

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 of the transaction. 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: (i) consideration for the disposition of assets or the provision of services must be allocated reasonably among them; (ii) the same allocation must apply to the vendor and the purchaser; and (iii) 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. This section 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. Where this section applies, it increases the purchase price allocated to the building such that no terminal loss results, and

correspondingly reduces the capital gain on the land by reducing the purchase price allocated to the land.

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.

C. CASE LAW

Canada v Golden et al., [1986] 1 S.C.R. 209, 25 D.L.R. (4th) 490

This Supreme Court of Canada case is considered to be one of the leading cases on the allocation of the proceeds of disposition in an asset sale.

The taxpayer and his partners sold a parcel of land that contained apartment buildings. The taxpayer and purchaser dealt at arm's length with each other, and arrived at a final purchase price of \$5,100,000 for the land and \$750,000 for the buildings and other facilities. It was clear that the purchaser was primarily interested in acquiring the land rather than the buildings and placed most of the value of the purchase price on the land.

The Minister reassessed the taxpayer, allocating a much greater proportion to the buildings and other facilities, resulting in a significant recapture of capital cost allowance. The taxpayer's appeal to the Federal Court was dismissed. However, the taxpayer's appeal was subsequently allowed by the Federal Court of Appeal. The Minister then appealed to the Supreme Court of Canada.

The Supreme Court of Canada dismissed the Minister's appeal. The Supreme Court stated that so long as the parties have competing interests specifically with respect to the allocation of the purchase price and the transaction is not a sham or subterfuge, the allocation will likely be considered reasonable.

Further, the Supreme Court made it clear that the requirement of reasonableness under section 68 of the Act means that the allocation should be reasonable in the view of the parties to the agreement. There is no requirement for the allocation of the purchase price to reflect FMV necessarily as long as the parties have their own separate vested interests in arriving at the allocation of the purchase price and are

dealing at arm's length not only with respect to the total purchase price, but with respect to the allocation of the purchase price.

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