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ASSET PURCHASE TRANSACTIONS – PART 1

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 from the respective viewpoints of the purchaser and the vendor.

A. SALE OF CAPITAL PROPERTY

(a) Non-Depreciable Capital Property

The disposition of non-depreciable capital property, such as land or shares of a corporation, will give rise to a taxable capital gain or allowable capital loss upon disposition. A capital gain is the amount by which the proceeds of disposition of a property exceed the adjusted cost base (the “ACB”) of that property. If the proceeds of disposition are less than the ACB, a capital loss will result.

Capital gains are taxed preferentially, in that only 50% of a capital gain must be included in income. Subsection 38(a) of the *Income Tax Act* (the “Act”) defines a taxable capital gain as 50% of a capital gain, and subsection 38(b) of the Act defines an allowable capital loss as 50% of a capital loss. Allowable capital losses can only be claimed to offset taxable capital gains. Pursuant to the provisions of subsection 111(8) of the Act, a net capital loss can be carried back for 3 taxation years and carried forward indefinitely.

Expenses of acquisition of a capital property will increase the ACB of the property, thereby reducing the capital gain or increasing the capital loss upon disposition. Pursuant to subsection 40(1) of the Act, any expenses incurred for the purpose of making the disposition of the capital property, such as selling expenses, will reduce the capital gain or increase the capital loss.

(b) Depreciable Capital Property

The disposition of depreciable capital property, such as a building or machinery and equipment, may give rise to either a recapture of capital cost allowance (“CCA”) or a terminal loss.

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Where the proceeds of disposition allocated to a class of depreciable property exceed the undepreciated capital cost (the "UCC") of that class, a recapture of CCA will result. Such recapture must be fully included as income, meaning that any recapture arising from the sale of business assets by a corporation will be taxed at the applicable rates for business income. Any gain over the initial capital cost of depreciable property is taxed as a capital gain, 50% of which must be included in income.

If the proceeds of disposition allocated to a class of depreciable property are less than the UCC of that class, a terminal loss results. A terminal loss may be offset against all sources of income. Losses on depreciable property are fully deductible from business or property income either as CCA under paragraph 20(1)(a) of the Act or as terminal loss pursuant to subsection 20(16) of the Act.

Subsection 13(21.1) of the Act places limitations on a taxpayer's ability to claim a terminal loss in transactions involving the disposition of land and a building. When this subsection applies, it reduces the capital gain on the land by reducing the purchase price allocated to the land and increasing the purchase price allocated to the building such that no terminal loss results. For a more detailed discussion of subsection 13(21.1) of the Act, please see the issue of the Legal Business Report addressing the topic of price allocation.

(c) Capital Gains Reserves

Where a taxpayer has disposed of capital property but is not entitled to full payment in the year of disposition, such as in a case where payments are to be made in installments over several years, a reserve for future proceeds of disposition may be claimed pursuant to subsection 40(1) of the Act. This provision is optional, rather than mandatory.

The maximum period for which a reserve may be claimed is the lesser of: (i) the number of years it takes until the entire proceeds of disposition have been paid and (ii) five years. The taxpayer must recognize at least one-fifth of the capital gain over each year in which the reserve is claimed. A reserve cannot be claimed by a person who is, or becomes, a non-resident.

B. SALE OF ELIGIBLE CAPITAL PROPERTY

An eligible capital expenditure (the "ECE") arises when a purchaser acquires certain kinds of intangible property, also referred to as eligible capital property, such as goodwill, patents, trademarks, customer lists, franchises and licenses. Any ECEs for a particular business are placed into the business's cumulative eligible capital pool (the "CEC pool").

The CEC pool is used to calculate a business's allowable deduction in respect of the eligible capital property for each taxation year. Three-quarters of an ECE is added to the CEC pool of the business and the purchaser is allowed to claim a deduction equal to 7% of the balance in the pool each taxation year on a reducing-balance basis. A purchaser must maintain a separate pool for separate businesses.

On a disposition of an eligible capital property, three-quarters of the proceeds of disposition must be subtracted from the vendor's CEC pool. If the CEC pool becomes negative as a result of the disposition, the vendor is required to (i) include the negative amount in its income to the extent of previously claimed deductions (i.e. 7% reducing-balance deductions) and (ii) include one-half of the balance of the negative amount in its income. Alternatively, if the CEC pool is positive after the disposition, the balance may be deducted as a loss against all sources of income, provided that the vendor ceases to carry on the business.

In 2014, the federal government released new proposed rules regarding the tax treatment of eligible capital property and invited the public to make submissions in regards thereof. The proposed rules would eliminate the tax advantages associated with eligible capital property by introducing a new class of property for the purposes of CCA and taxing eligible capital property in the same way that gains on other depreciable property are taxed. The effect of the proposed rules would be a 10% increase in the tax payable on gains on eligible capital property. The possibility of the government adopting the proposed rules may be a relevant consideration for individuals who are currently considering selling their business.

C. <u>SALE OF INVENTORY</u>

Pursuant to section 23 of the Act, where a taxpayer sells all or part of the inventory of a business, the consideration received for the inventory must be included in income. The cost or book value of the inventory will be deducted in the same manner as if it had been sold in the course of business. Subsection 39(1) of the Act specifically excludes inventory from being treated as capital property for taxation purposes. Therefore, a sale of inventory does not receive the preferential tax treatment accorded to other capital property.

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D. SALE OF ACCOUNTS RECEIVABLE

Section 22 of the Act deals with the sale of accounts receivable and is applicable upon the joint election in prescribed form by a vendor and a purchaser, where the vendor sells all or substantially all (i.e. at least 90%) of the assets of a business that was carried on in Canada to a purchaser who proposes to continue the business. The business assets sold must include all the accounts receivable of the vendor that are outstanding at the time of the sale.

If the Canada Revenue Agency (the “CRA”) accepts the election, then the vendor is entitled to deduct in the year of sale any loss on sale of the accounts receivable, computed as the difference between the proceeds received and their face value (excluding those accounts previously written off by the vendor as bad debts under paragraph 20(1)(p) of the Act). The loss is computed without regard to any reserve for doubtful debts, whether or not such reserve has been previously allowed as a deduction under paragraph 20(1)(l) of the Act.

The amount that the vendor is allowed as a deduction in the year of sale, pursuant to paragraph 22(1)(a) of the Act, is required to be included in the purchaser’s income in the year of the purchase. Paragraph 22(1)(c) of the Act provides that the purchaser may then deal with the accounts receivable for tax purposes as though they had arisen while the purchaser was the owner of the business. The purchaser may claim a deduction for a reserve for doubtful debts under paragraph 20(1)(l) of the Act and may deduct bad debts under paragraph 20(1)(p) of the Act. A receivable that the vendor previously deducted under paragraph 20(1)(p) of the Act may not be deducted by the purchaser. In the event that the purchaser should collect a receivable previously deducted by the vendor under paragraph 20(1)(p) of the Act, it must be included in the purchaser’s income.

The portion of the sale price of the business that is the consideration for the accounts receivable is required to be set out in the joint election which the vendor and purchaser must execute pursuant to subsection 22(2) of the Act. The joint election must be made on Form T2022 and should be filed with the tax return for the taxation year of the sale.

As far as the vendor and purchaser are concerned, the amount that is stated in the joint election to be the consideration for the accounts receivable is final for tax purposes and cannot later be altered. However, the joint election is not necessarily binding on the CRA, and may be challenged on assessment if it is considered not to reflect the facts of the sale, such as when the face value of the debts sold is incorrectly stated or when the consideration actually paid is different from that set out in the election.

If the vendor and purchaser are not dealing at arm's length and the fair market value (the "FMV") of the accounts receivable sold was more or less than the consideration paid for them, the provisions of paragraph 69(1)(a) or (b) of the Act will be applied to the transaction. Subsection 69(1) of the Act operates only to adjust one side of the transaction. When the sale price is below FMV, paragraph 69(1)(b) of the Act increases the transferor's proceeds of disposition to FMV but does not increase the purchaser's cost. Alternatively, when the sale price is above FMV, paragraph 69(1)(a) of the Act adjusts the transferee's cost downward to FMV but does not reduce the vendor's proceeds. A price adjustment clause should be used in the asset purchase agreement to retroactively readjust the sale price and the consideration received to FMV to avoid this outcome.

If the asset purchase agreement does not specify which portion of the total consideration is for the accounts receivable, a reasonable allocation must be made between accounts receivable and other assets included in the sale.

It is desirable that the asset purchase agreement should contain a list of the accounts receivable that are being sold and should contain an allocation of the purchase price specifying the amount of the consideration relating to the accounts receivable, which should attempt to reflect their FMV.

E. ALLOCATION OF PURCHASE PRICE OF ASSETS

As mentioned above, a sale of assets generally gives rise to one or any combination of the following: (i) capital gains or capital losses; (ii) a recapture of or terminal losses on CCA; or (iii) income or a terminal allowance from the disposition of eligible capital property. The amount of income tax payable on a sale of assets is directly affected by the allocation of the purchase price between the aforementioned items.

In an asset sale, negotiating the allocation of the purchase price to the various tangible and intangible assets that form part of the sale is a key component. 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 it, would greatly benefit the other party.

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

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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.

In certain circumstances the CRA may reallocate the purchase price. Section 68 of the Act allows 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 on a balance of probabilities.

For a more detailed discussion of price allocation, please see the issue of the Legal Business Report addressing the topic.

F. NON-RESIDENT VENDORS AND SECTION 116 CLEARANCE CERTIFICATES

(a) General Provisions

Under the current provisions of the Act, a non-resident vendor of "taxable Canadian property" as defined in subsection 248(1) of the Act is generally liable to remit tax in Canada on any capital gain on the property. Tax will not be payable in the following circumstances: (i) a particular income tax treaty exempts the capital gains from taxation; (ii) a rollover provision applies to the transaction pursuant to the Act; or (iii) the property is considered "excluded property" as defined in subsection 116(6) of the Act.

To ensure this tax is collected, section 116 of the Act contains a compliance measure, often referred to as a "116 Clearance Certificate", which must be obtained from the CRA upon the purchase of taxable Canadian property from a non-resident vendor.

The definition of "taxable Canadian property" includes "options in respect of, or interests in…[real or immovable property situated in Canada, Canadian resource properties, and timber resource properties, whether or not the property exists]" under paragraph (d) of the definition in subsection 248(1) of the Act. Consequently, a 116 Clearance Certificate is likely needed, for example, if a non-resident who entered into an Agreement of Purchase and Sale for a condominium sells rights under the agreement to a Canadian resident even if the condominium is not ready for occupancy or closing at the time of the sale.

In the event that a non-resident vendor requires a 116 Clearance Certificate, the non-resident vendor must provide notification to the CRA of the details of the sale transaction and the parties thereto. In addition, the non-resident vendor must pay the CRA 25% of the vendor's capital gain on the transaction (or 50% in the case of inventory or depreciable property) or must provide security for such payment which is acceptable to the CRA.

In the alternative, the parties may close the transaction, and the vendor is required to: (i) report the disposition to the CRA within 10 days after the date of disposition and (ii) remit 25% (or 50%, as noted above) of the vendor's capital gain on the transaction or provide security for such payment, which is acceptable to the CRA.

Where a non-resident vendor of taxable Canadian property has not obtained a 116 Clearance Certificate issued by the CRA regarding the proposed disposition, the purchaser of the property is liable to withhold and remit to the CRA 25% or 50%, as appropriate, of the aggregate purchase price. When an application for a 116 Clearance Certificate has been made but the certificate has not yet been issued, the CRA may provide a comfort letter upon the non-resident vendor's written request. If a comfort letter is issued, the purchaser may withhold the appropriate percentage of the proceeds of disposition and may wait for the certificate to be issued without being liable for penalties or interest.

Under subsection 227(10.1) of the Act, there is no limitation period on an assessment for failing to withhold tax under section 116 of the Act. Therefore, the CRA can reassess the purchaser many years after the transaction has transpired.

Before the CRA will issue a 116 Clearance Certificate, the non-resident vendor must have an Individual Tax Number, a Canadian Social Insurance number, or a Temporary Taxation Number. There are currently wait times associated with obtaining these numbers, as well as with obtaining a 116 Clearance Certificate itself.

For dispositions of taxable Canadian property occurring after 2008, 116 Clearance Certificate requirements have been eased for certain non-residents investing in taxable Canadian property. The definition of "excluded properties" was amended to include "treaty-exempt property", which includes "treaty-protected property", which is defined in subsection 248(1) of the Act to mean "property any income or gain from the disposition of which by the taxpayer at that time would, because of a tax treaty with another country, be exempt from tax under Part I [of the Act]".

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For dispositions of taxable Canadian property occurring after 2008, a non-resident vendor of taxable Canadian property will not be required to obtain a 116 Clearance Certificate if: (i) the vendor is a resident of a jurisdiction with which Canada has a tax treaty and (ii) the gain from the disposition of the property is tax-exempt through the provisions of the treaty. If a disposition of treaty-exempt property occurs between a non-resident vendor and a related purchaser, the purchaser must provide the CRA with notice of the acquisition and certain specified information within 30 days after the date of the acquisition under subsection 116(5.02) of the Act.

Most tax treaties permit Canada to tax capital gains from the disposition of Canadian real estate or resource properties, or the disposition of shares of companies that derive most of their value from such kinds of properties.

In addition, a purchaser of property from a non-resident vendor will not be liable to withhold tax as long as: (i) the purchaser concludes after reasonable enquiry that the vendor is a resident of a country that has a tax treaty with Canada; (ii) the gain from the disposition of the property would not be subject to tax in Canada by virtue of the treaty; and (iii) the purchaser provides the CRA with notice of the acquisition and certain specified information within 30 days after the date of the acquisition.

In addition, section 150 of the Act eliminates the requirement that non-resident individuals and corporations file Canadian tax returns in respect of "excluded dispositions". A non-resident will be exempt from filing a Canadian tax return in a particular year if: (i) no tax is payable as a result of the disposition of the taxable Canadian property; (ii) the taxpayer is not liable to pay tax under Part I of the Act in respect of any prior taxation year; and (iii) each property disposed of was either "excluded property", which includes "treaty-protected property", or a 116 Clearance Certificate was obtained in respect of the disposition of property.

(b) Recent Case Law

1. *Canada v Morris*, 2009 FCA 373

In this Federal Court of Appeal case, the taxpayer was a Barbados trust (the "Trust") that disposed of taxable Canadian property, in the form of shares of a Canadian corporation, during 2006. The Trust sought a declaration that section 116 of the Act did not apply to the transaction. The solicitor for the Trust wrote a letter to the CRA advising the Minister of the transaction and enclosed Form T-2062, which constituted a request by the Trust for a clearance certificate under section 116 of the Act. The Form T-2062 showed that although the gain on the transaction was approximately $145,000,000, the taxable capital gain was $0. In the event that the capital gain realized from this

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transaction was not eligible for a tax treaty exemption, the amount of tax payable would have been approximately $36,250,000.

The Trust took the following position: (i) the capital gain from the disposition of the shares was exempt under the provisions of the *Canada-Barbados Income Tax Agreement* (the "Treaty") because the shares were sold by the Trust which was resident in Barbados and (ii) the Trust fulfilled all the requirements of section 116 of the Act and was immediately entitled to receive a 116 Clearance Certificate showing exempt status under the Treaty.

The Minister refused to issue the 116 Clearance Certificate on the basis that: (i) the issuance of a 116 Clearance Certificate confirming a treaty exemption is a matter of Ministerial discretion and the onus was on the Trust to satisfy the Minister that the Treaty applied to the transaction and (ii) the Minister had not received enough information from the Trust to determine whether the Treaty applied.

The Trust applied to the Federal Court of Canada seeking a declaration that the Treaty exempted the Trust from paying capital gains tax in Canada on the disposition of the shares because the Trust was resident in Barbados. The Federal Court of Canada made a finding of fact that the Trust was resident in Barbados and held that the Trust was entitled to a binding ruling from the Minister about whether the shares disposed of were treaty-exempt property, accepting that the Trust was a resident only of Barbados. The Federal Court stated the principle that where a tax treaty exists, decisions about residence are to be based solely on the language of the tax treaty. According to the Treaty, a finding of dual residence must be based on actual physical factors linking the Trust to Canada. In this case, there were no factors linking the Trust to Canada, and therefore the Trust was found to be resident only in Barbados.

The Federal Court concluded by saying that: (i) when no tax is owing because of a tax treaty, the Minister should not use section 116 of the Act to accomplish enforcement and collection objectives and (ii) the Court's view was supported by recent amendments to section 116 of the Act, which came into effect in 2008, clearly providing that section 116 of the Act does not apply to treaty-protected property. The Minister appealed to the Federal Court of Appeal.

The Federal Court of Appeal agreed with the Minister's argument that the Federal Court should not have attempted to resolve the question of the residence of the Trust before the Minister made a determination on the matter. The Court of Appeal allowed the Minister's appeal, and held that: (i) while the Federal Court has the jurisdiction to entertain an application for judicial review of a refusal by the Minister to issue a 116 Clearance Certificate, the Federal Court should not exercise that jurisdiction in a situation where the person seeking the certificate may have recourse to the Tax

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Court of Canada by filing an income tax return and appealing the Minister's assessment of that tax return and (ii) section 116 of the Act is a statutory device for requiring the withholding of tax at source or the provision of security, so that if a tax liability arises under Part I of the Act, collection is facilitated – a procedure established by Parliament. An application by the Trust for leave to appeal to the Supreme Court of Canada was dismissed.

2. <u>*Olympia Trust Co. v Canada*, 2014 TCC 372</u>

This decision of the Tax Court of Canada determined whether the Olympia Trust Company ("Olympia Trust") fell within the definition of "purchaser" under section 116 of the Act. The Court found that Olympia Trust was a purchaser and it had failed to obtain a 116 Clearance Certificate and remit withholding tax on the purchase of shares from a non-resident vendor.

Olympia Trust was a trust company that acted as trustee for self-directed registered retirement savings plans ("RRSPs"). The annuitants of the RRSPs directed Olympia Trust as to which property would be acquired and held within the RRSP and Olympia Trust would implement these instructions. Acquisitions of shares were conducted under share purchase agreements to which Olympia Trust was not a party and which described the purchaser as the RRSP's annuitant. Some of the vendors of the shares were in fact non-residents. At no time was Olympia Trust a beneficial owner of the acquired shares and in some instances the identity of the non-resident vendors was unknown to Olympia Trust.

The Court held that Olympia Trust was a "purchaser" as defined under subsection 116(3) Act to be "the person to whom the non-resident disposed of [any taxable Canadian property]". The Court noted that the plan applications for the RRSPs stated that Olympia Trust was to hold legal title to all shares held within the plans. Although use and enjoyment of the shares rested with the annuitant of the RRSP, Olympia Trust at all times had possession, legal title, and control of the shares. Under the share purchase agreements, Olympia Trust tendered the purchase money and took title and received delivery of the purchased shares. The Court found that it was relevant that Olympia Trust's name figured prominently in the documentation available to the vendor and/or its counsel, since section 116 of the Act relates to seller's liability and purchaser's vicarious liability for non-compliance in the context of the section.

The Court also held that Olympia Trust was a "purchaser" who "acquired…taxable Canadian property" as contemplated under subsection 116(5) of the Act. Although the annuitant was the "true owner" of the RRSP, the Court noted that the shares were the underlying trust property within the *corpus* of the RRSP and were legally acquired by Olympia Trust in its capacity as trustee of the RRSP.

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Consequently, when shares were acquired for the RRSPs from a non-resident vendor, Olympia Trust was required to either: (1) obtain a 116 Clearance Certificate or (2) withhold and remit the equivalent of the non-resident vendor's deemed disposition tax.

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