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TAXSTRATEGY

Selling a Private Business – Part II

To Sell Shares or Assets?

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In last month's article, I discussed what most business owners wonder about at some point: How do I best sell my business? In particular, I touched on the topic of who should you sell your business to.

In this article, I will explore two options for structuring the sale of your business and the tax considerations relating to each (and how to best optimize your current structure to minimize taxes payable in order to maximize the amount in your pocket post- ale).

Sell assets or shares? That Is the Question

If you decide to sell to a third party, you'll need to choose whether to sell the assets or the shares of your company. This may involve some negotiation with your prospective purchaser. In general, vendors prefer a share sale and purchasers prefer an asset sale. Why, you ask? Well, a purchaser will sometimes be hesitant to take on any "luggage" that comes with a purchase of shares since they will be buying the corporation and everything that comes with it (i.e. any potential skeletons in the closet).

Moreover, by purchasing assets directly, the assets get a bumped-up cost base, which means that they have a higher amount to depreciate for those depreciable assets. From a vendor's perspective, a sale of shares can potentially allow them to take advantage of the lifetime capital gains exemption (LCGE), which allows individual vendors to shelter around $971,000 in capital gains on the sale of shares of a company carrying on an active business (subject to certain conditions of course). So let's explore a little more the tax issues from the vendor's perspective with both a shares sale and an asset sale.

Share Sale Considerations

With a share sale occurs, the vendor's proceeds in excess of his or her adjusted cost base are treated as a capital gain, which is only 50 per cent taxable. As noted above, some or all of the gain could qualify for the LCGE. In addition, with a share sale the purchaser inherits the liabilities of the business, so the vendor doesn't have to worry about business liabilities arising from actions taken before the sale (subject to any representations or warranties given by the vendor to the purchaser).

☛ You'll want to declare and pay a capital dividend prior to the sale to the extent that this is available. Capital dividends are paid out tax-free to shareholders from a company's capital dividend account, which is made up of the non-taxable portion of capital gains received by the corporation (recall that only 50 per cent of a capital gain is taxable). This will have the effect of reducing the purchase price of the business and consequently the amount that is subject to tax.

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☛ The tax implications of share sale to you are usually straightforward. You may have a capital gain, some or all of which may be sheltered by the capital gains exemption. You may also have unused capital losses from prior years, which can reduce the tax you pay on your capital gain.

The LCGE

Capital gains are taxed more favourably than other forms of income. Only 50 per cent of the gain is included in income. In addition, and as noted a couple of times already (which is reflective of how important this can be to you), you may be able to save tax on around $971,000 of capital gains (indexed for 2023) from tax under the LCGE. This amount will be reduced by amounts you've previously claimed under the LCGE, and by your allowable business investment loss and cumulative net investment loss at the end of the year. In order to be eligible for the LCGE, you must be an individual (not a corporation) who is a Canadian resident and who has sold shares of a "qualified small business corporation" (QSBC). In general, shares will be treated as shares of a QSBC if the following requirements are met:

☛ The corporation is a Canadian-controlled private corporation.

☛ At the time the shares are sold, at least 90 per cent of the assets are used to carry on an active business in Canada and/or are shares of a connected QSBC.

☛ You (or together with a related person to you from whom you have acquired the shares) have owned the shares for 24 months before the sale.

☛ During those 24 months, more than 50 per cent of the corporation's assets were used in an active business in Canada and/or were shares of a connected QSBC.

The rules that apply to QSBC shares and the LCGE are very complex, and beyond the focus of this article. So, if you're considering selling your business, you should consult a tax professional.

If you think you may eventually sell your business down the road, and you are the only shareholder, you should also consider putting in place a corporate structure that could allow you to multiply the LCGE among your family members. Remember, each person (no matter how old, or how young), has access to the LCGE. Moreover, if a family trust is a shareholder of your company, the trust can claim the LCGE for each beneficiary, which means multiplying the tax savings on over $971,000 of capital gains PER FAMILY MEMBER.

If you read my articles regularly, you will recall how one can implement an "estate freeze" to introduce a family trust on a tax-deferred basis as a shareholder of your company. But beware – don't wait too long to think about doing an estate freeze. This is because the trust will need to meet the 24 month holding period per the conditions noted above. So it's never too early to think about the proper corporate structure if you want to maximize the tax savings on a future liquidity event.

If you're selling the shares of your business and you hold the shares through a personal holding company, you may be able to take advantage of "safe income" dividends paid tax-free to your holding company to reduce the purchase price of the shares. You'll therefore reduce the amount of your taxable capital gain (while moving excess cash out of your company to your holding company). "Safe income" is, very generally, the corporation's after-tax income earned or realized after 1971. The point of this technique is to defer the tax on the safe income until your holding company pays it out to you. A note of caution, however: This strategy makes sense only if you can leave the safe-income dividend in your holding company for a long time. This is because the capital gains tax rate is significantly lower than the dividend tax rate you would have to pay personally if you were to pay these monies out to you from your holding company as a taxable dividend. So, if you need access to all of the proceeds from the sale personally in a short time post-sale, this technique produces a worse after-tax result, since you would be paying a dividend tax on these funds.

Keep in mind, also, that the lifetime capital gains exemption is available only to individuals. So if the holding company sells the shares, the proceeds won't qualify for this exemption. You could claim the capital gains exemption by selling the shares of your holding company, but this may not be appropriate, as there are strict requirements to meet in order to claim the capital gains exemption in this manner. If you have cash or other investment assets in your holding company, it will cost you, tax-wise, to pull

everything out in order to purify the holding company. However, with proper advance planning, it's possible both to pay a safe income dividend and take advantage of the lifetime capital gains exemption. If you're considering tax planning based on safe income, be sure to seek professional tax and legal advice first.

Asset sale

With an asset sale, there are potentially two levels of tax:

☛ 1. Tax paid by the corporation as a result of the sale of the assets.

☛ 2. Tax paid by you personally, as you take the proceeds of the sale out of the corporation.

While there is integration to prevent double taxation, selling assets may not result in the best after-tax result as selling shares. It's important to analyze and compare the tax implications of both actions to determine which avenue is more advantageous for you.

The tax implications of an asset sale will depend on the tax position of your corporation before the sale, the allocation of the purchase price, and how and when the corporation's after-tax proceeds are paid out to you and any other shareholders. In some circumstances, an asset sale can provide a tax-deferral advantage if the after-tax sale proceeds are left in the corporation until you need them as corporate tax rates are generally lower than personal tax rates. If the purchaser insists on an asset sale, you should ask your tax advisor to calculate the difference in the after-tax result to you compared with a share sale. This may lead you to ask for a higher price in exchange for agreeing to an asset sale.

If you do decide on an asset sale, you and the purchaser will have to agree on how the purchase price will be allocated among the assets that are being sold. The purchaser will typically want to allocate as much of the purchase price as possible to inventory or depreciable property in order to reduce the taxable income that the business will generate in future years (a higher cost base for these assets provides for more capital-cost allowance to be claimed as the assets are depreciated).

You, on the other hand, will want to ensure the opposite -- that the allocation of the purchase price minimizes any recapture of any capital cost allowance previously deducted on depreciable property, or a realization of income on the sale of inventory (both of which are taxed at full rates and not as capital gains). The purchase agreement should specify the agreed-upon allocation and require both parties to file their tax returns in a manner consistent with that allocation. ❏

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