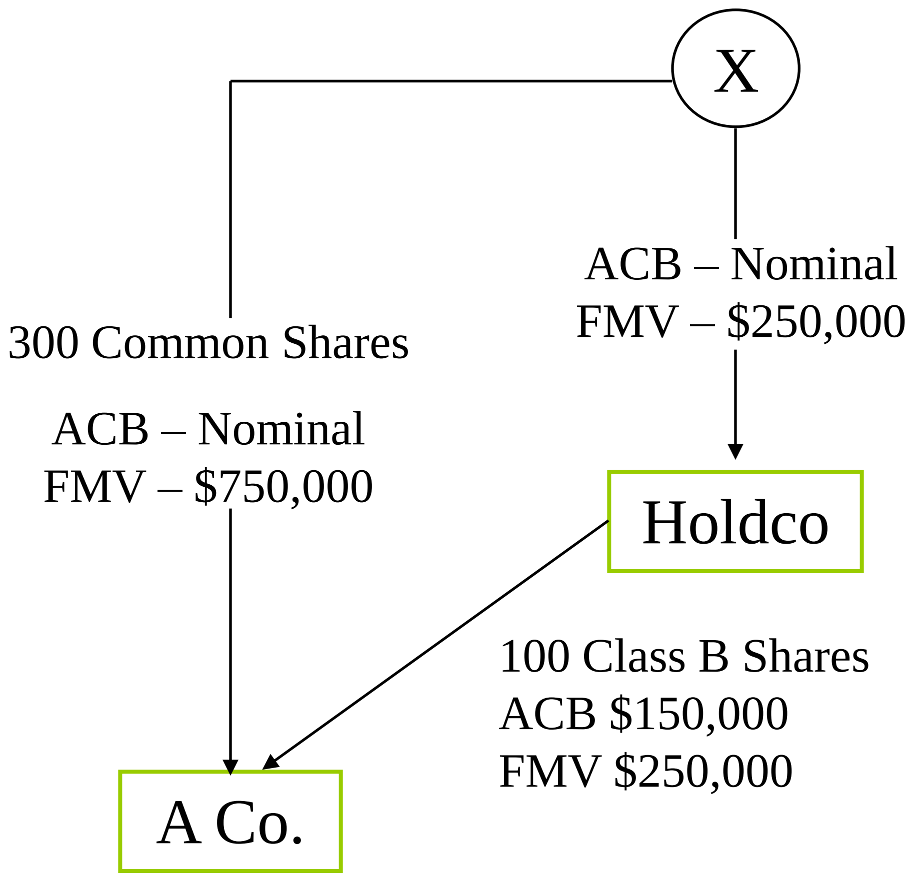
Capital Gains / Safe Income Strips

Hybrid Transaction



Capital Gains / Safe Income Strips

Hybrid Transaction



Capital Gains / Safe Income Strips

- Hybrid Transaction
  - X sells Common Shares of A Co. for $750,000 and claims s. 110.6 deduction.
  - A Co. pays $150,000 dividend to Holdco, which is not subject to tax, and Holdco makes a $150,000 contribution of capital to A Co.
  - Holdco sells Class B Shares for $250,000 and a $100,000 capital gain is realized. Holdco pays tax of $24,350.

Non-Resident Purchaser

Vendor

100%

Cdn Target

Fair Market Value	$5M
Adjusted Cost Base	$1M
Paid-up Capital	$1M

Non-Resident Purchaser

US Co.

100%

Cdn Target

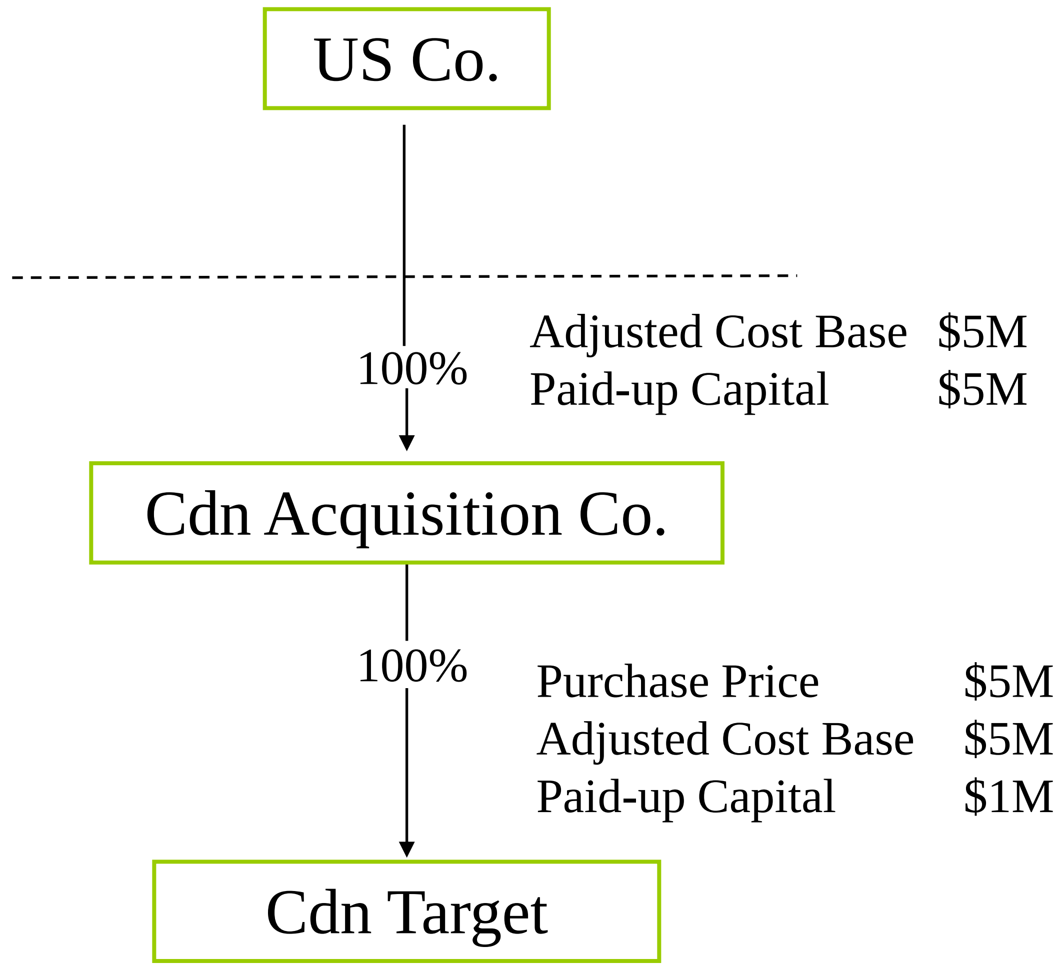
Purchase Price	$5M
Adjusted Cost Base	$5M
Paid-up Capital	$1M

Non-Resident Purchaser

- Amount distributed by Canadian Target in excess of $1 million will be deemed to be a dividend subject to Canadian withholding tax at a rate of 25%.

- Rate may be reduced under the provisions of an applicable bilateral tax convention.

Non-Resident Purchaser

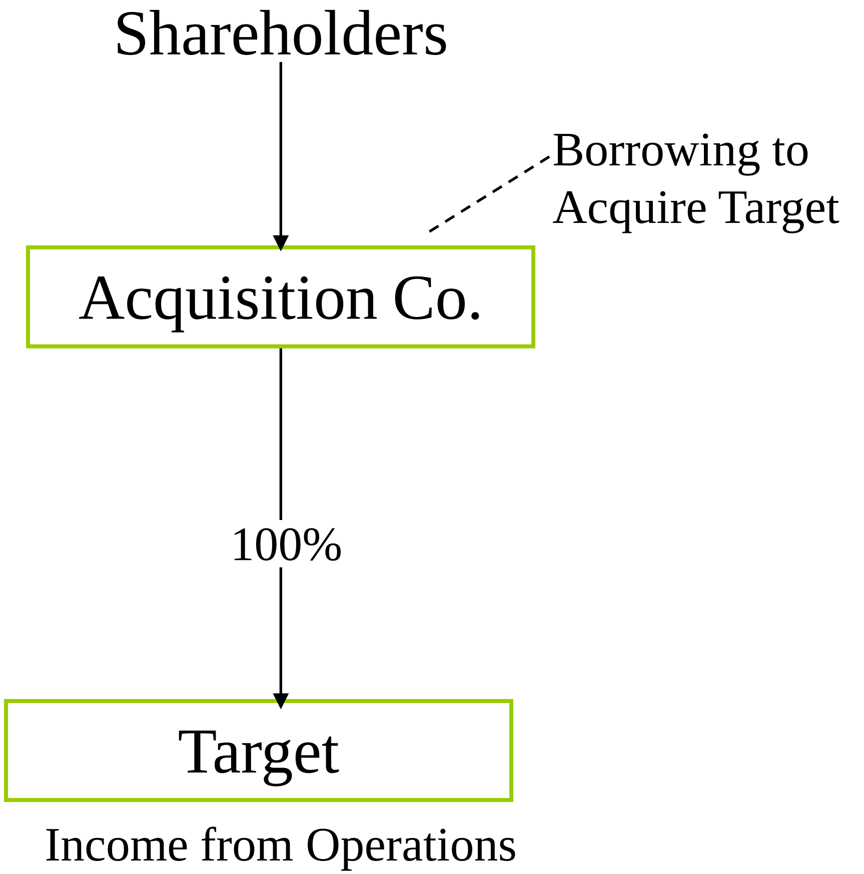


Financing the Purchase

- Deduction for interest on borrowed money used for the purpose of earning income from a business or property.

- CRA's position is that interest on money borrowed to acquire common shares is generally deductible under paragraph 20(1)(c) and (d).

Financing the Purchase



Financing the Purchase

Shareholders

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Amalco

- Interest deduction against income from operations
- Interpretation Bulletin IT-533/linkage
- Increased capital tax liability – eliminated federally, eliminated in Ontario on July 1, 2010

Loss of Small Business Deduction

- A Canadian-controlled private corporation ("CCPC") is entitled to the small business deduction.
- A deduction from tax otherwise payable equal to 17% of the least of
  - a) Corporation's active business income for year
  - b) Taxable income for year
  - c) Business limit for year

Loss of Small Business Deduction

- Business limit is $500,000.

- Must be CCPC throughout the year.

Loss of Small Business Deduction

- Paragraph 251(5)(b) deems a person who has a right to acquire shares to be in same position as if the person owned the shares.

- Non-resident purchaser / public company purchaser will cause CCPC-target to lose status when the purchase agreement is entered into even though no closing.

249(3.1) Trap

- Subsection 249(3.1) deems a corporation to have a year-end on becoming or ceasing to be a CCPC.
- Paragraph 249(4)(a) deems a corporation to have a year-end immediately before an acquisition of control of the corporation.
- Entering into an agreement to acquire a controlling interest is not an acquisition of control.

249(3.1) Trap

- Therefore potentially two year-ends.
- CRA does not appear to be prepared to grant administrative relief.

Stepping-Up the Inside Basis

- Acquisition of assets gives the purchaser tax cost for the assets equal to the purchase price.

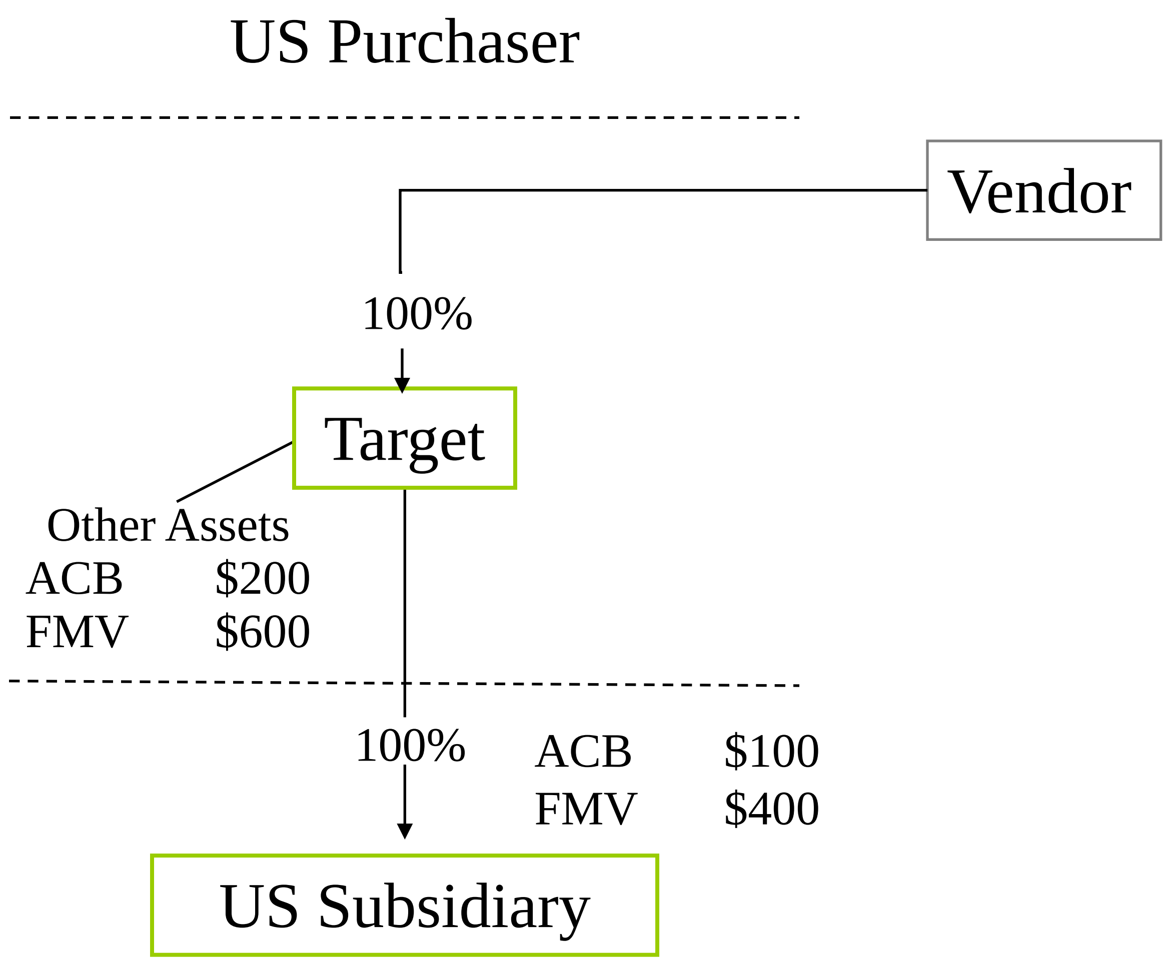
- Acquisition of shares does not increase the tax bases of assets owned by the corporation.

Stepping-Up the Inside Basis

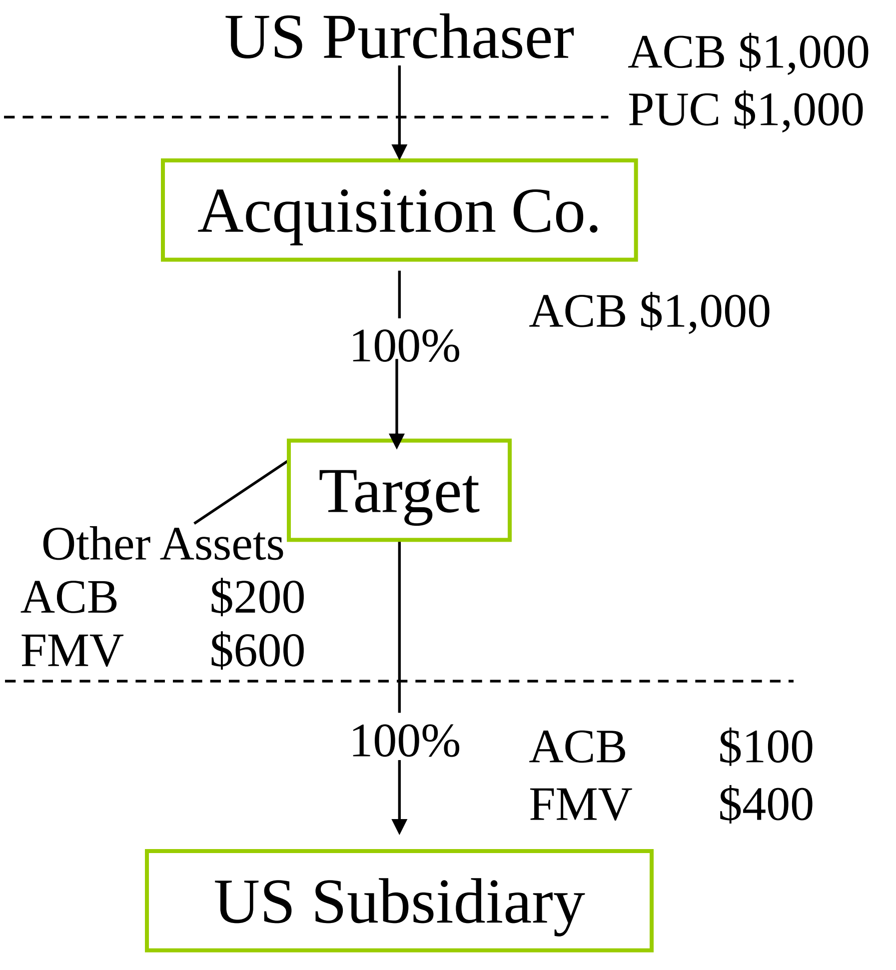
- Canadian target corporation may have unwanted assets or own non-Canadian affiliates.

- Bump transaction allows the purchaser to increase the tax cost of shares and partnership interests held by the target corporation at the time control was acquired.

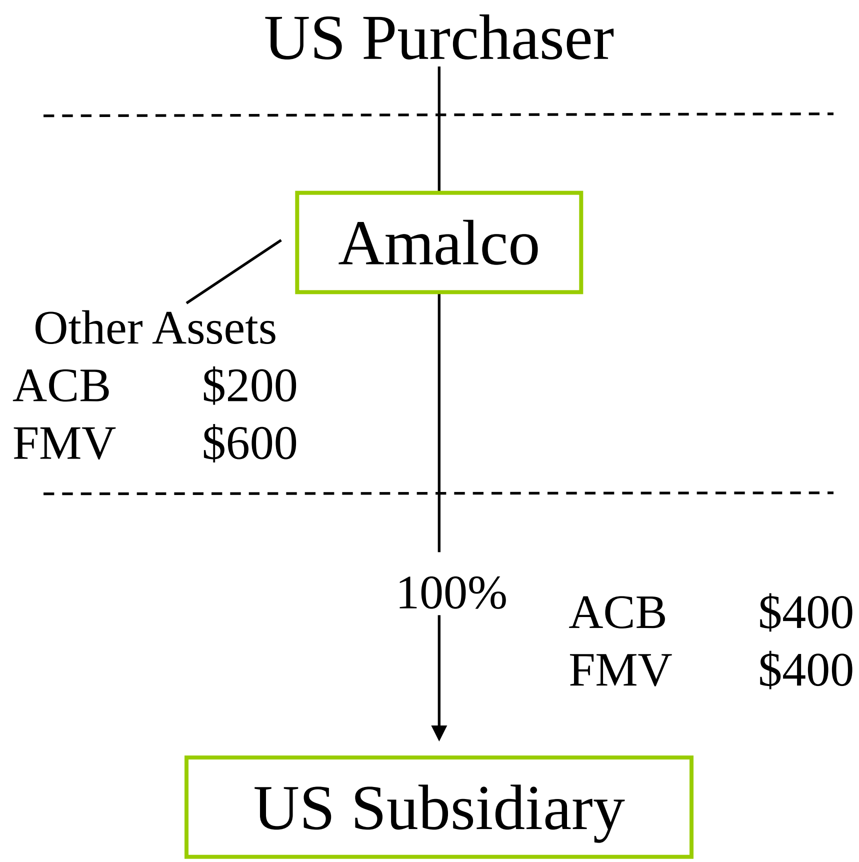
Stepping-Up the Inside Basis



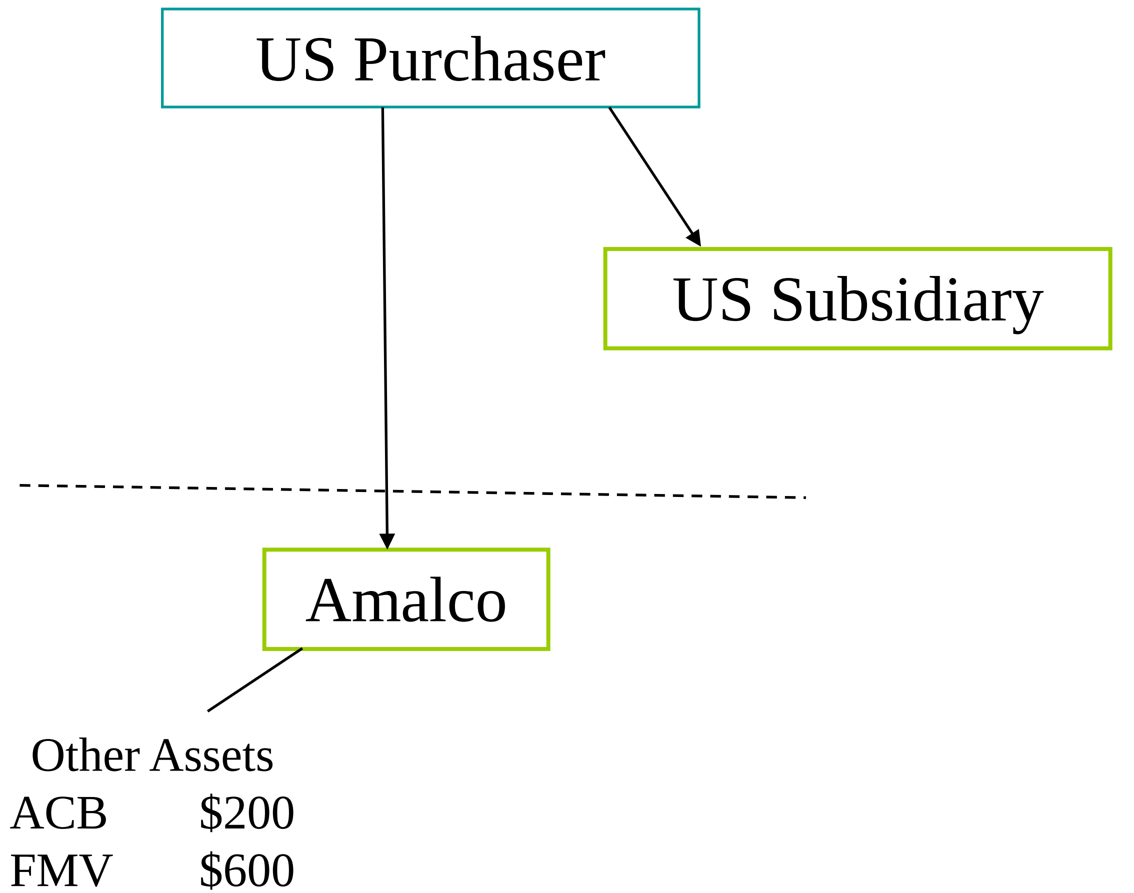
Stepping-Up the Inside Basis



Stepping-Up the Inside Basis



Stepping-Up the Inside Basis



Exchange of Options

- Employees relinquish options for cash or exercise options before certain take-up of shares.

- Employees of a target company exchange existing stock options (“Old Options”) for stock options of new public parent company (“New Options”).

Exchange of Options

- 7(1.4) "rollover" applies if:
  - employee receives no consideration for the disposition of the Old Option other than the New Options from a designated person; and
  - the total value of new shares under the New Option (less new exercise price) does not exceed the total value of the old shares under Old Option (less old exercise price).

Exchange of Options

- Example:
  - Terms of Old Option:
    - exercise price per share: $10
    - value of share: $13
  - Terms of New Option:
    - exercise price per share: $?
    - value of share: $15

Exchange of Options

- If new exercise price is $12 or more then subsection 7(1.4) will apply to provide rollover treatment.

- If new exercise price is less than $12 then subsection 7(1.4) will not apply.

Exchange of Options

- If value of new shares is not known with certainty, then the stock option plan for New Option could provide for exercise price by way of formula to ensure 7(1.4) applies.

- If 7(1.4) does not apply, the tax consequences will be governed by paragraph 7(1)(b).

Exchange of Options

- Income inclusion equal to excess of value of New Option received over the amount paid, if any, to acquire the Old Option.
- 1/2 deduction under paragraph 110(1)(d) may be available.
- Cost base to employee of New Option should be equal to value of Old Option at time of exchange.

Option for Cash Payment

- Where the employee opts to receive cash in lieu of shares paragraph 7(1)(b) will apply in respect of the payment received; however, Budget 2010 proposes that paragraph 110(1)(d) will only apply if the employer elects to forego any deductions in respect of the “cash out” payment to the employee.

- In a takeover context, an amount paid by the employer in settlement of an option may often be considered a capital outlay and not deductible. See *Canada Forgings Ltd*. and *Kaiser Petroleum Ltd*. See also, however, *Shoppers Drug Mart*.

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