The TaxLetter®

Vol. 41, No. 3 — Your Guide to Tax-Saving Strategies — March 2023

TAXSTRATEGY

Selling a Private Business

Tax Considerations

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(This is the first of two articles on selling a private business. The next article will appear in our April issue).

If you're the owner of a private business that has grown in value over the years, much of your personal and family wealth is likely to be tied up in your company. At some point, you may want to access that wealth, whether to fund your retirement, finance a major purchase, or just provide for your family. And you'll want to do it in the most tax-effective way possible.

For many business owners, the most effective way of realizing the value of their business is to sell it. This raises two key questions: Who do you sell the business to (assuming it's not being sold on the open market), and How do you structure the sale to make it as tax efficient as possible?

As you can imagine, these questions can raise a multitude of issues. For this article, we will focus on the first question, being who do you sell your business to. Next month's article will focus on how to best structure a sale.

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Non-monetary considerations

Your decision on who you sell your business to may be motivated by non-monetary issues. For example, you may want to reward loyal employees by offering them the opportunity to purchase the business. Or you may want to sell to a child or other family member, with your prime consideration being the continuation of the family-run business. If you have other shareholders, your choice of a purchaser may be restricted by the terms of an existing buy-sell agreement.

For many owners, however, a sale to a third party may be the most attractive. In this case, you'll want to structure the sale to maximize your tax advantages.

Sale to other shareholders

In many cases, the company shareholders will have worked out a buy-sell agreement at some point in the company's history, which sets out the conditions of sale and the purchase price (or a method of calculating the purchase price). The sale to other shareholders will almost always take the form of a share deal in which you either sell the shares to the other shareholders or the company redeems your shares.

If the company redeems your shares, you will be deemed to receive a dividend for the difference between the redemption price and the paid-up capital (PUC) of the shares (see discussion of PUC below). This is not a desirable result, as this difference will be taxed at the dividend tax rate of between 39 per cent and 46 per cent, depending on the province and the type of dividend. A more favourable option is to have the other shareholders purchase your shares directly. The proceeds you receive (in excess of your cost base) are considered a capital gain and taxed at the lower capital gains tax rate (approximately 26.7 per cent for Ontario).

If the shares are from a qualified small business corporation, you may also be able to claim the Lifetime Capital Gains Exemption (LCGE). The LCGE is available to each Canadian resident who sells shares of a private corporation that meets certain tests (at a high level, the target corporation must be a Canadian- controlled private corporation that is carrying on an active business, primarily in Canada (whose assets do not include too much in passive assets). If these tests are met at the time of a sale of shares, the shareholder can shelter just over $971,000 (CAD) in capital gains (indexed for 2023). In addition, the actual amount of the capital gain may be less than the actual amount of the deemed dividend. This would occur where you purchased your shares from the company directly, after other shareholders had acquired shares from the company for a lower price.

Your capital gain is calculated based on what you paid for your shares, that is, your adjusted cost base (ACB). As noted above, your deemed dividend is calculated based on the PUC of your shares. PUC is calculated by averaging the total amount of shareholder capital that has been paid in full of all issued shares of the class, over the issued shares of that class to you (and not just your shares held by you). As a result, your PUC could be less than your ACB and so a capital gain would be smaller than a deemed dividend.

If your fellow shareholders don't have the funds to purchase your shares, they may want to use funds from the business to finance the purchase. To do this, a new company is usually incorporated on their behalf in order to purchase the shares from you. This allows you to still benefit from the lower capital gains rate, and possibly the LCGE, on the sale of the shares. However, thus transaction must be at arm's length (i.e. the new company purchasing the shares cannot be owned by persons related to you) or else you will be subject to a deemed dividend.

There are exceptions, however, to this (including some recent changes to the tax rules that will be explored in next month's article); therefore, professional tax advice is critical to ensure that the capital gain is not recharacterized as a dividend.

Sale to employees

Similar issues arise if you are selling the business to employees. In many situations, the employees will not have the required funds to buy you out. To fund the purchase over time, you may want to consider "freezing" the value of the company. You could exchange your common shares for preferred shares that have a redemption value based on the value of your common shares on the date of the freeze. The employees would subscribe to new common shares with a nominal value. Over time, the company could redeem your preferred shares, resulting in a deemed dividend, or the employees could purchase them (resulting in a capital gain).

Transfer to the next generation

Rather than sell the business to a third party or to an employee, you may want to keep it in the family and bring the next generation into the company. However, your kids may not have the funds to buy your shares. Or you may simply want to slowly bring the children into the business over time, while you are still involved.

A common method of achieving this goal is to implement an "estate freeze". As in a sale to employees, you would exchange your common shares of the company for preferred (or "freeze" shares) which will have a redemption value equal to the fair market value of the company at the time of the estate freeze. New growth shares would be issued to the children (or a discretionary family trust for the benefit of your issue).

Any future growth in the value of the company would then accrue to the new growth shares held by your kids (and not to you).

The benefit of an estate freeze is twofold. Firstly, you will maximize the value of your estate upon death, as the value of your interest in the company will be limited to the freeze value of the preferred shares, resulting in less capital gains tax for your estate. Secondly, you will have deferred the tax on the future growth of the company until the death of the next generation (or when they sell). Accordingly, capital gains and other tax exposure on the future growth that would otherwise arise when the assets pass from you to your kids are avoided.

Once you have implemented an estate freeze, you can slowly have the company redeem your preferred shares over time by using retained earnings in the company. Keep in mind, however, that any redemptions will be treated as a deemed dividend to you.

If you don't need the cash, you can simply let the preferred shares remain in place, and upon your death, your estate will realize a capital gain on the preferred shares (which is only 50 per cent taxable).

In next month's article, I'll explore different ways that a sale of a business might be structured and discuss the tax consequences. ❑