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FINANCIAL ADVISORY SUPPORT

Selling the Business

A checklist of tax strategies to consider when selling your business

This article provides a non-exhaustive checklist of Canadian tax and financial planning strategies that you can consider with your professional advisors before selling an active business to an outside buyer. If you are a U.S. person, you should consult with a qualified cross-border tax advisor to determine the U.S. tax implications of any of the following strategies.

- Determine if the purchaser is interested in purchasing the assets of your business or the shares of your business. If they are interested in purchasing the assets of your business, then you will **not** be eligible to claim the $750,000 capital gains exemption. As a result, you should consider negotiating a higher sale price to factor in the additional tax that you will incur on the sale of the assets of the corporation and the after-tax sale proceeds your corporation will pay out to you as a taxable dividend. The capital gains exemption can only be claimed by an **individual** on capital gains resulting from the sale of qualified small business corporation shares or qualified farm/fishing property.

- If the purchaser is willing to purchase the shares of the business, then ensure that the shares qualify for any remaining capital gains exemption you have available to use. If all or substantially all of the business assets are not considered active Canadian business assets at the time of sale, then the shares will not qualify for the capital gains exemption. As a result, the shares may need to be "purified" prior to the sale. The CRA generally takes the position that "all or substantially all" means 90% or more. Non-active assets generally consist of an investment portfolio not used in day-to-day business activities. Furthermore, more than 50% of the assets throughout the 24 months prior to sale have to have been used in an active Canadian business in order to qualify for the exemption.

- Consider having your advisor prepare a financial plan for you to determine if the expected after-tax sale proceeds are adequate for you and your family to meet your retirement income and estate planning goals. Your advisor can also have a discussion with you regarding effective structures for the post-sale proceeds to achieve goals such as maximizing retirement income, minimizing tax and maximizing your estate such as with insured annuities, family trusts, tax-exempt life insurance, etc.

- If the business is currently not incorporated but there is a prospective purchaser, then consider incorporating the business and selling the shares of the corporation in order to utilize any remaining capital gains exemption. In this case, the shares do not have to be held for at least two years to qualify for the capital gains exemption.

- Consider using some of the sale proceeds to make a charitable gift either directly to a registered charity or to your own charitable foundation in the year of sale. The donation tax credits can assist in minimizing the tax on the capital gain from the sale of the business. Note that in order for this strategy to be effective, the charitable donation must be made in the year of sale. Since the donation is irrevocable, ensure that you have adequate other assets to meet your retirement income and estate planning goals. If you require more information on setting up your own charitable family foundation, speak to your advisor.

- If the sale is not imminent and you expect the value of the business to increase, then consider reorganizing the company (e.g. estate freeze) such that some or all of the future capital gain can accrue to other family member shareholders, either directly or through a family trust. This can multiply the use of the $750,000 capital gain exemption among family members if the shares qualify. However, keep in mind that a portion of the sale proceeds equal to the taxable capital gain allocated to the family members for multiplying the capital gains exemption will now belong to them.

- By reorganizing your company prior to the sale, you may be able to convert a portion of the capital gain that would have been taxed currently into a dividend that will be taxed in the future. This strategy is called a "safe income strip," and you will need to speak to your accountant to determine if you qualify. The strategy results in receiving some of the sale proceeds tax-free in a holding company instead of paying capital gains tax today. Tax is deferred on these monies until either death or such time they are withdrawn during lifetime and taxed as a dividend. Note that dividend tax rates are generally higher than capital gains tax rates; however, the tax deferral is the main advantage, and this can last many years. You may want to consider life insurance, using the amounts in the holding company as a tax-effective vehicle to minimize the taxes on the holding company shares at death and withdraw monies from the holding company on a tax-free basis for beneficiaries.

- Consider paying yourself a retiring allowance from the company prior to the sale. If you had years of service prior to 1996, then all or a portion of the retiring allowance can be transferred to your RRSP on a tax-deferred basis without impacting your unused RRSP deduction limit. However, if it's a share sale and you continue working for the purchaser, then the CRA will not believe that the payment qualifies as a retiring allowance.

- In some cases, you may want to consider the pros and cons of setting up an IPP or an RCA prior to the sale of the business. If the sale is structured as an asset sale, then the employer's contribution to these retirement plans may assist in reducing the corporate tax and deferring your personal tax. For this strategy to work, it is recommended that you continue to receive T4 income and pensionable service from the corporation that set up the IPP or RCA for a few years after the sale.

- If you reside in a province outside of Alberta and are in the top marginal tax bracket, then consider rolling your shares into a qualifying spousal trust (if you have a spouse or common-law partner) prior to the sale. If the spousal trust is structured in such a way that the residence of the trust is Alberta and there is no attribution of investment income back to the transferor, then selling the shares within the Alberta trust may result in some tax savings since Alberta has the lowest top capital gains tax rate in Canada at 19.5%. A cost benefit analysis must be undertaken since there will be professional fees and potential trustee fees to set up an Alberta trust. Also it is important to check your province of residence's current stance on the validity of using an Alberta trust.

- If you expect to reinvest some or all of the sale proceeds in shares of another active Canadian business within the year of sale or within 120 days after the year of sale, then you may be able to defer the recognition of some or all of the capital gain on the original sale.

- Instead of receiving all the sale proceeds in the year of sale, consider taking back a note and having the purchaser pay the proceeds over a number of years, assuming you have an adequate guarantee of payment. 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, assuming not all of it qualifies for the capital gains exemption.

- If the capital gains on the sale are expected to be substantial, speak to your tax advisor regarding any advanced strategies that can be considered prior to the sale for tax and/or estate reasons.

- Instead of receiving all cash from the purchaser in exchange for your private shares, consider receiving some shares of the purchaser as consideration. If the purchaser is another Canadian corporation, then it may be possible to receive the purchaser's shares in exchange for your shares on a tax-deferred basis. If the purchaser is a foreign corporation, then it will be necessary to create Canadian "exchangeable" shares of the purchaser to treat the exchange as tax-deferred for Canadian tax purposes.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with your advisor.

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