READING 6-1

Purchase or sale of shares

LEVEL 1

The purchase or sale of shares calls for many considerations for minimizing tax consequences and for planning the transaction for both the purchaser and the vendor. Another consideration is the impact of the transaction on the corporation itself.

Reducing the sale price

A purchaser does not always have the liquid assets available to acquire a business. In addition, he would like to minimize his financing costs so as to obtain a worthwhile return on his investment as quickly as possible. Furthermore he may not have sufficient guarantees to obtain the total financing that the transaction requires.

Certain steps may be taken to reduce the price of the shares for the purchaser without placing the vendor at a disadvantage with respect to their value.

Retiring allowance

If the vendor-shareholder is a key employee of the corporation, consideration should be given to having the shareholder-employee leave the company before the sale of shares and receive a reasonable retiring allowance. The retiring allowance is an expense deductible by the corporation. Cash and accumulated profits would be reduced by the amount of the allowance, thereby lowering the value of the shares. The employee may transfer the retiring allowance to his RRSP within the limits provided in paragraph 60(j.1) which defers all or a portion of the income tax liability on the retiring allowance depending on the number of years of service with the company prior to 1996. The two transactions should be well segregated to avoid having the retiring allowance considered as a portion of the sale price of the shares. In such a case, the retiring allowance would be added to the POD and thus increase the vendor's capital gain. Therefore, the payment of a retiring allowance must not be included in the sales agreement itself.

Even if the recognized years are prior to 1996, this opportunity should not be missed. It is not unusual for the business sold to have been created 20 or 25 years ago, and after all, this represents some ten years eligible for transfer to the RRSP. If the spouse of the vendor-shareholder is also an employee, he also has the possibility of receiving a retiring allowance.

Capital dividend

Whether or not the corporation has a CDA balance must be determined. If a balance exists in the CDA, consideration should be given to paying the vendor-shareholder a dividend from the CDA under subsection 83(2) before the sale of shares. To avoid penalties on late filing, the election to pay a dividend from the CDA must be made using the prescribed Form T2054, and must be filed before the dividend becomes payable. This election will reduce the value of the shares and enable the vendor to receive amounts tax free.

Using a corporation

If the vendor is an individual, he may be entitled to the CGD of $375,000 if the shares are qualified small business corporation shares or shares of a family farm or fishing corporation. If the CGD is not available to the vendor or if the capital gain exceeds the available CGD and another corporation has tax attributes that would serve to reduce the tax consequences, the individual may wish to use this other corporation to defer all or a portion of the tax on the

capital gain. This would be the case, for example, if the individual owns 100% of the shares of another corporation that has a loss carryforward that would serve to reduce or eliminate the capital gain on the sale of the shares. The payment of a dividend out of the surplus earned or realized after 1971 (safe income) could also be made as part of the reorganization preceding the disposition of the shares.

Under the rollover provisions of section 85, an individual may transfer all or a portion of the shares to be sold to a corporation on a tax-free basis and receive shares of the transferee corporation in return.

If the corporation whose shares are to be sold has a substantial accumulated surplus and all its shares have been transferred to the corporation, a dividend may be paid to the corporation without any Part I tax liability to the corporation, given that the dividend is deductible under subsection 112(1). In addition, since the corporations are connected at the time the dividend is paid, there will be no Part IV tax liability unless the corporation paying the dividend is entitled to a dividend refund on the payment of the dividend. This will reduce the value of the shares to be sold. However, section 55 contains an anti-avoidance rule that, in certain cases, may deem a dividend, paid immediately before the sale of shares, to be POD rather than a dividend. This could be the case where the amount of the dividend exceeds the income earned or realized after 1971, which is attributable to the shares sold.

In other cases, the vendor will want to take advantage of the CGD, and only a portion of the shares will be transferred to the corporation. Example 6-1 illustrates this situation.

EXAMPLE 6-1

Sophie Séguin, the sole shareholder of Infotech Ltd., has received an offer for the 1,000 common shares of Infotech Ltd. that she holds. These are the only outstanding shares of Infotech Ltd., which qualifies as a SBC. All other conditions are met for the shares to qualify for the CGD.

Additional information:

- The 1,000 common shares have an ACB and PUC of $1,000. The offer for the 1,000 shares is $700,000.
- Sophie already took advantage of the CGD for an amount of $125,000, has no CNIL balance, and has never had an allowable business investment loss (ABIL).
- Sophie owns shares in other corporations, including Graphitex Ltd., of which she is the sole owner. Graphitex Ltd. has a net capital loss carryforward of $300,000 that she does not expect it to be able to use.

Graphitex Ltd. could be used to defer a portion of the taxes payable on the sale of the shares by following the steps below:

1. Determine the FMV per share.

$$\frac{\$700{,}000}{1{,}000 \text{ shares}} = \$700$$

2. Determine the number of shares to be transferred to Graphitex Ltd.

Capital gain per share: $\$700 - \$1 = \$699$

Number of shares not to be transferred: $\frac{\$500{,}000}{\$699} = 715$

Number of shares to be transferred: 1,000 – 715 = 285

3. Transfer 285 of Sophie's shares of Infotech Ltd. to Graphitex Ltd. for an agreed amount of $285 using the rollover provisions of section 85. In return Sophie receives 285 preferred shares of Graphitex Ltd., which have a PUC of $285 and are redeemable at $199,500 (285 × $700), that is, the FMV of the 285 common shares of Infotech Ltd.

4. Sale by Sophie and Graphitex Ltd. of Infotech Ltd. shares to the third party offering to purchase.

Tax consequences

1. For Sophie:

POD (715 × $700)	$ 500,500
Less: ACB (715 × $1)	(715)
Capital gain	$ 499,785
Taxable capital gain (1/2)	$ 249,893
Less: CGD	(249,893)
	$ —

However, the AMT may apply.

2. For Graphitex Ltd.:

POD (285 × $700)	$ 199,500
Less: ACB (285 × $1)	(285)
Capital gain	$ 199,215
Taxable capital gain (1/2)	$ 99,608
Less: Net capital loss carryforward	(99,608)
	$ —

An amount of $99,608 is added to the CDA of Graphitex Ltd. which could be paid tax-free to Sophie. However, since Graphitex Ltd. has a net capital loss carryforward of $300,000, it is likely that the CDA is currently negative and no election is possible under subsection 83(2) to pay a dividend on the CDA.

Since Graphitex Ltd. has no tax payable on the disposition of the shares, all the taxes that would have been paid by Sophie have been deferred, but will be payable when the funds held by Graphitex Ltd are received by her as dividends.

It is interesting to note that if Sophie doesn't need the complete amount of money she will receive on the sale of the shares of Infotech Ltd., she could transfer more shares to Graphitex Ltd., being able to use more of the $300,000 net capital loss carryforward. This decision is valid provided that Sophie holds shares of another SBC that can give her the opportunity to claim the CGD when they are disposed of. Otherwise the POD are received by Graphitex Ltd. and Sophie will pay income tax when she receives the amount in the form of taxable dividends, whereas by using the CGD on the disposition of the shares, she has no income tax payable.

The above transaction may be even more worthwhile if there were substantial income earned or realized after 1971 and attributable to the Infotech Ltd. shares transferred to Graphitex Ltd. In such a case, Infotech Ltd. could purchase or repurchase the shares held by Graphitex Ltd. before the sale to the third party, which would result in a deemed dividend under

subsection 84(3). This dividend could be eligible for a deduction up to the amount of income earned or realized after 1971 that is attributable to the shares, if the election under paragraph 55(5)(f) is made. The excess would be considered as POD of the shares under subsection 55(2). As noted above, the eligible dividend will be exempt from Part I tax as well as from Part IV tax if there is no dividend refund in Infotech Ltd. The purchaser would then have to acquire Sophie's shares for $500,500.

Settlement of advances

Often, a shareholder will loan funds to a corporation. Consequently, at the time of the sale of shares, the corporation may have an amount owing to the vendor-shareholder. If the corporation has sufficient liquid assets, the loan may be repaid without any tax consequences for the vendor. If the corporation has had significant losses, it may not have the liquid assets required to repay the loan and the purchaser would probably not want this liability to remain on the books. The purchaser may acquire from the vendor the debt for an amount less than face value. If the loan meets the conditions of a loan made to earn income, the vendor would realize a capital loss. In addition, if the purchaser and the vendor deal at arm's length, the loss could be considered as a business investment loss as defined in paragraph 39(1)(c). With respect to the purchaser of the debt, when the corporation has sufficient funds to repay the debt, the excess of the amount paid over the cost may be considered business income. This interpretation is based in part on the decision rendered in *Stephen S. Steeves v. R.* (77 DTC 5230).

If the corporation is indebted to the vendor, writing off or settling the debt for a lesser amount should not be considered if the provisions of section 80 are to be avoided. However, various rules have been introduced to prevent **debt parking**, a situation that sometimes arises when debts are assigned. One goal of debt parking was to avoid the application of section 80 when the debtor (corporation) was unable to repay the entire amount of its debt to the shareholder (creditor) upon the sale of the shares. Thus, a person acquired the debt at a discount, say 40%, and required the corporation to pay only 60% of the debt. The balance of the debt was neither written-off nor repaid. This stratagem allowed the shareholder to receive payment for 60% of the debt without there being debt forgiveness, with its resulting consequences for the corporation. Currently, the following rules regulate debt parking.

First, the debt must, at a particular time, be a **specified obligation** of the debtor, as defined in subsection 80.01(6), meaning that

a. at any previous time,
   (i) the person who owned the obligation dealt at arm's length with the debtor, and where the debtor is a corporation, the person did not have a **significant interest** in that corporation,
   or
   (ii) the obligation was acquired by the holder of the obligation from a person who was not related to the holder,

or

b. the obligation is deemed under subsection 50(1) to have been reacquired after the deduction for a bad debt.

   A person has a **significant interest** in a corporation, as defined in paragraph 80.01(2)(b), where:

   (i) the person owns shares of the corporation that give the person 25% or more of the voting rights at the annual meeting of shareholders,
   or
   (ii) the person owns shares of the corporation having an FMV of 25% or more of the FMV of all the issued shares of the corporation.

For the purposes of this definition, a person is deemed to own the shares of the corporation that belong to another person with whom he does not deal at arm's length.

If it is determined that the debt is a specified obligation, it becomes a parked obligation if, among other things, as provided by subsection 80.01(7), at any time the holder of the obligation does not deal at arm's length with the debtor.

If this is the case and if the specified cost to the holder of the obligation is less than 80% of the principal amount, then under subsection 80.01(8), the debtor faces the following tax consequences:

(i) the obligation is deemed to have been extinguished at the particular time, and

(ii) the forgiven amount is determined as if the debtor had paid an amount equal to the specified cost of the obligation.

Therefore, if an obligation is, among other things, transferred from a creditor who deals with the debtor at arm's length to a creditor who does not deal with the debtor at arm's length or to a person who has a significant interest in the debtor for an amount that is less than 80% of the principal amount, the obligation is deemed to be settled.

Example 6-2 illustrates how subsections 80.01(6) to (8) apply where there is debt parking in the sale of a business.

EXAMPLE 6-2

John Elliott is the sole shareholder of Cargo Ltd., a CCPC having a fiscal year ending November 30. John owns 1,000 shares of Cargo Ltd. for which he paid $1,000. In addition, over the years, he has advanced $100,000 to Cargo Ltd. in the form of interest-bearing loans.

Cargo Ltd. has accumulated losses for a number of years. It has the following non-capital loss carryforwards:

November 30, 2003	$ 20,000
November 30, 2004	30,000
November 30, 2005	75,000
November 30, 2006	80,000
	$ 205,000

In 2008, Levino Ltd., a competitor of Cargo Ltd., made the following offer to John:

- Levino Ltd. will purchase the 1,000 shares from John for $1,000

and

- John may choose either of the following options:
  a. Levino Ltd. would purchase John's loans for $25,000.
  b. Following the purchase of the shares by Levino Ltd., John would accept a settlement of his loans to Cargo Ltd. for $25,000. To effect this transaction, Levino Ltd. would advance $25,000 to Cargo Ltd., which would in turn pay John $25,000 in settlement of his loans. The $75,000 shortfall would be written off the books by Cargo Ltd.

Cargo Ltd. and John are not related to Levino Ltd.

Tax consequences

1. For John:

   Shares

   There are no tax consequences since the POD are equal to the ACB of the shares.

   Loans

   Under both options, a capital loss will be realized equal to:

POD	$ 25,000
ACB	(100,000)
Capital loss	$ (75,000)
Allowable capital loss (1/2)	$ (37,500)

   This loss may be claimed as an allowable business investment loss (ABIL) provided the conditions in paragraph 39(1)(c) are met, including the condition that Cargo Ltd. must be an SBC at any time in the twelve months preceding the disposition of the debt. This specification is contained in the definition of SBC set out in subsection 248(1).

2. For Cargo Ltd.:

   If Levino Ltd. purchases the loans

   The debt is a specified obligation since it was acquired from John, a person not related to Levino Ltd. [80.01(6)(a)(ii)].

   The debt becomes a parked obligation since Levino Ltd. does not deal at arm's length with Cargo Ltd. following the acquisition of the shares [80.01(7)].

   The obligation is deemed to be extinguished, since the specified cost for Levino Ltd. is $25,000, which is less than 80% of the principal amount [80.01(8)(a)].

   The forgiven amount is $75,000 ($100,000 – $25,000) [80.01(8)(b)].

   Therefore, there is debt forgiveness, and subsection 80(3) applies.

Non-capital loss carryforward	$ 205,000
Less: Forgiven amount	(75,000)
Non-capital loss carryforward after the application of 80(3)	$ 130,000
Distributed as follows:	
2005	$ 50,000
2006	80,000
	$ 130,000

   If Cargo Ltd. settles the loans due to John for $25,000

   The rules on debt parking do not apply, but there is debt forgiveness and subsection 80(3) applies, with the same tax consequences as if Levino Ltd. had purchased the loans.

3. For Levino Ltd.:

<u>If Levino Ltd. purchases the loans</u>

ACB of the shares of Cargo Ltd.	$ 1,000
ACB of the $100,000 loan now due by Cargo Ltd. to Levino Ltd.	$ 25,000

<u>If Cargo Ltd. settles the loan owing to John for $25,000</u>

ACB of the shares of Cargo Ltd.	$ 1,000
ACB of the $25,000 advance made by Levino Ltd. to Cargo Ltd.	$ 25,000

Financing and other costs related to the transaction

Specifications regarding interest deductibility are contained in paragraph 20(1)(c):

- a reasonable amount must be paid during the year or be payable in respect of the year
- the amount must be paid pursuant to a legal obligation
- the use of the money borrowed must be stated
- the **purpose** of this use must be to earn business or property income that is not tax-exempt

The requirements of paragraph 20(1)(c) may be interpreted in opposite ways by a taxpayer and CRA. The courts often have to decide whether interest paid or payable is deductible in computing business or property income. For some years now, since the *Bronfman Trust* case (87DTC 5059), taxpayers have had the burden of showing that the borrowed money was used for an eligible purpose. If the borrowed money was applied directly to a given use, it was easy to determine how it was used. However, it is not always possible to trace money through its different uses.

In recent years, decisions such as those in *Tennant, Shell,* and *Ludco* have introduced the concept of linking the borrowed money rather than tracing its use, and have thus approved a more flexible approach to tracing/linkage. The references to these decisions are the following:

- Ludco Enterprises Ltd. [2002 DTC 7583]
- Tennant [96 DTC 6121]
- Shell Canada Ltd. [99 DTC 5669]

Paragraphs 1 to 18 of IT-533 should be consulted concerning interest deductibility. These paragraphs explain CRA's position regarding the criteria set out in paragraph 20(1)(c), a position based on different court decisions.

If the purchase of shares is financed with borrowed money, the interest paid or payable will be deductible because the money has been used to acquire shares earning income from property, namely dividends. The situation would be different if it were clear when the shares were acquired that the corporation did not plan to pay a dividend and that the shareholders would have to sell their shares to realize the gain relating to the shares.

A purchaser may therefore borrow money in order to acquire shares and the interest expense will be deductible and thus reduce his income tax liability. However, if the amount of the loan is significant and the interest expense very large in relation to the purchaser's income, or if an individual wishes to avoid the impact of interest expense on the CGD through the increase or creation of a CNIL, the purchase of shares may be carried out in another way.

The purchaser might use an existing income-earning corporation to acquire the shares. The existing corporation, assuming it borrowed funds to make the acquisition, would therefore have an interest expense that would reduce its net income and might, in certain cases, reduce its taxable income under the business limit threshold, making all its taxable income eligible for the SBD. However, if the two corporations are associated after the transaction within the meaning of section 256, the purchaser must split the business limit with the acquired corporation.

The purchaser could also form a new corporation which would borrow funds to acquire the shares. Since this new corporation would have no taxable income, and the only income it is likely to receive is from dividends on the shares, which are deductible under subsection 112(1) in computing taxable income, the interest expense would not result in any tax saving. Immediately after the acquisition, the target company could either be wound up under subsection 88(1) or amalgamated with the new corporation under section 87. The interest expense would then be deductible from the operating income of the newly acquired corporation, as illustrated in Example 6-3 (see IT-533, paragraph 21).

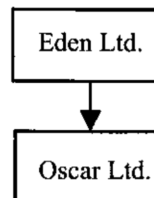
EXAMPLE 6-3

Henry Cheung wishes to acquire the shares of Oscar Ltd. and would like the interest payable on the loan used to purchase the shares to be deductible in computing the income of Oscar Ltd.

Steps

1. Henry incorporates Eden Ltd.

2. Eden Ltd. borrows the money required for the purchase and acquires the shares of Oscar Ltd.



3. Oscar Ltd. is wound up into Eden Ltd. under subsection 88(1), or Eden Ltd. and Oscar Ltd. are amalgamated under section 87 to form Eden Ltd.

4. The interest is deductible by Eden Ltd., since Eden Ltd. has income derived from the operations of the former company, Oscar Ltd.

In this example, a link can be established between the initially acquired shares of Oscar Ltd. and the assets of Oscar Ltd. that now belong to Eden Ltd., which was initially the borrower.

Note:

It is not essential to create a new corporation to achieve this objective. Another possible option would be to use a corporation already wholly owned by Henry.

Another financing method used by a corporate purchaser is to have one of its subsidiaries take out a loan which it then remits to the parent as a dividend. A loan by an income-earning subsidiary is preferable because the subsidiary will then be able to make use of the interest deduction, as shown in Example 6-4.

EXAMPLE 6-4

Holdco Inc. is a corporation that owns shares in a number of subsidiaries including Novaltec Ltd., an operating company which realizes substantial profits every year.

Little of Holdco Inc.'s income is taxable annually since it consists mainly of dividends paid by the subsidiaries.

Holdco Inc. is to acquire the shares of Culinor Ltd. and would like the interest paid on the loan to acquire the shares to be deductible in computing the income of Novaltec Ltd.

Steps

1. Novaltec Ltd. borrows the funds required to purchase the shares of Culinor Ltd.

2. Novaltec Ltd. pays Holdco Inc. a dividend equal to the amount of the loan. Provided Novaltec Ltd. has retained earnings equal to or greater than the amount of the dividend, the interest on the loan taken out by Novaltec Ltd. and used to pay the dividend to Holdco Inc. will be deductible by Novaltec Ltd.

3. Holdco Inc. purchases the shares of Culinor Ltd. with the money received from Novaltec Ltd.

In reading paragraph 23 of IT-533, you will see that the policy of CRA is generally to consider as deductible the interest on the money borrowed to pay dividends.

This position is justified on the basis that a corporation that uses its profits for expansion and then borrows money to pay dividends should not be penalized in comparison with a corporation that pays dividends and then borrows money to finance an expansion.

It should also be kept in mind that under paragraph 20(1)(e), certain other expenses incurred in the course of the transaction, such as the fees charged for examining the application for financing, are deductible at the rate of 20% per year.

As the courts have upheld, interest ceases to be deductible under paragraph 20(1)(c) if the source of income no longer exists. However, relief measures are available in some circumstances.

Loan to earn income from property

Subsection 20.1(1) applies:

- where a taxpayer ceases to use borrowed money for the purpose of earning income from a capital property (other than real property and depreciable property),

and

- a portion of the borrowed money has been lost due to a decline in the value of the property.

The amount lost is deemed to continue to be used for the purpose of earning income from the property. Legal precedent is therefore no longer applicable in all situations.

Under paragraph 20.1(1)(b), the amount of the loan that is outstanding just before it ceases to be used to earn income from the property is reduced by the amount of borrowed money that is not considered to have been lost. That amount is determined as follows:

- where the taxpayer has disposed of the property for an amount of consideration at least equal to the FMV of the property, the amount of the borrowed money that is traceable to the consideration received

or

- where the taxpayer has not disposed of the property (as in the case of a bankruptcy, for example), the amount of the money borrowed that would be traceable to the proceeds that he would have received if he had disposed of the property, that is, the FMV of the property.

Where the taxpayer disposes of the property to the creditor in return for a reduction in the amount owed, the amount of the reduction reduces the balance of the loan on which interest continues to be deductible.

Examples 6-5 and 6-6 show how subsection 20.1(1) applies.

EXAMPLE 6-5

A few years ago, Maria Garcia borrowed $10,000 to acquire common shares of Magic Inc. at a cost of $16,000. The shares have declined in value, and Maria sells them for $9,000 during the current year to a non-related person and acquires common shares of Monet Ltd. for $9,000. There is still $10,000 owing on the loan at the time of the disposition of the shares of Magic Inc.

Tax consequences

Subsection 20.1(1) applies, since

- Maria has stopped using the borrowed money to earn income from the shares of Magic Inc.

and

- part of the borrowed money is lost since the shares of Magic Inc. have declined in value.

1. The amount of the loan to which relief measures apply is determined by subtracting from the amount of the loan ($10,000) that portion of the borrowed money which is attributable to the consideration received ($9,000).

Loan balance	\$ 10,000
Less: $\frac{\text{Consideration received}}{\text{Cost of transferred shares}} \times \text{loan balance}$	
$\frac{\$9,000}{\$16,000} \times \$10,000$	(5,625)
	\$ 4,375

This loan portion of $4,375 is deemed to continue to be used to earn income from property. Maria can therefore continue to take a deduction under paragraph 20(1)(c).

2. The balance of the loan, namely $5,625 ($10,000 – $4,375), is considered to be used to acquire the shares of Monet Ltd. Under paragraph 20(1)(c), the interest on this amount is deductible.

EXAMPLE 6-6

Following Example 6-5, assume that Maria used the POD of the shares, namely, $9,000, for personal purposes.

Tax consequences

1. Interest on $5,625 is not deductible, since that portion of the borrowed money is not deemed to be used for an income-earning purpose.
2. Interest on $4,375 is deductible under paragraph 20(1)(c).

Loan to earn income from a business

Under subsection 20.1(2), where a taxpayer who has borrowed money for the purpose of earning income from a business, ceases to carry on the business, three rules apply to the determination of the use of the borrowed money:

- Where the taxpayer disposes of property that was used in the business just before its cessation, a portion of the borrowed money is deemed to have been used to acquire this property. The portion of the borrowed money that is traceable to a given property corresponds to the lesser of the following amounts:

  a. the FMV of the property at the time of its disposition, and
  b. the amount of the borrowed money outstanding at that time that is not traceable to another property.

  The deductibility of this portion of the loan depends on the use of the POD at the time of disposition of the property [paragraph 20.1(2)(a)].

- The borrowed money is considered to have been used to acquire the property remaining at the cessation of the business only to the extent provided for in paragraph 20.1(2)(a) [paragraph 20.1(2)(b)].
- The portion of the borrowed money that is not deemed to have been used to acquire property is deemed to continue to be used for the purpose of earning income from the business [paragraph 20.1(2)(c)].

In addition, under paragraph 20.1(2)(d), the business is considered to have fiscal periods that coincide with the taxation year of the taxpayer. The first such period is deemed to start at the end of the last actual fiscal period of the business.

Example 6-7 applies the provisions of subsection 20.1(2).

EXAMPLE 6-7

On August 1, 2008, Louis Décarie ceases to carry on his business. At that time, the borrowed money used in the business amounts to $100,000. On November 1, 2008, Louis sells all his property used in the business to a non-related buyer for $40,000. He uses the POD to pay off the mortgage on his cottage, which is used solely for personal purposes. Louis repays the $100,000 debt on August 1, 2009.

Tax consequences

1. Under paragraph 20.1(2)(c), the full amount of the borrowed money, namely, $100,000, is deemed to continue to be used for the purpose of earning income from the business for the period from August 1, 2008, to November 1, 2008. Thus, the interest is deductible under paragraph 20(1)(c).

2. Under paragraph 20.1(2)(a), $40,000 is deemed to have been used to acquire property immediately before its disposition on November 1, 2008. Since the POD are used for personal purposes, the $40,000 is no longer considered to be used for an income-earning purpose after November 1, 2008, and the interest on that amount ceases to be deductible.

3. Under paragraph 20.1(2)(c), $60,000 of the borrowed money is deemed to continue to be used to earn income from the business until August 1, 2009, the date of repayment of the loan. Thus, interest for the period from November 1, 2008, to August 1, 2009, is deductible under paragraph 20(1)(c).

Vendor financing

Rather than borrow funds from a financial institution to finance the purchase, the purchaser may ask the vendor to provide financing through a balance of sale agreement.

In such a case, the vendor should obtain assurance of the purchaser's solvency. He should also decide on the amount of the unpaid balance on the selling price that would allow him reasonable cash flow. Consequently, he must take into account that the reserve under subparagraph 40(1)(a)(iii) may not exceed five years and that, each year, a cumulative minimum of 20% of the capital gain, up to 100%, must be included in computing income. Yearly repayments of the balance of sale should, therefore, cover at least the income taxes payable on the taxable gain, including AMT, where applicable. Otherwise, the vendor could have liquidity problems.

However, if the property is disposed of to the vendor's child and is

- a farm property,
- a share of a farm or fishing corporation,
- an interest in a family farm or fishing partnership,

or

- a share of an SBC,

under subsection 40(1.1), the reserve may be spread over 10 years and only 10% of the capital gain, rather than the cumulative 20% otherwise stipulated, must enter into the calculation of income each year.

Planning to use the CGD

It is necessary to ensure that, prior to the sale, the shares of the corporation are eligible for the CGD of $375,000 on qualified small business corporation shares and the vendor shareholder is able to reduce his taxes to a minimum. However, not all transactions are conducive to this type of planning. This is the case, for example, if the transaction involves the sale of shares of an investment company or a corporation other than a CCPC, or if the vendor shareholder is himself a corporation.

Dispositions subject to warranty

Generally, an agreement for the sale of shares contains a compensation clause whereby the vendor must reimburse the purchaser for any financial loss resulting from warranties, covenants, or other conditional or contingent obligations that he has given or incurred. For example, reassessment notices may be issued by CRA involving additional taxes, as well as interest for previous taxation years ended before the date of disposition of the shares. Legal and accounting costs may also be attached to supplementary income taxes if the notices are disputed.

Section 42 provides for such a situation. The vendor of the shares must treat the amounts paid as a capital loss.

Loss on disposition of shares

Where a corporation or an individual disposes of shares that are capital property and the result is a loss, this loss may be reduced in whole or in part if the vendor received dividends before the transaction. Subsections 112(3.1) and (3.2) contain similar provisions for cases where the share is owned by a partnership or trust. These provisions are **not examinable**.

The purpose of the provisions of subsections 112(3) and 112(4) is to prevent a shareholder from deducting a capital loss where the shareholder has received dividends, with the effect that the FMV of the shares is reduced. Since the taxpayer has suffered no economic loss, no tax relief should be granted.

The provisions of subsection 112(3) apply to reduce the capital loss:

a. in the case of an individual, by the lesser of the following amounts:

- any capital dividend received by the individual on the share
- the capital loss otherwise determined, minus all taxable dividends received by the individual on the share

Once the taxable dividends received by the individual exceed the capital loss incurred, the capital dividend no longer serves to reduce the capital loss incurred on the disposition of the shares.

b. in the case of a corporation, by the total of the following amounts received by the corporation on the share:

- any taxable dividend that was deductible in computing its taxable income under section 112
- any capital dividend
- any life insurance capital dividend

However, under subsection 112(3.01), a reduction of the capital loss under subsection 112(3) will not apply if

a. at the time the dividend was received, the taxpayer and persons with whom the taxpayer was not dealing at arm's length did not own more than 5% of the shares of any class of the capital stock of the corporation which paid the dividend,

and

b. the taxpayer owned the shares throughout the 365-day period that ended immediately before the disposition.

EXAMPLE 6-8

In 1997, Orchestra Inc., being interested in the field in which Cornet Ltd. was operating, acquired 50% of the outstanding shares of Cornet Ltd. for $400,000. In 1999, Cornet Ltd. paid a taxable dividend of $50,000 to Orchestra Inc. which was deducted under subsection 112(1) in computing its taxable income. The situation of Cornet Ltd. deteriorated, and Orchestra Inc. decided to sell its shares for $100,000 to a Cornet Ltd. shareholder who believed that the situation was about to turn around.

Tax consequences

POD	$ 100,000
Less: ACB	(400,000)
Capital loss	$ (300,000)

Under paragraph 112(3)(b), the capital loss is reduced by the total of the following amounts, which would have been received by Orchestra Inc. on the shares of Cornet Ltd. that it disposed of:

• taxable dividend deductible under section 112	$ 50,000
• capital dividend	—
• capital dividend on life insurance	—
Amount of reduction	$ 50,000
Capital loss	$ (300,000)
Less: Reduction	50,000
Capital loss	$ (250,000)
Allowable capital loss (1/2)	$ (125,000)

This loss could be claimed as an ABIL if the conditions set out in paragraph 39(1)(c) are met.

To determine whether subsection 112(3) applies with respect to the percentage of shares held, it is necessary to analyze the situation at the time the dividend is received by the vendor corporation. Since paragraph 112(3.01)(a) refers to the ownership of more than 5% of any class of shares, the provisions will apply even if the dividend is not received on the class of shares of which the taxpayer holds more than 5%. However, the capital loss reduction applies only to shares on which the taxpayer has received dividends.

In addition, subsections 112(4) and 112(4.01) extend the rules contained in subsections 112(3) and 112(3.01) to any shareholder — a corporation or otherwise — that disposes of a share that is not capital property. The conditions of application are similar to those contained in subsections 112(3) and 112(3.01).

Under subsection 112(7), in the case of a reorganization in which new shares were issued in exchange for the outstanding shares of a corporation by means of a transaction to which sections 51, 85.1, 86, or 87 applied, subsections 112(3) and 112(4) would apply to these new shares if the dividends have been paid on the old shares, before the reorganization.

To complete your study of this topic, read IT-328R3.

LEVEL 2

Capital gain deferral

Where the disposition of shares of an SBC by an individual gives rise to a capital gain, the CGD may be used to reduce or eliminate income tax payable. However, the CGD may be insufficient to reduce the tax to zero or may no longer be available because it was used in an earlier transaction. The individual may find that he has a sizable tax burden on the disposition of the shares. He therefore has fewer liquid assets to invest, say, in another business.

In order for small businesses to have easier access to the capital that they need, measures are set out in section 44.1. They enable **individuals** to defer tax-free the capital gains realized on the disposition of an investment in a small business when the POD are reinvested in another eligible small business. If all the conditions are met, all or a portion of the capital gain will be taxed only on the disposition of the replacement shares. These rules are similar to those that will be studied with respect to the exchange of property on a voluntary or involuntary disposition of capital property.

An individual who realizes a capital gain on a qualifying disposition during a taxation year may, under subsection 44.1(2), deduct the permitted deferral in determining his capital gain. Under paragraph 44.1(2)(b) and subparagraph 53(2)(a)(v), the ACB of the replacement shares is then reduced by the same amount.

Subsection 44.1(1) contains a number of definitions that are useful in determining the capital gain deferral.

The disposition of shares is considered a qualifying disposition if the share transferred

- is an eligible small business corporation share,
- was a common share of an active business corporation (ABC) throughout the period during which the individual owned the share,

and

- was owned by the individual throughout the 185-day period that ended immediately before the disposition of the share.

Under subsection 44.1(9), the assets of the ABC must have been used for at least 730 days in the period of holding of shares in a business carried on primarily in Canada, or for the entire period during which the shares were held if that period is less than 730 days.

An eligible small business corporation share is a common share issued by a corporation which, at the time the share was issued, was an eligible small business corporation (ESBC). In addition, the total carrying value (determined according to GAAP) of the assets of the corporation and corporations related to it must not have exceeded $50 million at the time the share was issued.

An ESBC is a CCPC, all or substantially all of the FMV of the assets of which are either

- used principally in an active business carried on primarily in Canada by the corporation or by an ESBC that is related to it,
- shares issued by or debt owing by other ESBCs that are related to it, or
- a combination of these assets.

A replacement share is an eligible small business corporation share thus designated by the individual in his return of income. It must be acquired in the year or within 120 days after the end of the year.

Thus an individual who disposes of eligible small business corporation shares and acquires replacement shares may take the permitted capital gain deferral. That deferral is equal to

$$\frac{G}{H} \times I$$

where

G = the lesser of:
- POD from the qualifying disposition
- cost of replacement shares

H = POD from the qualifying disposition

I = capital gain from the qualifying disposition

The application of these rules governing capital gain deferral is illustrated in Example 6-9.

EXAMPLE 6-9

In 1996, Arnold Gates purchased shares of Virus Ltd. for an amount of $1,000,000. He sells them for $1,500,000 in 2008. The shares are eligible small business corporation shares. Arnold purchases replacement shares using $1,050,000 of the POD received for the shares of Virus Ltd. He has already used the entire CGD in a past transaction.

Tax consequences

1. If Arnold does not make the election allowed in section 44.1

POD	$ 1,500,000
ACB	(1,000,000)
Capital gain	$ 500,000
Taxable capital gain (1/2)	$ 250,000

2. If Arnold makes the election in section 44.1

Permitted deferral

$$\frac{G}{H} \times I$$

where

G = the lesser of

- POD: $1,500,000
- cost of the replacement shares: $1,050,000

H = POD: $1,500,000
I = capital gain: $500,000

Therefore, the permitted capital gain deferral is

$$\frac{\$1,050,000}{\$1,500,000} \times \$500,000 = \$350,000$$

Capital gain in 2008

POD	$ 1,500,000
ACB	(1,000,000)
Capital gain	500,000
Permitted deferral	(350,000)
Capital gain	$ 150,000
Taxable capital gain (1/2)	$ 75,000

ACB of the replacement shares

ACB (price paid)	$ 1,050,000
Permitted deferral	(350,000)
ACB of the replacement shares	$ 700,000

READING 6-2

Purchase or sale of property

LEVEL 1

In this reading, you will not analyze the purchase or sale of a specific asset but rather the purchase or sale of a business through acquisition or sale of the assets held by the corporation.

Financing

The concepts reviewed with respect to financing are equally relevant to asset acquisition, and provisions such as those in paragraphs 20(1)(c) and 20(1)(e) also apply to the purchaser.

For the vendor, the comments on the advisability of a balance of sale agreement are equally valid in a sale of assets. It should nevertheless be noted that, if there is CCA recapture or sale of ECP, no reserve may be claimed on the resulting income, even if there is a balance of sale agreement. The consequences relating to a disposition with guarantee also apply.

Allocating the price

The sale price is allocated among the assets according to the agreement between the vendor and the purchaser. Because the interests of the parties are generally opposed, the allocation of the sale price is, therefore, the result of negotiation between the parties and can be expected to be reasonable in the circumstances. A public accountant is often consulted on this subject and should assist the parties to reach an agreement.

However, one of the parties may be indifferent to the allocation. This may be the case where one party is tax exempt or has significant losses or tax credit carryovers. Often, the purchaser and the vendor merely agree to a total price and each party carries out his own allocation once the transaction has been completed. The allocation must be reasonable given the facts and must respect the FMV of the assets in question. For example, if land and building are sold for a total amount, a reasonable allocation might be made using the municipal valuation.

If the allocation is considered to be unreasonable, the tax authorities may use the provisions of section 68 to establish a reasonable allocation. Where an amount received or receivable can reasonably be regarded as being in part consideration for the disposition of any property, the part of the amount that can reasonably be regarded as being the consideration for such disposition is deemed to be POD of that property. Regardless of the form or legal effect of any relevant contract, the purchaser is then deemed to have acquired the property for the same amount. In this regard read IT-220R2, paragraphs 4 to 7. In 1986, the Supreme Court, in the case of *R. v. Golden et al.* (86 DTC 6138), held that section 68 could be used to allocate the total sale price among the various assets. A similar decision was rendered in 1990 in the case of *H. Baur Investments v. R.* (90 DTC 6371).

According to IT-220R2, if the provisions of section 68 are applied, the allocation will be the same for both the vendor and the purchaser and may be made by reference to what may be reasonable for the vendor. However, CRA is prepared to take the purchaser's arguments into consideration before making its determination. In any event, CRA seldom applies section 68 when the transaction involves persons dealing with each other at arm's length.

The vendor and the purchaser, if at arm's length, will also have opposing viewpoints as to the value to be allocated to certain assets in the sale agreement:

- With respect to non-depreciable property, the vendor will probably wish to allocate the maximum amount to these assets because the portion of the POD in excess of the ACB will

be taxed as a capital gain. The purchaser will prefer the lowest possible amount because he will not be entitled to any deduction, such as CCA, on the asset. This would be the case with land, for example.

- With respect to depreciable property, the vendor will wish to allocate a minimum amount to reduce the potential recapture of CCA and perhaps even create a terminal loss deductible under subsection 20(16). The purchaser will prefer to allocate the maximum amount because he will wish to be able to claim a deduction for CCA. This would be the case with a building, for example. He will also wish to allocate more of the purchase price to property in classes with high CCA rates.

Also, the vendor might want to postpone the transaction to the start of the subsequent taxation year in order to defer the income tax resulting from it. This may also enable him to benefit from the SBD on the business income resulting from the transaction, if his business income exceeds the business limit for the current year. For his part, the purchaser will prefer a year-end transaction in order to claim CCA sooner and reduce the consequences of the application of the half-year rule that applies in the year in which depreciable property is acquired.

Exchanges of property

Sometimes, all or a portion of the capital gain and/or recapture of CCA may be deferred if the property sold or otherwise transferred is replaced as provided for in paragraph 44(1)(a) in the case of an involuntary disposition and in paragraph 44(1)(b) on the voluntary disposition of a former business property.

Thus, under subsection 44(1), all or a portion of the capital gain realized on the disposition of a non-share capital property may be deferred if certain conditions are met. Similarly, under subsection 13(4), all or a portion of the recapture of CCA may be deferred and, under subsection 14(6), all or a portion of the POD of an ECP may be deferred.

Subsection 248(1) defines **former business property** as a capital property that was used by the taxpayer or a related person primarily for the purpose of gaining or producing income from a business and that was real property or an interest therein. The definition does not include

a. a rental property
b. land subjacent to a rental property including adjacent land that is a parking area, driveway, yard, or garden or that is otherwise necessary for the use of the rental property
c. a leasehold interest in a property described in (a) or (b)

Under proposed amendments, the definition of "former business property" would include a concession or licence for a limited period that is wholly attributable to the carrying on of a business in a fixed place and that is the subject of a valid election. The proposed amendments are **not examinable**.

For this purpose, **rental property** means real property owned by the taxpayer, if the property was used by the taxpayer in the taxation year principally for the purpose of gaining or producing gross revenue that is rent, unless it was leased to a related person who used it in his business. Rental property does not include property leased in the ordinary course of a business of the taxpayer or a related person which consists of selling goods or rendering services under an agreement by which the lessee undertakes to use the property to carry on the business of selling or promoting the sale of the goods or services of the taxpayer or a related person.

To be entitled to defer the capital gain and/or recapture of CCA, the taxpayer must acquire a replacement property

a. before the end of the first taxation year following the year in which the property was sold, if it is considered a former business property,

or

b. before the end of the second taxation year following the taxation year in which the property was disposed of, in the case of an involuntary disposition in which the POD are covered by subparagraph (b), (c), or (d) of the definition of proceeds of disposition in subsection 13(21) or in section 54, such as in the case of an expropriation.

Amendments are proposed for when a taxation year is less than 12 months long. In such a case, the time period for a voluntary disposition would now be 12 months after the end of the taxation year in which the property is disposed of. In the case of a non-voluntary disposition, the time period would be 24 months. The proposed amendments are **not examinable**.

In order for the tax relief rules to apply to a transferred property used in a business actively carried on in Canada, the replacement property must be located in Canada.

Subsections 13(4.1), 14(7), and 44(5) stipulate that a particular property is a replacement property

a. if it is reasonable to conclude that the property was acquired by the taxpayer to replace the former property,

a1. if the replacement property is used by the taxpayer or a person related to the taxpayer for the same or a similar use,

b. where the former property was used by the taxpayer or a person related to the taxpayer for the purpose of gaining or producing income from a business, the replacement property was acquired for the purpose of gaining or producing income from that or a similar business,

c. the former property was a taxable Canadian property (TCP) and the replacement property also is a TCP, and

d. if the former property was a TCP other than a treaty-protected property and the replacement property is also a TCP other than a treaty-protected property.

In summary, under these rules, the capital gain may be reduced *to* the portion of the POD of the former business property that exceeds the cost of the replacement property, if this portion is less than the capital gain otherwise determined. However, the capital gain thus deferred reduces the CC of the replacement property and will generally result in a higher capital gain on the disposition of the replacement property. If the cost of the replacement property exceeds the POD of the former business property, the capital gain will be entirely deferred. Recapture of CCA for the year of disposition will be completely deferred if the CC of the replacement property (reduced by the deferred capital gain) exceeds the amount of the recapture of CCA resulting from the disposition of the former business property. In addition, the inclusion of 3/4 of the POD of an ECP in computing the cumulative eligible capital (CEC) may be deferred if a greater amount is used to acquire a replacement property.

These deferrals are not advantageous in all cases. Each case should be analyzed on an individual basis. The benefit of the income tax deferral should be compared with the disadvantage due to the fact that the CCA deduction or the CECA deduction will be reduced in the year of acquisition and subsequent years.

Example 6-10 shows the partial deferral of a capital gain in cases where a former business property is sold and replaced during the following taxation year.

EXAMPLE 6-10

Assumptions:

CC of the former property	$ 100,000
POD	$ 175,000
CC of the replacement property	$ 130,000

This non-depreciable capital property was sold during the fiscal period ending December 31, 2008. The replacement property was acquired in January 2009.

Tax consequences

1. Capital gain realized on the disposition of the former property if the rules in subsection 44(1) are applied:

<u>2008</u>

The lesser of [44(1)(e)]:

a.	POD	$ 175,000
	CC	(100,000)
	Capital gain otherwise realized	$ 75,000
b.	POD	$ 175,000
	which exceeds	
	CC of the replacement property	(130,000)
		$ 45,000

Capital gain on the disposition [lesser of (a) and (b)]	$ 45,000

A capital gain of $30,000 may be deferred until the replacement property is disposed of.

2. CC of the replacement property [44(1)(f)]:

CC of the replacement property		$ 130,000
Less:		
The amount computed in (1a)	$ 75,000	
which exceeds		
The amount computed in (1b)	(45,000)	(30,000)
		$ 100,000

Example 6-11 illustrates a situation where the capital gain and recapture of CCA are partially deferred in the case of an involuntary disposition.

EXAMPLE 6-11

Assumptions:

CC of the former property	$ 300,000
Compensation paid by the insurer	$ 425,000
CC of the replacement property	$ 400,000
UCC before the fire	$ 250,000

During the fiscal period ended October 31, 2008, the factory of Magenta Ltd. was completely destroyed by a fire. Agreement regarding the compensation to be paid by the insurer was reached on September 15, 2009. Since the insurer did not pay the compensation until November 12, 2009, it was not until October 20, 2010, that reconstruction was completed and the new building was put into operation.

Tax consequences

Even though the fire destroyed the factory during the fiscal period ended October 31, 2008, the disposition is deemed under paragraph 44(2)(a) to have taken place during the following fiscal period, since the agreement with the insurer took place on September 15, 2009.

2008

There is no tax consequence, and Magenta Ltd. may claim a deduction for CCA under paragraph 20(1)(a), since no disposition is deemed to have taken place in this taxation year.

Assume that Magenta Ltd. does not claim any deduction for CCA for 2008.

2009

Since it was only in the 2010 taxation year that the replacement property was constructed, Magenta Ltd. must include in its income a taxable capital gain and recapture of CCA, as a result of the deemed disposition of the factory under subsection 44(2).

POD (agreed compensation)		$ 425,000
Less: CC		(300,000)
Capital gain		$ 125,000
Taxable capital gain (1/2)		$ 62,500
UCC		$ 250,000
Less: the lesser of		
• CC	$ 300,000	
• POD	$ 425,000	(300,000)
Recapture of CCA [13(1)]		$ (50,000)

2010

Since the replacement property was acquired within the time limit provided for in paragraph 44(1)(c), an election is made by Magenta Ltd. under subsections 44(1) and 13(4) so as to amend the taxable capital gain and the recapture of CCA included in income for 2009.

2009 amendment — capital gain [44(1)]

The lesser of the following amounts [44(1)(e)]:

a.	POD	$ 425,000
	Less: CC	(300,000)
	Capital gain declared	$ 125,000

b.

POD	$ 425,000	
Less: CC	(400,000)	
	$ 25,000	
Capital gain on disposition		$ 25,000
Initial cost of the replacement property		$ 400,000
Less: Deferred capital gain ($125,000 – $25,000)		(100,000)
CC of the replacement property [44(1)(f)]		$ 300,000

Recapture of CCA [13(1)]:

UCC before disposition [13(21)]	$ 250,000
Add: CC of the replacement property [44(1)(f)]	300,000
	550,000
Less: • disposition [13(21) and 13(4)(c)][1]	(250,000)
• disposition [13(4)(d)][2]	(50,000)
UCC after adjustment	$ 250,000

Therefore, there is no recapture of CCA.

[1] The lesser of [13(21)*]:

i) CC of the former property	$ 300,000		
ii) POD	$ 425,000	$ 300,000	
Less: the lesser of [13(4)(c)]:			
i) 13(21)* – UCC ($300,000 – $250,000)	$ 50,000		
ii) Initial cost of the replacement property	$ 400,000	(50,000)	$ 250,000

* F in the definition of UCC

[2] Under paragraph 13(4)(d), the reduction ($50,000) calculated on the application of paragraph 13(4)(c) is deemed to constitute the POD of a depreciable property, the CC of which was equal to $50,000.

CRA has provided additional information regarding its policy on replacement property:

- The replacement property must be acquired within the specified time limits and, in this respect, a cash deposit on an asset will not be considered as an acquisition of a replacement property.
- The acquisition of several properties to replace a property will be accepted provided these properties in fact replace the property disposed of. The replacement of several properties with one property is also acceptable.

A taxpayer wishing to make an election under subsections 44(1), 13(4), or 14(6) must proceed as follows:

- If the disposition and replacement take place in the same year, the computation of the recaptured CCA under subsection 13(4), the amount payable under E in the definition of CEC in subsection 14(5) by reason of subsection 14(6), or the computation of the capital gain under the provisions of subsection 44(1) in the taxpayer's income tax return will constitute an election.

- If the property is replaced in the subsequent year, the election should take the form of a letter attached to the income tax return for the year the replacement property is acquired. The letter should include a description of the replacement property and the former property, a request to have an adjustment to the recapture of CCA, the taxable capital gain reported or the amount included in income by virtue of subsection 14(1) in the previous year, and a computation of the revised CCA recapture, taxable capital gain or cumulative eligible capital.

For more examples and details concerning exchanges of property, read IT-259R4 and IT-491.

Sale of accounts receivable

The sale of accounts receivable in the disposition of the assets of a business is considered to be a capital transaction. In general, the vendor obtains an amount less than the value entered as receivables on the balance sheet. The loss realized is then recognized as a capital loss. Under paragraph 12(1)(d), the vendor must also include in his income the reserve for doubtful debts claimed for the preceding taxation year under paragraph 20(1)(l). He is not entitled to claim a new reserve at the end of the taxation year during which he sold his accounts receivable.

The purchaser, for his part, is not entitled to claim a reserve for doubtful debts under paragraph 20(1)(l) or a deduction for bad debts under paragraph 20(1)(p) for receivables acquired, since the latter have never been included in his income. Any loss incurred by the purchaser for non-receipt of receivables is therefore considered as a capital loss under paragraph 50(1)(a).

However, if the vendor was carrying on a business during the year and sold all or substantially all (90%) of the property used in the business, a joint election may be made under section 22, using the prescribed Form T2022, "Election in Respect of the Sale of Debts Receivable."

The provisions of section 22 apply to the vendor and the purchaser, if the latter continues to carry on the business, so that the transaction will no longer be considered a capital transaction.

Thus, for the year in which the sale of receivables took place, the vendor may deduct the loss incurred on the sale of the receivables, which is calculated as follows:

$$\text{POD} - \frac{\text{Nominal value of the accounts receivable,}}{\text{excluding those deducted under paragraph 20(1)(p)}} = \text{Deductible loss}$$

This amount recognized as a deductible loss must be included in the calculation of the purchaser's income for the taxation year in which he acquired the accounts receivable. Since the purchaser is now deemed to have included the amount of the accounts receivable in his income, he is entitled under paragraphs 20(1)(l) and 20(1)(p) to a deduction, if applicable.

Under subsection 22(2), if the vendor and the purchaser do not deal at arm's length, subsection 69(1) could apply if the consideration is not equal to the FMV of the accounts receivable.

Section 22 sets no time limit for the election to be valid. In general, Form T2022, signed by both parties, is filed with the tax return for the taxation year in which the assets are sold. According to a technical interpretation published by CRA, Form T2022 will be accepted if it is filed no later than the deadline for filing a notice of objection for the year during which there was a disposition of debts. This time limit relates to the first notice of assessment for the taxation year in question.

Read IT-188R, which provides a detailed treatment of the sale of accounts receivable and the election under section 22.

READING 6-3

Assets or shares

LEVEL 1

Comparison between purchase of assets and purchase of shares

In selecting the most advantageous option for the vendor, a number of factors must be analyzed, several of which have already been covered in previous readings.

Thereafter, both options should be compared to determine the best net after-tax return for the vendor.

A great deal of information must be obtained from the vendor for the purpose of comparing a purchase of shares with a purchase of assets, such as:

- a reconciliation between accounting income and taxable income for the last five years
- a computation of the effective tax rate
- the eligibility of the corporation for the SBD
- a computation of the CDA
- a computation of the GRIP
- the unused tax credit balance
- the loss carryforward balance
- the UCC balance by class, for the purpose of determining the availability of CCA
- the existence of a valuation or statement of values to the tax authorities by a shareholder, such as on a rollover under section 85
- the RDTOH balance
- the balance of unused scientific research and experimental development expenditures
- the tax position adopted by the corporation in non-statute barred years (aggressive or conservative)
- a list of shareholders and their tax rate

If a share purchase is contemplated, the purchaser must take certain facts into account. In some cases there will be consequences depending on whether or not the corporation that is the object of the transaction is a CCPC, while in other cases consequences will exist regardless of whether or not the corporation is a CCPC. These facts include

- the status of the purchaser (private or public corporation) is very important because this may affect the status of the acquired corporation if the purchaser is a corporation
- if the PUC of the shares acquired is less than their ACB for the purchaser, redemption could give rise to a deemed dividend which would only be partially compensated for by the capital loss resulting from the redemption
- net capital losses and business investment losses are no longer available on acquisition of control
- non-capital losses and farm losses may be carried forward only under certain conditions
- the acquired corporation may become associated with other corporations in the purchaser's group and be required to share its SBD with these other corporations
- if the purchaser is a non-resident, the acquired corporation will lose its right to the SBD, the RDTOH will no longer be available after the acquisition, and capital dividends will be subject to withholding tax under Part XIII of the ITA

- there may be a reduction in the acquired corporation's investment tax credit (ITC) rate for scientific research and experimental development (SR&ED) expenditures

Therefore, the purchaser must consider the above possible situations that may arise following the acquisition. This may reinforce his preference for purchasing assets.

For purposes of illustration and comparison, Example 6-12 shows the computation of a vendor's net after-tax proceeds from both a sale of shares and a sale of assets.

EXAMPLE 6-12

Cynthia Dubé holds all the shares of Argotin Ltd., which are qualified small business corporation shares. Cynthia's tax rates in 2008 are estimated at 35% (after gross up and credits) on non-eligible dividends and at 45% on other income. The fiscal period of Argotin Ltd. ends on July 31, 2008, and Cynthia has never claimed the CGD. On August 1, 2008, Cynthia received an offer of $1,000,000 for the shares which have an ACB and PUC of $1,000. The purchaser alternatively offered $1,170,000 for the net assets of Argotin Ltd. He is prepared to pay more for the assets, because he will be able to claim a greater amount of CCA on the building and will also be entitled to a deduction on the CEC, that is, the goodwill. Argotin Ltd. has the following assets:

	FMV	Cost amount
Inventory	$ 320,000	$ 320,000
Land	200,000	$ 125,000
Building (CC — $310,000)	420,000	$ 200,000
Goodwill	230,000	—
	$ 1,170,000	

Argotin Ltd. has $50,000 in its CDA but has no RDTOH. Argotin Ltd. had no active business income (ABI) before the sale and has no general rate income pool (GRIP). Its combined federal-provincial tax rates for 2008 are estimated as follows:

• ABI eligible for the SBD up to $400,000	20%
• ABI not eligible for the SBD	38%
• income from investments	50%

In such a situation, Cynthia's accountant would be consulted to advise her on the most advantageous approach. Depending on the circumstances, he might suggest that she go with him to consult an accountant specializing in sales of businesses. This would serve to determine whether there might be a better alternative from a financial standpoint (for example, use of a new corporation or a trust).

Tax consequences for Cynthia

1. Sale of shares:

POD	$1,000,000
ACB	(1,000)
Capital gain	$ 999,000
Taxable capital gain (1/2)	$ 499,500
CGD	(375,000)
	$ 124,500
Income taxes (estimated at 45%) (AMT is not taken into consideration since this is a tax payment that can be recovered in subsequent years)	$ 56,025

Net proceeds for Cynthia:

POD	$1,000,000
Income taxes	(56,025)
	$ 943,975

2. Sale of assets:

Inventory:	no gain or loss on the disposition		
Land:	POD	$ 200,000	
	ACB	(125,000)	
	Capital gain	$ 75,000	
	Taxable capital gain (1/2)		$ 37,500
Building:	POD	$ 420,000	
	CC	(310,000)	
	Capital gain	$ 110,000	
	Taxable capital gain (1/2)		55,000
	CC	$ 310,000	
	UCC	(200,000)	
	Recapture of CCA		110,000
Goodwill:	POD ($230,000 × 3/4 × 2/3)	$ 115,000	
	CEC	—	
	Income		115,000
			$ 317,500

Income tax payable

ABI:	$225,000 × 20%	$ 45,000
Taxable capital gain:		
	$92,500 × 50%	46,250
Total income taxes		$ 91,250

Refundable portion of Part I tax

Income from investments × $26^2/_3$%	
$92,500 × $26^2/_3$%	$ 24,670

CDA

Opening balance		$ 50,000
Plus: land ($75,000 × 1/2)	$ 37,500	
building ($110,000 × 1/2)	55,000	
goodwill ($230,000 × 1/2)	115,000	207,500
Balance after the sale		$ 257,500

To compare the net after-tax proceeds for Cynthia, the computation should be carried out as if Argotin Ltd. were wound-up under subsection 88(2) immediately after the sale of the assets.

Amount available for distribution in Argotin Ltd.

POD	$1,170,000
Total income taxes	(91,250)
RDTOH	24,670
	$1,103,420

Deemed dividend [84(2)]

Amount received	$1,103,420
PUC of shares	(1,000)
Deemed dividend	$1,102,420

Distribution of dividend [88(2)]

Deemed dividend	$1,102,420
Capital dividend if the election is made under 83(2)	(257,500)
Taxable dividend	$ 844,920

Under paragraph 82(1)(b), this dividend must be grossed up by 1/4 when it is included in Cynthia's income.

Tax for Cynthia on the taxable dividend $844,920 × 35%	$ 295,722

Disposition of shares

Amount received		$1,103,420
Less: Capital dividend	$ 257,500	
Taxable dividend	844,920	(1,102,420)
POD [54] (equal to PUC)		1,000
ACB		(1,000)
Capital gain		$ —

Net proceeds for Cynthia

Return of capital	$ 1,000
Non-taxable capital dividend	257,500
Taxable dividend — after tax ($844,920 – $295,722)	549,198
	$ 807,698

If the purchaser does not wish to offer more for the assets of Argotin Ltd., it would be more advantageous, from a tax standpoint, for Cynthia to sell the shares rather than the assets of Argotin Ltd. The net proceeds from the sale of shares are greater than the net proceeds from the sale of assets by $136,277 ($943,975 – $807,698).

Restrictive covenant

When shares or property are sold, a restrictive covenant is often included in the agreement, stipulating that the vendor must not become a competitor of the purchaser. Until 2003, the tendency was to consider any amount received in respect of a restrictive covenant as non-taxable since it was not related to the disposition of property. This interpretation is found in *Manrell vs. The Queen* [2003 DTC 5225].

Because such a position was taken by the Court, new measures were introduced in the legislative proposals tabled on November 9, 2006 in sections 56.4 and 68. According to those proposals, any amounts received or receivable in respect of a restrictive covenant would, with some exceptions, have to be included in income effective October 8, 2003. A restrictive covenant is principally defined as an agreement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer, whether legally enforceable or not, that affects the acquisition or provision of property or services by the taxpayer or by another taxpayer who does not deal at arm's length with the taxpayer.

Among the exceptions under which the amount received or receivable would not be considered income are the following:

- If the shares are sold to a person with whom the vendor deals at arm's length and the amount is provided to obtain an undertaking not to compete, that amount could be taxed as capital. In such a case, the amount could be added to the POD of the shares insofar as the restrictive covenant increases the value of the shares.
- In the case of a sale of assets with a restrictive covenant, the amount receivable in this respect could be considered as the POD of the goodwill and thus serve to reduce the CEC balance.

In both these exceptions, the amount to be included in income would not exceed 50% of the amount received or receivable in respect of the presence of a restrictive covenant.

The proposed amendments are **not examinable**.

READING 6-4

Acquisition of control

LEVEL 2

Determination of acquisition of control

The sale of a business through the sale, redemption or cancellation of shares generally results in an acquisition of control except if the transaction falls within one of the exceptions included in subsection 256(7), under which a person is not deemed to have acquired control of a corporation.

The concept of control is not specifically defined in the ITA. We have to refer to the concept of "de jure control" defined by the Courts. Generally, control means the right to control enough shares carrying a majority of votes in the corporation.

Under paragraph 256(7)(a), the control of a corporation is deemed not to have been acquired solely as a result of the acquisition of the shares of that corporation, in cases involving the following circumstances:

a. the acquisition of shares by any person from a related person, other than by virtue of a right contemplated in paragraph 251(5)(b)

   - Under subparagraph 251(5)(b)(i), a person who has a right to acquire or control the voting rights of the shares is deemed to own the shares.
   - Furthermore, under subparagraph 251(5)(b)(ii), a person who has a right to oblige a corporation to redeem, acquire, or cancel shares of its capital stock owned by other shareholders is deemed to be in the same position in relation to the control of the corporation.
   - Under subparagraph 251(5)(b)(iii), a person who has a right to (or to acquire or control) voting rights in respect of a corporation's shares is considered to be able to exercise those voting rights at that time.
   - Under subparagraph 251(5)(b)(iv), a person who has a right to cause the reduction of other shareholders' voting rights is treated as though those voting rights were so reduced at that time.
   - For the purposes of paragraph 251(5)(b), a right whose exercise is contingent on the death, bankruptcy or permanent disability of an individual may not be taken into account.

b. the acquisition of shares from any person by a person related to the particular corporation, other than by virtue of a right contemplated in paragraph 251(5)(b)

c. the acquisition of shares by an estate

d. the acquisition of shares by any person from the estate of a related person

e. the redemption or cancellation of shares of a corporation or another corporation controlling that corporation, provided the corporation is controlled, after the redemption or cancellation, by a person or group of persons related to the corporation immediately before the redemption, cancellation or death

Where there is an amalgamation, paragraph 256(7)(b) provides that the control of a corporation is deemed not to have been acquired because of the amalgamation. The main exception to this rule is that a person or group of persons that controls the new corporation, but did not control the predecessor corporation, is deemed to have acquired control of the predecessor corporation and each corporation that it controlled before the amalgamation. Some relief is provided in the case of internal reorganizations of corporate groups.

Paragraph 256(7)(c) deals with reverse takeover transactions. The control of a particular corporation is deemed to have been acquired by a person or group of persons if the shares issued by the particular corporation to the shareholders of the acquiring corporation are such that if they had been acquired by one person, that person would have acquired control of the particular corporation.

Under paragraph 256(7)(d), no acquisition of control of a corporation is considered to have occurred solely because of a share-for-share exchange. There is no acquisition of control if the person or group of persons that controlled the corporation before the exchange still controls it after the exchange.

Finally, under paragraph 256(7)(e), no acquisition of control of a particular corporation is considered to have occurred solely because of an exchange of its shares for shares of the acquiring corporation, if

a) the acquiring corporation is not controlled by a person or group of persons immediately after the exchange,

and

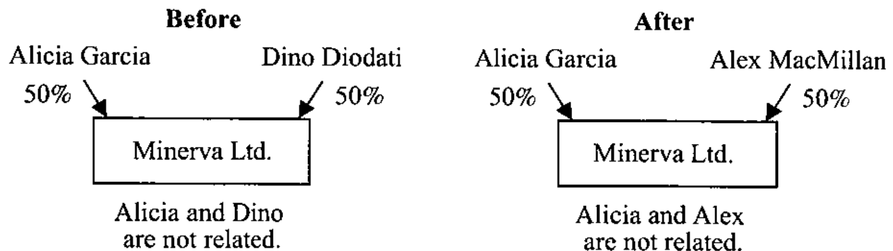
b) the FMV of the shares of the particular corporation is not less than 95% of the FMV of the assets of the acquiring corporation.

Examples 6-13 and 6-14 illustrate circumstances that do not result in the acquisition of control.

EXAMPLE 6-13

Exception [256(7)(a)(i)(A)]

EXAMPLE 6-14



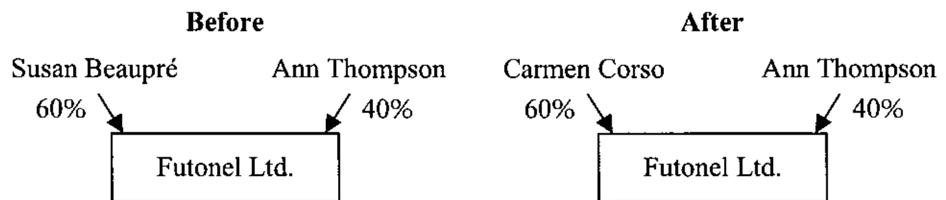
No person controlled Minerva Ltd. *before* the acquisition, and no person controls Minerva Ltd. *after* the acquisition.

Examples 6-15 and 6-16 illustrate circumstances which result in an acquisition of control.

EXAMPLE 6-15

Susan and Ann are not related.

EXAMPLE 6-16



Susan, Ann, and Carmen are not related.

LEVEL 1

On the acquisition of control, a number of ITA provisions apply. They should be considered when the purchase or sale of a business is contemplated.

Deemed year end

Under subsection 249(4), on the acquisition of control of a corporation at a particular time:

a. the taxation year of the corporation is deemed to end immediately before that time

b. a new taxation year of the corporation is deemed to have commenced at that time

c. where the acquisition of control took place within seven days following the end of the corporation's usual taxation year, the corporation may elect in its tax return to have its usual taxation year end immediately before the acquisition of control

d. for the purpose of determining the corporation's fiscal period after that time, the corporation is deemed not to have established a fiscal period before that time

Since paragraph 249(4)(a) deems the fiscal period to have ended immediately before the acquisition of control, the corporation is subject to all the consequences resulting from a "short" fiscal period, including

- preparing financial statements and income tax returns for the period preceding the acquisition,
- amending the computation of income tax instalments and accelerated income tax payments,
- claiming CCA only in proportion to the number of days in the "short" fiscal period divided by 365,
- if a loan to a shareholder must be repaid in the year following the lender's taxation year to avoid the provisions of subsection 15(2), the deemed taxation year end may accelerate the expiry of the time period,
- the repayment period of unpaid amounts subject to the provisions of section 78 may be affected,

- the time period for carrying forward losses under section 111 may be shortened and could even result in certain losses being lost,
- any expense or reserve based on a carryover period may be affected (charitable donations, capital gains reserves, etc.), and
- shortening the time to acquire replacement property for voluntary and involuntary dispositions.

If the acquisition of control took place within seven days following the corporation's usual taxation year, paragraph 249(4)(c) provides some relief. Where possible, the acquisition of control should be planned so that it takes place on the day following the end of the fiscal period or within the seven following days, so that the election provided in paragraph 249(4)(c) may be made.

EXAMPLE 6-17

Year end	June 30, 2008
Acquisition of control	July 7, 2008

Under paragraph 249(4)(a), a new year end will be deemed on July 6, 2008, unless the corporation makes the election provided in paragraph 249(4)(c) to have its usual fiscal period end on July 6, 2008, rather than on June 30, 2008. In this way, the corporation avoids having an additional fiscal period of only six days.

Under paragraph 249(4)(d), a new fiscal period may be selected in the first fiscal period following acquisition without requesting CRA's authorization. Remember that the 53-week maximum contained in subsection 249.1(1) must be respected.

Losses

Net capital losses

Under subsection 111(4), on the acquisition of control of a corporation

a. net capital losses for a taxation year ending before the acquisition of control may not be carried forward to a taxation year ending after that time

b. net capital losses for a taxation year ending after the acquisition of control may not be carried back to a taxation year ending before that time

c. the excess of the ACB of each non-depreciable capital property over its FMV must be deducted in computing the ACB of the capital property

d. the excess mentioned in (c) is deemed to be a capital loss of the corporation for the taxation year ending immediately before the acquisition of control

e. the corporation may elect to deem a disposition of any capital property (both depreciable and non-depreciable), other than those mentioned in paragraph 111(4)(c) and subsection 111(5.1), for POD equal to the lesser of

   - the FMV of the property immediately before the acquisition of control, and
   - the greater of the ACB of the property immediately before disposition or the amount designated for the property.

The new cost of the property to the corporation corresponds to the designated amount, except in the case of depreciable property the CC of which exceeds the POD. In such a case, the CC of the property after the acquisition of control is deemed to be the same as it was before the deemed disposition, and the excess is deemed to have been deducted by the corporation as CCA. The corporation is then deemed to have acquired the property at the deemed POD.

Thus, under the provisions of paragraphs 111(4)(a) and (b), the corporation's net capital losses for taxation years preceding the acquisition of control cannot be carried forward to taxation years ending after that date and net capital losses for taxation years following the acquisition of control cannot be carried back to taxation years commencing before the acquisition of control.

Under paragraphs 111(4)(c) and (d), unrealized capital losses on non-depreciable capital property are deemed to be realized immediately before the acquisition of control. These losses become capital losses realized before the acquisition of control and cannot be carried forward to a taxation year ending after the acquisition of control.

An alleviating provision is contained in paragraph 111(4)(e) to reduce or eliminate the effect of paragraph 111(4)(d). Under this provision, a corporation may elect to realize all or a portion of the unrealized capital gains on other property (depreciable or non-depreciable) and apply these gains against all or a portion of the capital losses that would otherwise be lost. The election cannot be made on a property to which paragraph 111(4)(c) applies, or on a property to which the provisions of subsection 111(5.1) apply. This subsection will be examined further on in this topic. The election may also result in a recapture of CCA, which could be applied against non-capital losses that would otherwise expire. In this way, the corporation also obtains an increase in the ACB of the property.

EXAMPLE 6-18

Immediately before it was the object of an acquisition of control, Cayenne Inc. owned capital property having the following attributes:

	Land 1	Land 2
ACB	$ 10,000	$ 9,000
FMV	$ 8,000	$ 13,000

The acquisition of control deems a reduction in the ACB of Land 1 from $10,000 to $8,000. This excess of $2,000 is deemed to be a capital loss.

Cayenne Inc. may elect to deem Land 2 to be disposed of at a value of $11,000 and, thus, offset the capital loss of $2,000 which is deemed to have been incurred immediately before the acquisition of control and which could not be carried forward to a taxation year ending after the acquisition of control.

111(4)(c)

Reduction in ACB:		
ACB		$ 10,000
Less: Excess ACB over FMV	$ 10,000 (8,000)	(2,000)
ACB		$ 8,000

111(4)(d)

Excess is deemed to be a capital loss	$ 2,000

111(4)(e)

Election:	
Elected POD	$ 11,000
ACB	(9,000)
Capital gain	$ 2,000

Under paragraph 111(1)(b), the capital losses computed under paragraph 111(4)(d) may be carried back against the capital gains of the three preceding taxation years ending before the acquisition of control.

Non-capital losses and farm losses

Under subsection 111(5), a non-capital loss or farm loss for a taxation year ending before the acquisition of control is deductible for a taxation year ending after the acquisition of control, only if the loss is incurred in carrying on a *business* in a taxation year ending before the acquisition of control, is carried forward to a subsequent year, and if

(i) *that business* was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year,

and

(ii) the loss is deducted to the extent of income *from that business* which generated the loss and, where properties were sold, leased, rented or developed or services provided in the course of carrying on the business before the acquisition of control, from any other business substantially all of the income of which was derived from the sale, leasing, rental or development or rendering of similar services.

Therefore, a non-capital loss or farm loss incurred by the corporation before acquisition of control cannot be deducted against a taxable capital gain for a taxation year ending after acquisition of control.

In addition, a non-capital loss or farm loss incurred in a taxation year ending after the acquisition of control will be deductible in a taxation year ending before the acquisition of control *only* if the loss is incurred in carrying on a business in a taxation year ending after the acquisition of control, is carried back to a preceding year, and if

(i) that business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the carryback year and the year of the loss,

and

(ii) the loss is deducted to the extent of the corporation's income for the carryback year from that business and from any other business the income of which was derived from the sale, leasing, rental or development or rendering of similar services in the carryback year.

In addition, losses from property and business investment losses incurred by the corporation before the acquisition of control cannot be carried forward and deducted after the acquisition of control. Similarly, such losses incurred after an acquisition of control cannot be carried back to taxation years ending before the acquisition of control.

It is important to be aware of these restrictions. Review the provisions of subsection 111(5) on the purchase of an enterprise whose losses are to be used by a profitable enterprise. Read IT-302R3 on this subject.

EXAMPLE 6-19

Topstar Inc.'s fiscal year ends on June 30. It has accumulated the following non-capital losses:

June 30, 2005	$ 20,000
June 30, 2006	$ 30,000
June 30, 2007	$ 40,000
June 30, 2008	$ 50,000

On July 1, 2008, Joan Phillips, the sole shareholder of Topstar Inc., sells all her shares to Etienne Doyon, a non-related person. For the fiscal period ended June 30, 2009, the business carried on by Topstar Inc. until June 30, 2008, is continued and earns a profit of $25,000. On August 1, 2009, Etienne decides to discontinue the business and carry on another type of business from which he realizes a profit of $100,000 for the fiscal year ended June 30, 2010. The losses may be carried forward as follows:

June 30, 2009:	Net income	$ 25,000
	Loss from 2005	(20,000)
	Loss from 2006	(5,000)
	Taxable income	$ —
June 30, 2010:	Net income	$ 100,000
	Losses carried forward	—
	Taxable income	$ 100,000

Since Topstar Inc. did not carry on the business that generated the losses throughout the 2010 taxation year, the losses cannot be applied against the net income of $100,000.

Depreciable property and ECP

On an acquisition of control of a corporation, subsections 111(5.1) and 111(5.2) provide for the immediate realization of unrealized losses on depreciable property and ECP.

Subsection 111(5.1) applies if the UCC (before CCA for the year) of property in a class immediately before the acquisition of control exceeds the total of:

- the FMV of the property of the class immediately before the acquisition of control, and
- CCA claimed for that class for the taxation year ending immediately before the acquisition of control or a terminal loss claimed on property of that class for the taxation year ending immediately before the acquisition of control.

This excess must be deducted in computing income for the year ending immediately before the acquisition of control. This deduction is deemed to be CCA deductible under paragraph 20(1)(a), and it therefore reduces the income or increases the non-capital loss for that taxation year.

Example 6-20 illustrates how subsection 111(5.1) applies.

EXAMPLE 6-20

UCC of the class (before CCA for the year)	$ 70,000
FMV of the class	$ 50,000
CCA claimed for the year	$ 10,000

111(5.1)

Deemed CCA, deductible		
UCC		$ 70,000
Less:	FMV	(50,000)
	CCA	(10,000)
		$ 10,000

In addition, subsection 111(5.2) applies in a similar manner to ECP if the CEC exceeds the total of:

- 3/4 of the FMV of ECP in respect of the business,

and

- the amount deducted under paragraph 20(1)(b) in computing income for the taxation year ending immediately before the acquisition of control.

This excess must be deducted under paragraph 20(1)(b) in computing income for the taxation year ending immediately before the acquisition of control.

Reserve for doubtful accounts

Subsection 111(5.3) requires that no amount be deducted as a reserve under paragraph 20(1)(l) in the taxation year ending immediately before the acquisition of control. A deduction is required if the face value of the debt exceeds its FMV and is taken as a bad debt under paragraph 20(1)(p) rather than paragraph 20(1)(l). The excess reduces the income or increases the corporation's loss for the taxation year ending immediately before the acquisition of control and it must be included in computing the corporation's income for a subsequent taxation year under paragraph 12(1)(i) if there is any recovery of the previously deducted amount.

No other deduction may be claimed under paragraph 20(1)(l) for the taxation year ending immediately before the acquisition of control.

Other

Acquisition of control can also affect the use of investment tax credits, research and development expenditures and the status of the corporation. Those rules are not studied in this course and are **not examinable**.