LEGAL BUSINESS REPORT ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS
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SHARE PURCHASE TRANSACTIONS – PART I

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the major tax considerations arising from the purchase and sale of shares of a corporation from the viewpoint of the purchaser and vendor. 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 shares of a corporation from the viewpoint of the purchaser and vendor.

A. CHANGE OF CONTROL ISSUES

The *Income Tax Act* (the “Act”) contains numerous provisions which will be of concern to a purchaser of shares of a corporation regarding the tax effects of a “change of control” of the corporation. For the purpose of these provisions, a strict *de jure* test of the meaning of “control” is applied in lieu of the more flexible *de facto* test of control. In other words, these provisions of the Act contemplate the acquisition by the purchaser of greater than 50% of the voting shares of a corporation. In such a case, the following rules will apply:

(a) Deemed Year End

Pursuant to subsection 249(4) of the Act, a corporation’s taxation year is treated as having ended immediately before the time that a change in control occurred and a new taxation year of the corporation is treated as having commenced at such time. This section will require a separate determination of the income or loss of the corporation for the period ending immediately before the acquisition of control in order that the loss carry-over restrictions discussed below can be applied to that taxation year.

(b) Restrictions on Net Capital Loss Carry-Overs

1. Pursuant to the provisions of subsection 111(4) of the Act, where control of a corporation is acquired, the corporation’s net capital losses for taxation years preceding the acquisition of control may not be carried forward to taxation years ending after the acquisition, and its net capital losses for taxation years following the acquisition may not be carried back to taxation years commencing before the acquisition.

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2. The rules restrict the deductibility to the corporation of accrued but unrealized losses on non-depreciable capital property owned by the corporation immediately before the change of control. The corporation is required to reduce its adjusted cost base for each such property to its current fair market value thereby resulting in the corporation realizing a capital loss in the taxation year immediately prior to the change of control.

3. To attempt to offset the harshness of this rule, the Act provides an optional election whereby the corporation may, upon a change of control, elect to treat such of its capital properties as it chooses as having been disposed of at the end of the taxation year immediately prior to the change of control. The elected proceeds of disposition of each property may be any amount between the adjusted cost base and its fair market value. This optional election enables the corporation to realize capital gains that may be off-set by capital losses of the corporation for pre-acquisition taxation years. Where the election is used, the corporation is treated as having reacquired such capital properties immediately after the acquisition of control at a cost equal to the elected proceeds of disposition. The corporation may make this election by making a designation in its corporate taxation return for the year ending immediately before the acquisition of control.

(c) <u>Restrictions on Deductibility of Losses</u>

1. Subsection 111(5) of the Act provides that where a corporation undergoes a change of control, non-capital losses and farming losses incurred in years prior to such change of control may only be deducted in the following years if: (i) after the acquisition of control has taken place, the corporation continues to carry on the business that gave rise to the loss throughout the later year in which the loss is sought to be deducted; (ii) the corporation has a reasonable expectation of profit in that business; and (iii) the losses are applied against future income generated by the same or similar business.

2. The portion of the loss which may be deducted from income in the later year may not exceed the corporation's income from the particular business which gave rise to the loss or from any other business substantially all of the income of which is from activities of a similar nature to those of the particular business.

3. This provision imposes strict limitations on purchasers who wish to trade in "loss companies" whereby a profitable business is injected into a company with accumulated non-capital or farm losses to reduce the income for tax purposes of the profitable business.

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4. The Act allows taxpayers a twenty-year period to carry forward non-capital losses that arise in the 2006 and subsequent taxation years.

(d) <u>Restrictions on Deductibility of Undepreciated Capital Cost</u>

1. Subsection 111(5.1) of the Act restricts the deductibility of undepreciated capital cost in certain cases where there has been a change in control of a corporation. Namely, where a corporation owns depreciable property which has a fair market value that is less than the sum of: (i) the undepreciated capital cost of such property; and (ii) the capital cost allowance or terminal loss otherwise deductible for such property, the difference must be deducted as capital cost allowance in computing the corporation's income for the year immediately preceding the change of control.

2. Therefore, the corporation will either reduce its income or increase its non-capital loss or farm loss for that year and such deductions will not be available to be deducted in later years except under the loss carry-forward rules contained in subsections 111(1) and 111(5) of the Act.

(e) <u>Restrictions on Deductibility of Cumulative Eligible Capital</u>

Subsection 111(5.2) of the Act provides restrictions regarding the deductibility of cumulative eligible capital upon the acquisition of control of a corporation. Namely, where there has been a change of control of a corporation, and the corporation's cumulative eligible capital at that time exceeds the aggregate of (i) 3/4 of the fair market value of the eligible capital property in respect of the business, and (ii) the cumulative eligible capital amount otherwise deductible, the excess must be deducted as a cumulative eligible capital amount in computing the corporation's income for the year immediately prior to the change of control.

(f) <u>Restrictions on Deductibility of Debts Owing to a Corporation</u>

Subsection 111(5.3) of the Act provides restrictive rules regarding the deductibility of doubtful debts after a change of control of a corporation. Specifically, this subsection precludes a corporation from deducting as a doubtful or bad debt in a year following a change of control any debt or portion of a debt which was doubtful when control was acquired. Instead, a corporation must deduct the full amount of its doubtful debts as bad debts in the taxation year immediately preceding the change of control. Any amounts subsequently recovered by the corporation with respect to such debts must be included in the income of the corporation in the year of receipt.

(g) Depreciable Property

1. When a corporation has acquired depreciable property within the twelve-month period ending immediately before a change in control and the property was not used in a business carried on by the corporation before that period, subsection 13(24) of the Act provides that the capital cost of the property may not be included in computing undepreciated capital cost until after the change in control. Where the property is disposed of by the corporation before the change in control, the corporation is treated as having acquired the property immediately before the disposition.

2. This rule prevents a loss corporation from transferring depreciable property to a profitable corporation in contemplation of a change in control in order to reduce its taxable income where the person acquiring control would not himself be in a position to use the capital cost allowance on the property.

(h) Carry-forward of Charitable Donations

1. The Act prevents the carry-forward of charitable donations, for the purposes of deductions, after a change in control of a corporation.

2. In order to prevent avoidance, a charitable donation deduction will not be allowed in respect of a gift of property made by a corporation (or successor corporation) after control of the corporation has been acquired, if the property was obtained by the corporation before the acquisition of control under an arrangement that control of the corporation would be acquired and the gift would then be made.

B. $800,000 LIFETIME CAPITAL GAINS EXEMPTION

(a) General Considerations

1. Beginning in 2014 capital gains arising on dispositions of qualifying shares of small business corporations, as well as dispositions of qualified farm property are eligible for a lifetime capital gain exemption of $800,000.00 which will be indexed to inflation. If a portion of the former general lifetime capital gains exemption of $750,000.00 has already been used, then the balance of the small business capital gain exemption will still be available in the future for shares of a small business corporation and qualified farm property.

2. The use of these exemptions achieves actual tax savings since the cost base of the shares to the transferee is increased to their current fair market value for future

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dispositions. It may be possible to double up on the use of this exemption if both spouses acquired capital assets with their own funds.

(b) Small Business Corporations

1. The term "small business corporation" is defined in subsection 248(1) of the Act as a Canadian-controlled private corporation ("CCPC") of which all or substantially all of the fair market value of the assets were at the particular time: (a) used in an active business carried on primarily in Canada by the corporation or a related corporation; or (b) shares or debt of one or more other small business corporations that were at that time connected with the corporation; or (c) a combination of the assets described in (a) and (b) above.

2. According to the Canada Revenue Agency (the "CRA"), the term "all or substantially all" is interpreted to mean 90% or more. This definition was clarified so that "all or substantially all" refers to the fair market value of the assets in question. Prior to this legislative change, there was some uncertainty as to whether this phrase referred to the cost of assets or to their fair market value.

3. The CRA has generally interpreted the term "primarily", as used in "an active business carried on primarily in Canada", to mean more than 50%. The facts of each particular case must be considered for this test, with relevant factors including gross assets, employees and sales.

(c) Qualified Small Business Corporation Shares

1. A corporation that meets the above-mentioned criteria is a small business corporation pursuant to the Act. However, not all shares held by an individual in a small business corporation qualify for the $800,000.00 capital gains exemption. Only "qualified small business corporation shares" are eligible for this exemption.

2. Generally, in order to be a qualified small business corporation share, such share: (a) must be a share of the capital stock of a small business corporation at the time of disposition; (b) must not have been owned by anyone other than the individual or persons related to the individual throughout the 24 months immediately preceding the time of disposition; and (c) throughout the 24-month holding period, must be a share of the capital stock of a CCPC that used more than 50% of the fair market value of the assets of such corporation in an active business carried on primarily in Canada by the corporation or a related corporation.

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3. The 24-month holding period, referred to above, specifies that no unrelated person may hold the shares in question during that period. However, the individual is not required to own the shares for the entire 24-month period. Shares held by an individual for less than the 24-month holding period, including newly issued shares acquired by an individual as part of a tax-free rollover of a sole proprietorship business to a new corporation pursuant to subsection 85(1) of the Act, may still be qualified small business corporation shares assuming all other requirements are met.

4. The transfer of shares in a small business corporation to a spouse or spousal trust on the death of an individual now has more significance as a result of the $800,000.00 capital gains exemption. Shares of an individual who died prior to the end of the 24-month holding period do not qualify for this exemption when a deemed capital gain occurs automatically on the death of the individual. A transfer of such shares on the death of the individual to the individual's spouse or a spousal trust has the advantage of tax savings as a result of the use of the $800,000.00 capital gains exemption, as well as the advantage of further tax deferral.

5. An individual taxpayer was previously entitled to a lifetime capital gains exemption for up to $750,000 of capital gains realized on the disposition of qualified property. The 2013 Federal Budget increased the limit to $800,000, effective for the 2014 taxation year. In addition, the exemption will be indexed to inflation for taxation years after 2014, and the new limit will apply to all individuals, even those who have previously used the lifetime capital gains exemption.

(d) <u>Holding Company Considerations</u>

1. The conditions to be met in order to be a qualified small business corporation share are similar where shares of a small business corporation are held indirectly through the use of a holding company. Where a holding company is used, all or substantially all of the fair market value of the assets of the holding company must, throughout the 24-month holding period, be attributable to: (a) shares or debt of connected corporations that meet the 50% test during the holding period; (b) assets used directly in an active business carried on primarily in Canada; or (c) any combination of such shares, debt and assets.

2. In the event that the holding company does not meet the "all or substantially all" test throughout the 24-month period, its shares will be qualified small business corporation shares only if the connected corporation in which it holds shares meets the "all or substantially all" test throughout the 24-month period rather than the 50% test as otherwise provided. This substitution of a 90% test for the 50% test is intended to prevent the stacking of corporations.

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3. In order to be a connected corporation under the Act, the holding corporation must control the other corporation or own shares having at least 10% of the voting rights of such corporation and having a fair market value of more than 10% of the fair market value of all the issued shares of the corporation.

(e) Specified Investment Businesses

Proceeds of disposition arising from shares in a corporation that is considered a "specified investment business" are not eligible for the lifetime capital gains exemption. A specified investment business is defined in subsection 125(7) of the Act as a corporation whose principle purpose is to derive income from property, unless: (a) the business employs more than five full-time employees; or (b) in the course of carrying on the active business, any other corporation associated with it provides managerial, administrative, financial, maintenance or other similar services to the corporation and the corporation could reasonably be expected to require more than five full-time employees if those services had not been provided.

(f) Additional Considerations

1. The provisions of the Act dealing with the $800,000.00 capital gains exemption are extremely complicated. For this reason, individuals should not wait until they wish to dispose of their shares in a small business corporation to do their tax planning. Consideration must be given to purification of the assets of the corporation by removing tainted assets in excess of the prescribed percentages prior to realization of the capital gains exemptions.

2. In addition, individuals who own qualified small business corporation shares should consider transferring such shares to a holding company or a related party in order to trigger a $800,000.00 capital gain and take advantage of the present exemption.

3. For more information regarding the capital gains exemption, see Alpert Law Firm's Legal Business Report, "Lifetime Capital Gains Exemption".

(g) Limits on the Capital Gains Exemption

1. The capital gains exemption referred to above must be reduced by a vendor's cumulative net investment loss ("CNIL") at the end of the year in which the sale occurs. A CNIL balance may arise where a taxpayer has realized a cumulative loss on passive investments. A vendor's CNIL is the vendor's total investment expenses minus the

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vendor's total investment income realized any time after December 31, 1987. This rule ensures that a taxpayer who borrows in order to invest does not have access to both the capital gains exemption and a deduction for investment losses.

2. In addition, the capital gains exemption that the vendor wishes to claim will also be reduced by the amount of any allowable business investment losses ("ABILs") previously realized by the vendor in the year or preceding years after 1984.

3. In cases where a taxpayer is carrying a CNIL balance, or where the taxpayer has already used the lifetime capital gains exemption, it may be possible to offset capital gains by realizing capital losses on non-performing investments.

4. For more information regarding ABILs refer to Alpert Law Firm's Legal Business Report on ABILs.

C. CAPITAL GAINS RESERVES

1. Where a vendor of shares does not receive all of his sale proceeds in the year of the sale, subsection 40(1) of the Act permits a limited deferral of tax by allowing the vendor to claim a "reserve" based on a proportion of the sale proceeds not yet due. In general, the maximum reserve from share sale proceeds is five years, since shares fall into the category of capital property.

2. Therefore, each year, a minimum of one-fifth of the gain on the sale of the shares must be reported as a capital gain in the vendor's tax return regardless of whether or not any of the sale proceeds are actually received in that particular year. However subsection 40(1.1) of the Act extends this reserve to ten years at the rate of 10% per year for a disposition of the shares of a "small business corporation" to resident children and grandchildren.

D. CAPITAL GAIN ROLLOVER FOR INVESTMENT IN SMALL BUSINESS

1. To improve access to capital for small business corporations, individuals (other than trusts) are permitted a rollover of capital gains on the disposition of eligible small business investments where the proceeds of disposition are used to make other small business investments pursuant to section 44.1 of the Act. The cost base of the new investment will be reduced by the capital gain deferred in respect of the initial investment. An individual's permitted deferral is proportional to the percentage of the

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proceeds from a qualifying disposition that the individual reinvests in replacement shares.

2. The deferral is available in connection with capital gains realized on eligible small business investments (by reference to adjusted cost base) in any particular corporation or related group. These measures are also available for investments held through a qualifying pooling arrangement. The total amount of proceeds a taxpayer may reinvest is not limited.

3. Pursuant to subsection 44.1(2) of the Act, the small business deferral can be utilized when there has been a “qualifying disposition” by an individual of the shares of a corporation in which the following conditions have been met:

- the share disposed of is an “eligible small business corporation share” at the time of disposition;
- the individual has owned the share for a 185-day period ending immediately before the disposition; and
- the share was a common share of an active business corporation throughout the period during which the individual owned the share.

4. Pursuant to subsection 44.1(9) of the Act, the requirements of a “qualifying disposition” will not be met unless the active business of the corporation was carried on primarily in Canada by the Corporation during the lesser of: (i) the period commencing when the individual last acquired the share and ending when the disposition occurred; or (ii) a period of at least 730 days.

5. The following requirements must be met in order to qualify as an “eligible small business investment”:

- The investment must be in ordinary common shares newly issued to the investor;
- The investment must be in a corporation that is, at the time the shares are issued, an eligible small business corporation, generally defined as a CCPC all or substantially all of the assets of which are used in an active business carried on primarily in Canada, or are shares of other related eligible small business corporations;

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- The total carrying value of the assets of the corporation and related corporations must not exceed $50,000,000 immediately before and after the investment is made (with look-through rules applying to account for assets held through partnerships and trusts); and

- While the investor holds the shares, the issuing corporation must be an eligible active business corporation, generally defined as a taxable Canadian corporation all or substantially all of the assets of which are used in an active business carried on primarily in Canada (or consisting of shares of related eligible active business corporations).

6. The above-noted provisions are designed to accommodate rollovers of gains regardless of the company's size at the time of the sale or the fact that it may have gone public before the sale. However, the eligible small business investment must be held for more than six months from the time of acquisition before a gain can be deferred. In addition, the replacement eligible investment must be made after the beginning of the year of disposition of the original small business investment and before the earlier of the 120th day following the disposition and the 60th day after the end of the year.

7. Subsection 44.1(12) of the Act is an anti-avoidance provision that prevents taxpayers from increasing the permitted deferral through internal reorganization. This provision deems the permitted deferral to be nil where: (i) new shares were issued to a related group where either old shares were disposed of by the related group, or the paid-up capital or adjusted cost base of the old shares was reduced; (ii) the new shares were issued by a corporation that issued the old shares, or by a corporation that did not deal at arm's length with the corporation that issued the old shares; and (iii) it is reasonable to conclude that one of the main reasons for the transaction was to increase the permitted deferral of the related group. The provision is worded broadly to potentially encompass any internal reorganization that results in the increase the permitted deferral of a related group of companies.

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 the 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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