Business sale considerations when selling shares or assets

The Canadian economy depends on the success of small businesses. As a business owner, you create jobs for many Canadians. In turn, you depend on your business for your own income. Selling your business is one of the largest transactions you will ever face. Planning opportunities to minimize taxes upon sale play a large role in these transactions.

If you are incorporated, selling your business commonly happens in one of two ways. You can sell the shares of the business or cause the corporation to sell the business assets. A complete share or asset sale is not the only way to transition your business. Other transition strategies may include an estate freeze, gifting shares, or transferring the business at death. Although useful, we will not cover these strategies in this article. Various factors may play a role when deciding between the sale of shares or assets. The goal of this article is to help you decide which factors are important to you.

The need for advanced planning

In many cases, your main goal is to sell the business as an exit strategy. When selling shares, you receive the proceeds yourself. In contrast, when selling the corporation's assets, the proceeds remain in your corporation. In either case, minimizing taxes and maximizing after-tax proceeds on the sale is in most cases the priority. Advanced tax planning and advice is integral in achieving these goals. Without the proper planning, you may miss strategies that can save you significant taxes.

Share sale considerations

Seller and buyer motivations

Buyers usually want to purchase assets over shares due to the tax and non-tax considerations. However, brand name, reputation, and internal tax pools may persuade a buyer to buy your shares. Sellers usually want to sell the shares of the business to realize tax benefits. As a result, share sales can attract a lower sale price than an asset sale would. The lower sale price stems from the buyer taking on the risk associated with buying shares. With ownership of the shares, the buyer is taking over current and future liabilities of the company. In an asset sale, owners do not take on any liabilities connected with the corporation itself.

Considerations	Seller's perspective	Buyer's perspective
Taxes	Capital gain transaction and potential lifetime capital gain exemption (LCGE).	Use of internal capital losses. Will not be able to bump up tax costs of assets for future depreciation purposes.
Complexity	Share sale transaction plus proceeds retained personally after-tax.	Share sale transaction plus due diligence costs.
Liability	Walk away from all current and future tax and legal liabilities of the corporation. Protective clauses in sale agreement may retain some risk with seller.	Concerned with future tax and legal obligations that may arise. Protective clauses in sale agreement may lower risk to buyer.

Reorganizations and advanced planning

When planning for a share sale, most sellers want to use the LCGE. The LCGE only applies when an individual person sells shares.[1] Where the share structure does not allow an individual to sell the shares, you may need to reorganize. Further, for the exemption to apply, the shares must be qualified small business corporation (QSBC) shares. QSBC shares must meet the following tests in the Income Tax Act:

The 90% test[2]	**The 50% test**[3]	**The holding period test**[4]

Two of the tests above refer to the business having specific levels of active[5] assets relative to passive assets.[6] In order to meet the tests you may need to purify the corporation of passive assets. In addition to meeting the tests, the corporation may own assets that you do not want to sell. You may want to remove these assets before the sale. This also may require a reorganization of the current structure to prevent roadblocks at the time of sale.

Planning early and understanding the barriers to a successful share sale is key. As an example, the LCGE can require two years of advance planning to ensure your shares qualify. You will need even more time if you plan to multiply the LCGE among family members. This is because it takes time for the business to grow. Only growth occurring after issuing shares to family members will allow the use of their LCGE.

Share sale transaction results

A share sale transaction is administratively simpler because you have one transaction. It is also simpler from a taxation perspective. The sale proceeds less the adjusted cost base for your shares produces a capital gain. Only 50% of the total gain is taxable to you. Therefore, capital gain income is favorable compared to other types of income. Finally, the LCGE can lower your personal tax bill if the shares qualify as QSBC shares.

Tax deferral strategies

The largest tax minimization strategy for a share sale is the use of the LCGE. You may also be able to defer taxation using one of the following strategies:

- **Replacement shares.** You can use the share sale proceeds to buy new shares of an eligible small business. This may allow you to defer all or part of the capital gain.
- **Deferred sale.** You can sell portions of your shares over a long period to spread out the tax bill.
- **Capital gain reserve.** Spread the capital gain over a maximum 5-year period if the payment occurs in installments. This can be over 10 years if the sale is to non-arm's length persons.
- **Rollover for shares.** You can sell shares to a public company. If the proceeds include shares in the public company, you can defer the taxation to when you sell the public company shares.

The above strategies need extra planning with your accountant and lawyer. Be sure to discuss these options with your professional advisors.

Asset sale considerations

Seller and buyer motivations

As mentioned above, a buyer's motivation is in purchasing assets of the business. This is often because they do not want to take on the chance of paying for future liabilities. Sellers might consider selling assets if they have other assets in the business they want to retain. As an example, you may have a goal to keep real estate assets and pass them on to the next generation. Further, sellers may be able to demand a higher price on assets or time the sale to market conditions.

Considerations	Seller's perspective	Buyer's perspective
Taxes	Asset sales produce capital gains and recapture[7] inside a business. Taxes payable to remove sale proceeds as dividends to shareholders. Produces capital dividend account (CDA).	Sales taxes or land transfer taxes can turn into extra costs.
Tax pools	Use of capital and non-capital losses to offset income and gains.	Higher undepreciated capital cost allowance balances provide for future tax deductions.
Asset allocation	Keep assets you want and wait for a better market to sell. Land transfer taxes may lower the price buyer is willing to pay.	Ability to choose the assets for purchase.

Advantages and disadvantages

Selling your business' assets can be straightforward. You need to find a buyer for individual assets rather than a buyer for the entire business. Asset sales do not have to involve just a single buyer. As an example, new companies may need your equipment. Your rival may want to buy the customer list, goodwill, or company name to expand their business. You have the potential to sell assets to whomever and whenever. Timing the sale of different assets in differing market conditions can help you increase the total sales proceeds. As an example, selling real estate over time may produce greater sale proceeds.

With the sale of assets, you miss accessing the LCGE. This is a large downside; however, you can mitigate tax concerns through planning. Other downsides for the seller include tax on deferred gains of appreciating assets. You may also have tax on recapture if you claimed depreciation on these assets. Asset sales leave you with cash and investments trapped inside your company. You will then incur personal taxes to remove the proceeds from the company over time.

Purchase price allocation

Buyers and sellers will negotiate the allocation of the purchase price among assets. Each asset has a fair market value. The buyer may want to allocate a higher amount to certain assets to benefit from greater future depreciation expense. The capital gain or recapture produced will influence the allocation for the seller. As a seller, you may want to allocate lesser amounts to depreciable property and more to assets such as land. However, the allocation agreed between both parties cannot be in anyway tax driven. Where the allocation is unreasonable, a reallocation by the Canada Revenue Agency (CRA) is possible.[8]

Typical assets sold in business transactions

The assets your corporation sells will depend on the buyer. The following is a summary of typical assets that are part of a business sale and the general tax implications.

	Capital gain	Business income
Accounts receivable. Corporations include the face value of accounts receivable as business income when sold. However, your corporation can discount receivables based on the likelihood of future collection. Sellers and buyers can jointly elect the purchase price to be the discounted amount. Your corporation deducts from income the discount amount and the buyer includes this same amount as income. The buyer can then write off future bad debts as they occur.[9]		✓
Inventory. Corporations include the difference between the purchase price and the book value as business income when sold. Sellers and buyers will typically allocate the purchase price at the book value. The buyer can then deduct the inventory against income when sold.		✓
Depreciable capital property. Corporations include capital gains and any recapture as income when sold. The capital gain equals the proceeds amount less the adjusted cost base. Recapture is included as business income. The buyer then depreciates the asset at the new cost base.	✓	✓
Non-depreciable capital property. Corporations include capital gains as income when sold. The proceeds amount less its adjusted cost base will produce a capital gain or loss. The buyer's adjusted cost base on the property is the purchase price amount allocated.	✓	

Tax pools generated on sale

With the sale of assets comes the world of corporate taxation. Each asset sale produces income, capital gains, or recapture. General business income and capital gains (investment income) have different tax rates and produce different tax pools. These tax pools help you extract the after- tax proceeds and reduce potential for double tax. The tax pools generated include the CDA, refundable dividend tax on hand (RDTOH), and the general rate income pool (GRIP).

The CDA tax pool tracks the non-taxable part of a capital gain. Your corporation can pay accumulated amounts in this notional account to shareholders tax-free.[10]

Your corporation pays tax on investment income such as capital gains at investment tax rates. A portion of the investment tax rate credits the RDTOH notional account. RDTOH is a refundable amount the corporation recoups from the CRA when your corporation pays taxable dividends to shareholders.

Lastly, GRIP tracks income taxed in your corporation at the general active business income tax rate. This is any income above your corporation's small business threshold. As high tax rates are applicable to this income, your corporation can pay eligible dividends to its shareholders. Tax on eligible dividends is lower at the personal tax level and preferred by shareholders.

Extraction of after-tax proceeds

Once your corporation sells its assets, you need to extract the proceeds in a tax-efficient way. Contrasted to a share sale where proceeds land in your hands personally, asset sales result in proceeds in your corporation. You have a few methods of removing proceeds from your company. You can repay shareholder loans made to your corporation tax-free to help extract proceeds. Where asset sales have created a CDA balance, you can extract proceeds as a tax-free dividend. Lastly, your corporation can declare taxable dividends to shareholders to remove remaining proceeds. This may involve recouping RDTOH and paying eligible dividends on the GRIP balance. To lower your personal tax burden, you can pay dividends over time to meet your personal cash flow needs. Each situation is unique and requires coordination among your tax, legal, and financial advisors to optimize after-tax results.

Tax minimization strategies

Tax minimization starts during the negotiating phase of the transaction. You need to be aware of tax results related to each asset. This information can help you and your advisors negotiate a reasonable allocation of the purchase price. When you are past the negotiating phase, you can consider the following strategies:

- **Payment deferral.** Payment deferrals allow you to spread income tax over several years. Your corporation may even benefit from the small business rate if income in the current year is high.

- **Replacement property.** Your corporation can defer part of the capital gain when it purchases similar property before the end of the following year.
- **Use tax losses.** Your corporation may carry capital and non-capital losses from previous years. It can use these losses to offset capital gains and income generated on sales.
- **Donations.** If you have charitable intentions, donations from your corporation create an expense against income.

The above strategies require extra planning steps by you and your tax and legal advisors. Be sure to discuss these options with your professional advisors.

Post-sale considerations

Whether the sale of your business results in a share or asset sale, there is a lot to consider. Every individual will use the after-tax proceeds differently. A share sale results in you receiving proceeds personally. Asset sales result in proceeds inside your corporation. In either case, you will need to build a holistic financial plan. This will help you determine how to spend, invest and protect the sale proceeds throughout your lifetime.

Summary

There are many factors to consider when choosing between a share or asset sale. We recommend you plan for both situations and compare the after-tax results. Understand the various considerations, advantages, disadvantages, and taxation. Planning assists with price negotiations and provides the knowledge and confidence to negotiate the right sale price. Discussing the differences with your professional advisors will help guide your decision.

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[1] Shares held by a trust may also allocate the taxable capital gain to individual beneficiaries to use their available LCGE.

[2] At the time of sale, more than 90% of the fair market value of the corporation's assets must be used principally in an active business carried on primarily in Canada (either by the corporation or by a related corporation), be shares or debt in a connected small business corporation, or be a combination of both. [3] In the 24-month period immediately preceding the sale, more than 50% of the fair market value of the corporation's assets must be used principally in an active business carried on primarily in Canada, invested in shares or debt of a qualifying connected corporation, or a combination of both.

[4] The shares cannot be owned by anyone other than the individual seller or a person or partnership related to the seller during the 24-month period immediately preceding the sale.

[5] Assets of a business used principally in generating active business income.

[6] Passive assets are business assets not used for the active operation of the business. These may include marketable securities, excess cash, cash surrender value of life insurance, or rental properties.

[7] Recapture equals the difference between the undepreciated capital cost and the lower of the original cost and proceeds amount. [8] Section 68 of the ITA addresses the reallocation of proceeds.

[9] Buyer and seller would have to elect under section 22 of the ITA for this tax treatment for accounts receivable. Otherwise, taxation is more complicated and unfavorable for both buyer and seller.

[10] A capital dividend election needs to be filed with the CRA when making a payment out of the CDA.