1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

ASSET PURCHASE TRANSACTIONS – PART 2

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the tax implications of various aspects of asset purchase transactions. Alpert Law Firm is experienced in providing legal services to its clients in tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions and estate administration.

This memorandum deals with select tax considerations arising from the purchase and sale of assets including Earnout Agreements, transfers under subsection 85(1) of the *Income Tax Act*, Harmonized Sales Tax considerations, and Land Transfer Tax considerations from the respective viewpoints of the purchaser and the vendor.

A. EARNOUT AGREEMENTS

When negotiating a sale agreement, parties may have a limited capacity to affix a value to the company's future earnings and thus may encounter difficulty agreeing upon a final sale price. A strategy commonly employed to overcome this obstacle is the use of an earnout provision, whereby the portion of the proceeds of disposition that is determinable by future earnings generated by the corporation is payable at a later date. These payments may be payable on a periodic basis or in a lump sum.

The general position taken by the Canada Revenue Agency (the "CRA"), as set out in Interpretation Bulletin IT-426R, is that where the purchase price is a fixed sum plus an earnout, the fixed sum will be treated on account of capital and the earnout payments will be required to be included in computing income under paragraph 12(1)(g) of the Income Tax Act (the "Act").

The CRA has made special allowance for earnout payments in a share sale to be exempt from inclusion under paragraph 12(1)(g) of the Act, but has never confirmed that asset sales can benefit from this same treatment. Case law in the area is also unclear. In *Varga v MNR* (84 DTC 1278), the Tax Court of Canada found that where an amount paid for goodwill was subject to an earnout clause, the amounts received by the taxpayer were in respect of goodwill and therefore were capital receipts.

Subsequently, in *289018 Ontario Ltd. v MNR* (87 DTC 38), the Tax Court held that where the consideration received for eligible capital property ("ECP"), such as goodwill and know-how, is dependant upon the use or production from property, it is taxable as income under paragraph 12(1)(g) of the Act.

In *Rouleau Estate v Canada* (91 DTC 115) the taxpayer, who was a chartered accountant, entered into an agreement to sell his list of clients to a chartered accounting firm. The purchase price payable for the list of clients was 20% of the amount of gross fees earned from the clients on the taxpayer's list of clients per annum over a 5-year period. The Tax Court allowed the taxpayer's appeal and held that where amounts payable were paid, according to a predetermined percentage of future gains over a fixed period of time, the amounts received by the taxpayer were in respect of goodwill and paragraph 12(1)(g) of the Act did not apply.

However, in *Smith v Canada* (2011 TCC 461), an insurance brokerage sold its client list and the purchase price was payable in annual instalments over a 4-year period. The purchase agreement set out the amount of the annual payments but they were to be increased or decreased depending upon the commission revenue earned by the purchaser in the year preceding the payment. The purchaser was also required to pay interest. The Tax Court found that the annual payments were taxable under paragraph 12(1)(g) of the Act because the initially agreed upon purchase price was only an estimate that could fluctuate depending on the annual commissions earned from the purchased client list. Consequently, although the annual payments were expressed as instalments of the purchase price, they were entirely dependent on the use of or production of the client list and were taxable under paragraph 12(1)(g) of the Act. The Tax Court found that the interest payments were taxable under paragraph 12(1)(c) of the Act because they were accessories to the principal payments, which were taxable under paragraph 12(1)(g) of the Act.

The tax treatment accorded earnout agreements in asset sales is far from clear. Parties to an asset sale who are contemplating using an earnout agreement should undertake careful analysis of the underlying legal form of the transaction and solicit legal tax advice before entering into such an agreement.

In 2014, the federal government released new proposed rules regarding the tax treatment of eligible capital property and invited the public to make submissions in regards thereof. The proposed rules would eliminate the tax advantages associated with ECP by introducing a new class of property for the purposes of capital cost allowance and taxing ECP in the same way that gains on other depreciable property are taxed. The effect of the proposed rules would be a 10% increase in the tax payable on gains on ECP. The possibility of the government adopting the proposed rules may be a

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

relevant consideration for individuals who are currently considering selling their business.

B. SUBSECTION 85(1) TRANSFERS

(a) Eligible Transactions

The general rule governing a transfer of assets to a corporation is that assets must be transferred at their fair market value (their "FMV"). Subsection 85(1) of the Act provides an exception to this general rule in the form of a rollover. In particular, pursuant to a subsection 85(1) rollover, parties can elect to transfer certain assets to a corporation in exchange for shares at amounts which will result in either a deferral or minimization of tax.

Assets that are eligible for a tax deferred transfer to a corporation pursuant to a subsection 85(1) rollover, include: (i) capital property, including depreciable assets and accounts receivable; (ii) eligible capital property, such as goodwill; (iii) inventory (other than real estate), including the work-in-progress of a taxpayer who is a professional; and (iv) Canadian resource property and foreign resource property. Assets that are not eligible for a subsection 85(1) rollover, include: (i) real property, an interest therein, or an option in respect thereof, where the transferor is a non-resident person or a non-Canadian partnership; (ii) real property that represents inventory to the taxpayer; and (iii) prepaid expenses.

To qualify for a subsection 85(1) rollover, the transferor of the property must receive at least one share in the capital stock of the purchasing corporation as consideration for the transfer. In addition to this one share, the transferor may also receive non-share consideration from the purchasing corporation. Such non-share consideration could include cash, promissory notes, the assumption of liabilities, or any other property.

For additional information regarding subsection 85(1) rollovers, see the issues of the Legal Business Report on this topic.

(b) Section 85 Elections

In order to claim the subsection 85(1) rollover, the purchasing corporation and the transferor must jointly execute and file with the CRA an election on the prescribed form on or before the earlier of the days on which the transferor and the purchasing

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

corporation are required to file their respective tax returns for the taxation year in which the transaction occurred.

On the prescribed election form, the parties must state an "elected amount" for each asset transferred. This elected amount is then deemed to be the transferor's proceeds of disposition for the asset and the purchasing corporation's cost of acquisition. Subject to certain limitations, the parties usually choose an elected amount equal to the transferor's tax cost of the asset transferred, as follows: (i) for a non-depreciable capital asset such as land or shares: the transferor's adjusted cost base;
(ii) for a depreciable asset such as a building, machinery, or equipment: the transferor's undepreciated capital cost; (iii) for eligible capital property such as goodwill: four-thirds of the transferor's cumulative eligible capital; and (iv) for other assets such as inventory: the transferor's cost (with the exception that no subsection 85(1) election may be made in respect of real property inventory). By following these rules in choosing the elected amounts, the transferor will not be liable for tax on the transfer of the property; rather, the purchasing corporation will assume the transferor's position with respect to the capital gain, recaptured depreciation, or other unrealized income inherent in the assets.

It is open to the parties to choose a different elected amount other than the tax cost of the transferred asset within certain limitations set out in subsection 85(1) of the Act. The upper limit on the elected amount is the asset's FMV at the time of the transfer. In the event that the parties elect a higher amount, the elected amount is automatically reduced to the FMV. The lower limit on the elected amount is the lesser of the value of the asset at the time of the transfer and the cost amount of the asset to the transferor (i.e. the adjusted cost base for a non-depreciable asset, the undepreciated capital cost for a depreciable asset, four-thirds of the cumulative eligible capital for eligible capital property, or the cost of other assets). In the event that the parties choose an elected amount that is lower than the lower limits imposed by section 85 of the Act, the elected amount is automatically increased to the lower limit.

In addition, the parties cannot choose an elected amount that is less than the value of any non-share consideration received for the transferred asset. Again, in the event that the parties choose an elected amount that is less than the value of any non-share consideration received by the transferor as consideration for the transferred asset, the elected amount would be automatically increased to the value of the non-share consideration, which may result in the triggering of tax consequences to the transferor.

A price adjustment clause is generally used to retro-actively adjust the elected amounts in the event they are successfully challenged by the CRA.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

(c) <u>Late or Amended Section 85 Elections</u>

Subsection 85(6) of the Act prescribes the time limits within which an election under subsection 85(1) or subsection 85(2) of the Act must be filed. In particular, an election must be made on the earliest date when any party to the election must file an income tax return for the taxation year in which the transfer occurred pursuant to section 150 of the Act. Subsection 150(1) of the Act requires an individual to file an income tax return for the calendar year in which the individual has disposed of a capital property or has a taxable capital gain.

Subsection 85(7) of the Act allows an election to be filed up to 3 years after the filing deadline set out in subsection 85(6) of the Act, where an estimate of the penalty was paid by the taxpayer or partnership, as the case may be, when the election was filed.

Subsection 85(7.1) of the Act allows an election to be filed beyond 3 years after the filing deadline set out in subsection 85(6) of the Act, or an election to be amended, where it would be just and equitable in the circumstances. The election or amended election must be made in prescribed form and an estimate of the penalty must be paid when the election or amended election is filed.

Pursuant to the CRA's Information Circular 76-19R3, an amended election will generally be accepted if it involves: (i) a change to an inaccurate valuation of the property that gave rise to unintended tax consequences; (ii) a reduction of the agreed amount of transferred shares to the correct cost amount when a transfer at cost was intended; (iii) a correction of situations where it is clear that the insertion of an amount was made in error; or (iv) a correction of other situations which give rise to unintended tax consequences. The CRA will correct clerical errors without requiring an amended election.

An amended election will not be accepted where, in the view of the CRA the main purpose of the amended election is: (i) to effect retroactive tax planning; (ii) to take advantage of statutory amendments enacted after the election was filed; (iii) to improperly avoid or evade tax; or (iv) to change the agreed amount in a statute-barred year.

Subsection 85(8) of the Act prescribes the penalty for a late and amended election made pursuant to subsection 85(7) or subsection 85(7.1) of the Act. In particular, the penalty is the lesser of: (i) one-quarter of one percent of the amount (0.25%), if any, by which the FMV of the property at the time of disposition exceeds the amount agreed upon in the election or amended election by the taxpayer or partnership, as the case may be, and the corporation, for each month or part of a month after the original due date and before the filing of the late or amended election and (ii) $100 for each month or part of a month after the original due date and before the filing of the late or amended election, not to exceed $8,000. Elections filed after the 3-year deadline will only be accepted if, in the opinion of the Minister of National Revenue, it is just and equitable to allow the late-filed election subject to the late filing penalty. It should be noted that the penalty is not discretionary and the Act does not permit a reduction or waiver of the penalty.

The equitable remedy of rectification may also be available for parties who are faced with an unexpected tax consequence because their original intention was not accurately reflected in their purchase agreement. There are three criteria that must be established in order to obtain rectification: (1) the existence and content of the prior agreement; (2) an error in the written instruments such that the instrument is not consistent with the prior agreement; and (3) a proposed correction that shows the precise form in which the written document can be made to express the prior agreement. If a document is sought to be rectified to avoid taxation, it must also be established that the original purpose of the transaction was to avoid taxation in a particular way, not simply to avoid an unexpected tax advantage. In other words, rectification is not available to parties attempting to achieve retroactive tax planning when faced with an unintended tax consequence; rectification is available to parties so that they can correct a mistake in the documentation of their agreement so that it will align with their true intentions.

In *Kaleidescape v Computershare* (2014 ONSC 4983), the Ontario Superior Court of Justice granted rectification to a taxpayer of a deed of trust that the CRA had interpreted as having the effect that the taxpayer was no longer a Canadian-controlled private corporation (“CCPC”). The taxpayer was originally set up as a deadlock corporation, such that it would not be controlled by a non-resident and would qualify as a CCPC. However, an amendment to the deed of trust inadvertently gave a non-resident person effective control over the taxpayer and the CRA argued that the taxpayer could no longer qualify as a CCPC. The Court found: (1) the parties to the deed of trust had always intended that the taxpayer would be a CCPC, since the taxpayer had no other functions than research and development and it was required to be classified as a CCPC to be eligible to claim the highest level of federal scientific research and experimental development tax credits and Ontario innovation tax credits; (2) the wording in the deed of trust that prevented the taxpayer from being a CCPC was chosen by mistake; and (3) the proposed correction to the deed of trust would correct the mistake in the original wording.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

C. HARMONIZED SALES TAX CONSIDERATIONS

The impact of the harmonized sales tax (the "HST") on the transfer of each of the assets will, with certain exceptions, depend upon the HST rules applicable on the transfer of each type of asset. In particular, the transfer of certain assets including cash, prepaid expenses (unless they relate to an exempt supply), inventory (unless the goods in inventory are zero-rated under the HST legislation), fixed assets, leases of real property or tangible personal property, and intangible property supplied in Canada will be subject to HST based on the FMV of the assets being transferred.

Where such assets constitute assets of a business that is carrying on a commercial activity within the meaning of the HST legislation, the transferee corporation would be able to claim an input tax credit for the HST paid on the costs of the transfer, including legal and accounting fees. By contrast, the transfer of debt securities or loans, accounts receivable or residential real estate will not attract HST since these are exempt supplies pursuant to the HST legislation and therefore the transferee corporation will not be able to claim an input tax credit for HST paid on the costs of the transfer. For transfers of assets, the entire value of goodwill on the sale of a business or part of a business, regardless of whether the goodwill is attributable to commercial or non-commercial activity, is exempt from HST.

There are two types of elections under the HST legislation which may apply to effectively eliminate the HST payable on a transfer of assets to a corporation.

The first election, under section 167 of the *Excise Tax Act* (the "ETA"), applies where both the transferor and the transferee are registrants and all or substantially all of the assets used by a business in a commercial activity are being transferred. In this case, the transferor and the transferee may file a joint election to treat the transfer as a zero-rated supply. As a result: (i) the transferee would be able to claim an input tax credit for the HST paid on the acquisition costs and (ii) the applicable rate of HST would be nil.

The following rules apply with regard to the above-mentioned election under section 167 of the ETA: (i) the election is also available upon the sale of <u>part</u> of a business of a supplier, provided that the part constitutes all or substantially all of the property that the recipient would require to carry on that part as a business; (ii) the election applies to property sold as part of a business used in both <u>commercial and non-commercial</u> activities rather than only property used in commercial activities; and (iii) the election is available for transfers of <u>ownership, possession, or use</u> of all or substantially all of the property that the recipient requires to operate the business, which would allow

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

some of the property to be leased to the recipient. Where the conditions of this election are met, it will be effective if the prescribed election form is filed with the recipient's tax return for the reporting period in which the supply is made.

The second type of election can be made pursuant to section 156 of the ETA. This election is available for transfers that involve two registrants that are Canadian resident corporations and the two corporations are closely related (ie. 90% common voting shareholdings). Where this ongoing election is made, most taxable supplies between such corporations will be deemed to be for nil consideration and therefore, no HST will arise on transfers between them. It should be noted that transfers of real property or goods not for use exclusively in a commercial activity between such corporations are not covered under this election. For transfers of other assets between qualifying corporations, the election is available regardless of whether all or substantially all of the assets used in a commercial activity are being transferred.

Effective January 1, 2015, parties to a section 156 election must file an election in a prescribed manner. The deadline for filing the election will be the first day on which any of the electing parties is required to file a corporate tax return for the period in which the election becomes effective. The election is automatically revoked on the day on which either of the joint electors ceases to qualify as a specified member of a closely related group. The joint election or a voluntary revocation of such an election can be made at any time but must specify its effective date.

Also effective January 1, 2015, the availability of group relief was extended to new members of a group of corporations that have not yet acquired any property, provided that the new members continue as going concerns engaged exclusively in commercial activities. Additionally, parties to an existing or new group relief election are jointly and severally liable with respect to the HST liability that may arise in relation to supplies made between them.

D. LAND TRANSFER TAX CONSIDERATIONS

(a) Imposition and Rate of Tax

Ontario imposes a land transfer tax on certain conveyances of land in the province. This tax is generally payable by the transferee and is levied upon the value of consideration passing to the grantor or transferor pursuant to the conveyance.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

The rates of tax escalate with the value of consideration given for the conveyance. Currently, subsection 2(1) of the Ontario *Land Transfer Tax Act* provides that the tax in the lower tier is computed as 0.5% of the value of the consideration for the conveyance up to and including \$55,000, 1% of the value of consideration which exceeds \$55,000 up to and including \$250,000, plus 1.5% on the remaining excess above \$250,000 (except if the land being conveyed contains one or two single family residences, in which case the 1.5% rate only applies to the amount of consideration above \$250,000 up to and including \$400,000). An additional tax is imposed at a rate of 2% of the amount by which the value of consideration exceeds \$400,000 where the land being conveyed contains one or two single family residences. In this type of situation there are special rules for first-time homebuyers.

The City of Toronto also imposes an additional land transfer tax on conveyances, computed as follows: (i) for commercial and industrial properties: 0.5% of the value of the consideration for the conveyance up to and including \$55,000, 1% of the value of consideration which exceeds \$55,000 up to and including \$400,000, and 1.5% on the remaining excess which exceeds \$400,000 up to and including \$40,000,000, plus 1% of the amount above \$40,000,000 and (ii) for residential properties where the land being conveyed contains at least one and not more than two single family residences: 0.5% of the value of the consideration for the conveyance up to and including \$55,000, 1% of the value of consideration which exceeds \$55,000 up to and including \$400,000, plus 2% on the remaining excess which exceeds \$400,000. There are special rules for first-time homebuyers.

Land transfer tax is imposed on persons who tender for registration in Ontario any instrument by which land is conveyed including a final order of foreclosure under a mortgage or charge, or a caution in writing which gives notice of the existence of an instrument by which land is conveyed. The word “convey” is given a broad definition in section 1 of the Ontario *Land Transfer Tax Act*. As a result, tax would be payable in respect of any grant, assignment, release, lease, disposition, or agreement to sell any interest in Ontario land that is presented for registration.

Subsection 3(2) of the Ontario *Land Transfer Tax Act* extends the application of land transfer tax to certain unregistered conveyances of beneficial interests in land. As a result tax will be imposed at the same rate and on the same basis as if the disposition had been evidenced by a registered conveyance. In addition, the use of multiple deeds to minimize land transfer tax is not allowed, pursuant to subsection 2.3(1) of the Ontario *Land Transfer Tax Act*.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

An agreement of purchase and sale or any related notice or caution is a taxable conveyance when tendered for registration. The value of the consideration is the full amount of the consideration set out in the agreement. When the subsequent conveyance of the land to which the agreement relates is tendered for registration, no additional tax is payable where the Affidavit of Residence and Value of the Consideration state that the tax was paid when the agreement of purchase and sale or notice thereof was tendered for registration.

(b) <u>Exceptions to Imposition of Land Transfer Tax</u>

With respect to the land transfer tax implications of a rollover under subsection 85(1) of the Act, where such a rollover involves the transfer of land from a shareholder which is a corporation to an affiliate of the vendor corporation, a deferral of land transfer tax will be available upon application to the Ontario Ministry of Finance where the underlying control of the corporate group remains in the same hands and the interest in land remains within the corporate group for 3 years after the disposition. However, this exemption does not eliminate the imposition of land transfer tax payable upon the registration of a change in legal ownership following a transfer to an affiliate. Consideration should be given to having a bare trustee hold the title to the land in anticipation of the transfer to an affiliate in order to avoid this problem.

Likewise, pursuant to Regulation 697 under the Ontario *Land Transfer Tax Act*, where the shareholder is an individual, who is a “member of the family”, transfers land pursuant to a rollover under subsection 85(1) of the Act to a “family business corporation”, an application for exemption from land transfer tax will be considered by the Ontario Ministry of Finance. The regulation defines “family business corporation” to mean a CCPC, all of whose issued shares, other than directors’ qualifying shares, are owned by “members of the family” of an individual.

In addition, for unregistered dispositions of a beneficial interest in land from one corporation to another through a rollover under subsection 85(1) of the Act as part of a butterfly reorganisation, an application for an exemption from land transfer tax can be made to the Ontario Ministry of Finance. However, this exemption does not eliminate the imposition of land transfer tax payable upon the registration of a change in legal ownership following a butterfly reorganisation. Consideration should be given to having a bare trustee hold the title to the land in anticipation of the butterfly reorganisation in order to avoid this problem.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.