

PRICE ALLOCATION IN A SALE TRANSACTION

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the tax implications regarding price allocation in a sale transaction. 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.

A. ALLOCATION OF PURCHASE PRICE AMONG ASSETS

In an asset sale, negotiating the allocation of the purchase price to the various tangible and intangible assets that form part of the deal is a key component. Both sides likely have two goals in negotiating the allocation. First, each side will want to obtain the most favourable tax treatment possible. Second, a party can obtain bargaining power if allocation that is tax-neutral to its side would greatly benefit the other side.

The goal of the purchaser is to maximize the potential for future income tax deductions on the assets acquired, while the goal of the vendor is to minimize income tax arising from the disposition of those assets. It is more beneficial for the vendor if a greater portion of the purchase price is allocated to assets that give rise to capital gains rather than assets that generate business income. Purchasers may want to minimize amounts allocated to land or buildings, which will be subject to land transfer tax. In addition, it is more beneficial for purchasers to allocate a greater portion of the proceeds to assets that provide a faster tax write-off, such as high-rate depreciable property.

B. REASSESSMENT AND REALLOCATION BY THE CRA

Two sections of the *Income Tax Act* (the "Act") deal specifically with allocation of purchase price. Section 68 of the Act allows the Canada Revenue Agency (the "CRA") to reassess any allocation that does not appear commercially reasonable. Subsection 13(21.1) of the Act allows the CRA to reassess an allocation of the purchase price between land and a building in certain circumstances. The CRA may reassess an allocation of the purchase price pursuant to the above mentioned sections of the Act, even if the total purchase price is reasonable.

If the allocation of the proceeds of disposition is reassessed by the CRA, a taxpayer may file a notice of objection or notice of appeal to dispute the reassessment.

However, the burden of proof is on the taxpayer to demonstrate that the CRA's proposed allocation is incorrect.

(a) SECTION 68 REALLOCATION

Section 68 of the Act provides that consideration for the disposition of assets or the provision of services must be allocated reasonably among them; it also provides that the same allocation must apply to the vendor and the purchaser. Section 68 of the Act also states that the allocation of a portion of the purchase price to restrictive covenants must also be reasonable. For a more detailed discussion of restrictive covenants, please see the issue of the Legal Business Report on the topic.

Where the parties negotiating are at arm's length and have competing interests, and where both parties make identical allocations, the CRA will likely consider the allocation reasonable. Conversely, where one side is indifferent to the allocation or enjoys favourable tax treatment (such as a non-resident of Canada or a charity) the CRA may be more likely to question the allocation. Both parties should therefore be careful to negotiate, agree upon, document, and file the same allocation.

Case law regarding allocation brings several principles to light. The purchase price allocation only needs to be reasonable from the perspective of the parties involved and need not necessarily be the fair market value (the "FMV") of the assets. FMV, however, may constitute evidence of reasonableness. In addition, in order for the allocation to be considered reasonable, the parties have to be at arm's length and exhibit competing interests specifically with respect to the allocation, not merely with respect to the total purchase price. Absent a sham or subterfuge, evidence of hard bargaining on the issue of allocation will be persuasive that the allocation is reasonable.

(b) SUBSECTION 13(21.1) REALLOCATION

Subsection 13(21.1) of the Act comes into play if an agreed allocation for land and a building results in a capital gain on the land but a loss on the disposition of the building. Where this section applies, it reduces the capital gain on the land by reducing the purchase price allocated to the land and increases the purchase price allocated to the building such that no terminal loss results. Subsection 13(21.1) of the Act is triggered where the purchase price allocated to the building is less than either: (i) the original capital cost of the building or (ii) its "cost amount", which is the proportion of the relevant undepreciated capital cost allocated to the building, if the taxpayer owns several buildings.

If the FMV of a building is less than the cost amount of that building, application of subsection 13(21.1) of the Act can bring about an unfair result. In this case, an actual economic loss has occurred and normally a terminal loss would have been created. However, subsection 13(21.1) of the Act will deny the terminal loss to the extent that the FMV of the building is less than its cost amount.

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.

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