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ASSET PURCHASE TRANSACTIONS – PART 1

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 from the respective viewpoints of the purchaser and the vendor.

A. SALE OF CAPITAL PROPERTY

(a) Non-Depreciable Capital Property

The disposition of non-depreciable capital property, such as land or shares of a corporation, will give rise to a taxable capital gain or allowable capital loss upon disposition. A capital gain is the amount by which the proceeds of disposition of a property exceed the adjusted cost base (the "ACB") of that property. If the proceeds of disposition are less than the ACB, a capital loss will result.

Capital gains are taxed preferentially, in that only 50% of a capital gain must be included in income. Subsection 38(a) of the *Income Tax Act* (the "Act") defines a taxable capital gain as 50% of a capital gain, and subsection 38(b) of the Act defines an allowable capital loss as 50% of a capital loss. Allowable capital losses can only be claimed to offset taxable capital gains. Pursuant to the provisions of subsection 111(8) of the Act, a net capital loss can be carried back for 3 taxation years and carried forward indefinitely.

Expenses of acquisition of a capital property will increase the ACB of the property, thereby reducing the capital gain or increasing the capital loss upon disposition. Pursuant to subsection 40(1) of the Act, any expenses incurred for the purpose of making the disposition of the capital property, such as selling expenses, will reduce the capital gain or increase the capital loss.

(b) Depreciable Capital Property

The disposition of depreciable capital property, such as a building or machinery and equipment, may give rise to either a recapture of capital cost allowance ("CCA") or a terminal loss.

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Where the proceeds of disposition allocated to a class of depreciable property exceed the undepreciated capital cost (the "UCC") of that class, a recapture of CCA will result. Such recapture must be fully included as income, meaning that any recapture arising from the sale of business assets by a corporation will be taxed at the applicable rates for business income. Any gain over the initial capital cost of depreciable property is taxed as a capital gain, 50% of which must be included in income.

If the proceeds of disposition allocated to a class of depreciable property are less than the UCC of that class, a terminal loss results. A terminal loss may be offset against all sources of income. Losses on depreciable property are fully deductible from business or property income either as CCA under paragraph 20(1)(a) of the Act or as terminal loss pursuant to subsection 20(16) of the Act.

Subsection 13(21.1) of the Act places limitations on a taxpayer's ability to claim a terminal loss in transactions involving the disposition of land and a building. When this subsection applies, it reduces the capital gain on the land by reducing the purchase price allocated to the land and increasing the purchase price allocated to the building such that no terminal loss results. For a more detailed discussion of subsection 13(21.1) of the Act, please see the issue of the Legal Business Report addressing the topic of price allocation.

(c) Capital Gains Reserves

Where a taxpayer has disposed of capital property but is not entitled to full payment in the year of disposition, such as in a case where payments are to be made in installments over several years, a reserve for future proceeds of disposition may be claimed pursuant to subsection 40(1) of the Act. This provision is optional, rather than mandatory.

The maximum period for which a reserve may be claimed is the lesser of: (i) the number of years it takes until the entire proceeds of disposition have been paid and (ii) five years. The taxpayer must recognize at least one-fifth of the capital gain over each year in which the reserve is claimed. A reserve cannot be claimed by a person who is, or becomes, a non-resident.

B. SALE OF INVENTORY

Pursuant to section 23 of the Act, where a taxpayer sells all or part of the inventory of a business, the consideration received for the inventory must be included in income. The cost or book value of the inventory will be deducted in the same manner as if it had been sold in the course of business. Subsection 39(1) of the Act specifically excludes inventory from being treated as capital property for taxation purposes. Therefore, a sale of inventory does not receive the preferential tax treatment accorded to other capital property.

C. <u>SALE OF ACCOUNTS RECEIVABLE</u>

Section 22 of the Act deals with the sale of accounts receivable and is applicable upon the joint election in prescribed form by a vendor and a purchaser, where the vendor sells all or substantially all (i.e. at least 90%) of the assets of a business that was carried on in Canada to a purchaser who proposes to continue the business. The business assets sold must include all the accounts receivable of the vendor that are outstanding at the time of the sale.

If the Canada Revenue Agency (the "CRA") accepts the election, then pursuant to paragraph 22(1)(a) of the Act, the vendor is entitled to deduct in the year of sale any loss on sale of the accounts receivable, computed as the difference between the proceeds received and their face value (excluding those accounts previously written off by the vendor as bad debts under paragraph 20(1)(p) of the Act). The loss is computed without regard to any reserve for doubtful debts, whether or not such reserve has been previously allowed as a deduction under paragraph 20(1)(l) of the Act.

The amount that the vendor is allowed as a deduction in the year of sale is required to be included in the purchaser's income in the year of the purchase pursuant to paragraph 22(1)(b) of the Act. Paragraph 22(1)(c) of the Act provides that the purchaser may then deal with the accounts receivable for tax purposes as though they had arisen while the purchaser was the owner of the business. The purchaser may claim a deduction for a reserve for doubtful debts under paragraph 20(1)(l) of the Act and may deduct bad debts under paragraph 20(1)(p) of the Act. A receivable that the vendor previously deducted under paragraph 20(1)(p) of the Act may not be deducted by the purchaser. In the event that the purchaser should collect a receivable previously deducted by the vendor under paragraph 20(1)(p) of the Act, it must be included in the purchaser's income.

The portion of the sale price of the business that is the consideration for the accounts receivable is required to be set out in the joint election which the vendor and purchaser must execute pursuant to subsection 22(2) of the Act. The joint election must be made on Form T2022 and should be filed with the tax return for the taxation year of the sale.

As far as the vendor and purchaser are concerned, the amount that is stated in the joint election to be the consideration for the accounts receivable is final for tax

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purposes and cannot later be altered. However, the joint election is not necessarily binding on the CRA, and may be challenged on assessment if it is considered not to reflect the facts of the sale, such as when the face value of the debts sold is incorrectly stated or when the consideration actually paid is different from that set out in the election.

If the vendor and purchaser are not dealing at arm's length and the fair market value (the "FMV") of the accounts receivable sold was more or less than the consideration paid for them, the provisions of paragraph 69(1)(a) or (b) of the Act will be applied to the transaction. Subsection 69(1) of the Act operates only to adjust one side of the transaction. When the sale price is below FMV, paragraph 69(1)(b) of the Act increases the transferor's proceeds of disposition to FMV but does not increase the purchaser's cost. Alternatively, when the sale price is above FMV, paragraph 69(1)(a) of the Act adjusts the transferee's cost downward to FMV but does not reduce the vendor's proceeds. A price adjustment clause should be used in the asset purchase agreement to retroactively readjust the sale price and the consideration received to FMV to avoid this outcome.

If the asset purchase agreement does not specify which portion of the total consideration is for the accounts receivable, a reasonable allocation must be made between accounts receivable and other assets included in the sale.

It is desirable that the asset purchase agreement should contain a list of the accounts receivable that are being sold and should contain an allocation of the purchase price specifying the amount of the consideration relating to the accounts receivable, which should attempt to reflect their FMV.

D. <u>ALLOCATION OF PURCHASE PRICE OF ASSETS</u>

As mentioned above, a sale of assets generally gives rise to: (i) capital gains or capital losses; and/or (ii) a recapture of or terminal losses on CCA. The amount of income tax payable on a sale of assets is directly affected by the allocation of the purchase price between the aforementioned items.

In an asset sale, negotiating the allocation of the purchase price to the various assets that form part of the sale 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 it would greatly benefit the other party.

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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.

In certain circumstances the CRA may reallocate the purchase price. Section 68 of the Act allows 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 on a balance of probabilities.

For a more detailed discussion of price allocation, please see the issue of the Legal Business Report addressing the topic.

E. NON-RESIDENT VENDORS AND SECTION 116 CLEARANCE CERTIFICATES

(a) General Provisions

Under the current provisions contained in section 116 of the Act, a non-resident vendor of "taxable Canadian property" as defined in subsection 248(1) of the Act is generally liable to remit tax in Canada on any capital gain on the property. The definition of "taxable Canadian property" includes real or immovable property situated in Canada, Canadian resource property, timber resource property, property used or held in a business carried on in Canada, shares of certain Canadian private corporations (or trust or partnership interests), and options or interests in such properties. Tax will not be payable in the following circumstances: (i) a particular income tax treaty exempts the capital gains from taxation; (ii) a rollover 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.

To ensure this tax is collected, section 116 of the Act contains a compliance measure, often referred to as a “section 116 Clearance Certificate”. To obtain a section 116 Clearance Certificate at any time before the sale transaction, the non-resident vendor must provide notification to the CRA of the details of the sale transaction. In addition, the non-resident vendor must either pay the CRA 25% of the vendor’s estimated capital gain on the transaction (or 50% on the disposition of certain properties including depreciable properties, Canadian resource properties, timber resource properties, and real or immovable properties that are not capital properties) or provide security that is acceptable to the CRA.

In the alternative, the vendor may obtain a section 116 Clearance Certificate after the sale transaction by: (i) reporting the disposition to the CRA within 10 days after the date of disposition; and (ii) remitting 25% (or 50%, as noted above) of the vendor’s capital gain on the transaction or providing security that is acceptable to the CRA.

Where a non-resident vendor of taxable Canadian property has not obtained a Clearance Certificate issued by the CRA regarding the disposition, the purchaser of the property is liable to withhold and remit to the CRA 25% or 50% of the aggregate purchase price of such property within 30 days after the end of the month in which the purchaser acquired the property. When an application for a Clearance Certificate has been made but the certificate has not yet been issued, the CRA will usually provide a comfort letter upon written request. If a comfort letter is issued, the purchaser may continue to withhold 25% or 50% of the purchase price beyond the statutory remittance deadline and may wait for the certificate to be issued without being liable for penalties or interest.

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 wait times associated with obtaining these numbers, as well as with obtaining a section 116 Clearance Certificate itself.

Under subsection 227(10.1) of the Act, there is no limitation period on an assessment for failure to withhold tax under section 116 of the Act. Therefore, the CRA can reassess the purchaser many years after the transaction has transpired.

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 property” to include “treaty-exempt property” as defined in subsection 116(6.1) of the Act.

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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 a non-resident vendor and a related purchaser, 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 subsection 116(5.02) of the Act.

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.

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

In addition, section 150 of the Act eliminates the obligation of non-resident taxpayers to 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 under Part I of the Act as a result of the disposition of the taxable Canadian property; (ii) the taxpayer is not liable to pay any amount under the Act in respect of any prior taxation year at the time of the disposition; and (iii) each property disposed of was either “excluded property” as defined in subsection 116(6) of the Act, or a section 116 Clearance Certificate was obtained in respect of the disposition.

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.