
Masters Series

This is one of a series of articles prepared for CIBC Private Wealth Management™. The series is written by professionals in such fields as taxation, trusts, and estates.

HOW TO REALIZE THE VALUE FROM A PRIVATE BUSINESS

By John Campbell, Partner, and James Hutchinson, Associate, Miller Thomson LLP

If you're the owner of a private business that has grown in value over the years, much of your personal and family wealth is likely to be tied up in your company. At some point, you may want to access that wealth, whether to fund your retirement, finance a major purchase, or just provide for your family, and you'll want to do it in the most tax-effective way possible.

For many business owners, the most effective way of realizing the value of their business is to sell it. This raises two key questions: who do you sell the business to, and how do you structure the sale?

Non-monetary considerations

Your decision on who you sell your business to may be motivated by non-monetary issues.

For example, you may want to reward loyal employees for their years of service by offering them the opportunity to purchase the business, even if you could obtain a better price elsewhere.

Or you may want to sell to a child or other family member, with your prime

consideration being the continuation of the family-run business.

If you have other shareholders, your choice of a purchaser may be restricted by the terms of an existing buy-sell agreement.

For many owners, however, a sale to a third party is the most attractive. In this case, you'll want to structure the sale to maximize your tax advantages.

Decision time — sell assets or shares?

If you decide to sell to a third party, you'll need to choose whether to sell the assets or the shares of your company. This may involve some negotiation with your prospective purchaser.

In general, vendors prefer a share sale and purchasers prefer an asset sale.

Share sale. With a share sale, the vendor's proceeds in excess of his or her adjusted cost base are treated as a capital gain, which is only 50% taxable. Some or all of the gain may even qualify for the capital gains exemption.

In addition, with a share sale the purchaser inherits the liabilities of the business, so the vendor doesn't have to

John Campbell practises taxation law, advising clients on domestic and international income tax issues. He has extensive experience with the tax implications and structuring of corporate reorganizations, mergers and acquisitions, securitizations, and other business transactions. He also specializes in tax litigation.

James Hutchinson practises in the firm's Tax Group, where he is involved in every area of taxation from individual and corporate planning to dealing with assessment disputes with the Canada Revenue Agency and litigation before the courts. His practice focuses primarily on corporate tax planning.

worry about business liabilities arising from actions taken before the sale.

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

Take advantage of the lifetime capital gains exemption

Capital gains are taxed more favourably than other forms of income. Only 50% of the gain is included in income.

In addition, if you are able to claim the lifetime capital gains exemption (LCGE), you may be able to shelter up to \$500,000 of capital gains (\$250,000 of taxable capital gains) from tax. This amount will be reduced by amounts you've previously claimed under the LCGE, and by your allowable business investment loss and cumulative net investment loss at the end of the year.

In order to be eligible for the LCGE, you must be an individual (not a corporation) who is a Canadian resident and who has sold shares of a qualified small business corporation (QSBC).

In general, shares will be treated as shares of a QSBC if the following requirements are met:

- The corporation is a Canadian-controlled private corporation.
- At the time the shares are sold, at least 90% of the assets are used to carry on an active business in Canada and/or are shares of a connected QSBC.
- You have owned the shares for the 24 months before the sale.
- During those 24 months, more than 50% of the corporation's assets were used in an active business in Canada and/or were shares of a connected QSBC.

The rules that apply to QSBC shares and the LCGE are very complex, so if you're considering selling your business, you should consult a tax professional.

The tax implications to you of a share sale are usually straightforward. You may have a capital gain, some or all of which may be sheltered by the capital gains exemption. You may also have unused capital losses from prior years, which can reduce the tax you pay on your capital gain.

Asset sale. With an asset sale, there are two potential levels of tax:

- Tax paid by the corporation as a result of the sale of the assets;
- Tax paid by you personally as you take the proceeds of the sale out of the corporation.

Selling assets may result in a larger tax liability than selling shares. It's important to analyze and compare the tax implications of both actions to determine which avenue is more advantageous for you.

The tax implications of an asset sale will depend on the tax position of your corporation before the sale, the allocation of the purchase price, and how and when the corporation's after-tax proceeds are paid out to you and any other shareholders.

In some circumstances, an asset sale can provide a tax deferral advantage if the after-tax sale proceeds are left in the corporation until you need them.

If the purchaser insists on an asset sale, you should ask your tax advisor to calculate the difference in the after-tax result to you compared with a share sale. This may lead you to ask for a higher price in exchange for agreeing to an asset sale.

If you do decide on an asset sale, you and the purchaser will have to agree on how the purchase price will be allocated among the assets that are being sold.

The purchaser will typically want to allocate as much of the purchase price as possible to inventory or depreciable property in order to reduce the taxable income that the business will generate in future years. You will want to ensure that the allocation of the purchase price minimizes any 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 agreed-upon allocation 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 will have worked out a buy-sell agreement at some point in the company's history, which sets out the conditions of sale and the purchase price (or a method of calculating the purchase price). The sale to other shareholders will almost always take the form of a share deal in which you either sell the shares to the other shareholders or the company redeems your shares.

If the company redeems your shares, you will be deemed to receive a dividend for the difference between the redemption price and the paid-up capital of the shares. This is not a desirable result as this difference will be taxed at the dividend tax rate of up to 37%, depending on the province.

If you have a holding corporation, you may be able to defer the tax on a redemption by receiving the deemed dividend as a tax-free intercorporate dividend. In addition, it may be possible to convert the deemed dividend into a lower-taxed capital gain that is taxed in the holding corporation. Such an arrangement will work only in certain circumstances, however, and may be challenged by the Canada Revenue Agency.

A more favourable option is to have the other shareholders purchase your shares directly. The proceeds you receive (in excess of your cost base) are considered a capital gain and taxed at the lower capital gains tax rate (approximately 8% below the rate that applies to dividends). If the shares are from a qualified small business corporation, you may also be able to claim the lifetime capital gains exemption (see the sidebar on Page 2).

In addition, the capital gain may be less than the deemed dividend. This would occur where you purchased your shares from the company directly after other shareholders had acquired shares from the company for a lower price. Your capital gain is calculated based on what you paid for your shares, that is, your adjusted cost base (ACB). Your deemed dividend is calculated based on the paid-up capital (PUC) of your shares. PUC is calculated by averaging the paid-up capital of all shares of the class over the issued shares of that class. As a result, your PUC could be less than your ACB and so a capital gain smaller than a deemed dividend.

If your fellow shareholders don't have the funds to purchase your shares, they may want to use funds from the

business to finance the purchase. To do this, a new company is usually incorporated in order to purchase the shares from you. This allows you to still benefit from the lower capital gains rate, and possibly the lifetime capital gains exemption, on the sale of the shares. However, the transaction must be at arm's length. This will usually be the case when shareholders are unrelated, but there are exceptions and professional tax advice is critical to ensure that the capital gain is not recharacterized as a dividend.

Strategic use of a holding company could bring benefits

If you're selling the shares of your business and you hold the shares through a personal holding company, you may be able to take advantage of "safe income" dividends paid tax-free to your holding company to reduce the purchase price of the shares, and therefore reduce the amount of your taxable capital gain. "Safe income" is, very generally, the corporation's after-tax income earned or realized after 1971.

The point of this technique is to defer the tax on the safe income until your holding company pays it out to you. A caution, however: this once standard tax planning technique is generally now worthwhile only if you can leave the safe income dividend in your holding company for a long time (about 12 years assuming a 5% annual return on the deferred taxes). Because the capital gains tax rate is now significantly lower than the dividend tax rate and because your holding company will usually pay these monies out to you as a dividend, this technique produces a worse after-tax result where your holding company pays the safe income dividend monies out to you as a dividend in the short to medium term.

Keep in mind, also, that the lifetime capital gains exemption is available only to individuals. So if the holding company sells the shares, the proceeds won't qualify for this exemption. You could claim the capital gains exemption by selling the shares of your holding company, but this may not be appropriate. With advance planning, it's possible both to pay a safe income dividend and take advantage of the lifetime capital gains exemption.

If you're considering tax planning based on safe income, be sure to seek professional tax and legal advice first.

Sale to employees

Similar issues arise if you are selling the business to employees. In many situations, the employees will not have the required funds to buy you out.

To fund the purchase over time, you may want to consider “freezing” the value of the company. You could exchange your common shares for preferred shares that have a redemption value based on the value of your common shares on the date of the freeze. The employees would subscribe to new common shares with a nominal value. Over time, the company could redeem your preferred shares or the employees could purchase them.

Non-competition covenants

Whether you sell your business to a third party, other shareholders, or to employees, the purchaser may ask you to enter into a non-competition agreement as a condition of closing. Such an agreement will require you not to compete with the sold business within a certain geographical area for a specified period of time following the sale.

Courts have upheld these agreements as long as they're reasonable in terms of both the time period and the geographical area, and are no wider than necessary to protect the purchaser's interest.

For example, an agreement preventing the owner of a pizza restaurant in Ottawa from opening a similar business within five kilometres of the sold restaurant for two years from the sale date would probably be enforceable, but terms that prevented the vendor from opening a pizza restaurant anywhere in Canada for 10 years probably would not.

The tax treatment of non-competition agreements entered into in conjunction with a sale of shares recently changed. In two decisions in 2003, the Federal Court of Appeal held that payments received for a non-competition agreement could be tax-free. The Department of Finance quickly introduced legislation that will treat amounts received for granting a non-competition covenant as ordinary income. An exception can apply to

non-competition payments received as part of an arm's-length sale. In that situation, a portion of the payments for the non-competition covenant can be taxed as a capital gain.

Keep your house in order

If you're considering selling your business at some point in the future, ensuring that your corporate records are up-to-date will avoid both unnecessary costs and potential delays.

For example, if shares were issued to an employee and the shares were repurchased when the employee left the corporation, you should have the share certificate in your possession. If the ultimate purchasers are concerned that validly issued share certificates may be outstanding, they may demand a lost share certificate indemnity, and you may have to purchase lost share certificate insurance.

In addition, if your company has intellectual property, it's important to show that you have good title to it. All trademark registrations and royalty arrangements should be documented and kept in good standing.

In all instances, it's best to review your objectives, your possible courses of action, and the potential results with the input of appropriate qualified professionals. The manner of the sale — how it is structured and who the purchaser is — can have far-reaching tax, estate-planning, and legal implications. You'll want to feel confident that you are making the best decisions for you, your family, and your business.

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