



Tax Issues in Asset Purchase Transactions

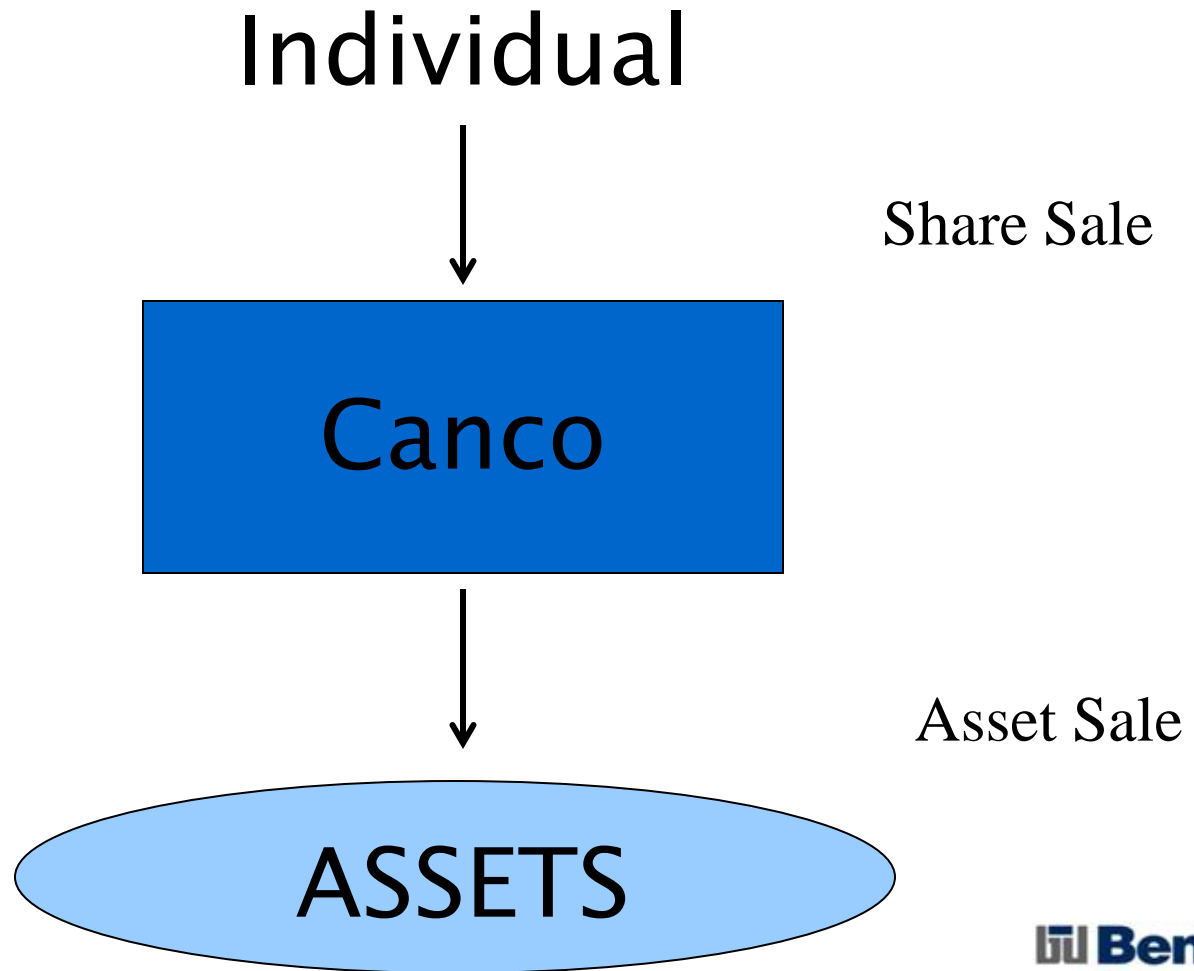
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Overview

- Assets vs. Shares – How to decide?
- What's the big deal about allocation clauses?
- Where are the forms?
- How can they pay tax if they're not getting any money?
- Let's reduce the purchase price with consulting agreements!
- Now that all this money is in the company ...

Who is Selling?





Assets vs. Shares ... How to Decide?



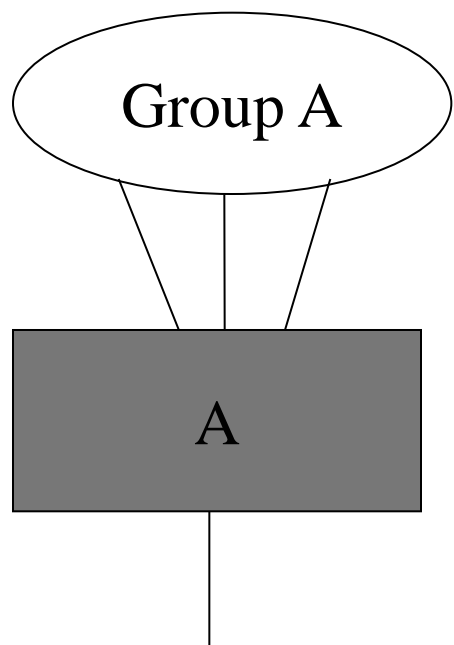
Purchase and Sale of Assets

- Purchaser Issues
 - Selection of assets and liabilities
 - Tax basis = Purchase price allocated to asset
 - Future deductions
- Vendor Issues
 - Income
 - Recapture / Terminal Loss
 - Reserves

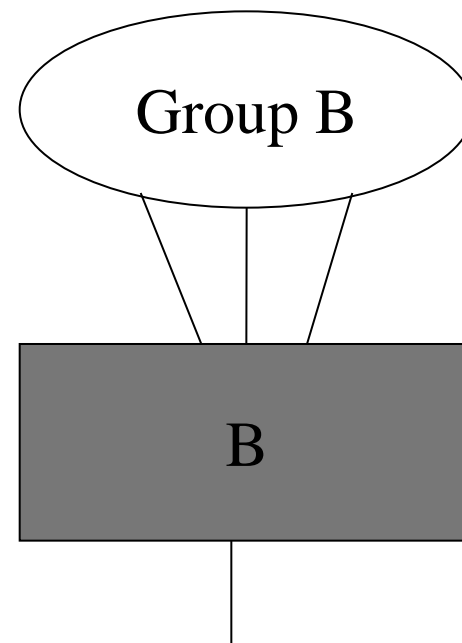
Purchase and Sale of Shares

- Purchaser Issues
 - Inherit tax and other liabilities
 - Inherit tax cost of assets
 - Limited opportunity to set up cost base
- Vendor Issues
 - One level of tax
 - Capital Gains Treatment
 - \$750,000 Capital Gains Exemption

Example

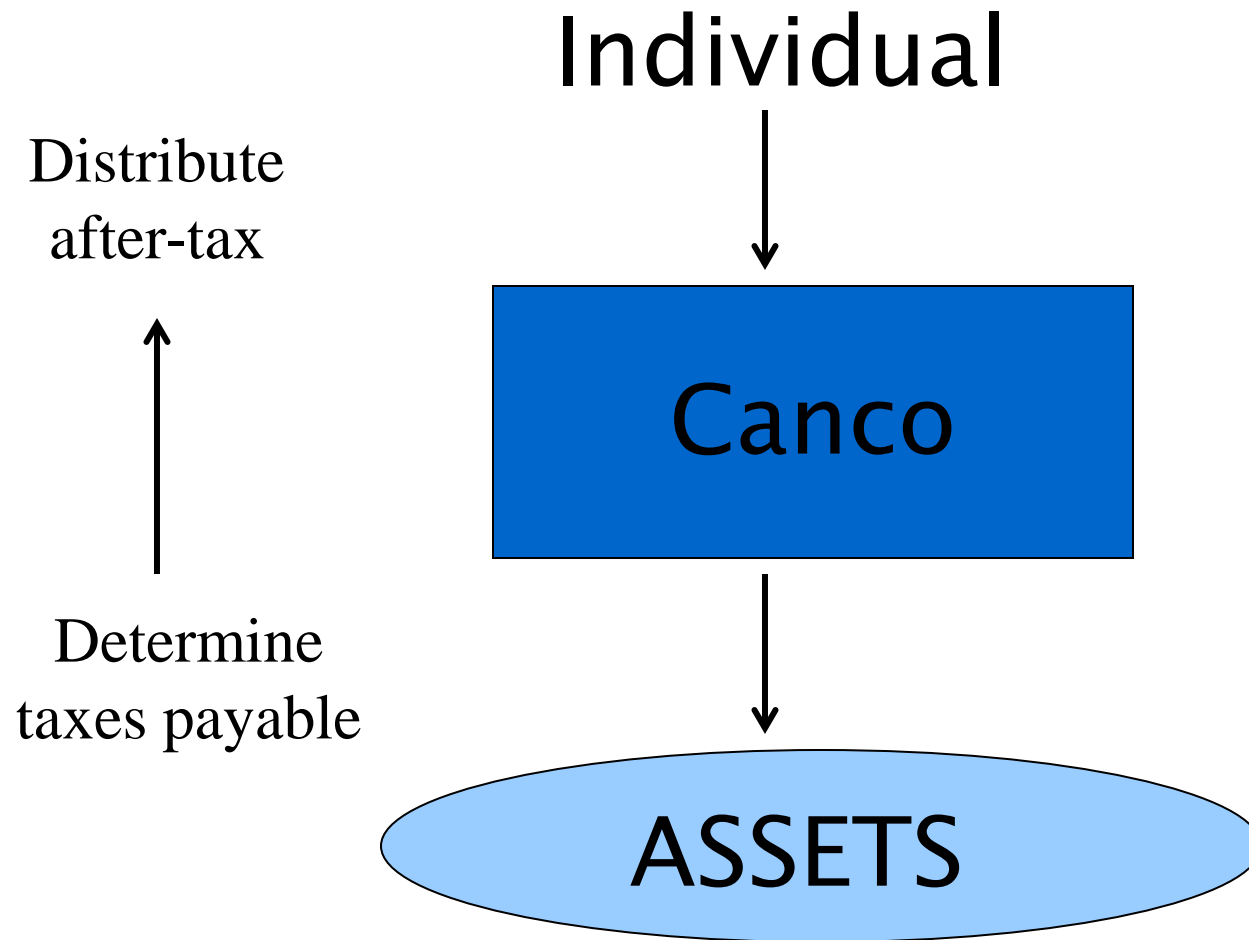


- Target Business
- Excluded Assets



- Target Business
- Excluded Assets

Vendor's After-Tax Proceeds



Tax Factors Influencing Structure

- Tax Status of
 - Target
 - Shareholders of Target
 - Purchaser

- Tax Rates
 - Vendor
 - Purchaser
 - Shareholders of Target

Tax Factors Influencing Structure

- Income Generated from Sale of Assets
 - Ordinary Income
 - Property
 - Business
 - Capital Gains or capital gains equivalent
- Tax Cost
 - ACB of Target Shares to Shareholders of Target
 - Assets of Target that are subject of sale

Tax Factors Influencing Structure

- Tax Attributes of Assets in hands of Purchaser
 - Will CCA Rates Change?
 - Goodwill
- Assets in Target not to be part of sale
 - Can they be removed on tax effective basis?
- Safe Income in Target
 - Allow for tax-deferred distribution to Holdco
- Liabilities for Tax

Tax Factors Influencing Structure

- Availability of Deferral
 - Vendor Shareholders – Share Sale
 - Vendor Corporation – Asset Sale
- Losses in Vendor Corporation
 - Existence
 - Nature
 - Carry forward on share sale?
- \$750,000 Capital Gains Exemption
 - how many?

Due Diligence

- Financial Statements
 - Consolidated versus entity basis
 - What are you given?
 - Balance Sheet
 - Income Statement
 - Statement of Changes in Financial Position
 - Notes
 - Complete picture?
- Source of tax information – T2
- Minute book

Due Diligence

- T2 and notices of assessment and reassessment
 - look at Sch 1 – reconciliation of accounting income to tax
 - aggressive treatment of income or expense – risk of reassessment?
- Tax Rate of Target
 - SBD?
 - M+P?
- Tax Rate of Shareholders
- Tax Accounts
 - CDA
 - RDTOH

Due Diligence

- Losses
 - Non capital losses
 - business
 - property
 - Net capital losses
 - Carryforward periods
- Other Carryforwards
 - Charitable donation
 - ITC's
- Foreign Affiliates
 - Existence
 - Status

Due Diligence

- Shares of Target to Shareholders
 - ACB
 - PUC
 - \$750,000 Capital Gains Exemption?
- Valuations
 - Any?
 - Tax elections (e.g. T2057)
- Assets: Tax Cost vs. Book Value vs. FMV
- PST, GST
- LTT

SELLER CO
Balance Sheet as at December 31, 2009

Assets		Liabilities	
Cash	\$ 18,575	Accounts Payable	\$115,991
Accounts Receivable	183,560	Long Term Debt	248,571
Prepaid Expenses	171,330	Due to Shareholder	173,311
Inventory	248,048		
Shares of Subsidiaries	6		
		Shareholders' Equity	
Land	500,000	Stated Capital	\$ 45,000
Fixed Assets	815,274	Retained Earnings	1,353,920
	\$1,936,793		\$1,936,793

Depreciation vs. CCA

- Accounting concept
- Financial Statement
 - Cost net of depreciation
- Estimated useful life
- Asset by asset basis
- Mandatory deduction
- Tax concept
- Statutory rates and classes
- Class by class basis
- Business by Business Basis
- Discretionary deduction
 - not claim in loss year

T2S(8) – Capital Cost Allowance

CAPITAL COST ALLOWANCE (CCA) (2006 and later tax years)

Name of corporation SELLER CO	Business Number 123 456 789	Taxation year end Year: 2010 Month: 09 Day: 31
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For more information, see the section called "Capital Cost Allowance" in the T2 Corporation Income Tax Guide.

Is the corporation electing under Regulation 1101(5q)? **101** 1 Yes 2 No

1 Class number	2 Undepreciated capital cost at the beginning of the year (undepreciated capital cost at the end of the year from column 13 of last year's CCA schedule)	3 Cost of acquisitions during the year (new property must be available for use) See note 1 below	4 Net adjustments (show negative amounts in brackets) See note 2 below	5 Proceeds of dispositions during the year (amount not to exceed the capital cost)	6 Undepreciated capital cost (column 2 plus column 3 plus or minus column 4 minus column 5)	7 50% rule (1/2 of the amount, if any, by which the net cost of acquisitions exceeds column 5) See note 3 below	8 Reduced undepreciated capital cost (column 6 minus column 7)	9 CCA rate %	10 Recapture of capital cost allowance	11 Terminal loss	12 Capital cost allowance (column 8 multiplied by column 9; or a lower amount) See note 4 below	13 Undepreciated capital cost at the end of the year (column 6 minus column 12)	
200	201	202	205	207		211		212	213	215	217	220	
1.	8	75,800			75,800			20			15,160	60,640	
2.	10	27,500			27,500			30			8,250	19,250	
3.	12	5,000			5,000			100			5,000	0	
4.													
5.													
6.													
7.													
8.													
9.													
Totals											0	0	23,910

Note 1. Include any property acquired in previous years that has now become available for use. This property would have been previously excluded from column 3. List separately any acquisitions that are not subject to the 50% rule, see Regulation 1100(2) and (2.2).
Note 2. Include amounts transferred under section 85, or on amalgamation and winding-up of a subsidiary. See the T2 Corporation Income Tax Guide for other examples of adjustments to include in column 4.
Note 3. The net cost of acquisitions is the cost of acquisitions (column 3) plus or minus certain adjustments from column 4. For exceptions to the 50% rule, see Interpretation Bulletin IT-285, Capital Cost Allowance - General Comments.
Note 4. If the tax year is shorter than 365 days, prorate the CCA claim. Some classes of property do not have to be prorated. See the T2 Corporation Income Tax Guide for more information.

Enter the total of column 10 on line 107 of Schedule 1.
 Enter the total of column 11 on line 404 of Schedule 1.
 Enter the total of column 12 on line 403 of Schedule 1.

Depreciable Capital Property

VENDOR

- Only year end balances count
- No doubling up for deductions not claimed
- Recapture and terminal loss
 - Property to class?
 - Replacement property?

PURCHASER

- Half-year rules
- Pro-rate
- Change in classes

Categorize Assets from a Tax Perspective

- Accounts Receivable
- Inventory
- Non-depreciable capital property
- Depreciable capital property
- Eligible capital property

Software in Development

- Categorization of asset for tax purposes
 - Inventory
 - Eligible capital property
 - Depreciable capital property
- Significance
 - Inclusion rate
 - Reserves only if depreciable capital property
- Conclusion: Eligible capital property



What's the big deal about allocation clauses?



Allocation of Purchase Price

- Mutual
- Vendor's interest and purchaser's interest mutually exclusive
- Trade-offs?

TENSION!!!!

Vendor's Preference

- Non-depreciable capital property
- Depreciable capital property
 - Little or no recapture
- Eligible capital property
- Depreciable capital property
- Inventory

Purchaser's Preference

- Inventory
- Depreciable capital property – high rate CCA
- Eligible capital property
- Depreciable capital property – low rate CCA
- Capital Property

Acceptance by CRA

- Opposing Interests
- CRA Generally Accepts
- S.68
 - Not reasonable in circumstances
 - No evidence of hard bargaining in negotiations
 - Sham, Subterfuge
 - Property and Services
- Agreement
 - Detailed allocation
 - Schedule
 - Process to determine
 - Covenant to file consistently



Where are the Forms?



Accounts Receivable

- Sale \$10,000
 - Income inclusion – 12(1)(b)
 - Income inclusion notwithstanding the fact that the amount or any part of it is not due until a subsequent year
 - All or a portion is not collectable
 - Doubtful debt reserves – 20(1)(1)
 - Bad debt deduction - 20(1)(p)
 - Subsequent year
 - Income inclusion - 12(1)(d)

Accounts Receivable

Year 1

Income	\$10,000
20(1)(1)	<u>10,000</u>
Net	00

Year2

12(1)(d)	\$10,000
20(1)(1)	<u>10,000</u>
Net	00

Sale of Accounts Receivable

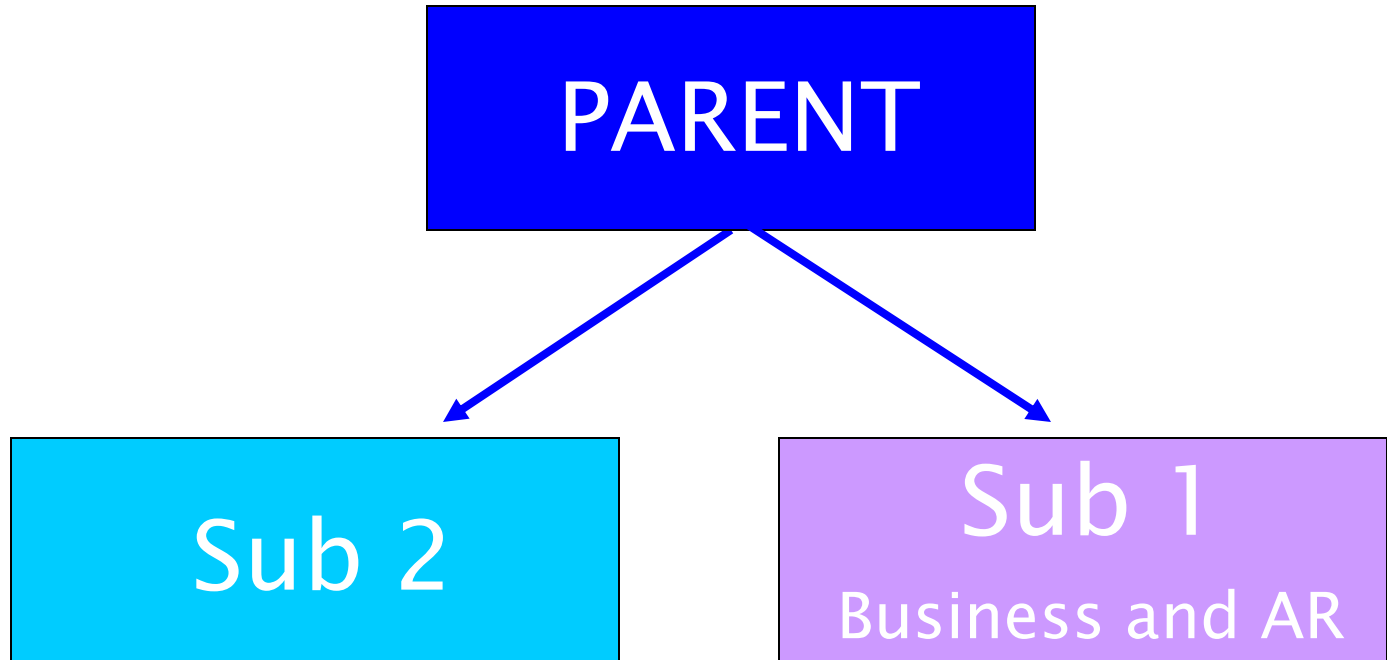
- Vendor
 - Income inclusion
 - Include doubtful debt of previous year
 - No reserve
 - Capital loss
- Purchaser
 - No reserve in future years

Year2	
12(1)(d)	\$10,000
20(1)(1)	<u>0</u>
Net	10,000

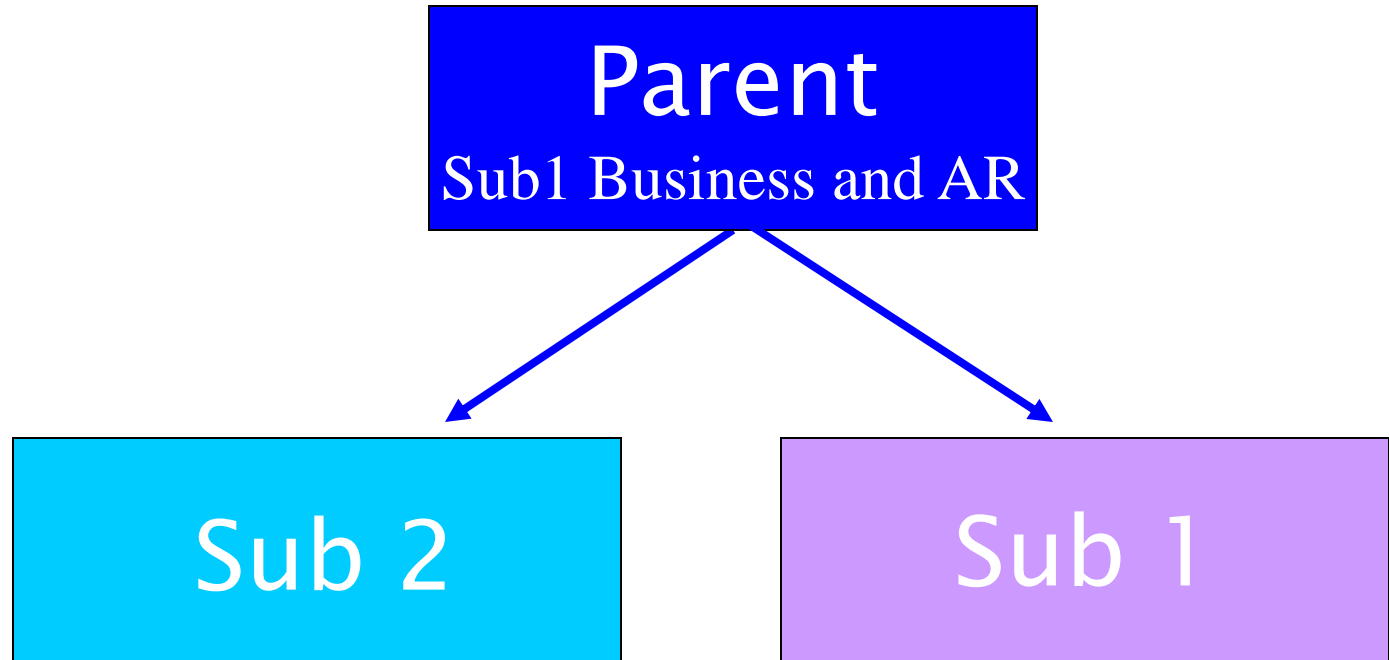
Accounts Receivable Solution

- Section 22 Election
 - Joint
- Conditions
 - Vendor carries on business
 - Purchaser proposes to carry on business
 - All or substantially all of assets of business

Accounts Receivable

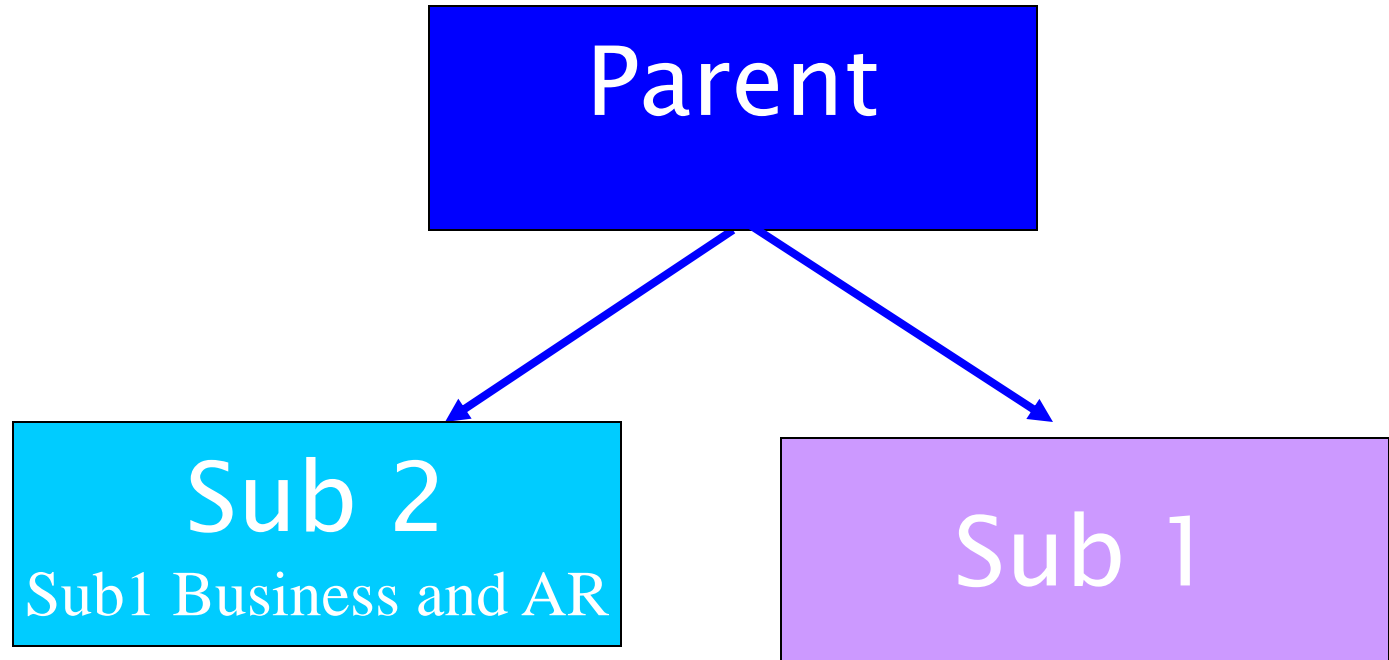


Accounts Receivable



Parent acquires Sub 1's business

Accounts Receivable

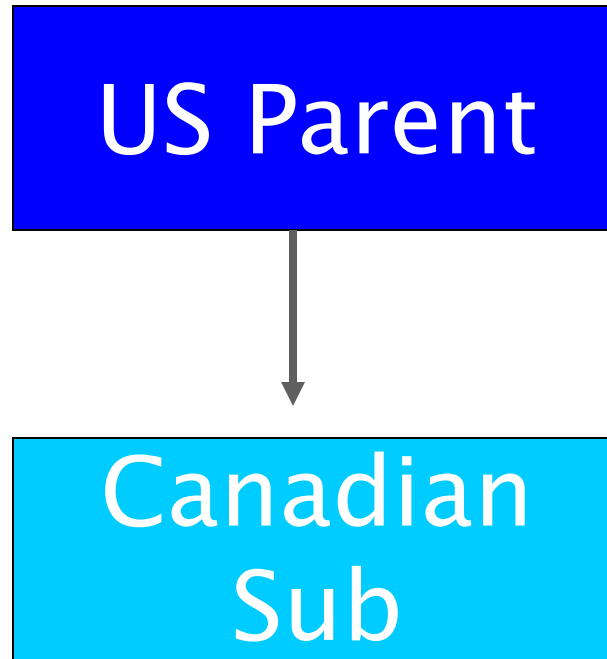


Parent transfers Sub 1's business to Sub 2

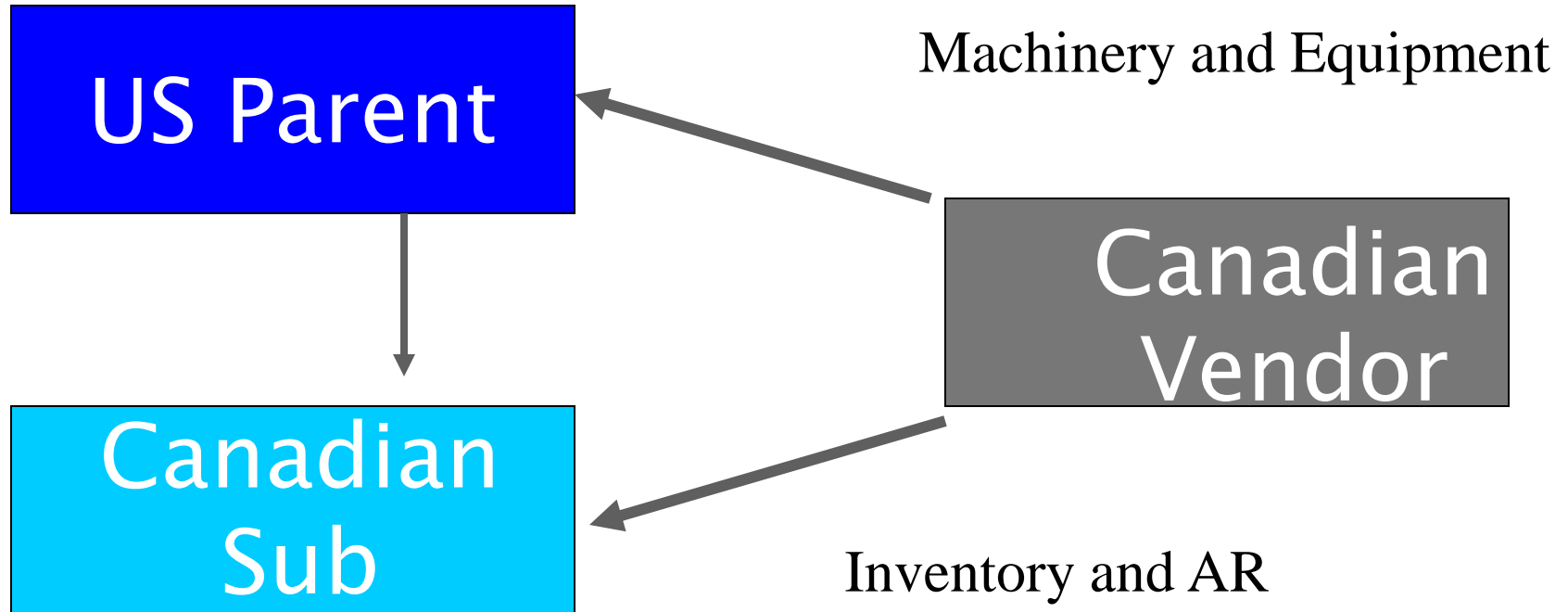
Accounts Receivable, cont'd

- Conditions
 - Vendor carries on the business
 - Purchaser (Parent) proposes to carry on the business
 - Section 22 election not available

Accounts Receivable



Accounts Receivable



Accounts Receivable, cont'd

- Conditions
 - All or substantially all of the assets of the vendor
- Section 22 election not available

Accounts Receivable, cont'd

- All accounts receivable of business?
- Transportation Company
 - Trucking business, courier business
 - Selling trucking business
- Separate business
- Who bears risk if election not available?



How can they pay tax if they're not getting any money?



Deferrals

- Reserves
 - Amount due after end of year
 - Demand note?

- Strategy
 - Term of promissory note
 - Amount of down payment

Sale of Land: Cash and Mortgage

- Land – capital property
- Purchase price allocated to land: \$4.5 million
- Cost:\$250,000
- Capital gain: \$4.25 million
- Consideration:
 - \$500,000 cash,
 - \$4 million mortgage,
 - interest only
 - principal in 5 years

Tax in Year of Sale

Proceeds	4,500,000
Less: ACB	<u>250,000</u>
Capital Gain	4,250,000

Taxable capital gain 2,125,000

Tax (48.7%)**	1,034,875
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** a portion of tax is refundable on payment of dividends

Tax in Year of Sale

Tax (48.7%)**	1,034,875
Cash	<u>(500,000)</u>
SHORTFALL	534,875

Reserves

- Capital Property
 - Not depreciable capital property
 - Non eligible capital property
- Inventory

Tax in Year of Sale

Proceeds	4,500,000
Less: ACB	<u>250,000</u>
Capital Gain	4,250,000
Reserve	<u>3,400,000</u>
Gain	850,000

Taxable capital gain 425,000

Tax (48.7%)** 206,975

Cash Remaining = \$293,025

** a portion of tax is refundable on payment of dividends

Tax in Year 2

Reserve	3,400,000
Less: Reserve	<u>2,550,000</u>
Gain	850,000
Taxable capital gain	425,000
Tax (48.7%)**	206,975
Cash Remaining =	\$86,050

Tax in Year 3

Reserve	2,550,000
Less: Reserve	<u>1,700,000</u>
Gain	850,000
Taxable capital gain	425,000
Tax (48.7%)**	206,975
Cash Remaining	= <\$120,925>

Tax in Year 4

Reserve	1,700,000
Less: Reserve	<u>850,000</u>
Gain	850,000
Taxable capital gain	425,000
Tax (48.7%)**	206,975
Cash Remaining	= <\$327,900>

Tax in Year 5

Reserve	850,000
Less: Reserve	<u>000</u>

Gain	850,000
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Taxable capital gain	425,000
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Tax (48.7%)**	206,975
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Cash Remaining = 4,172,100



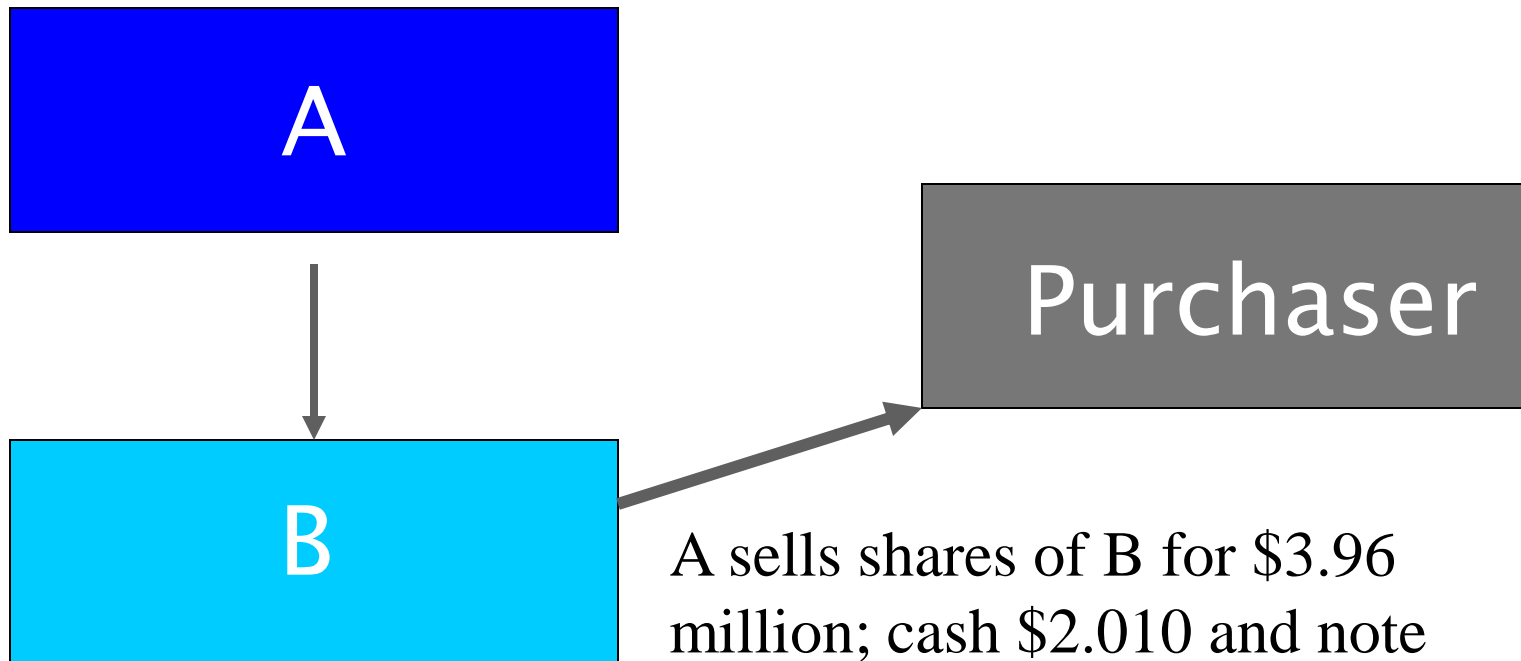
Let's Reduce the Purchase Price with Consulting Payments!



Consulting Agreement

- Purchase deduct payments provided reasonable
 - services provided, etc.
- Income inclusion at full rates
 - Deferral
 - Earned income for RRSP

Foresbec



A sells shares of B for \$3.96 million; cash \$2.010 and note 1.95

Purchaser's owner becomes B's president

Foresbec

- Major disagreement between Purchaser's shareholder and A's president
- Purchaser's shares in B acquired by A: price was equal to cash of \$1,750,000 unpaid purchase price and waiver of other amounts
- Contract provided that B would enter into contract for services with Purchaser's President for \$150,000 to be paid over 3 years
 - Signed by A, B, not Purchaser
- B deducted payment

Foresbec

- TCC, FCA
- Deduction in computing income denied
 - Guarantee of payment
 - enable to purchase shares
 - no services
- 15(1) benefit since B paid part of purchase price for purchase of shares by A
- Statute barred years open
- Penalties

Let's reduce the purchase price

- Separate agreements
- Consideration
- Reasonable
- Pigs get fat, hogs get slaughtered



**Now that all this money is in
the company**



Distribution of After-Tax Proceeds

- Repayment of shareholder loans
- Return of paid-up capital
- Capital dividend
- Taxable dividend

Thank you