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Purchase or Sale of a Business: How to Optimize the Tax Impact

When an entrepreneur begins the process of selling a business or a buyer evaluates an acquisition opportunity, the first question is almost always the same:

What is the business worth?

In many situations, however, the more important question is:

How much will remain after taxes?

Two transactions with the exact same purchase price may produce dramatically different economic outcomes. The acquisition structure, financing arrangements, allocation of the purchase price, available tax attributes, and post-closing tax consequences often have a greater impact on the ultimate result than the negotiated price itself.

This reality is reflected throughout the *Income Tax Act*, which contains numerous provisions specifically governing business transfers. These include, among others, the rules relating to the Lifetime Capital Gains Exemption, purchase price allocation, acquisitions of control, corporate tax attributes, acquisition financing structures, and restrictive covenants. In many transactions, the application of these rules has a greater impact on the parties' after-tax proceeds than the purchase price itself.

In a business succession or acquisition context, taxation should never be viewed as a mere compliance exercise. Rather, it is a fundamental component of transaction strategy.

1. Preparing for a Transaction Before Going to Market

One of the most common mistakes made by business owners is beginning a sale process without prior tax planning.

Many tax-planning opportunities can only be implemented months, and sometimes years, before a transaction is completed.

At this stage, the analysis will often focus on:

- the potential qualification of the shares for the Lifetime Capital Gains Exemption;
- the existence of passive investments within the corporation;
- excess cash balances;

- assets not used in the active business;
- tax attributes accumulated within the corporation;
- pre-sale corporate reorganizations;
- the optimization and utilization of tax attributes prior to a sale;
- the transaction structure likely to be preferred by a prospective purchaser; and
- matters likely to be addressed in a letter of intent, including whether the transaction should be structured as an asset sale or a share sale, acquisition financing, restrictive covenants, and pre-closing reorganizations.

Many business owners view a letter of intent as a purely commercial document. In reality, the parameters established at that stage often influence the entire transaction process. It is not uncommon for a structure agreed upon too early in the negotiations to limit future tax-planning opportunities or create unintended consequences.

For that reason, a tax review performed before negotiations begin can often identify significant issues and preserve options that may no longer be available once discussions become advanced.

2. The Lifetime Capital Gains Exemption: An Opportunity That Requires Planning

For many entrepreneurs, the most valuable tax asset associated with their business does not appear anywhere on the balance sheet.

That asset is the Lifetime Capital Gains Exemption ("LCGE").

The LCGE is not automatic. The requirements applicable to shares of a qualifying small business corporation are highly technical and often require advance planning. A corporation holding excessive passive investments or assets unrelated to the active business may require a reorganization in order to preserve access to this valuable tax benefit.

In our practice, some of the most significant tax-planning opportunities are identified long before a business is officially placed on the market. Proper planning can preserve benefits that may be permanently lost once negotiations begin.

Family Trusts: A Frequently Overlooked Tool

Where the sale of a business is anticipated in the medium or long term, consideration should also be given to the use of a family trust.

When established sufficiently early and structured appropriately, a family trust may allow future growth in value to accrue to beneficiaries who may themselves be entitled to claim a capital gains exemption upon a future sale.

This strategy is frequently considered in the context of:

- family succession planning;
- estate freezes;
- businesses expected to experience significant future growth; and
- planning intended to maximize the use of available exemptions within a family group.

Such planning requires careful consideration of numerous corporate and tax rules. Since qualifying-share requirements must generally be satisfied over an extended period, the benefits of this strategy are usually maximized when implemented several years in advance of a sale.

Not surprisingly, the most valuable planning opportunities are often identified long before a business owner seriously contemplates selling. Once a purchaser has been identified or a letter of intent has been signed, available restructuring options may become substantially more limited.

For that reason, entrepreneurs contemplating a business transfer in the coming years should periodically review their corporate structure well before entering into transaction discussions.

3. Share Sale or Asset Sale: The Real Tax Negotiation

Once preliminary planning has been completed, the first major transactional question becomes how the sale should be structured.

From a commercial perspective, the business may appear unchanged after closing.

From a tax perspective, however, the consequences can be completely different.

Why Sellers Generally Prefer a Share Sale

A share sale generally allows the seller to realize a capital gain directly.

Depending on the circumstances, it may also permit the use of the Lifetime Capital Gains Exemption.

In addition, a share sale often avoids the complexities associated with selling corporate assets and subsequently extracting the proceeds from the corporation.

For many entrepreneurs, a share sale also offers greater operational simplicity because the business is transferred as a whole rather than through the individual transfer of assets.

Why Buyers Generally Prefer an Asset Purchase

By contrast, purchasers often favour an asset acquisition.

This approach allows the buyer to:

- select the assets to be acquired;
- limit exposure to certain historical liabilities;
- obtain a new tax basis in the acquired assets; and
- benefit from future depreciation and amortization deductions.

This divergence of interests explains why the most significant negotiations frequently concern transaction structure rather than purchase price.

In many cases, the gap between a seller's expectations and a buyer's position is driven not by a disagreement regarding value, but by the tax consequences associated with each possible structure.

4. Tax Due Diligence: Where the True Value of a Business Is Revealed

In a share acquisition, the purchaser acquires not only a business but also its tax history.

The purpose of tax due diligence is therefore to identify issues that may affect the true value of the transaction.

A review typically includes:

- income tax filings;
- payroll remittances and source deductions;
- GST/HST and QST compliance;
- shareholder loans;
- related-party transactions;

- historical corporate reorganizations;
- corporate tax attributes; and
- potential reassessment risks.

In many transactions, tax due diligence uncovers issues that were not evident from the financial statements or preliminary discussions.

Issues identified before closing can often be addressed through contractual protections, purchase price adjustments, or tax indemnities. The same issues discovered after closing frequently become the purchaser's responsibility.

For that reason, tax due diligence serves not only as a validation exercise but also as a powerful negotiating tool.

5. Asset Sales: Why Purchase Price Allocation Matters

Where a transaction is structured as an asset acquisition, attention quickly turns to the allocation of the purchase price.

Section 68 of The *Income Tax Act* permits tax authorities to challenge allocations that are unreasonable or inconsistent with economic reality.

Purchasers generally seek to allocate greater value to assets that will generate favourable future deductions.

Sellers, on the other hand, will often prefer allocations that produce more favourable tax treatment.

This issue becomes particularly important where the transaction includes:

- inventory;
- receivables;
- real estate;
- depreciable property;
- goodwill; and
- Class 14.1 intangible assets.

Depending on the circumstances, a single asset sale may simultaneously generate:

- business income;

- depreciation recapture;
- capital gains;
- additions to the Capital Dividend Account ("CDA");
- adjustments to Refundable Dividend Tax on Hand ("RDTOH"); and
- other corporate tax attributes.

Purchase price allocation is therefore far more than a simple accounting exercise. It is often one of the most important tax-planning opportunities available in a transaction.

6. Tax Attributes: Hidden Assets That May Be Worth a Great Deal

Financial statements do not always reveal the full tax value of a business.

Many corporations possess tax attributes capable of materially influencing transaction outcomes, including:

- the Capital Dividend Account (CDA);
- Refundable Dividend Tax on Hand (RDTOH);
- the General Rate Income Pool (GRIP);
- carried-forward tax losses; and
- other accumulated corporate tax attributes.

These items are frequently overlooked despite their potential economic value.

A thorough tax review can help determine whether these attributes may be preserved, utilized, or monetized as part of a planned transaction.

7. Non-Competition Covenants: A Detail With Significant Consequences

In most business acquisitions, the purchaser will require the seller to enter into a non-competition covenant.

Although often viewed as a standard commercial protection, these agreements may also create significant tax consequences.

Section 56.4 of the *Income Tax Act* can apply to amounts paid in respect of restrictive covenants, potentially resulting in tax treatment different from that applicable to the sale proceeds received for shares or assets.

Accordingly, amounts allocated to a non-competition covenant may not necessarily receive the same treatment as the sale price itself. In certain circumstances, this distinction may significantly increase the seller's tax burden.

The legislation does provide certain planning mechanisms that may permit the value of a restrictive covenant to be integrated into the primary tax treatment of the transaction, provided the relevant conditions are satisfied.

As a result, non-competition covenants should be analyzed at the letter-of-intent stage rather than during the drafting of definitive agreements.

8. Acquisition Financing: A Tax Issue as Much as a Banking Issue

Acquisition financing is often viewed solely through a banking lens.

In reality, the legal structure of the financing can have important tax consequences.

This is one reason why many acquisitions are completed through a holding corporation. Depending on the circumstances, such a structure may allow the acquisition debt to be serviced using cash flow generated by the acquired business rather than through personally taxed income.

In certain transactions, a post-closing amalgamation or winding-up may further enhance the tax efficiency of acquisition financing and the deductibility of financing costs.

Seller financing may also play an important role.

In many business succession transactions, the vendor agrees to finance a portion of the purchase price through a vendor take-back note or balance of sale arrangement.

Such arrangements may:

- facilitate completion of the transaction;
- improve financial flexibility for the purchaser;
- allow the seller to negotiate more favourable terms; and
- support a smoother transition of relationships and know-how.

From a tax perspective, where part of the purchase price remains unpaid over time, it may also be advisable to consider the availability of capital gains reserves and other tax deferral opportunities.

For these reasons, acquisition financing should be analyzed early in the transaction process rather than after commercial terms have already been finalized.

9. Indirect Taxes: The Frequently Overlooked Trap

When a transaction is structured as an asset sale, GST/HST and QST consequences must also be considered.

Depending on the nature of the assets being transferred, indirect tax implications may be substantial.

In many situations, the election under subsection 167(1) of the *Excise Tax Act* may apply to the transfer of a business and can significantly reduce closing-related cash flow requirements.

As with many tax-planning opportunities, this analysis should occur before definitive transaction documents are signed.

10. The Stated Price Is Not the Real Price

One of the most common mistakes is to compare offers solely on the basis of their headline purchase price.

A transaction should always be evaluated as a whole.

Relevant considerations include:

- corporate income tax;
- depreciation recapture;
- liquidation dividends;
- CDA balances;
- RDTOH balances;
- the Lifetime Capital Gains Exemption;
- indirect taxes;
- financing costs; and

- restructuring or liquidation expenses.

The transaction that produces the greatest economic value is therefore not necessarily the one with the highest purchase price.

Experience consistently demonstrates that value creation often depends more on transaction structure than on negotiation of the purchase price itself.

Conclusion

In a business succession context, the purchase or sale of a business is rarely just a commercial transaction.

Corporate, tax, financial, and legal considerations are deeply interconnected. Transaction structure, advance planning, due diligence, purchase price allocation, available tax attributes, acquisition financing, restrictive covenants, and indirect tax consequences can all significantly affect the outcome achieved by the parties.

In practice, the entrepreneurs who achieve the best results are not necessarily those who negotiate the longest. They are typically those who begin planning early enough to understand the full range of tax consequences associated with the proposed transaction.

Before accepting an offer or signing a letter of intent, a preliminary tax analysis can often identify opportunities that may no longer be available later in the process. In many transactions, a properly structured deal creates more value than a simple increase in the purchase price.