CHAPTER 18

BUSINESS ACQUISITIONS AND DIVESTITURES — ASSETS VERSUS SHARES

Review Questions

1. "The sale of business assets by a vendor corporation normally results in two levels of tax, rather than a single level of tax, as is the case when the shares of the business corporation are sold." Explain this statement.

2. In general terms, what types of gains or losses may occur for tax purposes when specific business assets are sold?

3. If a business is to be sold on terms that require deferred payments, why may the timing of the related tax cost to the vendor be different if the specific business assets, rather than the shares of the business corporation, are sold?

4. If a group of business assets is sold with specific values attached to each item, what difference, if any, does it make whether the terms of payment (that is, the amount of cash and deferred payments) are expressed separately for each asset sold or as a total for the group of assets sold?

5. When a corporation sells its business by disposing of its business assets, the amount of tax to the corporation resulting from the sale can be determined with relative certainty. Does the same degree of certainty exist with respect to determining the second level of tax when the proceeds of the asset sale are distributed to the shareholder? Explain.

6. The after-tax cash flow from the earnings of the acquired business may be different for the purchasers if they acquire the shares of the vendor corporation, rather than its specific assets. Explain why.

7. Why is it important for the purchaser to establish an accurate value for each individual asset acquired, when a group of business assets is being purchased for an agreed-upon total price?

8. "When a purchaser acquires the shares of a vendor corporation, it may be assuming a potential tax liability of the vendor corporation." What is meant by this statement? To the extent that such a potential liability exists, what impact may this have on the purchase price, and how can it be measured?

9. To what extent, if any, should the vendor be concerned about the tax status of the purchaser when contemplating the sale of a business?

10. Why is it important for the purchaser of a business to anticipate the post-acquisition organization structure before making the acquisition?

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11. When a business can be sold under either an asset sale or a share sale, why is it important that both the vendor and the purchaser attempt to determine the vendor's tax cost from the sale under a worst-case scenario?

12. What is the worst-case scenario when an individual who owns the shares of a business corporation is considering the sale of that business? How is the individual's tax position affected if the business for sale is held within a corporation that is a subsidiary of a large public corporation?

13. What are the three major tax issues that a purchaser must examine when deciding whether to acquire the assets or the shares of a business?

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Solutions to Review Questions

R18-1. When a vendor corporation sells its specific business assets (land, buildings, equipment, goodwill and so on) the corporation will incur a tax liability on gains arising from the asset sales. While this leaves after-tax proceeds in the corporation for possible investment, those proceeds must ultimately flow to the shareholder at which time a second level of tax will occur. Even if dividend distributions are not made, the shareholder may incur a second level of tax when the shares are sold or deemed to be sold on death.

If the shares of the business corporation are sold, the corporation does not incur a tax liability because it retains ownership of all of the business assets. Only the shareholder may incur a tax liability resulting from the gain on the share sale. Therefore, the amount and timing of tax to the vendor is different under each alternative.

R18-2. In general terms, the sale of business assets will consist of inventory, depreciable property, and capital property. As a result, the sale of a group of business assets will normally produce the following types of income/loss:

Inventory - business income/loss
Depreciable property - recapture of capital cost allowance/terminal loss (business income) and perhaps taxable capital gains (no capital losses on depreciable property)
Capital property - capital gains/losses

R18-3. If the shares of the corporation are sold, the entire gain would be a capital gain to the vendor. As a result, the full amount would be eligible for the application of the capital gains reserve provisions which permits (within limits) the gain to be recognized for tax purposes over a period of years in relation to the receipt of the deferred proceeds. However, if the corporation sells specific assets, it may incur recapture as well as capital gains, depending on the nature of the property sold. The capital gains reserve provisions would apply only to the capital gain portion of the income created. Therefore, under an asset sale, the recapture of CCA cannot be deferred even if the terms of payment are deferred. The timing of the tax liability will vary between an asset sale and a share sale.

R18-4. If the deferred payment terms are expressed in the agreement as a portion of the total price (i.e., the combined price of several assets), the amount of the deferred portion is allocated proportionately to each of the assets in the group. Consequently, some of the deferred payments would be allocated to assets that will create income that is not eligible for a reserve (e.g., depreciable equipment creates a recapture of CCA) and a lesser amount of the deferred proceeds applies to the assets that are eligible for the reserve. If the agreement defines the terms of payment separately for each asset in the group, the maximum deferred proceeds can be allocated to those assets which qualify for deferred recognition of income, such as capital gains.

R18-5. When corporate assets are sold, the amount and timing of the resulting tax to the corporation can be determined with relative certainty because the selling price, cost amounts, and payment terms are known for each asset sold. However, the timing of the second level of tax on the distribution of the corporation's after-tax proceeds to the shareholder are discretionary. In other words, after the sale, the corporation can retain its proceeds for reinvestment, distribute all of the proceeds immediately, or distribute the proceeds over a period of time. A delay in the distribution means that the tax rates that may apply at some future time are uncertain and therefore an accurate assessment of the decision to delay the distribution is more difficult.

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R18-6. When a purchaser acquires a business, it obtains ownership of a group of assets as well as the right to carry on the acquired business to generate profits. The amount of pre-tax profits acquired will be similar regardless of whether assets or shares of the acquired business are purchased. However, when assets are purchased, the amount of deductions from capital cost allowance is based upon the fair market value of each asset purchased. On the other hand, when shares are acquired, the specific assets housed within the acquired corporation remain at their undepreciated value at the time of the sale. Therefore, the amount of deductions for tax purposes will be different under each method.

R18-7. A major factor in deciding on the acquisition of a business is the amount of after-tax cash flows that are expected after acquisition. Therefore, the amount of CCA deductions for tax purposes that will be available is of paramount importance in projecting that cash flow. When a single purchase price is specified for the entire group of assets acquired, the purchaser must know how the total price will be allocated to each asset in order to determine the expected tax costs on future profits. As CRA has the power to allocate the unspecified value of each asset in accordance with its apparent fair market value, consideration of this issue by the purchaser before the purchase provides a greater degree of certainty with respect to anticipated after-tax cash flows.

R18-8. When shares of a business corporation are acquired, the asset base within the acquired corporation is not disturbed. Consequently, the cost base and undepreciated capital cost of the assets within the company remain unchanged. In effect, the purchaser, through the share acquisition, takes over the tax position of the vendor corporation. If the acquired corporation should subsequently sell some of its assets at values greater than their cost amounts, the corporation will incur a tax liability. Because of this inherited potential tax liability, the purchaser may attempt to discount the price of the shares as compensation. It is difficult to measure what the discount should be because it is not certain if or when the potential tax liability may occur. The final discount achieved, if any, is therefore a function of the negotiation process.

R18-9. The purchaser's willingness to purchase and the price that they are prepared to pay is dependent largely upon the expected after-tax profits after acquisition. The tax status of the purchaser may result in the acquired profits being subject to a different tax cost than that applied to the vendor. For example, the vendor may be entitled to use the small business deduction whereas the purchaser may not because of its other sources of income. This will affect the price the purchaser is willing to pay. As different purchasers may each have a different tax status, the vendor may achieve the highest price from the one which will incur the lowest tax cost on future profits. The vendor must therefore attempt to anticipate a proposed purchaser's tax position.

R18-10. It is important to recognize that the post-acquisition structure for the purchaser is not static. For example, if a corporate purchaser acquires the shares of a vendor corporation it will, immediately after the purchase, have a parent-subsidiary structure where the operations of each are separated. However, after the acquisition the two corporations could be amalgamated, combining their operations. This may or may not present tax advantages for the purchaser. This should be considered by the purchaser in establishing the expected cash flows from the purchase and the maximum purchase price that it is willing to pay in exchange for those cash flows.

R18-11. Once a business has been targeted for acquisition, it is important to establish the worst case scenario for the vendor. Both the vendor and the purchaser are interested in this analysis. For example, if the worst case scenario for a vendor is an asset sale and the net

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after-tax proceeds from this type of sale are known, the vendor can then establish a price for the sale of shares which would provide the same after-tax proceeds. This information is critical to vendors because it permits them to establish a minimum share price that equates, on an after-tax basis, to an asset price. Presumably a vendor would not accept a share price that is below this minimum.

At the same time, if a purchaser knows the tax position of the vendor and what share price equates to an asset price in a worst case scenario, they have a starting point from which to begin their negotiations.

R18-12. Normally, when an individual who owns the shares of a business corporation is considering the sale of the business, the worst-case scenario is an asset sale whereby the vendor corporation pays tax on the sale of the individual assets, and then immediately winds-up the corporation by distributing the after-tax proceeds, resulting in a second level of tax to the shareholder. In this case, because the corporation is closely held, the full impact on the corporation and the shareholder must be considered.

When the business for sale is held in a subsidiary of a public corporation, the distribution of after-tax proceeds from the subsidiary's sale of assets does not create a second level of tax as inter-corporate dividends to the parent corporation are tax free. It would be unrealistic to examine the tax impact on the shareholders of the public parent corporation as the sale would not likely alter its normal dividend policy.

R18-13. When contemplating a business acquisition, the purchaser should examine the following issues:

- The rate of tax that will apply, after acquisition, on expected profits.
- The amount of cash flow to be generated from tax savings on deductions of CCA.
- Where the purchase is a share acquisition, assess the likelihood of incurring additional tax liabilities if the acquired corporation should subsequently dispose of any of the assets it holds.

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Key Concept Questions

QUESTION ONE

Stewart Mueller, a Canadian resident, is considering selling his shares of AA Ltd. which operates a printing business in Canada. He hopes that he will be able to use the capital gains deduction to shelter the gain from tax. Stewart purchased his shares of AA Ltd. four years ago for $1,000,000 and he estimates that they are now worth $2,000,000. Stewart owns 100% of the company. The latest balance sheet for AA Ltd. is below.

AA Ltd.
Balance Sheet

Assets		Liabilities & Shareholder's Equity	
Cash	$ 100,000	Liabilities	$ 900,000
Inventory	20,000	Share capital	1,000
Due from shareholder	800,000	Retained earnings	899,000
Equipment	180,000		$1,800,000
Land and building	700,000		
	$1,800,000		

The value of the current assets approximates their fair market value. The business premises (land and building) are estimated to be worth $1,600,000. The equipment is valued at $80,000. The goodwill is estimated to be worth $500,000. The relative values of the assets have remained consistent throughout the last two years.

Determine if AA Ltd. is currently a qualified small business corporation.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC. Income tax reference: ITA 110.6(1) qualified small business corporation definition.

QUESTION TWO

A sale of the assets of B Ltd. took place on January 2, 2022. The assets and liabilities of B Ltd. at that time were as follows:

	Fair Market Value
Inventory (cost $200,000)	$300,000
Accounts receivable (cost $600,000)	450,000
Equipment (cost $100,000; UCC $70,000)	30,000
Land (cost $400,000)	700,000
Building (cost $300,000; UCC $230,000)	500,000
Goodwill (cost $0; UCC $0)	100,000
Liabilities	6,000

B Ltd. and the purchaser made a joint election under section 22 of the *Income Tax Act* with respect to the accounts receivable.

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An examination of the corporate tax return for the year ended December 31, 2021 showed the following:

- B Ltd. is a Canadian-controlled private corporation.
- An allowance for doubtful accounts of $100,000 was claimed at the December 31, 2021 year end.
- Paid-up capital of the corporation is $10,000.
- General rate income pool (GRIP) and ERDTOH/NERDTOH balances are nil.
- Capital dividend account balance is $20,000.

B Ltd. is a member of an associated group of companies and has been allocated $45,000 of the group's $500,000 annual business limit.

Determine the amount available for distribution to the shareholders after the sale of the assets. Assume a provincial tax rate of 4% on small business income and 12% on other income.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC.

QUESTION THREE

Based on the information in Question Two, if the winding up of B Ltd. takes place immediately after the assets are sold, determine the components of the distribution to the shareholders.

CPA Competency 6.6.3 Income tax implications of the purchase and sale of a CCPC. Income tax reference: ITA 88(1), 83(2).

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Solutions to Key Concept Questions

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[ITA: 110.6(1) qualified small business corporation definition]

If AA Ltd. is a qualified small business corporation at the time Stewart sells his shares, then Stewart will be able to shelter $913,630 (in 2022) of the gain by using the capital gains exemption.

Asset values:

Cash	$ 100,000	
Inventory	20,000	
Equipment	80,000	
Land and building	1,600,000	
Goodwill	500,000	
Assets used in an active business carried on in Canada	2,300,000	74%
Due from shareholder	800,000	26%
Total value of assets	$3,100,000	100%

For the shares of AA Ltd. to be qualified small business corporation shares, the following four tests must be met:

	Test Met
1) AA Ltd. must be a small business corporation at the time of the sale throughout the 24 months preceding the sale	No
2) AA Ltd. must be a Canadian-controlled private corporation	Yes
3) An unrelated person cannot have owned Stewart's shares of AA Ltd. that are being sold	Yes
4) More than 50% of the fair market value of assets of AA Ltd. are assets used in carrying on an active business in Canada	Yes

Since AA Ltd. is not a *small business corporation* (less than 90% of the fair market value of the assets are used in an active business), AA Ltd. is not currently a qualified small business corporation.

However, since the 24-month tests have been met, if the shareholder loan is repaid before the sale and the funds from the repayment used by AA Ltd. to repay liabilities, then AA Ltd. will be a *qualified small business corporation.*

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The amount available to distribute to the shareholders of B Ltd. after the sale of the assets is $1,998,700, determined as follows:

Asset	Proceeds	Business Income	Taxable Capital Gains	Capital Dividend Account
Balance, December 31, 2021				$ 20,000
Inventory	$ 300,000	$100,000	$ 0	0
Accounts receivable	450,000	(150,000)	0	0
Allowance for doubtful accounts		100,000	0	0
Equipment	30,000	(40,000)	0	0
Land	700,000	0	150,000	150,000
Building	500,000	70,000	100,000	100,000
Goodwill	100,000	0	50,000	50,000
	2,080,000	$ 80,000	$300,000	$320,000
Liabilities	(6,000)			
Income tax ($45,000 x 13%)	(5,850)			
Income tax ($35,000 x 27%)	(9,450)			
Income tax ($300,000 x 50 2/3%)	(152,000)			
NERDTOH ($300,000 x 30 2/3%)	92,000			
Available for distribution	$1,998,700			

Non-eligible RDTOH tracks refundable taxes paid under Part I and refundable taxes paid under Part IV on non-eligible dividends.

The active business income is $80,000 while the annual business limit for B Ltd. is only $45,000. This means that only $45,000 will be subject to tax at the low corporate rate (9% federal + 4% provincial = 13%) while the remaining $35,000 will be taxed at the general corporate rate (15% federal + 12% provincial = 27%). This $35,000 is referred to as *full-rate taxable income*, and 72% of this amount gets added to GRIP (72% x $35,000 = $25,200).

GRIP consists of 72% of taxable income that has not benefited from the small business deduction or any other special tax rate. GRIP determines the maximum taxable dividend that can be designated as an eligible dividend.

KC 18-3

[ITA: 88(1), 83(2)]

The components of the distribution to the shareholders if the winding up of B Ltd. takes place after the sale of the assets:

Amount received on the winding up of B Ltd.	$1,998,700
Less PUC	(10,000)
Deemed dividend	1,988,700
Capital dividend (election required)	(320,000)
Taxable dividend	$1,668,700

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The taxable dividend consists of:

Eligible dividends (limited to GRIP (see KC 18-2))	$ 25,200
Non-eligible dividends	1,643,500
	$1,668,700

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