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# SHARE PURCHASE TRANSACTIONS – PART II

**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. NON-RESIDENT VENDORS AND SECTION 116 CLEARANCE CERTIFICATES

### (i) General Considerations

1. A non-resident vendor of "taxable Canadian property" as defined in section 248(1) of the *Income Tax Act* (the "Act"), including shares in a corporation incorporated in Canada, is generally liable to remit tax in Canada on any capital gain on the property. Tax will not be payable in the following circumstances: (i) a particular income tax treaty exempts the capital gains from taxation; (ii) a roll-over provision applies to the transaction pursuant to the Act; or (iii) the property is considered "excluded property" as defined in subsection 116(6) of the Act.

2. To ensure this tax is collected, section 116 of the Act contains a compliance measure, often referred to as a "116 Clearance Certificate". To obtain a Clearance Certificate, the non-resident vendor must provide notification to the Canada Revenue Agency ("CRA") of the details of the sale transaction and the parties thereto. In addition, the non-resident vendor must pay the CRA 25% of the vendor's capital gain on the transaction or must provide security for such payment that is acceptable to the CRA.

3. In the alternative, the parties may close the transaction, and the vendor is required to: (i) report the disposition to the CRA within 10 days after the date of disposition; and (ii) remit 25% of the vendor's capital gain on the transaction or provide security for such payment that is acceptable to the CRA.

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4. Where a non-resident vendor of taxable Canadian property has not obtained a Clearance Certificate issued by the CRA regarding the proposed disposition, the purchaser of the property is liable to withhold and remit to the CRA 25% of the aggregate purchase price of such shares. When an application for a Clearance Certificate has been made but the certificate has not yet been issued, the CRA will provide comfort letters upon the non-resident vendor's written request. If a comfort letter is issued, the purchaser may withhold 25% of the proceeds of disposition and may wait for the certificate to be issued without being liable for penalties or interest.

5. Before the CRA will issue a section 116 Clearance Certificate, the non-resident vendor must have an Individual Tax Number, a Canadian Social Insurance Number or a Temporary Taxation Number. There are currently significant wait times to obtain the above-mentioned tax numbers, in addition to the time required to obtain the section 116 Clearance Certificate itself.

6. For dispositions of taxable Canadian property occurring after 2008, section 116 Clearance Certificate requirements have been eased for certain non-residents investing in taxable Canadian property by expanding the definition of "excluded properties" to include "treaty-exempt property" as defined in subsection 248(1) of the Act.

7. For dispositions of taxable Canadian property occurring after 2008, a non-resident vendor of taxable Canadian property will not be required to obtain a section 116 Clearance certificate if: (i) the vendor is a resident of a jurisdiction with which Canada has a tax treaty; and (ii) the gain from the disposition of the property is tax-exempt through the provisions of the treaty. If a disposition of treaty-exempt property occurs between related persons, the purchaser must provide the CRA with notice of the acquisition and certain specified information within 30 days after the date of the acquisition under new subsection 116(5.02) of the Act.

8. Most tax treaties permit Canada to tax capital gains from the disposition of Canadian real estate or resource properties, or on shares of companies that derive most of their value from such kinds of properties.

9. In addition, a purchaser of property from a non-resident vendor will not be liable to withhold tax as long as: (i) the purchaser concludes after reasonable enquiry that the vendor is a resident of a country that has a tax treaty with Canada; (ii) the gain from the disposition of the property would not be subject to tax in Canada by virtue of the treaty; and (iii) the purchaser provides the CRA with notice of the acquisition and certain specified information within 30 days after the date of the acquisition.

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10. In addition, section 150 of the Act eliminates the requirement that non-resident individuals and corporations file Canadian tax returns in respect of "excluded dispositions." A non-resident will be exempt from filing a Canadian tax return in a particular year if: (i) no tax is payable as a result of the disposition of the taxable Canadian property; (ii) the taxpayer is not liable to pay tax under Part I in respect of any prior taxation year; and (iii) each property disposed of was either "excluded property," including tax-exempt property, or a clearance certificate was obtained in respect of the disposition of property.

11. The 2010 Federal Budget proposed the following important changes to the definition of taxable Canadian property, which were later adopted in Bill C-9. As a result of these changes, when a non-resident disposes of such property after March 4, 2010, the capital gain resulting from the disposition will no longer be taxable and the disposition will no longer be subject to the taxable Canadian property regime, regardless of when the property was acquired:

(i) shares in a Canadian corporation that are not listed on a designated stock exchange (or an option in respect thereof) will constitute taxable Canadian property only if at any time in the five-year period preceding the disposition more than 50% of their fair market value was derived directly or indirectly from real or immovable property situated in Canada, Canadian resource properties, timber resource properties, options or interests in any of the foregoing property, or any combination of the foregoing property ("derived value test");

(ii) shares in a Canadian corporation that are listed on a designated stock exchange (or an option in respect thereof) will constitute taxable Canadian property only if at any time in the five-year period preceding the disposition the shares met the derived value test and the non-resident alone or together with non-arm's length persons owned 25% or more of the issued shares of any class of the corporation ("ownership test");

(iii) shares of mutual fund corporations and units of mutual fund trusts will constitute taxable Canadian property only if they satisfy both the derived value and ownership tests; and

(iv) partnership interests and trust interests (other than units in a mutual fund or income interests in a Canadian trust) will constitute taxable Canadian property only if they satisfy both the derived value and ownership tests.

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12. There are also changes to the "deemed taxable Canadian property" rules, which became effective March 4, 2010. Previously, where taxable Canadian property shares were exchanged for new shares on a tax-deferred basis, the new shares would be deemed taxable Canadian property for as long as the exchanging shareholder owned the new shares. Bill C-9 provides that any new shares will continue to be deemed taxable Canadian property, but only during the five-year period following the tax-deferred exchange. However, any subsequent tax-deferred transaction involving the shares within the original five-year period will trigger a new five-year period from the date of that subsequent tax-deferred transaction.

## B. TAXATION OF EARNOUT AGREEMENTS

### (i) General Considerations

1. When negotiating an agreement for the sale of shares of a corporation, parties may have a limited capacity to affix a value to the company's future earnings and may thus encounter difficulty agreeing upon a final sale price. This obstacle may be overcome by using 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 periodic basis or in a lump sum.

2. When a share sale agreement includes an earnout provision, the vendor should endeavor to have the earnout amounts treated as capital receipts rather than as income for tax purposes. Paragraph 12(1)(g) of the Act requires that any amount received by the taxpayer that was dependent on the use of or production from property is included in income. In an earnout arrangement, because the proceeds received after the initial payment are dependent on the use of or production from the property of the corporation, they could be caught by this provision.

3. Without careful planning, some proceeds of disposition might not receive the favorable treatment available to capital gains. Vendors of shares of a qualified small business corporation could also lose the benefit of applying the lifetime capital gains exemption on those proceeds.

### (ii) Cost Recovery Method

1. The general position of the CRA is set out in Interpretation Bulletin IT-426R with regard to earnout payments. 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 Act. The CRA's policy to permit the cost recovery method requires that the earnout must relate to the goodwill component of the shares. If any of the earnout proceeds relate to the uncertainty of the valuation of accounts receivable or various capital assets of the corporation, then the cost recovery method cannot be utilized.

2. In order to avoid the uncertainty that may arise with respect to a share sale, where shares are sold subject to an earnout, the CRA has provided a method for allowing earnout payments to be treated as proceeds of disposition on account of capital if the following six conditions are met:

(i) the vendor must be a resident of Canada;

(ii) the vendor and purchaser must be dealing with each other at arm's length;

(iii) the gain or loss in question must be "clearly of a capital nature";

(iv) it must be reasonable to assume that the earnout feature relates to goodwill of the corporation, the value of which cannot reasonably be expected to be agreed upon at the date of sale;

(v) the earnout feature must end (i.e. the last contingent amount must become payable) no later than five years after the end of the taxation year in which the shares are sold; and

(vi) the vendor must submit a copy of the sale agreement, a letter requesting the application of the cost recovery method, and an undertaking to follow the cost recovery reporting method with the vendor's income return for the year the shares were sold.

3. If all of the above conditions are met, the CRA will allow the vendor to use the cost recovery method, which essentially allows capital treatment rather than income treatment for the earnout amounts in a share sale. Under this method, sums received in respect of the sale price reduce the vendor's adjusted cost base of the shares. Once the cumulative proceeds serve to reduce the adjusted cost base to nil, any excess proceeds are treated as a capital gain. A capital loss can be recognized when the maximum amount payable to the vendor is irrevocably established to be less than the adjusted cost base of the shares.

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### (iii) Reverse Earnouts

1. Where the vendor may not be able to meet the six conditions prescribed by the CRA, a "reverse earn-out" could be used: the sale price would be set at a reasonable maximum amount and would be reduced if certain performance targets are not met. This technique is possible because paragraph 12(1)(g) of the Act appears to be inapplicable in the case where a sale occurs for a fixed purchase price that is subsequently adjusted downward.

2. The CRA's position is that if, at the time of disposition, the parties reasonably expect that the conditions will be met, then the disposition can be treated in the ordinary manner and the original maximum amount is considered proceeds on account of capital. If, subsequently, the conditions are not met, then an appropriate adjustment will be made in the year in which the amount of the reduction in the sale price is known with certainty. If the sale price is not specified or is unreasonable, paragraph 12(1)(g) of the Act will apply to *all* payments in respect of the sale. A reverse earnout must therefore be carefully undertaken to ensure that the price is not taxed as regular income.

3. Section 40 of the Act provides that a reserve may be claimed "in respect of such of the proceeds of disposition of the property that are payable to the taxpayer after the end of the year." The CRA's position, regarding a reverse earnout, is that no amount can be considered "payable" pursuant to section 40 of the Act, since there is not a legally enforceable entitlement to receive that amount, and that no such entitlement exists until particular future events determine the total sum due as a result of the reverse earnout.

4. Therefore, the CRA takes the view that a section 40 reserve may only be used in an earnout situation where the taxpayer uses the cost recovery method and may not be used for reverse earnout situations.

5. In the event that the maximum amount of the reverse earnout is reduced because certain targets are not met by the due date of the final payment, a capital loss will arise at that date. The normal capital loss carry back rules will apply to this amount, meaning the vendor could apply it against the original proceeds of disposition if the reverse earnout period was not greater than three years.

### (iv) Tax Treatment of Purchaser

1. Payments made pursuant to an earnout agreement, even if made on a periodic basis, are not considered true royalty payments and therefore not deductible to the

purchaser. A royalty payment is a payment given for the right to use or produce something, usually without taking ownership of the underlying asset. However, where a purchaser uses and owns the property, these payments are not deductible, since they form part of the capital cost of the property.

2. In the event that the parties wish to structure the transaction on the basis that the earnout is deductible to the purchaser and taxable to the vendor as income, it may be desirable to restructure the transaction in order to reflect that the contingent amount will be payable by the purchaser to the vendor as a management fee.

## C. SECTION 88 WIND-UPS

This section deals with the purchase by an acquiring corporation of all or substantially all of the shares of another corporation (i.e. a subsidiary corporation) and utilizing the provisions of Section 88 of the Act in order to wind up the subsidiary corporation.

### (i) Income Tax Considerations

1. Section 88 of the Act sets out the general rules dealing with the winding-up or dissolution of a Canadian corporation. There is no definition in the Act of a "winding-up". However, the CRA, pursuant to Interpretation Bulletin IT-126R2, considers a corporation to have been wound up: (i) where it has followed the procedures for winding-up and dissolution as provided by the appropriate federal or provincial Corporations Act or the federal *Winding-up and Restructuring Act*; or (ii) where a corporation has carried out a winding-up and has been dissolved pursuant to the provisions of its incorporating statute.

2. The tax treatment of a winding-up depends upon whether the dissolving corporation is a taxable Canadian corporation that is a wholly-owned (90% or more) subsidiary of another taxable Canadian corporation. In this situation, a tax-free rollover is available with respect to property distributed to the parent and shares of the subsidiary held by the parent. No rollover is available for minority shareholders.

3. Where the Section 88(1) rollover does apply, the parent company will be deemed to have disposed of its shares in the subsidiary for proceeds equal to the greater of: (i) the adjusted cost base of the shares immediately before the winding-up; and (ii) the lesser of the paid-up capital of the subsidiary and the tax value of its net assets immediately before the winding-up. If the parent's adjusted cost base of the shares of

the subsidiary is equal to or greater than the paid-up capital of the shares, no gain will arise on the winding-up. Also, no capital loss will ever occur on a winding-up given that the proceeds of disposition must be equal to or greater than the adjusted cost base of the shares. Where a winding-up would trigger a capital gain, an amalgamation instead of a winding-up may be considered. Another option may be to increase the net assets of the subsidiary in a manner which would increase the adjusted cost base of the shares but not the paid-up capital. Alternatively, the paid-up capital could be reduced or a dividend could be paid to reduce the tax values of the net assets on hand immediately prior to the winding-up.

4. With respect to the winding-up of a Canadian corporation that is not a wholly-owned subsidiary of another Canadian taxable corporation, no rollover is available on the winding-up. Therefore, the corporation is considered to have disposed of all assets distributed by it to its shareholders at the fair market value of such assets immediately before the winding-up. This will result in either gains or losses and therefore, an income tax liability may result. In addition, each shareholder in the corporation is considered to have disposed of all of his shares in the corporation. As a result, the corporation is deemed to have paid a dividend equal to the amount by which the value of the cash or property distributed to the shareholders exceeds the amount by which the paid-up capital of the shares is reduced by the distribution. Each shareholder is deemed to receive the dividend on a pro-rata basis.

### (ii) Ontario Land Transfer Tax Considerations

1. With respect to the land transfer tax implications of a winding-up, land transfer tax will be eligible in respect of any Ontario land that is conveyed by the corporation to a shareholder in the course of a winding-up. This tax is based on the fair market value of the land at the time the conveyance is tendered for registration.

2. In addition, the *Land Transfer Tax Act* imposes land transfer tax on unregistered dispositions of a beneficial interest in land. However, the land transfer tax legislation does provide a procedure for applying for a deferral of land transfer tax where the underlying control of the corporate group and the interest in the land will remain within the corporate group for three years following the disposition.

3. For the purpose of determining whether this requirement has been met, a corporation which was an affiliate of another corporation immediately before winding-up shall be deemed to continue to exist. Therefore, provided that the disposition of the beneficial interest in the land is made from a corporation prior to its winding-up to an affiliate of that corporation, and the underlying control and interest in the land remains

with that affiliated corporation for three years, then the amount of tax deferred will no longer be owing.

4. The situation addressed in the *Land Transfer Tax Act* contemplates that a legal title remains in the name of the wound-up corporation. This creates a problem since both the *Corporations Act* and the *Business Corporations Act of Ontario* provide that upon dissolution, undisposed real property of a corporation is forfeited to the Crown. One possible solution is for the corporation to convey, prior to winding-up legal title to a trustee corporation prior to transferring beneficial title to the affiliate. Since a conveyance to a trustee corporation is not subject to land transfer tax until it is tendered for registration, there is a tax deferral on that transaction. The trustee corporation will then have the power to convey legal title to the lands at a future time on a tax-exempt basis to the beneficial owner which in turn may convey to a person outside of the corporate group. Land transfer tax will be payable upon registration of the conveyance to the outside party.

### (iii) HST Aspects

1. With respect to the HST consequences of a winding-up, where a subsidiary corporation is wound up and at least 90% of the shares of each class of the subsidiary are owned by the parent corporation, the parent is deemed to be the same corporation and a continuation of the subsidiary for HST purposes. Therefore, no HST will be payable on the wind-up, since the assets of the subsidiary are deemed not to have been "supplied" to the parent within the meaning of the HST legislation.

2. In addition, to determine the parent's reporting period for HST purposes, any taxable supplies made by the subsidiary before it is wound up will be treated as if such supplies were made by the parent. If the 90% share ownership test is not met, HST must be charged on the fair market value of the assets distributed to the shareholders.

## D. Additional Tax Planning Considerations

The following tax planning opportunities should be considered in connection with a winding-up:

### (i) Consolidation of Businesses

A winding-up may be used to consolidate business enterprises, thereby eliminating unnecessary companies with a corporate group. It should be noted that for

the purposes of a winding-up, as opposed to an amalgamation, the two companies need not have the same incorporating jurisdiction;

**(ii) Losses**

A winding-up may be considered in order to permit the future utilization of net capital and non-capital losses of a subsidiary against the profits of the parent provided that no change of control occurs as a result of the winding-up. It should be noted that deductibility of such losses by the parent commences only in the taxation year of the parent that follows the year in which the winding-up of the subsidiary took place. Therefore, the timing of the winding-up should consider the expiry of the loss carry forwards; and

**(iii) Asset Bump-Up**

1. When the parent company acquires the property distributed to it by the subsidiary on a Section 88(1) winding-up, it will be deemed to acquire most of the assets of a subsidiary at their cost amount for tax purposes. A feature of a Section 88(1) winding-up and an amalgamation of a wholly-owned parent corporation with its subsidiary is the availability of a bump-up in the tax cost of non-depreciable capital property of a subsidiary in certain circumstances. For instance, where the adjusted cost base of the shares held by the parent in the subsidiary exceeds the aggregate of the cost amounts to the subsidiary of property distributed by the subsidiary to the parent, a potential exists to bump up the tax costs of certain non-depreciable capital assets. Namely, the bump-up is only available with respect to non-depreciable capital property that was owned by the subsidiary when the parent last acquired control and has been owned without interruption since then.

2. It should be noted that the bump-up is not available in connection with property transferred in the course of the winding-up or the amalgamation of a subsidiary corporation that was part of a series of transactions or events that involved a butterfly reorganisation. However, the asset bump-up will be available if the property was the subject of a prior butterfly reorganisation.

3. Examples of non-depreciable capital property that would be eligible for the bump-up are land (excluding land held as inventory), securities such as shares in another corporation and partnership interests. Regardless of the type of non-depreciable capital asset being acquired by the parent in the course of a winding-up or amalgamation with a subsidiary, the cost basis of such asset cannot be increased to an amount which is

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greater than the fair market value of each capital property at the time control was acquired.

4. In order to take advantage of this optional bump-up provision, the parent corporation must designate the amount of the bump in respect of each capital property to which the bump-up is applied in the parent company's tax return for the taxation year in which the subsidiary is wound up or the amalgamation occurs. Therefore, the determination of the potential amount of the bump-up is not automatic.

5. Certain additional conditions must be satisfied in order for a corporation to obtain an increase in the adjusted cost base of capital property distributed to the parent in the course of the winding-up of its subsidiary or in the course of an amalgamation of a parent corporation with its subsidiary corporation. In particular, the list of property which is ineligible for this increase in adjusted cost base includes property that is transferred to the subsidiary by the parent corporation or by a person or partnership that was not dealing at arm's length with the parent corporation, except by reason of a right referred to in paragraph 251(5)(b) of the Act.

6. Ineligible property for the bump-up also includes property distributed to the parent corporation which is subsequently disposed of by the parent corporation as part of the series of transactions that includes the winding-up or amalgamation, to a transferee who was a specified shareholder (i.e. the owner of at least 10% of the shares of the corporation either directly or indirectly) of the subsidiary corporation before the parent corporation last acquired control of the subsidiary corporation. This rule prevents taxpayers from circumventing the rules against purchase butterflies by means of a series of transactions that effectively result in a sale of part of a corporation's assets to an arm's length corporate purchaser on a tax deferred basis.

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