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Tax Implications of Selling Your Shares in a Business

IN THIS ISSUE

Earn-Outs: Proceeds of Sale Dependent Upon the Earnings of Business

Change of Control Issues

Non-Resident Vendors and Section 116 Clearance Certificate

Covenants Related to Dispositions of Shares or Partnership Interest

There are a myriad of tax implications to consider when selling your shares in a business. From capital gains to restrictive covenants, several of these issues are discussed below.

Capital Gains

A sale of shares in a business will normally give rise to a capital gain or capital loss to the vendor. Currently, one-half of capital gains are included in income. One-half of capital losses are deductible as allowable capital losses, but they may be deducted only to offset taxable capital gains. If the vendor is a Canadian resident individual, the sale may be sheltered by the capital gains exemption if the shares are "qualified small business corporation shares" ("QSBC shares").

The lifetime capital gains exemption for an individual is $913,630 (for 2022), meaning that the exemption allows the individual to shelter up to $456,815 (for 2022) of taxable capital gains realized on the sale of QSBC shares (only half of capital gains are included as taxable capital gains). The capital gains exemption is indexed annually.

This exemption is available only to Canadian resident individuals. The amount of the exemption is reduced to the extent that the individual has used the enhanced capital gains exemption that applies to sales of qualified farming and fishing property. The enhanced capital gains exemption for qualified farm or fishing property is $86,370 (for 2022).

To qualify for the QSBC exemption, there are certain conditions that must be satisfied by the vendor and the corporation. First of all, the corporation must be a "small business corporation" at the time of the sale of the shares. This requires that the corporation be a Canadian-controlled private corporation ("CCPC"), which generally means a private corporation resident in Canada that is not controlled by non-residents or public corporations, or any combination thereof.

In addition, all or substantially all of the value of the corporation's assets must be attributable to assets used principally in an active business carried on primarily in Canada, or shares or debt invested in other small business corporations that are "connected" to the corporation. "All or substantially all" means 90% or more, and "principally" and "primarily" more than 50%. Additionally, throughout the two-year period preceding the sale, more than 50% of the fair market value of the corporation's assets must have been attributable to assets used principally in an active business carried on primarily in Canada, or shares or debt invested in other small business corporations connected to the corporation.

As a result, at the time of sale, you will be required to demonstrate that 90% of the fair market value of the assets of the corporation is attributable to an active business and that more than half of this active business is carried on in Canada.

If the corporation does not currently qualify as a small business corporation because it does not meet the 90% asset threshold, the non-qualifying assets may be removed from the corporation in order to "purify" it. However, this distribution of assets involves a disposition by the corporation, which may trigger tax if the value of the assets exceeds their tax costs. In addition, the distribution of assets to an existing shareholder will generally result in an actual or deemed dividend to the shareholder.

Finally, a two-year holding period is normally required in order for shares to qualify as QSBC shares. In general terms, this means that throughout the 24-month period preceding the date of sale, no person other than the vendor or a person related to the vendor can own the shares.

Cumulative Net Investment Loss

The capital gains exemption is reduced by the vendor's "cumulative net investment loss" ("CNIL"). The CNIL account for the year of sale equals the total of the vendor's investment expenses minus the vendor's total investment income realized in the period between January 1, 1988 and the end of the year of sale. "Investment income" and "investment expense" essentially mean income from property and expenses deducted in computing income from property, respectively (with some exceptions). The amount of the capital gains exemption that the vendor may claim is reduced by the amount of the vendor's CNIL account at the end of the year.

The result of the CNIL rules is that an individual's access to the capital gains exemption will be postponed if, in the year a capital gain is realized, the individual has investment expenses in excess of their investment income for the period beginning after 1987. The purpose of CNIL is to prevent an individual from having access to both the capital gains exemption and a deduction for investment losses.

Allowable Business Investment Loss

The amount of the capital gains exemption that the vendor may claim is also reduced by the amount of allowable business investment losses ("ABILs") realized by the vendor in the year or preceding years after 1984. Effectively, this rule forces the vendor to apply any current and previous ABILs against the QSBC taxable capital gains before the vendor can utilize the capital gains exemption against those gains. To the extent that the vendor's QSBC taxable capital gains exceed the vendor's ABILs, the capital gains exemption can be applied to the excess.

The legislation provides for the reduction in a taxpayer's business investment loss ("BIL"; an ABIL is one half-of a BIL) until the taxpayer has realized BILs equal to previous years' capital gains which were eligible for the capital gains exemption. A taxpayer's BIL is reduced by the lesser of the taxpayer's BIL determined without the reduction, and the amount of the capital gains exemption claimed by the taxpayer in previous years to the extent that the capital gains exemption amount has not otherwise reduced the taxpayer's BIL in the current or preceding year.

Capital Gains Reserve

If part or all of the proceeds on a share sale are deferred and not payable to the vendor until after the year of sale, the vendor will normally be allowed to claim the capital gains reserve. In general terms, the allowable reserve for each year equals the percentage of the capital gain that is the same as the percentage of the proceeds that are payable to the vendor after the year. The reserve claimed in one year is added back into income in the following year, and the process of deducting the reserve is repeated if proceeds are still payable after that year. The reserve can apply to a maximum of four years including the year of sale, which means that the gain can be spread out over a maximum of five years.

Additionally, in each year, the reserve is limited to the following amounts:

- in the year of sale, 4/5 of the capital gain;
- in the second year (the year after the year of sale), 3/5 of the capital gain;
- in the third year, 2/5 of the capital gain; and
- in the fourth year, 1/5 of the capital gain.

As a result of these limits, the vendor must include at least 1/5 of the capital gain in each year, even if all of the proceeds are payable in future years.

Earn-Outs: Proceeds of Sale Dependent Upon the Earnings of Business

If part or all or the proceeds of the sale are dependent upon the future earnings of the corporation's business (an "earn-out agreement"), any such amount (whether or not it is an instalment of the sale price) must be included in the vendor's income as income from a property or business (instead of a capital gain). Obviously, this treatment will be detrimental because the vendor will lose the advantage of the one-half capital gains inclusion rate and, in the case of a sale of small business shares, the capital gains exemption. However, the Canada Revenue Agency ("CRA") will accept the use of a "cost recovery method" of reporting a capital gain or loss on the sale of shares under an earn-out agreement where certain conditions are met.

Change of Control Issues

The taxation year of a corporation is deemed to end immediately before an acquisition of control of the corporation takes place, and a new taxation year is deemed to have started at the time of

the acquisition of control. Accordingly, the corporation whose control has been acquired must compute its income or loss up to that deemed year-end and file returns and pay taxes as necessary. Following an acquisition of control of a corporation, the corporation may adopt a new fiscal period in accordance with the definition of "fiscal period" in the legislation.

Non-Resident Vendors and Section 116 Clearance Certificate

If the vendor is a non-resident, the purchaser should ensure that the vendor has received a clearance certificate under section 116 of the Income Tax Act (Canada) prior to the actual sale indicating that the vendor has paid the appropriate capital gains tax or furnished security with the CRA. If the clearance certificate is not obtained prior to the sale, the purchaser may be obliged to withhold tax from the purchaser price and remit it to the CRA on account of the vendor's tax liability. The purchaser will not be liable if after reasonable inquiry there is no reason to believe that the vendor was a non-resident.

In the alternative, the parties may complete the transaction without the clearance certificate, and within 10 days after doing so the non-resident vendor can report the transaction to the Minister. In this case, if the vendor remits 25% of the vendor's capital gain on the transaction, the vendor and the purchaser will receive a certificate from the Minister. To ensure that the non-resident vendor files the notice and remits the amount required, the purchaser is liable for tax on behalf of the non-resident vendor and is entitled to withhold 25% of the purchase price or to otherwise recover it from the vendor. If the certificate is received, the purchaser's liability ceases. If no certificate is received, the purchaser must remit the withheld amount to the CRA within 30 days after the end of the month in which the shares were acquired.

If the vendor is resident in a treaty country (a country which has entered into an income tax treaty with Canada), the capital gain on the sale of shares may be exempt from Canadian tax by virtue of the treaty. The CRA allows a non-resident vendor to claim an exemption under a specific tax treaty at the time the vendor files Form T2062, *Notice of Disposition*.

Covenants Related to Dispositions of Shares or Partnership Interest

The general rule is that amounts received or receivable in a particular year under a "restrictive covenant" are included in income in full in that year unless some other specified treatment is explicitly provided for by the legislation. Where a taxpayer (the vendor) gives a covenant to an arm's length purchaser of the vendor's shares in a corporation which carries on business, or the vendor's partnership interest in a partnership that carries on business, and the covenant relates to the business, the purchaser and the vendor may jointly elect that amounts paid under the covenant will be treated as part of the vendor's proceeds of disposition of the shares or partnership interest, and will be treated as part of the purchaser's cost of the shares or partnership interest. It follows that the vendor will receive capital gains treatment, conceivably eligible for capital gains exemption or rollover, and the purchaser will have a reduction in gain on a later sale. Absent the joint election, the general rule for restrictive covenants applies.