RBC Wealth Management Services

The Navigator

Sale of Your Business – Part 3

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Year of sale of your business

The content of this article is for information purposes only and does not provide tax or legal advice. It is imperative that you obtain professional advice from a qualified tax and legal advisor before acting on any of the information in this article. This will ensure that your own circumstances are properly considered and that action is taken based on the most current legislation.

A study done by the Canadian Federation of Independent Business (CFIB) revealed that 70% of small and medium-sized business owners intend to exit their businesses within 10 years. The most common method among owners of exiting their businesses is to sell outright to non-family members (37%).

The third in a four-part series, this article introduces some tax planning strategies to consider in the year of sale of your business. This four-part series takes you through some of the key issues and tax planning strategies to consider during the various stages of your business:

Part 1: Running an active business with no immediate plans to sell

Part 2: Planning to sell your business or impending sale

Part 3: Year of sale of your business

Part 4: Year after the sale of your business

The terms 'corporation' and 'company' are used interchangeably to refer to a Canadian-controlled private corporation (CCPC). This means that the corporation is not controlled by a non-resident of Canada or a public corporation and no class of shares of the corporation is listed on a prescribed stock exchange. This four part series does not apply to public corporations.

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Tax Strategies to Implement Before Year-End

The third stage of selling your business is the year of sale. The sale may result in a significant capital gain, either in your hands personally because you have sold shares, or in your corporation because you have sold assets of your private corporation. If you sold shares of your private corporation personally, then the applicable year-end would be December 31 of the year in which the sale occurred. If your corporation sold assets the applicable year-end would be your corporation's year-end in which the sale of assets occurred. If your business was not incorporated and you sold your business assets, then your capital gains would be taxed in your hands personally and any tax planning would have to be completed before December 31.

Some tax strategies to minimize taxes on the capital gains on the sale of your business are listed below and discussed briefly later on.

1. Charitable donations or establishing a charitable foundation
2. Establishing an Individual Pension Plan (IPP) or a Retirement Compensation Arrangement (RCA)
3. Triggering capital losses to offset the capital gains
4. Investing in flow-through shares to claim the tax deductions
5. Receiving the proceeds from the sale over a number of years to claim a capital gain reserve to defer tax over up to five years

Charitable Giving/Foundation

You may want to think about using some of the sale proceeds to make a charitable gift in the year of sale either directly to a registered charity or to your own charitable foundation. Ask your RBC Advisor for information about our RBC Charitable Gift Program.

In general, every two dollars donated will eliminate one dollar of tax on the sale of the business. However, in order for this strategy to be effective, the charitable donation should be made before the end of the year in which the sale occurs (either December 31 in the case of an individual vendor or the fiscal year-end of the corporation for a corporate vendor). Since the donation is irrevocable, ensure that you have adequate other assets to meet your retirement income and estate planning goals. A financial plan can help in this regard.

Alternatively, if the purchaser is a Canadian public company, consider structuring the sale so that you receive some shares of the Canadian public company as part of the sale proceeds (received tax-free at cost). The shares could then be donated in-kind to eliminate the capital gains tax relating to the donated shares and you would also receive a donation tax receipt equal to the fair market value of the stock donated, which can help reduce the tax on your cash proceeds.

Individual Pension Plan (IPP) or Retirement Compensation Arrangement (RCA)

In some cases, you may want to look at the pros and cons of setting up an IPP or a RCA in the year of sale, if you have not already done so. Ask your RBC advisor for more information about IPPs and/or RCAs. If the sale is structured as an asset sale, then the employer's contribution to these retirement plans is considered a deduction to the corporation, which would reduce the corporate tax payable. Note that a more detailed

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analysis of the pros and cons of this should be performed given that income received from an IPP or an RCA in retirement is taxed as regular income. In comparison, tax payable today on an asset sale may be at lower tax rates (i.e., at capital gains rates or in the case of goodwill, at active business rates).

Capital Losses

If you have publicly traded securities that are in a capital loss position, consider selling these loss securities prior to year-end to trigger the capital loss. This may help reduce the capital gain on the sale of your business. This decision should be made based on investment merits as well. If you want to repurchase the stock, then you must wait thirty days to avoid the loss being denied as a “superficial loss”.

Flow-Through Shares

Another option might be to purchase flow-through shares prior to year-end to help reduce the tax relating to the sale of the business. Flow-through shares are resource-based investments where the government allows the purchase cost to be fully deducted against any other taxable income. However, the investments are more speculative in nature.

These are not suitable for all individuals. Speak to your RBC advisor to discuss whether this option is suitable for you. If you are considering purchasing these investments, you should realize that not all are created equal and as a result an impulsive purchase might be costly. It is very important to consider the quality of the investment, and not just the potential tax write-off. With the up-front tax deduction, the investment value can usually decrease by about thirty per cent and you will still breakeven. Keep in mind that in some cases, there is an eighteen to twenty-four month holding period.

To be eligible for the tax deductions, expenses incurred by the resource company and passed on to the investor must meet certain criteria. You should be aware that there may be a tax risk that Canada Revenue Agency may deny the resource company from passing on their expenses if they do not meet these qualifications, which means that you would not be eligible for the tax deduction.

Alternative Minimum Tax (AMT) may also apply on large personal flow-through purchases, so this should be discussed with your qualified tax advisor before making a purchase. In addition, you should seek the assistance of your qualified tax advisor to determine the optimal use of your share of the federal/provincial deductions/credits and for tax reporting assistance.

Capital Gains Reserve

Instead of receiving all the sale proceeds in the year of sale, consider taking back a promissory note and having the purchaser pay the proceeds over a number of years, assuming you have an adequate guarantee of payment and an attractive interest rate on the note. In this case, a capital gain reserve may be taken to spread the capital gain on the sale over a maximum of five years. If your marginal tax rate is expected to be lower in the near future, the deferral of the capital gain can help minimize your overall tax on the capital gain. However, if you are always going to be in the top marginal tax bracket then this strategy is not effective.

It may also be possible to implement some or all of the strategies discussed above at the same time to reduce your taxes on the capital gain that results from the sale of your business. If you are interested in any of these strategies your RBC advisor may be able to provide additional articles that provide more information, or speak to your qualified tax advisor.

Please contact us for more information about the topics discussed in this article.

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