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ASSET PURCHASE TRANSACTIONS – PART 2

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 including Earnout Agreements, transfers under subsection 85(1) of the *Income Tax Act*, Harmonized Sales Tax considerations, and Land Transfer Tax considerations from the respective viewpoints of the purchaser and the vendor.

A. EARNOUT AGREEMENTS

(i) General Considerations

When negotiating an agreement for the sale of assets 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. A strategy commonly employed to overcome this obstacle is the use of an earnout provision, whereby a 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 a periodic basis or in a lump sum.

Paragraph 12(1)(g) of the Income Tax Act (the "Act") requires any amount received by the taxpayer that was dependent on the use of or production from property to be 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.

The general position taken by the Canada Revenue Agency (the "CRA"), as set out in Interpretation Bulletin IT-426R, is that 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 has made special allowance for earnout payments in a share sale to be exempt from income inclusion under paragraph 12(1)(g) of the Act, but has never confirmed that asset sales can benefit from this same treatment. Case law in the area is also unclear, particularly with respect to goodwill sold subject to an earnout agreement.

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In *Varga v MNR*, 84 DTC 1278, the Tax Court of Canada held that where an amount paid for goodwill was subject to an earnout clause, the amount received by the taxpayer with for the goodwill was a capital receipt because the nature of the payment remains consistent in the form of goodwill, regardless of the fact that the amount was not determined and the payment might have been conditional.

In *Rouleau Estate v Canada*, 91 DTC 115, the taxpayer, who was a chartered accountant, entered into an agreement to sell his list of clients to a chartered accounting firm. The purchase price payable for the list of clients was 20% of the amount of gross fees earned from the clients on the taxpayer's list of clients per annum over a 5-year period. The Tax Court allowed the taxpayer's appeal and held that where amounts payable for a client list were paid according to a predetermined percentage of future gains over a fixed period of time, the amounts received by the taxpayer were in respect of goodwill and paragraph 12(1)(g) of the Act did not apply.

However, in *Smith v Canada*, 2011 TCC 461, the Tax Court of Canada made the opposite finding. In this decision, an insurance brokerage sold its client list and the purchase price was payable in annual instalments over a 4-year period. The purchase agreement set out the amount of the annual payments but they were to be increased or decreased depending on the commission revenue earned by the purchaser in the year preceding the payment. The Tax Court found that the annual payments should be included in the taxpayer's income under paragraph 12(1)(g) of the Act because the initially agreed upon purchase price was only an estimate that could fluctuate depending on the annual commissions earned from the purchased client list. Consequently, the annual payments were entirely dependent on the use of or production of the client list and were taxable as income under paragraph 12(1)(g) of the Act.

The tax treatment accorded to earnout agreements in asset sales is far from clear. Parties to an asset sale who are contemplating using an earnout agreement should solicit legal tax advice and undertake careful analysis of the transaction before entering into such an agreement.

(iii) Reverse Earnouts

Alternatively, for both asset sales and share sales, the parties can agree to use a "reverse earnout agreement": 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.

For reverse earnouts, the CRA's position is that the entire initial payment can be treated as a capital gain as long as the parties had a reasonable expectation at the time of disposition that the reverse earnout conditions would be met. If, subsequently, the

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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 treat *all* payments in respect of the sale as regular income. A reverse earnout must therefore be carefully undertaken to ensure that the price is not taxed as regular income.

In the event that the maximum amount of the reverse earnout is reduced because certain requirements 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.

B. SUBSECTION 85(1) TRANSFERS

(a) Eligible Transactions

The general rule governing a transfer of assets to a corporation is that assets must be transferred at their fair market value (their “FMV”). Subsection 85(1) of the Act provides an exception to this general rule in the form of a rollover. In particular, pursuant to a subsection 85(1) rollover, parties can elect to transfer certain assets to a corporation in exchange for shares at amounts which will result in either a deferral or minimization of tax.

Assets that are eligible for a tax deferred transfer to a corporation pursuant to a subsection 85(1) rollover include: (i) capital property, including depreciable assets and accounts receivable; (ii) inventory (other than real estate), including the work-in-progress of a taxpayer who is a professional; and (iii) Canadian resource property and foreign resource property. Assets that are not eligible for a subsection 85(1) rollover, include: (i) real property, an interest therein, or an option in respect thereof, where the transferor is a non-resident person or a non-Canadian partnership; (ii) real property that represents inventory to the taxpayer; and (iii) prepaid expenses.

To qualify for a subsection 85(1) rollover, the transferor of the property must receive at least one share in the capital stock of the purchasing corporation as consideration for the transfer. In addition to this one share, the transferor may also receive non-share consideration from the purchasing corporation. Such non-share consideration could include cash, promissory notes, the assumption of liabilities, or any other property.

For additional information regarding subsection 85(1) rollovers, see the issues of the Legal Business Report on this topic.

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(b) Section 85 Elections

In order to claim the subsection 85(1) rollover, the purchasing corporation and the transferor must jointly execute and file with the CRA an election on the prescribed form on or before the earlier of the days on which the transferor and the purchasing corporation are required to file their respective tax returns for the taxation year in which the transaction occurred.

On the prescribed election form, the parties must state an "elected amount" for each asset transferred. This elected amount is then deemed to be the transferor's proceeds of disposition for the asset and the purchasing corporation's cost of acquisition. Subject to certain limitations, the parties usually choose an elected amount equal to the transferor's tax cost of the asset transferred, as follows: (i) for a non-depreciable capital asset such as land or shares, the transferor's adjusted cost base;
(ii) for a depreciable asset such as a building, machinery, or equipment: the transferor's undepreciated capital cost; and (iii) for other assets such as inventory, the transferor's cost (with the exception that no subsection 85(1) election may be made in respect of real property inventory). By following these rules in choosing the elected amounts, the transferor will not be liable for tax on the transfer of the property; rather, the purchasing corporation will assume the transferor's position with respect to the capital gain, recaptured depreciation, or other unrealized income inherent in the assets.

It is open to the parties to choose a different elected amount other than the tax cost of the transferred asset within certain limitations set out in subsection 85(1) of the Act. The upper limit on the elected amount is the asset's FMV at the time of the transfer. In the event that the parties elect a higher amount, the elected amount is automatically reduced to the FMV. The lower limit on the elected amount is the lesser of: (i) the value of the asset at the time of the transfer; or (ii) the cost amount of the asset to the transferor (i.e. the adjusted cost base for a non-depreciable asset, the undepreciated capital cost for a depreciable asset, or the cost of other assets). In the event that the parties choose an elected amount that is lower than the lower limits imposed by section 85 of the Act, the elected amount is automatically increased to the lower limit.

In addition, the parties cannot choose an elected amount that is less than the value of any non-share consideration received for the transferred asset. In the event that the parties choose an elected amount that is less than the value of any non-share consideration received by the transferor as consideration for the transferred asset, the elected amount would be automatically increased to the value of the non-share consideration, which may result in the triggering of tax consequences to the transferor.

A price adjustment clause is generally used to retroactively adjust the elected amounts in the event they are successfully challenged by the CRA.

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(c) Late or Amended Section 85 Elections

Subsection 85(6) of the Act prescribes the time limits within which an election under subsection 85(1) or subsection 85(2) of the Act must be filed. In particular, an election must be made on the earliest date when any party to the election must file an income tax return for the taxation year in which the transfer occurred pursuant to section 150 of the Act. Subsection 150(1) of the Act requires an individual to file an income tax return for the calendar year in which the individual has disposed of a capital property or has a taxable capital gain.

Subsection 85(7) of the Act allows an election to be filed up to 3 years after the filing deadline set out in subsection 85(6) of the Act, where an estimate of the penalty was paid by the taxpayer or partnership, as the case may be, when the election is filed.

Subsection 85(7.1) of the Act allows an election to be filed beyond 3 years after the filing deadline set out in subsection 85(6) of the Act, or an election to be amended, where it would be just and equitable in the circumstances. The election or amended election must be made in prescribed form and an estimate of the penalty must be paid when the election or amended election is filed.

Pursuant to the CRA's Information Circular 76-19R3, an amended election will generally be accepted under subsection 85(7.1) of the Act if it involves: (i) a change to an inaccurate valuation of the property that gave rise to unintended tax consequences; (ii) a reduction of the agreed amount of transferred shares to the correct cost amount when a transfer at cost was intended; (iii) a correction of situations where it is clear that the insertion of an amount was made in error; or (iv) a correction of other situations which gave rise to unintended tax consequences. The CRA will correct clerical errors without requiring an amended election.

On the other hand, an amended election will not be accepted where, in the view of the CRA, the main purpose of the amended election is: (i) to effect retroactive tax planning; (ii) to take advantage of statutory amendments enacted after the election was filed; (iii) to improperly avoid or evade tax; or (iv) to change the agreed amount in a statute-barred year.

Subsection 85(8) of the Act prescribes the penalty for a late or amended election made pursuant to subsection 85(7) or subsection 85(7.1) of the Act. In particular, the penalty is the lesser of: (i) one-quarter of one percent of the amount (0.25%), if any, by which the FMV of the property at the time of disposition exceeds the amount agreed upon in the election or amended election by the taxpayer or partnership, as the case may be, and the corporation, for each month or part of a month after the original due date and before the filing of the late or amended election; and (ii) $100 for each month or part of a month after the original due date and before the filing of the late or amended election, not

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to exceed $8,000. Elections filed after the 3-year deadline will only be accepted if, in the opinion of the Minister of National Revenue, it is just and equitable to allow the late-filed election subject to the late filing penalty. It should be noted that the penalty is not discretionary and the Act does not permit a reduction or waiver of the penalty.

C. HARMONIZED SALES TAX CONSIDERATIONS

The impact of the harmonized sales tax (the "HST") on the transfer of each of the assets will, with certain exceptions, depend upon the HST rules applicable on the transfer of each type of asset. In particular, the transfer of certain assets including cash, prepaid expenses (unless they relate to an exempt supply), inventory (unless the goods in inventory are zero-rated under the HST legislation), fixed assets, leases of real property or tangible personal property, and intangible property supplied in Canada will be subject to HST based on the FMV of the assets being transferred.

Where such assets constitute assets of a business that is carrying on a commercial activity within the meaning of the HST legislation, the transferee corporation would be able to claim an input tax credit for the HST paid on the costs of the transfer, including legal and accounting fees. By contrast, the transfer of debt securities or loans, accounts receivable or residential real estate will not attract HST since these are exempt supplies pursuant to the HST legislation and therefore the transferee corporation will not be able to claim an input tax credit for HST paid on the costs of the transfer. For transfers of assets, the entire value of goodwill on the sale of a business or part of a business, regardless of whether the goodwill is attributable to commercial or non-commercial activity, is exempt from HST.

There are two types of elections under the HST legislation which may apply to effectively eliminate the HST payable on a transfer of assets to a corporation.

The first election, under section 167 of the *Excise Tax Act* (the "ETA"), applies where both the transferor and the transferee are registrants and all or substantially all of the assets used by a business in a commercial activity are being transferred. The section 167 election is also available upon the sale of part of a business, provided that the assets transferred constitutes all or substantially all of the property that the transferee would require to carry on that part as a business. In these circumstances, the transferor and the transferee may file a joint election to treat the transfer as a zero-rated supply. The prescribed election form must be filed with the transferee's tax return for the reporting period in which the assets are transferred. As a result: (i) the applicable rate of HST on the transfer of assets would be nil; and (ii) the transferee would be able to claim an input tax credit for the HST paid on the acquisition costs.

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The second type of election can be made pursuant to section 156 of the ETA. This election is available for transfers that involve two registrants that are Canadian resident corporations and the two corporations are closely related (i.e. 90% common voting shareholdings). Where this ongoing election is made, most taxable transfers between such corporations will be deemed to be for nil consideration and therefore, no HST will arise. The section 156 election is available regardless of whether all or substantially all of the assets used in a commercial activity are being transferred. However, it should be noted that transfers of real property or goods not for use exclusively in the course of commercial activity are not covered under this election.

The deadline for filing the section 156 election is the first day on which any of the electing parties is required to file a corporate tax return for the period in which the election becomes effective. The election is automatically revoked on the day on which either of the joint electors ceases to qualify as a specified member of a closely related group. The joint election or a voluntary revocation of such an election can be made at any time but the election or revocation must specify its effective date.

Prior to January 1, 2015, the section 156 election was not available to a new member of a closely related group of corporations if the new member does not have any property prior to acquiring assets from another member of the group. Effective January 1, 2015, the availability of the section 156 election was extended to new members of a group of corporations that have not yet acquired any property, provided that the new members continue to engage exclusively in commercial activities throughout the next twelve months after making the election. Additionally, section 156 of the ETA was amended such that parties to a section 156 election are jointly and severally liable with respect to any HST liability that may arise in relation to supplies made between them.

D. LAND TRANSFER TAX CONSIDERATIONS

(a) Imposition and Rate of Tax

Ontario imposes a land transfer tax on certain conveyances of land in the province. This tax is generally payable by the transferee and is levied upon the value of consideration passing to the grantor or transferor pursuant to the conveyance.

Subsection 2(1) of the Ontario Land Transfer Tax Act was amended effective January 1, 2017, changing the rates as follows: 0.5% for the amount of the purchase price up to $55,000, plus 1% of the amount between $55,000 and $250,000, plus 1.5% of the amount of the purchase price between $250,000 and $400,000, plus 2% of the amount of the purchase price over $400,000. For residential properties including at least one, but not more than two single family residences an additional tax bracket was added increasing the rate to 2.5% on the amount of the purchase price over $2,000,000.

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The City of Toronto also imposes an additional land transfer tax on conveyances known as the "municipal land transfer tax" ("MLTT"). The MLTT, as amended effective March 1, 2017, follows an identical rate scheme as the Ontario land transfer tax. For all properties purchased in the City of Toronto the following rates apply: 0.5% for the amount of the purchase price up to $55,000, plus 1% of the amount between $55,000 and $250,000, plus 1.5% of the amount of the purchase price between $250,000 and $400,000, plus 2% of the amount of the purchase price over $400,000. For residential properties including at least one, but not more than two single family residences an additional tax bracket was added increasing the rate to 2.5% on the amount of the purchase price over $2,000,000.

Land transfer tax is imposed on persons who tender for registration in Ontario any instrument by which land is conveyed including a final order of foreclosure under a mortgage or charge, or a caution in writing which gives notice of the existence of an instrument by which land is conveyed. The word "convey" is given a broad definition in section 1 of the Ontario Land Transfer Tax Act. As a result, tax would be payable in respect of any grant, assignment, release, lease, disposition, or agreement to sell any interest in land in Ontario which is presented for registration.

An agreement of purchase and sale or any related notice or caution is a taxable conveyance when tendered for registration. The value of the consideration is the full amount of the consideration set out in the agreement. When the subsequent conveyance of the land to which the agreement relates is tendered for registration, no additional tax is payable where the Affidavit of Residence and Value of the Consideration states that the tax was paid when the agreement of purchase and sale or notice thereof was tendered for registration.

Subsection 3(2) of the Ontario Land Transfer Tax Act extends the application of land transfer tax to certain unregistered conveyances of beneficial interests in land. As a result, tax will be imposed at the same rate and on the same basis as if the disposition had been evidenced by a registered conveyance.

In addition, the use of multiple deeds to minimize land transfer tax is not allowed. Pursuant to subsection 2.3(1) of the Ontario Land Transfer Tax Act, where land is conveyed by more than one conveyance and the Minister of Finance is of the opinion that one of the reasons for conveying the land by more than one conveyance is to reduce the total amount of land transfer tax payable in respect of the conveyances of the land to an amount less than the amount of tax that would have been payable if the land had been conveyed by one conveyance, then the total amount of land transfer tax payable in respect of the conveyances shall not be less than the amount of tax that would have been payable if the land had been conveyed by one conveyance. A parallel provision prohibits the use of multiple dispositions of beneficial interests in land under similar circumstances.

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(b) <u>Exceptions to Imposition of Land Transfer Tax</u>

Where a rollover under subsection 85(1) of the Act involves the transfer of land from a corporation to an affiliate corporation, a deferral of land transfer tax may be available pursuant to subsections 3(9) and 3(11) of the Ontario Land Transfer Tax Act. A corporation is deemed to be an "affiliate" of another corporation if one of them is a subsidiary of the other or if both are subsidiaries of the same company or if each of them is controlled by the same person or corporation. In order to obtain this tax relief, the transferor must submit an application to the Minister of Finance, along with security for the tax in the form of a letter of credit, wherein the Applicant undertakes that the underlying control of the corporate group will continue in the same hands and the interest in land will remain within the corporate group for three years following the transfer. The security is returned to the corporation which furnished it when the said undertaking has been satisfied, or the conveyance evidencing the disposition of the beneficial interest in land is registered and tax owing upon registration is paid, or when the beneficial interest in the land is transferred to a person who is not an affiliate of the corporation and tax is paid on the transfer;

In addition, pursuant to Regulation 697 under the Ontario Land Transfer Tax Act, where the shareholder is an individual who transfers land pursuant to a rollover under subsection 85(1) of the Act to a "family business corporation", an application for exemption from land transfer tax will be considered by the Ontario Ministry of Finance. The regulation defines "family business corporation" to mean a CCPC in which all of the issued shares, other than directors' qualifying shares, are owned by family members of the transferor. To qualify for the exemption, the land must have been in use by an active business that was operated by a member of the family prior to the conveyance and the purpose of the conveyance must be to enable the transferee corporation to continue operating the business under the direction of a member of the family.

In addition, for unregistered dispositions of a beneficial interest in land from one corporation to another through a rollover under subsection 85(1) of the Act as part of a butterfly reorganization, an application for an exemption from land transfer tax can be made to the Ontario Ministry of Finance. However, this exemption does not eliminate the imposition of land transfer tax payable upon the registration of a change in legal ownership following a butterfly reorganization. Consideration should be given to conveying the legal title of the land to a bare trustee corporation prior to the double-wing butterfly transaction in order to avoid this problem.

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.

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