Sale of Assets vs. Sale of Shares

Business owners devote their lives to their business and a lot of their personal and family wealth is tied up in the company. At some point they may wish to access that wealth either to fund retirement, finance a major purchase or just to provide for their family. For many business owners the most effective way of realizing the value of their business is to sell it.

Whatever the purpose, they would like to make the withdrawal in the most tax-effective way possible. This article deals with the options available to an owner of an incorporated business who wishes to realize the value of his or her business.

Once the decision has been made to sell an incorporated business two general approaches can be taken.

1. Sell the shares of the business.
2. Sell the assets of the business.

This involves some negotiation between the buyer and the seller as, in general, vendors prefer share sales and buyers prefer asset sales.

Sale of Shares

- With a share sale, the vendor's proceeds in excess of his adjusted cost base is considered a capital gain. Capital gains are taxed more favourably than other forms of income as only 50% is included in income. In addition, if the shares are those of a qualified small business corporation, (QSBC) [see below] the seller may be able to receive up to $750,000 of capital gains ($375,000 of taxable capital gains) tax-free.

- Only individuals (and not corporations) who are residents of Canada are eligible for the capitals gains exemptions on the sale of QSBC shares.

- If the vendor wishes to apply the capital gains exemption on the sale of the shares of the business, the vendor should ensure that he or she does not realize any capital losses in the year of sale. Otherwise, the losses will be used to offset the gains first thereby reducing the ability to claim maximum capital gains exemption.

- With a share sale the purchaser may inherit the potential liabilities of the business.

- The vendor may want to declare and pay a capital dividend prior to the sale. Capital dividends are paid out tax-free to the shareholders from the company's capital dividend account, which is commonly made up of the non-taxable portion of capital gains received by the corporation. This has the effect of reducing the purchase price of the corporation and consequently the amount subject to tax.

- For the purchaser, buying the shares means that he or she buys the company which owns the business. Technically, there is no change in the ownership of the business itself. The shares of the company are transferred from the seller to the buyer. However, the buyer loses the ability to pick and choose among assets. Generally, he or she buys all of the business. Also, the purchaser may find himself or herself to be liable for any claims or lawsuits arisen from running of the business by the seller before he or she purchased the business.

Qualified small business corporation (QSBC) shares – a share of a corporation will be considered to be a qualified small business corporation share if all the following conditions are met:

- at the time of sale, it was a share of the capital stock of a small business corporation and was owned by the seller, his or her spouse or common-law partner, or a partnership of which he or she was a member;

- at the time of sale at least 90% of the assets were used to carry on an active business in Canada and/or were shares of a connected QSBC.

- the share was owned by the seller for at least 24 months prior to the sale

- throughout the 24 months immediately before the share was disposed of, it was a share of a Canadian-controlled private corporation and more than 50% of the fair market value of the assets of the corporation were:
  - used mainly in an active business carried on primarily in Canada by the Canadian-controlled private corporation, or by a related corporation;
  - certain shares or debts of connected corporations; or
  - a combination of these two types of assets; and
- throughout the 24 months immediately before the share was disposed of, no one owned the share other than the seller, a partnership of which he was a member, or a person related to him. As a general rule, when a corporation has issued shares after June 13, 1988, either to the seller, to a partnership of which he is a member, or to a person related to him, a special situation exists. It is considered that immediately before the shares were issued, they were owned by an unrelated person. As a result, to meet the holding-period requirement, the shares cannot have been owned by any person other than the seller or a related person for a 24-month period that begins after the shares were issued and ends when he or she sold them.

However, this rule does not apply to shares issued:

- as payment for other shares;

- for dispositions of shares after June 17, 1987 as payment of a stock dividend; or

- in connection with a property that the seller, a partnership of which he was a member, or a person related to him disposed of to the corporation that issued the shares. The property disposed of must have consisted of either:
  - all or most (90% or more) of the assets used in an active business carried on either by the seller, the members of the partnership of which he were a member, or the person related to him; or
  - an interest in a partnership where all or most (90% or more) of the partnership's assets were used in an active business carried on by the members of the partnership.

Sale of Assets

There are two potential levels of tax with an asset sale:

- Tax paid by the corporation as a result of the sale of assets;

- Tax paid by the vendor personally as the proceeds are taken out of the corporation.

Selling assets may result in a larger tax liability for the vendor than selling shares. The seller will not be eligible to claim the capital gains exemption on the proceeds of the sale. It is important to analyse the tax implications of both avenues to determine which alternative is more advantageous to the seller.

- The tax implications of the asset sale will depend on the tax position of the corporation prior to the sale, the allocation of the purchase price and how and when the proceeds of the sale are paid out by the corporation to its shareholders.

- In some circumstances there may be some tax deferral advantage if the after-tax proceeds are left in the corporation until they are needed.

- Buying the assets means buying the inventory, equipment, land and goodwill of the business. There may be benefits to the buyer as he or she can pick and choose which assets to buy and which not to buy. He or she may be able to better avoid lawsuits or claims from the running of the business in the past.

- If the purchaser insists on an asset sale, it is important for the seller to consult their tax advisor to calculate the after-tax proceeds compared to a share sale. This could lead to asking for a higher price in exchange for agreeing to an asset sale.

- If an asset sale is agreed upon, the buyer and the seller must agree on how the purchase price is to be allocated among the assets being sold. The buyer will want to allocate as much of the price as possible to inventory or depreciable property in order to minimize future taxable income. The seller will want to ensure that the allocation of the purchase price minimizes recapture of any capital cost allowance previously deducted on depreciable property or a realization of income on the sale of inventory.

- The purchase agreement should specify the allocation of the price and require both parties to file their tax returns in a manner consistent with that allocation.

Sale to Other Shareholders

In many cases, the company shareholders may have worked out a buy-sell agreement which sets the conditions of sale and a method of calculating the purchase price. Sale to other shareholders almost always takes the form of a share deal in which either the retiring shareholder sells his or her shares to the other shareholders or the company redeems his or her shares.

If the shares are redeemed by the company the tax treatment to the shareholder may include a taxable dividend. The capital gains exemption cannot be applied to this dividend payment.

- If the vendor has a holding company he or she may be able to defer tax on redemption by receiving the dividend as a tax-free inter-corporate dividend.

- A more favourable option for the seller is to have the other shareholders purchase his shares directly. The proceeds in excess of his or her cost base are taxed as capital gains and he or she may be able to use the capital gains exemption described above if the shares are from a QSBC.

Paying a Retiring Allowance

The owner may withdraw some assets from the corporation and make additional contributions to his RSP on retirement by having the corporation pay him or her a reasonable retiring allowance (which the company can deduct). Provided that he or she worked actively in the business before 1996, a retiring allowance paid to him or her can be transferred to his or her RSP, up to the following limits:

- $2,000 for each year of service before 1996, plus
- $1,500 for each year of service before 1989 provided that he or she was not a member of a company-run pension plan.

The implementation of the sale of the corporation will have to be worked out between the buyer and the seller. As we have seen above a sale of shares is preferable to the seller while the buyer would prefer to buy the assets. Ultimately, the seller is concerned with the final after tax proceeds he or she receives. Therefore he or she may still agree to an asset sale but negotiate a higher price to compensate for the higher taxes he or she may have to pay.

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