Purchase and Sale of a Small Business
Some Recent Developments

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This article is intended to be a primer on a number of recent developments that may impact on the taxation of the purchase and sale of a small business. The article is being written in conjunction with the preparation of an update of an old checklist in CCH's *Canadian Small Business Financing and Tax Planning Guide***[i]** which will appear shortly in the newer *Small Business Guide*. The checklist has served as inspiration to add some additional commentary into this article about two issues that, while not new, could be overlooked in the context of a purchase and sale of a business. Like the checklist itself, the items discussed in this article are only intended as a general summary; reference should be made to the relevant provisions and authorities.

Legislative Changes

The last few years have been relatively quiet ones in legislative terms vis-à-vis the purchase and sale of small businesses. However, a number of pieces of legislation have been enacted/proposed that practitioners should keep in mind when advising their small business clients in the course of purchasing and selling small businesses.

Subsection 14(1.01)

Subsection 14(1.01) of the *Income Tax Act (Canada)* ("Act")**[ii]** was enacted to permit taxpayers selling eligible capital property ("ECP") with an identifiable cost to elect to report the income from the sale as a capital gain. Although both a sale of ECP and a deemed capital gain under subsection 14(1.01) will both result in amounts being added to the vendor's capital dividend account ("CDA"), only the latter will be capable of being offset against capital losses. In the event that funds are needed personally, making a subsection 14(1.01) election can reduce the integrated Ontario corporate and personal tax rate on the distribution from about 28.1% down to about 24.1%.**[iii]** On the other hand, if sale proceeds will be reinvested at the corporate level, making a subsection 14(1.01) election will increase the Ontario corporate tax rate from about 24.9% to about 18.1%.

There are other incidental advantages and disadvantages of making a subsection 14(1.01) election. For example, where proceeds in connection with a sale of ECP are received over time, taxpayers will be unable to claim a reserve unless they elect under this provision. Another advantage of making a subsection 14(1.01) election is that it can accelerate the ability to utilize CDA realized upon a sale of ECP. For example, since ECP is a year-end calculation, CDA arising from a sale of ECP would not be available prior to the end of the taxation year in which the sale occurred. However, proposed amendments to subsection 14(1.01) will permit a taxpayer that makes a subsection 14(1.01) election in either the taxpayer's year-end return or in a standard CDA election form,**[iv]** which in the latter case may make it possible for a taxpayer to accelerate the ability to use the CDA from a sale of ECP. On the other hand, CDA realized on a sale of ECP is not reduced by the taxable portion of realized capital losses of capital loss carry-forwards, whereas if a subsection 14(1.01) election is made, the taxable portion of such losses will be offset against the CDA generated from the sale.**[v]**

Section 44.1

The budget papers introducing section 44.1**[vi]** state that the purpose behind the introduction of this provision was "to improve access to capital for small businesses." The methodology chosen to achieve the objective referred to above was to create a regime similar to the replacement property regime in section 44 for certain eligible small business investments.**[vii]** In this regard, section 44.1 permits an individual to defer the recognition of all or a portion of any capital gain**[viii]** arising on a disposition of an eligible small business investment provided that the individual: (1) reinvests all or a portion of the sale proceeds into one or more other eligible small business investments in the year of sale or within 120 days of the end of that year, and (2) makes the required designation in the individual's tax return.

Section 44.1 will often be inapplicable to small business owners because most small business owners tend to sell their businesses and retire. However, the true target of section 44.1 is venture and angel investors who

might otherwise have their pool of capital available for reinvestments reduced by taxes in the course of buying and selling businesses. Nonetheless, it may be difficult for even these types of investors to take advantage of the section 44.1 deferral because only sales made by individuals of common-type shares (i.e., eligible small business investments) will qualify for the deferral. Further, in the event that any particular venture or angel investor would ordinarily be taxable on sales of investments on income account, such an investor would not be entitled to enjoy a deferral under section 44.1, which only applies to defer taxes on capital gains.[ix]

Restrictive Covenants

Once upon a time, the rules relating to restrictive covenants ("RCs") were thought to be relatively straight-forward. To the extent that most practitioners considered RCs at all, they were generally either incorporated into proceeds received in connection with a sale of shares or, in the case of an asset sale, treated as proceeds from a sale of ECP.

All of that changed as a result of the decisions in two cases; *Fortino*[x] and *Manrell*.[xi] The essence of the decisions in these cases was to enable taxpayers to receive amounts in connection with a non-competition covenant ("NCC") tax free.

The response of the Department of Finance to the *Fortino* and *Manrell* taxpayer victories was to not only legislate the victories away (a relatively common response these days) but to draft extremely broad draft legislation[xii] that would apply to all RCs[xiii] not just NCCs. For example, other RCs could include non-solicitation covenants, land transfer restrictions and geographic market restrictions. Theoretically, even a right of first refusal or a confidentiality covenant could fall within the ambit of the RC definition.

Although the draft legislation impacts on a number of pre-existing sections of the Act,[xiv] the discussion below will focus on new draft legislation in section 56.4. Pursuant to draft subsection 56.4(2), any amounts received or receivable in respect of RCs will be taxable on income account to the recipient, unless such payments fall within certain fairly narrow elective arm's length exceptions set out in subsection 56.4(3).[xv] Pursuant to various deeming rules in section 56.4 and section 68, a reasonable amount will be deemed to have been received by a vendor for every RC provided. Specific rules in subsection 56.4(4) outline the tax treatment to the purchaser for amounts paid in connection with RCs where amounts are included in an employee's income or where certain elections under subsection 56.4(3) are made.

Due to the amendments to the RC rules eliminating any tax benefit associated with allocating separate consideration to RCs (i.e., NCCs), taxpayers may be inclined to treat RCs in the same manner they were treated prior to *Fortino* and *Manrell* (i.e., to simply lump them into agreements without having separate consideration allocated to them). However, because such amounts will now be taxable on income account as opposed to on capital account, the Canada Revenue Agency ("CRA") could choose to attack taxpayers and perhaps even their advisors[xvi] for a failure to breakout separate consideration in respect of such amounts.

CPP/EI

A welcome change introduced in the February 27, 2004 Federal Budget are amendments to the *Canada Pension Plan Act* ("CPPA")[xvii] and the *Employment Insurance Act* ("EIA"),[xviii] which permit a successor employer to take into account CPPA and EIA contributions made by a predecessor employer when determining the successor employer's CPPA and EIA contributions in the calendar year a change in business structure occurs. These changes will simplify compliance and reduce payroll costs that would otherwise be incurred as a consequence of mid-year changes to business structures, other than amalgamations that result in employees being employed by a new employer.

The proposals in connection with the changes to the CPPA and EIA have now been enacted and are applicable to years commencing after 2003. The amendments also provide for situations where self-employed individuals become employees of a corporation controlled by them and vice versa.

Ontario *Retail Sales Tax Act* ("RSTA") – Related Party Transfers

Ontario practitioners are also welcoming the changes to section 13 of regulation 1013 of the RSTA and the introduction of sections 13.1 to 13.7 to regulation 1013 of the RSTA which deal with related party transfers.[xix] The amendments are effective from July 20, 2004.

The amendments are intended to permit unlimited tax-free transfers of tangible personal property ("TPP") that is "eligible property"[xx] between "related" corporations. Under the prior version of the legislation only one tax-free related party transfer of any particular item of TPP was possible. While the threshold for determining whether corporations are "related" is being maintained at 95% ownership, it will be possible to take indirect ownership

into account in making the determination. To avoid potential abuses of the rules, shares will need to continue to be held continuously for at least 180 days following the date of a particular transfer to qualify for the exemption; accordingly it will no longer be possible to avoid RST by transferring property to a corporation and selling the shares of the corporation immediately thereafter. Even where the 95% threshold is not met, the rules provide for the amount of RST payable to be pro-rated in accordance with the ratio of the aggregate of the transferor's stated capital in all classes of the corporation to the aggregate stated capital of all classes of the corporation. The rules are also being expanded to permit tax free and pro-rated transfers between partners and partnerships in a manner consistent with the rules applicable to corporate transfers.

CRA Administrative Change

Management Fees

Up until recently, there appeared to be a trend by the CRA towards liberalizing its policies in respect of challenging management fees. In particular, in *Technical News No. 22*, dated January 11, 2002, the CRA indicated it would not challenge the reasonableness of management fees so long as:

1. the salaries and/or bonuses were paid to managers who are either directly or indirectly shareholders of a Canadian-controlled private corporation ("CCPC");
2. the shareholders/managers were Canadian residents; and
3. the shareholders/managers were actively involved in the day-to-day operations of the business and contributed to the income-producing activities giving rise to the remuneration.

Furthermore, contrary to previous statements by the CRA, in *Technical News No. 22*, the CRA indicated that, so long as the foregoing criteria were met, this policy would apply to bonuses out of non-active business income (including income from a specified investment business), provided the shareholder was actually active in managing such a business.**[xxi]** In this regard, the CRA has indicated that in appropriate factual situations, it will accept the reasonableness of a bonus that gives rise to a corporation suffering a non-capital loss.**[xxii]**

The CRA's administrative largesse may not apply unequivocally in all situations. For example, consistent with previous statements, the CRA has continued to indicate that it may challenge the reasonableness of inter-corporate management fees. Furthermore, in *Technical News No. 30*, dated May 21, 2004, which published comments by the CRA at the 2003 Annual Canadian Tax Foundation Conference, the CRA indicated that it reserved the right to challenge management fee situations which are not straight forward, such as situations involving a major sale of business assets.**[xxiii]**

Overlooked Items

Impact of Granting Rights and Options to a Non-CCPC

In the course of selling a small business it is possible that a vendor could grant certain rights to a purchaser prior to the closing of a sale, such as granting the purchaser a right to buy all of the vendor's shares.**[xxiv]** Pursuant to paragraph 251(5)(b) and/or subsection 256(1.4), the granting of such rights could result in the purchaser being deemed to have acquired the shares and/or the right to vote the shares at the time the rights are granted.**[xxv]** The categories of rights that appear to be caught by these provisions are extremely broad. However, the CRA has indicated in the past that generally they will not apply the provisions unless there is a clear right or obligation on a party to buy or sell.**[xxvi]** For example, while rights provided under a binding share purchase agreement will be caught by these provisions, it is questionable whether a non-binding letter of intent would be caught.

Assuming these provisions are applicable and depending on the rights granted, the purchaser might be deemed to be related to the corporation in accordance with subsection 251(2) and/or to be associated with the corporation pursuant to section 256. An even more serious consequence from the perspective of most small business vendors would be that if the purchaser is not a CCPC, then depending on the rights granted, the corporation might be deemed to lose its status as a CCPC. Among other things, the loss of CCPC status would result in the corporation being unable to claim the small business deduction in the year the right is granted and in any other years if the right remains outstanding during any portion of such years. Another unfortunate result of granting such rights is that it will not be possible for a shareholder selling shares of the corporation at a loss to claim an allowable business investment loss ("ABIL") if CCPC status is lost since CCPC status is a prerequisite to claiming an ABIL. Fortunately, pursuant to paragraph 110.6(14)(b), the grant of such options will have no impact on whether a share is a qualifying small business corporation share.

Elections under Subsection 20(24)

Where a small business owner (or any business owner for that matter) is selling business assets and the vendor is assuming liabilities, including prepaid amounts that would be taxable under paragraph 12(1)(a), consideration should be given to arranging for both parties to execute and file a joint election under subsection 20(24).**[xxvii]** Where an election is made under subsection 20(24), the tax burden associated with prepaid income amounts will be shifted from the vendor to the purchaser, which appears to be reasonable since the purchaser will actually carry-out the activity to earn such amounts. In the absence of this election, the vendor would be required to pay tax on the prepaid amount (and/or the amount of any prior year reserve under paragraphs 12(1)(e)) without being entitled to claim any offsetting reserves or deductions. Furthermore, since the outlay expended by the purchaser to acquire the service contracts would be paid on capital account, any costs to complete the contracts will be incurred on capital account and not deductible, which would likely be a suboptimal result.

Special thanks to David Louis.

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[i] Now discontinued.

[ii] Unless otherwise specified all statutory references are to the Act. Subsection 14(1.01) was introduced by Bill C-22; S.C. 2001, c. 17, s. 7, applicable to taxation years that end after February 27, 2000, and is currently undergoing additional technical amendments, as set out in Department of Finance Release 2005-049, dated July 18, 2005.

[iii] The differential in rates arises because a sale of ECP does not attract the 6 2/3% refundable tax in section 123.3 and qualifies for the 7% business rate reduction in section 123.4.

[iv] Form T2054. It does not appear possible to late-file a section 14(1.01) election form.

[v] For further discussion, reference should be made to “Eligible Capital — Some Big Changes” Parts I and II, David Louis, *Tax Topics* #1718 and 1719.

[vi] Section 44.1 was introduced by Bill C-22; S.C. 2001, c. 17, s. 29.

[vii] The rules of eligibility are beyond the scope of this article. However, it should be kept in mind that only investments in “common-type” will qualify.

[viii] The actual deferral is determined by a formula and is beyond the scope of this article.

[ix] For a detailed review of “Angel Capital Rollovers” in Canada under section 44.1 as compared to those available in the United States, see Daniel Sandler, *Venture Capital and Tax Incentives: A Comparative Study of Canada and the United states*¸ Canadian Tax Paper no. 108 (Toronto: Canadian Tax Foundation, 2004), 105-112.

[x] *Fortino v. R.*, 2000 DTC 6060 (FCA).

[xi] *Manrell v. R.*, 2003 DTC 5225 (FCA).

[xii] Introduced in Department of Finance Release 2004-14, dated February 27, 2004, as updated by Department of Finance Release 2005-049, dated July 18, 2005.

[xiii] Proposed subsection 56.4(1) defines “restrictive covenant” as:

> an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer (other than an agreement or undertaking for the disposition of the taxpayer’s property or for the satisfaction of an obligation described in section 49.1 that is not a disposition), whether legally enforceable or not, that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer or by another taxpayer that does not deal at arm’s length with the taxpayer.

[xiv] For example, subsection 6(3.1), subparagraph 12(1)(x)(v.1), paragraphs 60(f) and 56(1)(m), section 68 and paragraphs 212(1)(i) and 212(13(g).

[xv] Joint elections are required. Additional narrow exceptions have been introduced in Department of Finance Release 2005-049, dated July 18, 2005. For a detailed discussion of these exceptions and their limitations see "The Non-Compete Saga Continues," Michael N. Kandev, *Tax Topics* #1747.

[xvi] For example, using the civil penalty rules in section 163.2.

[xvii] SC. 2004, c. 22, s. 15 adding subsections 9(2) and other consequential amendments.

[xviii] SC. 2004, c. 22, s. 27 adding section 82.1.

[xix] O. Reg. 391/04, s.2.

[xx] As that term is defined in subsection 13(5) of the proposed legislation.

[xxi] *Technical Interpretation* no. 2002-0128875 dated April 8, 2002.

[xxii] *Technical Interpretation* no. 2004-0072741R3, dated July 21, 2004.

[xxiii] Response 4:

> Yes. We would consider a situation in which a CCPC pays the remuneration out of the proceeds generated from a major a sale of business assets, including the sale of the entire business assets or those of a large division, to be beyond the intent of the policy. This would encompass all sources of income triggered by the proceeds, including capital gains, recapture of capital cost allowance, and income arising from the disposition of eligible capital properties. We would not generally be concerned with situations where there is a sale of some of the assets, which is incidental to the normal business operations.

The CRA has ruled favourably on reasonableness of management fees paid out of major asset sale proceeds in a number of recent *Technical Interpretations*. See for example document nos. 2004-0060191R3, dated April 7, 2004, 2004-0086191R3, dated November 24, 2004, 2004-0092931R3, dated December 15, 2004 and 2004-0101131R3, dated February 9, 2005. Document no. 2004-0106951I7, dated May 31, 2005, yielded more mixed results. The facts in this *Technical Interpretation* involved the purported payment by a corporation of large bonuses to two active salaried shareholders and five inactive previously non-salaried shareholders (the active shareholders received a much larger amount of the bonuses) out of proceeds of the sale of all of the corporation's operating assets. The CRA indicated that it would not challenge the bonuses paid to the active shareholders. However, the CRA indicated that it considered the amounts paid to the inactive shareholders to:

> represent a benefit that is conferred on them in their capacity as shareholders of the Company on the discontinuance of the business. It is our view that, by virtue of subsection 84(2) of the *Income Tax Act*, the Company is deemed to have paid a dividend to [the inactive shareholders] since there is a respectable argument that such amounts were paid on the discontinuance of the business.

Furthermore, in *Technical Interpretation* document no. 2002-0128865, dated April 10, 2002, the CRA confirmed that its administrative policy regarding management fees in TN 22 would not extend to management fees paid to reduce capital gain income since only outlays or expenses "made or incurred by the taxpayer for the purpose of making the disposition" can be deducted in computing a taxable capital gain.

[xxiv] While such a right may be referred to as an option the nature of the right and not the name governs the tax consequences.

[xxv] The provisions may also apply in other situations.

[xxvi] See paragraph 13 of former *Interpretation Bulletin IT-419R*. Although *IT-419R* has been replaced and these words do not appear in the current draft, it is likely that they continue to reflect the CRA's views on what is and what is not covered by the broad language in paragraph 251(5)(b). In *Technical Interpretation* document no. 2005-0121951E5, dated April 28, 2005, the CRA indicated that a "call" option alone (i.e., without there being an offsetting "put" option) could be caught by paragraph 251(5)(b). As set out in *Technical Interpretation* document no. 2002-0133675, dated January 7, 2003, cash call provisions that provide for the possibility of changes in shareholding among shareholders upon default (multiple contingencies were involved) could also be caught by this provision.

[xxvii] There is no prescribed form for this election.