CAN YOU AFFORD TO SELL? EFFECTIVELY STRUCTURING YOUR COMPANY FOR TRANSITION

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Agenda

Pre-Sale Considerations

Sale Planning

- Asset vs. share sales
- Transaction alternatives
- Common pitfalls
- Future tax audits and disputes

New Reality Post-Sale

- Tax on split income or “TOSI” rules
- Other tax considerations

Pre-Sale Considerations

- Optimal vendor sale planning should commence while sale is at conceptual stage (or before) and well before implementation

Pre-Sale Considerations

- Succession plan: family, employees and/or arm's length purchasers
  - Very different tax planning considerations and opportunities
- Estate planning
  - Is the vendor set up for optimal use of the capital gains deduction?
  - QSBC Shares
  - Shares must be owned by individuals
  - Consider use of a family trust

Pre-Sale Considerations

- Corporate records and tax compliance: current and accurate
  - Facilitates likely due diligence phase
  - Helpful in providing representations in sale agreements
- Structure
  - Identifying businesses/assets to be “kept” and “sold”
  - Are businesses/assets owned by the appropriate entities in the group to accommodate sales?
  - Holding corporations
- Dividend policies

Sale Considerations

- There are usually significant opportunities for “value added” planning for vendors, if the planning is carefully tailored and implemented
- Be wary of “marketed” or “off the rack” plans!

Sale Planning – Assets vs Shares

- "Usual" Preferences
  - Vendors generally desire a share sale
    - One level of tax, normally on capital account
    - Potentially tax-favoured for foreign shareholders
    - No recapture/income to target corporation
    - Liabilities assumed by purchaser
    - Access to capital gains exemption
    - Extraction of safe income
  - Purchasers generally prefer an asset purchase
    - Tax deductible cost of depreciable / resource property
    - Avoids risk of assuming (most) undisclosed liabilities
    - Opportunity to acquire selected assets
  - Purchaser may prefer share purchase
    - Target has unused tax attributes
    - Indirect cost of acquiring assets (PST, land transfer tax, conveyancing requirements)

Sale Planning – Assets vs Shares

- Consider if an "earn-out" can help bridge the valuation gap
  - Taxation of earn-outs on a share sale is more straightforward
  - Earn-out on an asset sale (typically relating to goodwill) generally requires a reverse earn-out to maintain capital treatment
- Other options
  - Tax deferred investment in shares of purchaser corporation
  - Consulting agreements
  - Partnership
  - Joint ventures

Sale Planning – Assets vs Shares

- Share sale issues
  - Reorganization may be required if only a portion of the business is to be sold
  - Indemnities to protect the purchaser from historic liabilities that would be inherited through a share purchase
- Asset sale issues
  - Conveyance costs
  - Purchase price allocation negotiations
    - Recapture of depreciation on depreciable assets included in income
    - Inventory gains on income account
- Potential "rollover" for any non-cash consideration
  - Avoids paying tax on share consideration

Sale Planning – Share Sale

- Lifetime capital gains deduction ("CGD"):
  - Allows up to roughly $850,000 of capital gain to be realized on "qualified small business corporation shares" → more than $200,000 of tax savings per capital gains deduction utilized
  - Vendor must be an "individual" to claim their CGD (*i.e.,* a "Holdco" does not qualify)
  - Various share ownership and asset-mix tests need to be satisfied
- Consider restructuring to:
  - Ensure corporation is "pure" and meets the asset-mix tests
  - Optimize access to available CGDs (*e.g.*, through family trust)
  - Ensure saleable portions of the business are appropriately separated
  - For family succession planning (sales to children) - 10 year deferral possible

Sale Planning – Share Sale

- Deferral or “safe income” planning
  - Use tax attributes to defer tax (generally up to retained earnings)
  - Requires use of a Holdco
- Deferral is only useful if you don’t need the cash personally, so consider:
  - Age and health of shareholders
  - Personal cash needs of shareholders
  - Whether shareholders plan on staying in Canada

Sale Planning – Asset Sale

- Asset sale – consider a “hybrid” transaction structure to access individuals’ available capital gains deductions
  - Involves sale of assets and sale of shares
  - Purchaser obtains full “tax cost” in the target assets
  - Shareholders of vendor corporation save tax on extracting after-tax proceeds → approximately $340,000 of potential tax savings per capital gains deduction utilized
  - Not as universal as they once were, but still useful in the right circumstances

Sale Planning – Canadian Resource Property

- Specific tax rules and opportunities for resource companies
  - Value of resource pools to vendor vs. purchaser
  - Use of holding corporations and partnerships in asset dispositions
- Regulatory restrictions on debt/asset ratio for purchasers (2:1)

Sale Planning - Other

- Other planning considerations will vary depending on the business complexity and degree of tax risk acceptable to the vendor, including:
  - International planning (*e.g.*, operations, assets, intellectual property in other countries)
  - Planning using non-CCPCs in an effort to defer tax
  - "Section 84.1" deferral planning
  - Loss corporation planning
  - Deferral for CCPC stock option shares

Sale Planning – Common Pitfalls

- There are a variety of common traps and pitfalls arising in sale transactions, including risks arising from:
  - Risk of reallocation of purchase price
  - Non-competition covenants or agreements
  - Pre-closing dividends
  - Structuring how earn-outs are calculated and paid
  - Sales to family members
  - Getting paid with your own money by your employees
  - GST/HST
  - Section 116 certificates for non-resident vendors
  - Acquisitions of control
  - Loss of CCPC status
  - Provincial tax considerations (e.g., PST or land transfer tax)
  - Deductibility of transaction costs

Sale Planning – Future Tax Audits & Disputes

- Effective planning to mitigate future tax audits and disputes
  - Obtain tax memorandum (or at least detailed transaction steps)
  - Documentation carefully implemented to reflect tax memorandum
    - Canada generally is a “form over substance” jurisdiction for tax purposes
    - Ensure the transactions are legally effective as intended
    - Appropriate allocation of risk in agreements
    - Consider defined responsibilities and cooperation with respect to future tax audits/disputes
  - Legal privilege over sensitive tax planning communications
  - Fixing mistakes – consider options

New Reality Post-Sale

- After a sale has been completed, there continue to be important opportunities and pitfalls with respect to taxation of sale proceeds

Important Considerations

- Tax efficient extraction of sale proceeds (*i.e.*, from a “HoldCo”)
- Tax on split-income rules
- Limitations on deductions post-sale
- Passive income proposals
- Salaries
- Shareholder loans

Options to Extract Sale Proceeds

- Capital gain rates are preferable to taxable dividend rates
  - Tax rate for top bracket taxpayer in Alberta (approx.):
    - Personal capital gains 24%
    - Eligible dividends 32%
    - Ineligible dividends 42%
- Consider strategies to extract cash at capital gains rates (or better)
  - Time sale of appreciated assets before sale of loss assets (*e.g.*, marketable securities)
  - Create an internal capital gain (a “pipeline” transaction)

Tax On Split Income ("TOSI")

- Concerned with "dividend sprinkling" to family members who are not active in the business
- Perceived mischief:
  - Paying dividends to related low income shareholders that are not involved in the business to use their unused marginal tax brackets
- If rules apply, split income is taxed at the highest marginal rate
- Potential savings of over $30,000 per year per person if you can avoid TOSI application

Tax On Split Income ("TOSI")

- The new rules add complexity
- Numerous potential exclusions, including:
  - Shareholder is active in the business – but there is threshold activity level required
  - 10% share ownership threshold (votes and value) for many shareholders – provided the business is NOT a service business
- Difficult to safely pay dividends to children under the age of 25
- More difficult to safely pay dividends from holding corporations and through family trusts
- Fewer exceptions for professionals and those operating service businesses

Questions

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