CORPORATE FINANCE FOR CANADIAN EXECUTIVES

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Chapter 9

THE TAXATION OF COMMERCIAL ENTERPRISES AND BUSINESS TRANSACTIONS IN CANADA

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Over the past several years, the Canadian economy has witnessed an impressive wave of merger and acquisition activity. In 2006, over 1,950 large mergers and acquisitions were announced in Canada, with total transaction values of $257 billion.[1] The cumulative value of the Canadian mergers and acquisitions announced in 2006 significantly exceeded the previous record of $234 billion established in 2000.[2]

A host of Canadian tax considerations had a significant impact on the manner in which virtually all recent Canadian M&A transactions have been structured. Since the imposition of Canadian taxes can substantially depress the economic advantages associated with an otherwise promising business acquisition, effective tax planning is often one of the keys to executing a successful commercial transaction.

This chapter provides a general overview of a number of the Canadian tax considerations and tax planning opportunities that frequently arise in the context of the ongoing operation of a Canadian business.

As a word of caution, Canadian tax law is inherently complex and the probable tax treatment of any transaction is highly dependant on a wide range of factors, including the unique circumstances of each of the relevant parties. The contents of this chapter are necessarily summary in nature and do not address all of the considerations that may arise in all commercial contexts. Although the information provided in this chapter is considered to be accurate at the time of writing, readers must remain cognizant that Canadian tax law is continually changing. Accordingly, readers should not make decisions based on the contents of this chapter alone. Professional advice from qualified tax

1 Crosbie & Company Inc., "Canadian M&A Activity – Fourth Quarter 2006 Report, Private Equity Drives Strong Finish to Record Year" (23 February 2007) <http://www.crosbieco.com/pdf/ma/MA_Q406.pdf>.

2 *Ibid.*

counsel should always be obtained prior to undertaking any material transaction in Canada.

I. BUSINESS TAXATION IN CANADA: THE FUNDAMENTALS

(a) General Federal and Provincial Taxation Statutes

The federal and provincial/territorial governments each impose a tax on income. Under the federal *Income Tax Act*[3] (the "**Tax Act**"), Canadian residents are generally subject to tax on their worldwide income, while non-residents are typically only subject to tax on income derived from activities or property with a specified connection to Canada. Each of the provincial and territorial governments also imposes a tax on income earned by a taxpayer in a particular province.

(b) Federal Tax Rates

The general federal corporate tax rate in Canada for the 2007 taxation year is 22.1%. The federal tax rate consists of a general corporate tax, levied at a rate of 38%, less a provincial abatement of 10%,[4] plus a federal surtax levied at a rate of 4% (computed by reference to the net general corporate tax rate),[5] less a general statutory rate reduction of 7%.[6]

2007 Federal and Provincial/Territorial Income Tax Rates for Corporations — General Active Business Income

Federal	22.1%
Provincial/Territorial[7]	
British Columbia	12.0%
Alberta	10.0%
Saskatchewan	14.0%

3 R.S.C. 1985, c. 1 (5th Supp.), as amended.

4 The provincial abatement is designed to allow the provinces to levy a tax on income earned in the year in a province. Provincial general corporate tax rates for 2007 (based on all announced changes to March 2007) range from 9.9% to 16%.

5 The federal corporate surtax is scheduled to be eliminated by 2008.

6 The statutory rate reduction will increase to 9.5% by 2011.

7 Based on (and reflecting) all changes announced up to March 2007.

Manitoba	14.0%
Ontario	14.0%
Québec	9.9%
New Brunswick	13.0%
Nova Scotia	16.0%
Prince Edward Island	16.0%
Newfoundland and Labrador	14.0%
Northwest Territories	11.5%
Nunavut	12.0%
Yukon	15.0%

The income of individuals in Canada is subject to a set of increasing federal marginal tax rates. In 2007, the highest federal marginal tax rate that applies to individuals is 29%.[8]

(c) Residency and the Scope of Canadian Taxation

While Canadian residents are generally subject to tax on their worldwide income, non-resident corporations are generally only subject to Canadian federal income tax on income earned from a business carried on in Canada or dispositions of "taxable Canadian property". However, if a non-resident resides in a country with which Canada has entered into a bilateral income tax convention (a "**Treaty**"), and is entitled to claim the benefits of the Treaty, the non-resident's Canadian business income will generally only be subject to Canadian federal income tax to the extent that the subject business is carried on through a "permanent establishment" in Canada.

Most of Canada's Treaties define a "permanent establishment" as a fixed place of business through which the business of a person that is a resident of one of the contracting states is wholly or partly carried on. A "permanent establishment" may include each of the following: places of management, branches, offices, factories, workshops, and certain building sites or construction or installation projects. A "permanent establishment" is also typically considered to exist for the purposes of most Treaties in any jurisdiction where a dependent agent, acting on behalf of the taxpayer, has authority to conclude contracts in the taxpayer's name (and habitually does so) in that jurisdiction.

8 The highest marginal provincial tax rate levied on individuals varies from province to province. Individuals with higher incomes may also be subject to provincial surtaxes.

(d) Determination of Profit – Reasonable Expectation of Profit

For the purposes of the Tax Act, a taxpayer's income or loss from a business or property for a taxation year is generally equal to the profit earned (or loss realized) from the business or property for that year. The profit or loss derived from a business or property is normally calculated on an accrual basis, subject to specific exceptions set out in the Tax Act.

However, the federal government recently released draft amendments to the Tax Act that, if enacted, will introduce a statutory "reasonable expectation of profit" test applicable to any taxation year beginning after 2004. Under the proposed legislation, a loss incurred in a year will generally only be deductible if it was reasonable to expect that the taxpayer would have realized a "cumulative profit" for the period during which it carried on the business or held the property that generated the loss.[9]

(e) Deduction of Business Expenses

The Tax Act generally permits the deduction of expenses incurred for the purpose of gaining or producing income. The deduction of such expenses, however, is limited to the amount of the expense that is reasonable in the circumstances.

In contrast to the deductibility accorded to most current expenses, the Tax Act prohibits the deduction of capital expenditures,[10] except where specifically permitted. Examples of such permitted deductions include "capital cost allowance" (i.e. depreciation for tax purposes), expenditures in respect of "eligible capital property", and interest and certain other financing expenses incurred in the course of borrowing money.

(i) Interest

Interest payments are deductible on a current basis when computing taxable income to the extent such payments meet the specific requirements contained in the Tax Act. Generally, for the payment of interest to be deductible for Canadian tax purposes, it must be paid or payable in the year pursuant to

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9 See proposed Section 3.1 of the Tax Act. In response to concerns raised with the scope of proposed Section 3.1, the federal government has pledged to develop "a more modest legislative initiative" and release alternative proposed legislative amendments "at an early opportunity".

10 An expense is generally considered to be on account of capital if, among other things, it is incurred to produce an "enduring benefit".

a legal obligation, and the borrowed money must be used for the purpose of earning income from a business or property.[11]

In addition to the general rules governing the deductibility of interest payments for Canadian tax purposes, special restrictions apply where a Canadian-resident corporation borrows funds from a non-resident that owns 25% or more of the capital stock of the corporation (the "**Thin Capitalization Rules**").[12] Under the Thin Capitalization Rules, a Canadian resident corporation is precluded from deducting interest in respect of the portion of any interest-bearing loans from "specified non-resident shareholders" that exceeds two times the corporation's equity. The required "equity" calculation generally captures the amount of the Canadian-resident corporation's share capital and contributed surplus attributable to the shareholdings of specified non-residents and non-consolidated retained earnings of the corporation.

(ii) Capital Cost Allowance

In computing income for Canadian tax purposes, taxpayers are not entitled to deduct depreciation expenses (as computed for financial reporting purposes). Instead, taxpayers are generally permitted to claim a "capital cost allowance" ("**CCA**") in respect of most capital assets used or acquired by a taxpayer for use in a business in a taxation year.[13] When a taxpayer acquires a CCA eligible asset for use in carrying on a business, the cost of the asset is generally added to the cost of all other assets of the taxpayer that fall within the same asset class, as prescribed by the regulations to the Tax Act (a "**CCA Class**"). Subject to various exceptions, CCA may then be claimed in amounts equal to stipulated percentages of the undepreciated capital cost ("**UCC**")[14] of the assets in each

11 For more information, see M.N.R., *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues" (31 October 2003). All Interpretation Bulletins and Information Circulars can be accessed online at <http://www.cra-arc.gc.ca/formspubs/menu-e.html>.

12 The Thin Capitalization Rules apply to all borrowings from a "specified non-resident shareholder", which is defined to include a non-resident who, together with other parties with which it does not deal at "arm's length", owns 25% or more of the votes or value of the Canadian corporation's capital stock.

13 A taxpayer is not required to claim CCA in a particular year and may defer claiming such allowances to subsequent years.

14 The UCC of the assets contained in a particular CCA Class will generally be equal to the cost of all of the properties included in the Class, less any CCA previously claimed. CCA is generally computed on a declining UCC-balance basis. See "The Tax Implications of an Asset Sale" below.

CCA Class.[15] However, CCA claimed in respect of assets acquired during a year is generally subject to a "half-year rule", pursuant to which the maximum CCA that may be claimed in the year in respect of such assets is restricted to one-half of the CCA that would otherwise be permitted to be claimed.[16]

(iii) Eligible Capital Property

A portion of capital expenditures made in respect of certain capital assets that are not included in a CCA Class (known as "eligible capital property") may still qualify to be deducted on an ongoing basis. The deduction (which is akin to CCA, although in many cases far less generous) is generally available in respect of amounts paid for goodwill, customer lists, trademarks and other similar intangible capital property. Specifically, three-quarters of amounts expended to acquire "eligible capital property" may be included in a taxpayer's "eligible capital expenditure pool", a portion of the balance of which may then be deducted from the taxpayer's business income at a maximum rate of 7% per year on a declining balance basis (thereby yielding an effective tax depreciation rate of 5.25%).[17]

(f) The General Anti-Avoidance Rule

In 1988, the Canadian federal government enacted a statutory "General Anti-Avoidance Rule" (the "**GAAR**"), aimed at preventing taxpayers from deriving "tax benefits" from transactions that amount to "abusive tax avoidance".

In highly simplified terms, the GAAR applies to deny any "tax benefit" that would otherwise result from an "avoidance transaction", provided the government can demonstrate that the transaction gives rise to a misuse or abuse of the provisions of the Tax Act.

For the purposes of the GAAR, a "tax benefit" includes any reduction, avoidance or deferral of tax or other amount payable under the Tax Act, or any increase in a refund of tax or other amount receivable under the statute. An

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15 The regulations to the Tax Act set out over 50 CCA Classes and the maximum allowable CCA rate that may be claimed in respect of each CCA Class. While the types of assets that are prescribed to belong to a particular CCA Class are often similar in character, there can also be great diversity within a single CCA Class. For instance, CCA Class 9 includes both radio transmission equipment and aircraft.

16 For more information, see M.N.R., *Interpretation Bulletin* IT-285R2, "Capital Cost Allowance – General Comments" (31 March 1994).

17 For more information, see M.N.R., *Interpretation Bulletin* IT-123R6, "Transactions Involving Eligible Capital Property" (1 June 1997).

"avoidance transaction" encompasses any transaction that, but for the GAAR, would result, directly or indirectly, in a "tax benefit", unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the "tax benefit". The GAAR provides that if at least one transaction in a "series of transactions" is an "avoidance transaction", any "tax benefit" resulting from the series may potentially be denied under the GAAR.[18]

When assessing the potential application of the GAAR, the onus falls on the taxpayer to establish that a particular transaction does not result in a "tax benefit" or, if a "tax benefit" does arise, that the impugned transaction was undertaken primarily for *bona fide*, non-tax purposes. Conversely, the onus rests with the government to establish that a particular "avoidance transaction" results in a misuse or abuse of the Tax Act. Unless the government can establish that a transaction frustrates or defeats the purpose of the provisions pursuant to which a "tax benefit" is claimed, the GAAR will generally not apply. However, whether the GAAR applies to a particular series of transactions is a highly fact-specific determination, requiring an assessment of the purpose and legislative objectives underlying the applicable provisions of the Tax Act.[19]

Many provincial income tax statutes, along with the *Excise Tax Act*, contain broad, general anti-avoidance rules that are comparable to the GAAR. The Tax Act and most other Canadian taxation statutes also contain a host of specific anti-avoidance rules that are designed to prevent taxpayers from securing tax advantages which the government has deemed to be abusive.

(g) Non-Arm's Length Transactions

The Tax Act contains a number of specialized anti-avoidance rules that govern the taxation of transactions between parties that are "affiliated" or do not deal with one another at "arm's length".[20] In particular, where a purchaser acquires property from a vendor with whom it does not deal at arm's length

18 The Supreme Court of Canada has previously stated that, "a series of transactions involves a number of transactions that are 'pre-ordained in order to produce a given result' with 'no practical likelihood that the pre-planned events would not take place in the order ordained'". The Tax Act further provides that a "series of transactions" includes "related transactions or events completed in contemplation of the series".

19 For more information, see M.N.R., *Information Circular* 88-2, "General Anti-Avoidance Rule – Section 245 of the *Income Tax Act*" (21 October 1988). See also Richard B. Thomas, "The Supreme Court Considers Canada's General Anti-Avoidance Rule" (BNA International: 2007).

20 For tax purposes, parties that are "related", or that factually do not deal with one another at arm's length, are considered not to be operating at "arm's length". For more information, see M.N.R., *Interpretation Bulletin* IT-419R2, "Meaning of Arm's Length" (8 June 2004).

for an amount in excess of its fair market value, the purchaser will be deemed to have acquired the property for an amount that is equal to its fair market value. Conversely, where a vendor disposes of property to a person with whom it does not deal at "arm's length" for an amount that is less than the fair market value of the property, the vendor is deemed to have received proceeds of disposition on the sale of the property equal to the fair market value of the property.

These non-arm's-length-deeming rules can be punitive in nature and give rise to double taxation. For example, the deeming rules may operate to reduce the amount at which a purchaser is deemed to have acquired property without simultaneously reducing the proceeds of disposition that the vendor is deemed to have received on account of the transaction. Similarly, a non-arm's length vendor that purports to have disposed of property for less than its fair market value may be deemed to have received proceeds of disposition equal to the fair market value of the property; yet the cost of the property acquired by the non-arm's length purchaser will not correspondingly be increased for tax purposes.

The Tax Act also contains a host of rules that prevent certain taxpayers from triggering a loss for tax purposes by transferring property to a party with which it is "affiliated".[21] Where such loss limitation rules apply, the relevant loss will generally be suspended for tax purposes until the earliest time at which the property in question is transferred to a non-affiliated party or one of certain other specified events occur.

(h) Business Losses

A taxpayer's losses from a business may generally be used to offset income from any source when computing the taxpayer's tax liabilities. Unused business losses may generally be carried back three years and forward 20 years for tax purposes.[22]

21 Whether two or more parties are "affiliated" is determined principally under section 251.1 of the Tax Act. For instance, corporations that are under common control are generally considered to be "affiliated" for tax purposes.

22 Business losses incurred in taxation years that ended before March 23, 2004 may generally only be carried forward seven years. Business losses incurred in taxation years that ended between March 23, 2004 and December 31, 2005, may generally be carried forward ten years.

(i) Capital Gains and Losses

The Tax Act sets out a separate regime for the taxation of gains and losses which arise on the disposition of "capital property". A taxpayer that disposes of capital property at a gain is generally required to recognize one-half of the gain as income (such taxable portion is known as a "taxable capital gain"). To the extent a taxpayer realizes a loss on the disposition of capital property, one-half of the loss (an "allowable capital loss") may be deducted from taxable capital gains incurred in the year. Unused allowable capital losses may generally be carried forward indefinitely or carried back three years to offset taxable capital gains incurred in other years.

In the absence of an applicable Treaty, non-residents are subject to Canadian income tax on capital gains realized on the disposition of certain types of property that have a close connection or nexus to Canada (**"Taxable Canadian Property"**). Real property situated in Canada, capital property used in carrying on a business in Canada that forms part of a Canadian permanent establishment, and shares of a private Canadian corporation are all examples of Taxable Canadian Property. Although the gains resulting from the disposition of Taxable Canadian Property may ultimately be exempt from Canadian taxation by virtue of a Treaty, such dispositions may nevertheless give rise to Canadian tax compliance obligations.[23]

The disposition of capital property with respect to which CCA has been claimed may, in addition to the capital gains described above, give rise to an income inclusion (generally referred to as "recaptured depreciation"), to the extent that the proceeds of disposition of the particular property exceed the UCC of all property in the relevant CCA Class.

(j) Domestic Source Withholdings

Employers are generally required to make source deductions in respect of salary, wages and other remuneration paid to an employee as a prepayment of the employee's tax liability. Employers must also make source deductions and contributions pursuant to the *Employment Insurance Act* (Canada), the *Canada Pension Plan* or *Québec Pension Plan*, and the applicable worker's compensation regime in the province or territory in which the relevant employment is performed.

Special withholding requirements also apply to a payment made to a non-resident of a "fee, commission or other amount in respect of services rendered

23 For example, non-residents are required to file a Canadian tax return in respect of each year in which they carry on business in Canada or dispose of Taxable Canadian Property.

in Canada". Specifically, 15% of all such payments made to non-residents must be withheld and remitted to the Canada Revenue Agency (the "**CRA**"). A non-resident that resides in a country with which Canada has entered into a Treaty may be entitled to a full refund of such withholdings, provided the non-resident establishes, through the filing of a Canadian tax return, that the service payments are exempted from Canadian tax by virtue of an applicable Treaty.[24]

The Province of Québec further imposes a 9% provincial withholding obligation on persons that pay non-residents to perform services in Québec. However, similar to the federal system, a non-resident recipient of such payments can typically apply for a refund of such withholdings to the extent that a Treaty exemption is available.

(k) Capital Tax

(i) Federal Capital Tax

The federal "Large Corporations Tax" was originally introduced as a temporary deficit reduction measure in the 1989 federal budget and was finally repealed as of January 1, 2006.[25]

(ii) Provincial Capital Taxes

The Provinces of Nova Scotia, New Brunswick, Québec, Ontario, Manitoba and Saskatchewan each impose a tax on the capital employed by a corporation in the province. The capital on which tax is imposed generally consists of the aggregate of a corporation's equity and most indebtedness, less a specified deduction amount and an allowance for certain reserves and other stipulated balance sheet items. The rates of provincial capital tax currently range from 0.2% in New Brunswick to 0.5% in Manitoba.

The Ontario capital tax is levied at a rate of 0.285% of the amount by which the "taxable paid-up capital" of a corporation exceeds its allowable capital deduction, multiplied by a prescribed "Ontario allocation factor".[26] The

24 Under certain circumstances, a non-resident can obtain a waiver of such withholding requirements from the CRA. For more information, see M.N.R., *Information Circular* 75-6R2, "Required Withholding From Amounts Paid to Non-Resident Persons Performing Services in Canada" (28 February 2005).

25 Financial institutions continue to be subject to a federal tax on capital under Part VI of the Tax Act.

26 The general Ontario capital tax rate will be reduced to 0.225% beginning in 2009 and, based on announced legislative amendments, will be completely eliminated by 2010.

"Ontario allocation factor" is used to allocate a corporation's taxable paid-up capital between Ontario and other jurisdictions.

(l) Canadian Sales Taxation

(i) Federal Goods and Services Tax/Harmonized Sales Tax

The federal Goods and Services Tax ("**GST**") is a 6% multi-stage, value-added tax levied under Part IX of the federal *Excise Tax Act*[27] (the "**GST Act**"). The GST applies to the domestic supply of most types of property and services, and is payable by the "recipient" of taxable property or services, unless the supply is specifically exempted from the application of GST (e.g. financial or educational services) or is "zero-rated" (e.g. medical devices and most exports). A "supplier" must generally collect GST from the recipient of a taxable supply as agent for the CRA.

The GST is not levied in the Canadian provinces of Newfoundland/Labrador, Nova Scotia and New Brunswick. These three provinces have eliminated their provincial retail sales taxes, instead combining an 8% provincial sales tax component with the 6% federal GST to create a combined 14% federal/provincial Harmonized Sales Tax ("**HST**").

The GST/HST is imposed at all trade levels, but is generally not intended to represent an added cost of doing business. The elimination of multiple levels of GST/HST on commercial inputs is generally achieved through the GST/HST input tax credit ("**ITC**") system. Businesses that are registered for GST/HST purposes are generally entitled to claim ITCs to recover GST/HST paid or payable in respect of business inputs, including acquisitions of capital property.

If a non-resident of Canada carries on business in Canada for GST/HST purposes and makes taxable supplies of property or services in Canada, the non-resident is generally required to become a GST registrant[28] and charge, collect and (subject to claiming ITCs) remit GST/HST to the CRA.

(ii) Provincial Retail Sales Taxes

The provinces of British Columbia, Saskatchewan, Manitoba, Ontario and Prince Edward Island each impose a single stage, retail sales tax ("**RST**") on the retail sale, lease, license or consumption of most goods and certain services.

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27 R.S.C. 1985, c. E-15, as amended.

28 GST registration automatically includes registration for HST purposes.

The applicable RST rate varies from province to province (with the current rate in Ontario being 8%), and is levied on the fair value of taxable supplies, exclusive of any GST. Unlike the GST/HST, businesses generally incur RST as a cost of doing business in Canada.

Subject to specific exemptions, RST generally becomes payable at the time of the taxable purchase or importation of taxable goods or services. Under a taxable lease or licence of property, RST is generally payable on each lease or licence payment.

The Province of Québec levies a 7.5% multi-stage, value-added sales tax (the "**QST**"), which generally mirrors the GST. The 7.5% QST is imposed on the 6% GST-included value of taxable supplies, yielding an effective combined rate of 13.95%.

The Province of Alberta does not impose an RST or any other general sales or value-added tax.

(m) Land Transfer Taxation

Most provincial governments levy a land transfer tax on transactions involving real property ("**LTT**"). For example, in Ontario, a purchaser of commercial real property must generally pay LTT based on the value of the consideration paid for real property at a rate of 0.5% on the first $55,000 of consideration, 1% on the next $250,000 of consideration and 1.5% on the balance of the consideration paid for the real property. Certain transactions involving the transfer of real property are exempt from LTT, including transfers involved in qualifying divisive reorganizations and certain unregistered transfers between qualifying affiliated corporations.[29]

II. DOMESTIC ACQUISITIONS AND REORGANIZATIONS

When considering whether to acquire or sell an established business, prospective purchasers and vendors must always assess whether they wish to simply buy or sell the outstanding ownership interests in the entity which operates the business (a "**Share Sale**") or, alternatively, structure the transaction so that the entity that conducts the business disposes of the assets used in carrying on the business (an "**Asset Sale**"). The decision to buy or sell a business by way of a Share Sale or an Asset Sale is dependent on a multitude

29 See, for example, Ontario Tax Bulletin No. LTT 3-2000, "Transfers Involving Corporations" (April 2000).

of commercial and tax-related factors which demand careful review. The following sections briefly discuss some of the Canadian tax considerations that are most relevant to determining the merits of an Asset Sale versus a Share Sale, along with some of the structuring techniques that may be used to increase the tax efficiency of a contemplated transaction.

III. THE TAX IMPLICATIONS OF AN ASSET SALE

A vendor will typically dispose of a host of tangible and intangible assets when selling a business. The types of assets that may be disposed of include tangible capital assets (e.g. real estate, equipment and vehicles), intangible capital assets (e.g. trademarks and accounts receivable), and current assets held on income account (e.g. inventory).

A vendor will generally incur a capital gain (loss) in respect of the sale of most capital assets transferred as part of the Asset Sale, equal to the amount by which the proceeds of disposition of each particular asset exceed (are exceeded by) the total of the adjusted cost base of the asset and any reasonable costs associated with the disposition.

The sale of assets held on the income account will generally give rise to a full income inclusion (deduction), equal to the amount by which the proceeds derived from the sale of such assets exceed (are exceeded by) the costs incurred in originally acquiring the assets.

If depreciable capital property is sold in the course of disposing of a business, the vendor may also be required to include the amount of any "recaptured" CCA in its income. More specifically, to the extent that depreciable capital property of a particular CCA Class is sold by a vendor for proceeds of disposition which exceed the UCC of that CCA Class, the vendor will generally be required to recognize the excess (up to an amount equalling the original cost of the subject assets) as income. The vendor of a business is generally more likely to recapture CCA in respect of depreciable capital property that belongs to a CCA Class that allows for CCA to be claimed at an accelerated rate.

Similarly, to the extent that a taxpayer disposes of all of its eligible capital property in respect of a business in the course of selling the business, and the sale proceeds allocated to the purchase of the eligible capital property exceed the original acquisition cost of the property, the vendor will generally be required to recognize all of the deductions previously claimed in respect of such property, along with half of the excess proceeds, as income for tax purposes.

It is generally open to the parties to an arm's length Asset Sale to determine how they wish to allocate the aggregate purchase price among the various assets being transferred. Not surprisingly, vendors generally prefer that a significant portion of the purchase price paid for the assets of a business be attributed to non-depreciable capital property, to depreciable capital property that will give rise to limited recapture of CCA, or to eligible capital property (provided the amount allocated to such eligible capital property does not trigger a large income inclusion).

By contrast, the purchaser in an Asset Sale will, in many cases, have a bias toward allocating a greater portion of the purchase price to inventory or assets that belong to a CCA Class which permits CCA to be claimed at an accelerated rate (thereby allowing for greater CCA to be claimed in the taxation years immediately following the acquisition).

The inherent conflict of incentives between vendors and purchasers in the context of an Asset Sale normally leads to hard bargaining and an allocation of the aggregate purchase price that is acceptable to the CRA.[30] However, if the parties to a transaction fail to explicitly stipulate an allocation of the purchase price among the assets being sold in an Asset Sale, the CRA may attempt to impose an allocation that was not contemplated by either the purchaser or the vendor.

(a) Purchase of Accounts Receivable

A purchaser in an Asset Sale may acquire the accounts receivable that are associated with the subject business. On the sale of the accounts receivable of a business, absent a special election, the vendor will generally be required to recognize the amount of the receivables that have previously been claimed as "doubtful debts" as income in the year of the Asset Sale.[31] The vendor may also realize a capital gain (capital loss) to the extent that the portion of the purchase price allocated to the sale of the receivables exceeds (is exceeded by)

30 In certain circumstances, the vendor or purchaser in an Asset Sale may not be particularly concerned with the allocation of the purchase price (for example, because of the availability of significant loss carry forwards, or the status of one of the parties as a tax-exempt entity for Canadian income tax purposes). Ultimately, the CRA is entitled to challenge any purchase price allocation that it believes is unreasonable (pursuant to section 68 of the Tax Act).

31 A taxpayer is typically entitled to claim a deductible reserve in respect of accounts receivable that constitute "doubtful debts" in a particular taxation year. In each subsequent year, the taxpayer is required to include the amount deducted in respect of its "doubtful debts" in the previous year in its income and reassess the amount of its receivables that may be considered "doubtful" for the purposes of claiming a new "doubtful debt" reserve for the current year. For more information, see M.N.R., *Interpretation Bulletin* IT-442R, "Bad Debts and Reserves for Doubtful Debts" (6 September 1991).

the face amount of the receivables. The purchaser of the accounts receivable will not, in such circumstances, be required to include in its income the amount of the receivables that are collected following the Asset Sale, yet it will also not be entitled to claim a reserve in respect of the portion of the receivables that are "doubtful debts". In addition, the purchaser will only be entitled to claim a capital loss (as opposed to a business loss) in respect of any portion of the purchased accounts receivable that are ultimately uncollectible. Conversely, if the purchaser acquires the accounts receivable at a significant discount from their face value, the purchaser may realize a capital gain if the amount eventually collected in respect of the receivables exceeds their purchase price.

(i) Accounts Receivable Election

To avoid the harsh tax consequences that may otherwise arise on the sale of accounts receivable, the vendor and the purchaser in an Asset Sale may make a joint election, commonly referred to as a "**Section 22 Election**". A Section 22 Election permits the vendor to deduct the difference between the face value of the accounts receivable being sold and the amount of the aggregate asset purchase price allocated to such receivables when computing its income for tax purposes. Conversely, the purchaser of the accounts receivable will be required to include the amount deducted by the vendor in its income, yet will be entitled to claim a reserve in respect of the portion of the receivables that may be uncollectible (i.e. are "doubtful debts").

To validly make a Section 22 Election:

- the vendor must have been carrying on business in Canada;
- the vendor must be selling "all or substantially all"[32] of the property used in carrying on the business, including all of the outstanding debts that have been or will be included in computing the vendor's income for the year and any previous taxation year;
- the purchaser must be proposing to continue to carry on the business previously carried by the vendor; and
- the parties must file a prescribed election form in a timely fashion.[33]

When considering the availability of a Section 22 Election, it is critical to note that the CRA has previously taken the position that all of the accounts receivable associated with a business at the time of sale be transferred to the

32 The CRA considers the phrase "all or substantially all" to generally mean 90% or more.
33 Form T2022, "Election in Respect of the Sale of Debts Receivable".

purchaser.[34] Accordingly, if there are any accounts receivable associated with the business that the purchaser does not wish to acquire, steps should be taken to ensure that such receivables are disposed of prior to the time of the Asset Sale.[35] Similarly, where an Asset Sale is to be consummated by way of a transfer of the assets of the business to a purchaser corporation, and a portion of the sale is to be effected on a tax-deferred basis by virtue of an election made under section 85 of the Tax Act,[36] care should be taken to ensure that the transaction is structured so that the availability of a Section 22 Election is not compromised. Finally, it is important for both the vendor and the purchaser involved in an Asset Sale to recognize that the purchase price stipulated in a Section 22 Election is binding on the parties for tax purposes. The CRA has taken the position that the parties to a Section 22 Election will not be permitted to alter the amount of the consideration stipulated in the election to have been paid for the receivables, even though the CRA does not consider itself to be bound by the elected amount for reassessment purposes.[37]

(b) Payments for Undertaking Future Obligations

As an element of some Asset Sales, the purchaser may agree to perform certain services or deliver certain goods in satisfaction of undertakings that the vendor previously made in the course of its business activities. To compensate the purchaser for agreeing to satisfy the vendor's future obligations, the vendor may make a payment to the purchaser or reduce the purchase price of the assets being transferred to the purchaser.

A vendor will normally not be entitled to deduct the amount of any payment or purchase price reduction that is made in exchange for a purchaser's undertaking to assume the future obligations of the vendor.[38] Similarly, a purchaser will normally not be entitled to deduct expenses incurred in satisfying such future obligations when computing its income (although the purchaser will not be required to include the amount of the payments received from the vendor,

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34 M.N.R., *Interpretation Bulletin* IT-188R, "Sale of Accounts Receivable" (22 May 1984) at para. 1.

35 For instance, receivables that are not to be sold to the purchaser could be transferred to a corporation affiliated with the vendor.

36 As discussed in further detail below, section 85 of the Tax Act generally permits a taxpayer to sell "eligible property" to a taxable Canadian corporation in exchange for shares of the transferee corporation and to elect to defer the tax that would otherwise arise on the disposition of the eligible property.

37 *IT-188R*, *supra* note 33 at para. 5.

38 A deduction from income will be precluded notwithstanding the fact that the vendor may previously have included an amount in its income in respect of payments received to deliver the goods or services in question.

or the amount of any reduction in the purchase price of the assets, in its income for tax purposes).

However, if both the vendor and purchaser agree to make a joint election pursuant to subsection 20(24) of the Tax Act, the vendor will be entitled to deduct the amount of any compensatory payment made to the purchaser when computing its taxable income for the year. The purchaser will be required to include the value of such payment in its income for the relevant taxation year, but will thereafter be entitled to claim both a reserve in respect of the portion of the payment attributable to obligations to be satisfied in future taxation years, and a deduction in respect of any expenses incurred in discharging the transferred obligations.[39]

While the execution of an election pursuant to subsection 20(24) of the Tax Act is almost invariably in the interests of the vendor, a purchaser should carefully consider whether making the election is in its interests. For instance, it will often be disadvantageous to a purchaser to make a subsection 20(24) election where the expenses associated with the satisfaction of the future obligations at issue are low relative to the payment being made to satisfy the obligations.

(c) Clearance Certificates

The Tax Act contains a number of provisions that require a vendor to obtain a "clearance certificate" from the CRA prior to disposing of certain types of property used in connection with a business. Such obligations, along with associated withholding requirements in some circumstances, are generally imposed to ensure that the CRA receives adequate notice of the disposition and retains the ability to effectively collect the tax liabilities that may arise as a result of the disposition.

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39 It is worthy of note that a subsection 20(24) election is only available where the vendor pays a "reasonable amount" in exchange for the purchaser agreeing to satisfy the future obligations of the vendor. Thus, if the amount paid by the vendor in exchange for the purchaser agreeing to satisfy the future obligations in question is, on an objective basis, unreasonable, the CRA may seek to disallow the subsection 20(24) election made by the parties.

While there is no prescribed election form that must be filed to make a subsection 20(24) election, the Tax Act requires that the parties to the election notify the Minister of National Revenue in writing on or before the earlier of the days on which either the vendor or the purchaser is required to file a tax return for the taxation year in which the payment to which the election relates is made.

(i) Dispositions of Taxable Canadian Property

Where a non-resident person disposes of certain types of Taxable Canadian Property, the non-resident must notify the CRA of the disposition and may need to obtain a clearance certificate (commonly referred to as a "**Section 116 Certificate**") from the CRA.[40] A non-resident vendor is not required to notify the CRA or obtain a Section 116 Certificate in respect of dispositions of Taxable Canadian Property which constitute "excluded property". Examples of "excluded property" include a share of a class of the capital stock of a corporation that is listed on a prescribed stock exchange, a bond or debenture, and certain types of property described in an inventory of a business carried on in Canada.

The obligation to obtain a Section 116 Certificate is imposed to ensure that non-resident taxpayers duly pay tax owing in respect of gains which arise on the disposition of Taxable Canadian Property. In order to obtain a Section 116 Certificate, a non-resident taxpayer is generally required to: (i) demonstrate that no Canadian income tax will be payable as a result of the sale of the Taxable Canadian Property in question; (ii) remit to the CRA 25% of the amount, if any, by which the proceeds of disposition of the property exceed the taxpayer's adjusted cost base in the property;[41] or (iii) post sufficient security with the CRA to satisfy the tax that will be payable as a result of the disposition. If a non-resident who disposes of Taxable Canadian Property does not provide the purchaser with a Section 116 Certificate within 30 days after the end of the month in which the property is transferred, the purchaser must generally withhold 25% of the cost of the property from the purchase price and remit the amount to the CRA.[42] If a purchaser fails to satisfy its remittance obligations, the CRA can hold the purchaser liable for the amount that should have been remitted by the purchaser.[43]

40 The CRA will accept an application for a Section 116 Certificate as notice of the disposition of Taxable Canadian Property.

41 The required remittance percentage may exceed 25% of the expected gain in respect of certain types of Taxable Canadian Property.

42 With respect to certain types of Taxable Canadian Property, the required remittance obligation is equal to 50% of the cost of the property.

43 For more infc⁻mation, see M.N.R., *Information Circular* 72-17R5, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada – Section 116" (15 March 2005).

(d) GST/HST and Provincial Sales Tax Elections and Certificates

In many instances, GST/HST will be exigible on the sale of property transferred as part of an Asset Sale. If the purchaser of the property is a registrant for GST/HST purposes, the purchaser will generally be entitled to claim an ITC in respect of GST/HST paid on the acquisition of the assets. The GST Act further provides that where "all or substantially all" of the assets used in a business are transferred to a GST/HST registrant, no GST/HST is required to be remitted in respect of the transaction, provided the parties make a joint election in the prescribed fashion.[44]

For provincial sales tax purposes, a purchaser is frequently required to obtain a clearance certificate from the vendor confirming that all provincial sales tax obligations have been satisfied prior to the sale of the assets of the business. Failure to obtain a provincial sales tax clearance certificate could result in the purchaser being held personally liable for the outstanding provincial sales tax obligations of the vendor.[45]

IV. THE TAX IMPLICATIONS OF A SHARE SALE

The sale of shares of a corporation (or of ownership interests in other entities such as partnerships or trusts) will, in most circumstances, give rise to a capital gain (loss) equal to the amount by which the proceeds of disposition exceed (are less than) the adjusted cost base of the shares or other ownership interests.[46] As only half of the amount of a capital gain must be included in income, there is often a bias on the part of many vendors to effect their business divestitures by way of a Share Sale. As discussed in greater detail below, this preference may be further heightened to the extent that the subject shares are "qualified small business corporation shares".

From the typical purchaser's perspective, the prospect of a share purchase may be less attractive than an asset acquisition, since the Tax Act provides very limited opportunities to "write-up" the tax cost of a target corporation's

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44 Section 167 of the *Excise Tax Act* and GST Form 44 "Election Concerning the Acquisition of a Business or Part of a Business". For more information, see C.R.A., *GST Policy Statement* P-188, "Supply of a Business or Part of a Business for the Purpose of the Election under Subsection 167(1)" (25 October 1995).

45 See, for example, the certificate required to be obtained pursuant to section 6 of the *Retail Sales Tax Act* (Ontario) upon a sale of property in bulk to which the *Bulk Sales Act* (Ontario) applies.

46 For simplicity, the discussion in this section will only refer to the sale of common shareholdings in a corporation.

underlying assets (one notable exception being the so-called "bump" transaction, discussed below). On the other hand, the acquisition of the shares of a company with significant operating losses or other desirable tax attributes may be attractive to a vendor to the extent that it will have the ability to access such tax benefits in post-closing periods.

A Share Sale will often give rise to an "acquisition of control" of the target corporation for Canadian tax purposes, an event that can have significant implications and raise a number of planning considerations. This issue, together with other tax considerations commonly encountered in the context of a Share Sale, is discussed below.

(a) Acquisitions of Control

The acquisition of control of a corporation can trigger several notable tax consequences, including restrictions on carrying forward the corporation's past operating losses, on the expiry of capital losses incurred by the corporation prior to the acquisition of control, and on the required write-down of the tax cost of certain assets.

The Tax Act employs a *de jure* or "legal control" standard to determine whether control of a corporation has been acquired.[47] Under the *de jure* control test, a person or group of persons[48] will generally be considered to "control" a corporation if that person or group of persons: (i) owns such number of shares that carry with them the right to a majority of the votes in the election of the board of directors of the corporation; or (ii) is otherwise vested with "effective control" of the corporation (e.g. by virtue of a "unanimous shareholder agreement").[49]

Where control of a corporation is acquired at a particular time,[50] the Tax Act deems the taxation year of the corporation to have ended immediately prior to that time and a new taxation year to have subsequently commenced.[51] An acquisition of control also raises certain loss utilization restrictions with respect to the non-capital business losses previously incurred by the target

47 As opposed to the *de facto* control concept that is employed in other contexts.

48 A "group" is generally interpreted as including those persons who have an agreement to vote their shares jointly or who otherwise "act in concert".

49 For more information, see M.N.R., *Interpretation Bulletin* IT-64R4 Consolidated, "Corporations: Association and Control" (13 October 2004).

50 Special rules in the Tax Act apply to determine the time on a particular day when control of a corporation is considered to have been acquired.

51 The target company thereafter has the ability to select a new fiscal year-end (within the general parameters set out by the Tax Act).

corporation,[52] and precludes the application of capital losses in post-acquisition tax periods.[53] These loss utilization restrictions and prohibitions are primarily aimed at discouraging taxpayers from trading or dealing in loss corporations.

An acquisition of control can also require an adjustment to the tax cost of certain properties held by the target corporation. For example, the tax cost of any non-depreciable capital property of the corporation that exceeds the fair market value of such property must be "written-down" to the property's fair market value (with the amount of the write-down being deemed to represent a pre-acquisition period capital loss). Similar write-downs are required with respect to depreciable capital property and eligible capital property, with the subject write-down amounts generally being treated as deductions in computing the target company's business income (or loss) in respect of the pre-acquisition period (any resulting operating losses are then subject to the loss utilization restrictions noted above).

An opportunity to realize the benefit of capital losses that will otherwise expire upon an acquisition of control is provided by subsection 111(4) of the Tax Act. Specifically, this provision allows a target corporation to "step-up" the tax cost of certain of its capital properties (by way of election) to an amount not exceeding their fair market value. Any capital gains arising from such deemed dispositions (which, by virtue of the applicable rules, are deemed attributable to the pre-acquisition-of-control fiscal period), may be offset with the otherwise expiring capital losses of the corporation.

(b) Debt Forgiveness Considerations

A purchaser of shares will typically seek to confirm that the "debt forgiveness" rules contained in the Tax Act have not applied to the target corporation in the past, and will not apply to the corporation as a result of the Share Sale or any related transactions. In general terms, the "debt forgiveness"

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52 Such losses will generally be deductible in post-acquisition years, provided the target corporation continues to carry on the same or a similar business that gave rise to the loss for a profit or with a reasonable expectation of profit. Further, the amount of the loss to be applied in a subsequent year is limited to income from: (i) the specific business that generated the loss; or (ii) a business from which substantially all of the income was generated from similar activities to those of the specific business.

For a taxation year of a corporation commencing after an acquisition of control, the corporation's non-capital losses are deductible in years prior to the acquisition only where the business from which the loss occurred was carried on for a profit, or with a reasonable expectation of profit, during the loss year and in the previous year in which the loss is applied.

53 For more information, see M.N.R., *Interpretation Bulletin* IT-302R3, "Losses of a Corporation: The Effect that Acquisitions of Control, Amalgamations and Windings-up have on Their Deductibility – After January 15, 1987" (28 February 1994).

rules can apply in circumstances where a "commercial obligation" of a debtor is extinguished or settled (or deemed to have been extinguished or settled) for consideration that is less than the lesser of the principal amount of the obligation and the amount for which the obligation was issued (the "**Debt Amount**"). If the application of the "debt forgiveness" rules is triggered in a particular case, the tax attributes of the debtor company and its assets may be negatively impacted and an income inclusion may ultimately arise.

For purposes of the "debt forgiveness" rules, the difference, if any, between the Debt Amount of an obligation and the amount for which the debt is settled is known as the "forgiven amount". Any forgiven amount is then applied to reduce the following tax attributes of the debtor (in the following order): (i) non-capital losses; (ii) farm losses; (iii) restricted farm losses; (iv) allowable business investment losses; and (v) net capital losses. The debtor then has the discretion to apply the remaining portion of the forgiven amount to reduce any of the following tax attributes: (i) the undepreciated capital cost of depreciable property; (ii) the taxpayer's cumulative eligible capital account; and (iii) certain resource expenditure accounts. After applying the forgiven amount to each of the above-noted tax attributes, the remaining forgiven amount (if any) may generally be applied, at the debtor's election, to reduce the adjusted cost base of certain of the debtor's capital property or the adjusted cost base of shares and debts of certain corporations of which the debtor is a "specified" shareholder.[54] One-half of any forgiven amount that still remains after applying the forgiven amount, as set out above, must generally be applied against adjusted aggregated capital losses incurred by the debtor in respect of the current year and, thereafter, any remaining amount must generally be included in computing the debtor's taxable income.

It is important for a purchaser to have confirmed the magnitude of any debt forgiveness adjustments previously made to the tax accounts or attributes of a target corporation, or those which may arise in connection with a contemplated Share Sale. It may be advantageous, for purposes of minimizing the impact of the debt forgiveness rules and ensuring that the vendor effectively bears responsibility for any applicable debt forgiveness, to structure a Share Sale such that any debt forgiveness events occur prior to the acquisition of control of the target corporation (e.g. to take advantage of capital losses that might otherwise expire).

54 The remaining capital amount may be applied to reduce the adjusted cost base of certain other shares, debts, and partnership interests under certain circumstances.

(c) Takeover Expenses

Costs incurred by companies subject to a take-over bid, such as legal, accounting, financial advisory fees and circular costs, have traditionally been characterized by the CRA in one of two ways. Certain of these expenditures have been viewed as falling entirely outside of the scope of the income-earning activity of a corporate target on the grounds that they were incurred primarily for the benefit of the company's shareholders. In other circumstances, where the expenditures were considered to lie within the ambit of a corporation's commercial activities, the current deduction of the expenditures was denied on the basis that they arose on "capital account".[55]

Two recent decisions of the Tax Court of Canada have called into question the CRA's traditional assessing position.[56] In the course of deciding the cases, the Tax Court held that expenses incurred by a company to manage and facilitate an acquisition of its shares may: (i) be directly linked to its efforts to earn income; and (ii) not represent expenditures incurred on capital account, with the result that such expenditures may be deducted on a current basis in computing the corporation's income.

Several planning opportunities may arise from this new jurisprudence. For instance, with a friendly takeover, it may be beneficial to consider having the target corporation bear a larger portion of the relative transaction costs, since any such expenses incurred by the acquiror will, in most circumstances, remain on capital account.

(d) Earn-outs

Where the purchase price of a company's shares is dependent (in whole or in part) on the future performance of the company, an "earn-out" arrangement is said to exist. Such arrangements are often a desirable means of accurately quantifying the true value of a corporation in circumstances where future performance is not readily predictable. While the specific earn-out terms in any given transaction will vary with the particular commercial objectives of

55 Note, however, that certain capital expenditures, such as printing costs associated with the preparation of "financial reports" for shareholders, may be entitled to be deducted pursuant to section 20 of the Tax Act.

56 See *International Colin Energy Corp. v. R.* (2002), 2002 D.T.C. 2185, 2002 CarswellNat 3098 (T.C.C. [General Procedure]) and *BJ Services Co. Canada v. R.* (2002), 2003 G.T.C. 513, 2002 CarswellNat 3228, 2002 CarswellNat 5064 (T.C.C.). See also Michael Friedman and Todd Miller, " 'Capital' Confusion: The Evolving Tax Characterization of Merger Costs" (2003) 51 Canadian Tax Journal 1 at 528.

the parties, several tax issues are commonly encountered in connection with an earn-out arrangement.

The issue that most often arises is whether the subject earn-out payments are to be treated as income from business or property pursuant to paragraph 12(1)(g) of the Tax Act (and thus taxable at full income tax rates), or instead considered as payments on account of capital and taxable in the vendor's hands as capital gains.[57]

Paragraph 12(1)(g) of the Tax Act generally applies to amounts received by a vendor that were "dependent on the use or production from property . . . whether or not the amount was an instalment for the sale price of property". It is generally accepted that payments made under an "earn-out" may fall within the ambit of paragraph 12(1)(g) of the Tax Act. However, there is a long-standing CRA policy in the context of Share Sales pursuant to which the CRA allows qualifying vendors to avoid the application of paragraph 12(1)(g) and report payments made under an "earn-out" as capital receipts.[58] For those earn-out arrangements that do not meet the conditions set forth in the CRA's earn-out policy, it may be possible to avoid the potentially disadvantageous results imposed by paragraph 12(1)(g) through the use of a "reverse" earn-out formula (that is, a maximum stipulated purchase price that is reduced to the extent that particular business performance benchmarks are not achieved).

(e) Consulting Arrangements

Operational and managerial continuity is a common issue of concern in the context of many business acquisitions. In some cases, the retention of the previous ownership group's technical expertise, and customer and other business relationships, represents a critical factor in ensuring a smooth and efficient ownership transition. Such arrangements (whether in the context of an Asset Sale or Share Sale), are often embodied in a consulting agreement under which the vendor and/or parties related to the vendor provide consulting services to the target business following the execution of the sale transaction.

From a tax perspective, such arrangements are generally entered into on the expectation that the purchaser (or the target company in the case of a Share Sale) will be entitled to deduct the subject payments. Deductibility will, however, only be available to the extent that the payments made under the agree-

57 This potential characterization concern is further heightened in the event the vendor is attempting to access a capital gains exemption in respect of the disposition (see "Pre-Acquisition Planning by Vendor" below).

58 See M.N.R., *Interpretation Bulletin* IT-426R, "Shares Sold Subject to an Earnout Agreement" (28 September 2004).

ment are commensurate with the services provided by the vendor or related parties. When deciding on the terms of a particular consulting agreement, vendors and purchasers should ensure that the consulting service payments are not inflated above market value (otherwise, the CRA could attempt to recharacterize at least a portion of the payments as being on account of the purchase price of the subject assets or shares, with the result that the purchaser would be left with non-deductible capital expenses).

Another issue that should be considered in the context of any post-closing consulting arrangements is the capacity in which the service provider is rendering the subject services (i.e. as an independent contractor or an employee). The answer to this question will help to determine the purchaser's (or, if applicable, the target company's) obligation to make any required payroll withholdings. While a discussion of the key factors that are generally taken into account when making the employee versus independent contractor determination is beyond the scope of this chapter, the use of a corporation as the consulting service provider may significantly reduce the risk that a consulting payment will be characterized as employment remuneration.[59]

(f) Non-Competition and Other Restrictive Covenants

The ability of a purchaser to effectively exploit the goodwill and other intangible assets of an acquired business may depend, at least in part, on the purchaser's ability to ensure that the previous ownership group does not engage in any post-closing activities that may undermine the acquired business (e.g. by competing with the business or by soliciting the customers or employees of the business). Such assurances are commonly sought in the form of non-competition or other restrictive covenants ("**Covenants**"), which may be contained either in the purchase agreement itself or in a separate contract. Covenants typically involve the vendor (and, in some cases, certain parties related to the vendor) undertaking not to compete with the acquired business for a certain period of time and/or within a particular geographical territory.[60]

Covenants have been a common feature of most purchase agreements for some time, although, until recently, it was fairly uncommon to see a purchase agreement that purported to allocate a specific portion of the purchase price to a Covenant. Yet, purchase price allocation practices changed dramatically in the context of Share Sales following the Federal Court of Appeal's decisions

59 As a matter of law, a corporation cannot generally be an employee.

60 Such provisions should be reviewed carefully in light of the prevailing state of the law to ensure their enforceability.

in the cases of *Fortino v. R.*[61] and *Manrell v. R.*[62] In each case, the parties to a Share Sale opted to allocate a sizeable portion of the purchase price to non-competition Covenants, and took the position that the amounts paid for the Covenants were not subject to Canadian income taxation. The Court found in favour of the taxpayers, ultimately holding that "the right to carry on business" (which the taxpayers had purported to sign away by virtue of the Covenants) was not "property" under the Tax Act, with the result that the subject payments could not be characterized as, among other things, proceeds of disposition of property.

These decisions sparked much interest within the tax community and it was hardly surprising that many Share Sale transactions were quickly crafted to access this perceived loophole in the Tax Act. Equally unsurprising, the Minister of Finance announced shortly after the release of the latter court decision that a number of new provisions would be added to the Tax Act to comprehensively address the taxation of "restrictive covenants".[63] Insofar as Share Sales are concerned, the proposed legislation provides that a payment in respect of a Covenant will generally be included in the recipient's income unless a prescribed election is filed, in which case the "elected amount" is deemed to represent proceeds of disposition of the subject shares. Accordingly, the proposed legislation will, if enacted, effectively neutralize the tax advantages that temporarily arose from the *Fortino* and *Manrell* decisions.

(g) Pre-Acquisition Planning by Vendors

A number of pre-acquisition planning opportunities may be available to a vendor in connection with a Share Sale.

(i) Lifetime Capital Gains Exemption ("LCGE")

The LCGE permits a vendor to shelter up to $500,000 of capital gains arising on a Share Sale from income tax, provided the vendor and the subject shares satisfy certain conditions.[64] To qualify for the LCGE, the vendor must

61 (1999), 2000 D.T.C. 6060, 1999 CarswellNat 2700 (Fed. C.A.).

62 (2003), 2003 D.T.C. 5225, 2003 CarswellNat 1904, 2003 CarswellNat 545 (Fed. C.A.).

63 See proposed section 56.4 of the Tax Act. The proposed amendments deal with, among other things, the tax treatment of payments made pursuant to a non-competition agreement entered into by a vendor of shares, as well as the tax treatment of payments made for most other restrictive covenants, regardless of whether the payment is received in the course of employment or upon the sale of shares or the assets of a business.

64 The exemption amount is reduced by the vendor's previous claims under the LCGE and certain other amounts. In the 2007 federal budget, it was announced that the exemption amount will be increased to $750,000.

be an individual who is a resident of Canada and normally have owned the subject shares for a period of at least two years preceding the disposition, and the subject shares must be shares of a "qualified small business corporation" ("**QSBC**").[65]

Generally, a share will be considered to be a share of a QSBC if several criteria are satisfied. First, the share must be a share of a "small business corporation" at the time of disposition.[66] Second, during the 24 months preceding the Share Sale, at least 50% of the fair market value of the subject corporation's assets must be attributable to: (i) assets used principally in an active business carried on primarily in Canada by the subject corporation or a related corporation; or (ii) shares or indebtedness of a "connected" QSBC.[67]

(ii) Capital Dividends

It may be advantageous for a vendor to arrange for the payment of a pre-closing dividend out of the target corporation's capital dividend account (the "**CDA**"). The CDA is a notional account maintained for tax purposes which consists of a number of amounts, including the non-taxable portion of capital gains previously realized by the subject corporation (net of capital losses), life insurance proceeds received by the corporation, and capital dividends received from other corporations.

Capital dividends received by the shareholders of a corporation are generally not subject to income tax. The declaration and payment of a capital dividend may present an attractive alternative to leaving funds in a target corporation and generating a higher purchase price for the shares of the corporation that may give rise to capital gains tax.

The Tax Act sets out several requirements that must be satisfied before a corporation will be viewed as having paid a valid capital dividend (including

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65 While the present discussion is limited to QSBC shares, the LCGE is also available in respect of the disposition of certain farm property. It should also be noted that many of the benefits of the LCGE may be lost where the vendor and purchaser do not deal with one another at arm's length.

66 A "small business corporation" is essentially defined as a "Canadian-controlled private corporation" (a "**CCPC**"), the fair market of the assets of which is attributable (or substantially attributable) to: (i) assets used principally in carrying on an active business in Canada; or (ii) shares in one or more corporations meeting the test in (i) above, and with which the subject corporation is "connected". (The CRA has indicated that "principally" means greater than 50%.)

67 Where "all or substantially all" of the fair market value of the assets of a corporation cannot be attributed to (i) or (ii) above, additional qualifying conditions will apply to the character of the assets held by "connected" QSBCs.

the filing of an election in prescribed form with the CRA).[68] It should also be noted that a corporation may be subject to a special tax equal to 75% of the amount (if any) by which any declared capital dividend exceeds the amount available (at the applicable time) in the corporation's CDA.

(iii) Safe Income Strips

Canadian corporations that receive dividends in respect of their shareholdings in other Canadian corporations are normally required to include the amount of such dividends in their income for tax purposes. However, the Tax Act provides that such corporate shareholders may, under a variety of circumstances, claim an offsetting inter-corporate dividend deduction that has the effect of reducing the tax imposed on the receipt of such inter-corporate dividends to nil.

Nevertheless, special anti-avoidance rules contained in the Tax Act can deem what would otherwise be a tax-free inter-corporate dividend to be proceeds of disposition of shares or a capital gain where the dividend is paid as part of a transaction or "series of transactions" which results in a reduction of the capital gain that would otherwise have been realized on a disposition of the shares. (This provision has the effect of converting tax-free dividends into taxable capital gains.)

A notable exception to this special anti-avoidance rule applies in respect of dividends paid out of the "safe income" of the paying company.[69] Accordingly, the removal or "stripping" of the "safe income" of a corporation prior to a Share Sale may serve as an effective means of reducing the capital gains tax which might otherwise arise as a result of the contemplated transaction.

The first step in effecting a safe income strip frequently involves the transfer of an individual vendor's shares from the subject corporation to a holding corporation. After the transfer, a dividend (in cash or stock) not exceeding the vendor corporation's "safe income" amount in respect of the vendor's shareholdings is paid to the holding corporation (thereby reducing the value of the subject corporation's assets or increasing the holding corporation's cost base of its shares of the subject corporation). Finally, the shares of the subject corporation are sold by the holding corporation.

Vendors undertaking a safe income strip should be aware of the potentially dire tax consequences associated with the declaration of dividends in excess

68 Form T2054, "Election for a Capital Dividend Under Subsection 83(2)".

69 Safe income is essentially the tax-adjusted retained earnings of the subject company that are attributable to the shares sold by the vendor over the period in which the vendor owned such shares.

of the applicable "safe income" balance (i.e. the application of the anti-avoidance rules described above to the entire dividend amount). For this reason, the general practice when executing a "safe income strip" is to declare a number of smaller dividends, rather than one large dividend. In addition, where the particular corporation so elects in its tax return, a single dividend can be treated as separate dividends for safe income purposes.

(iv) Eligible Small Business Corporation Gains Deferral

Introduced in 2000 by the federal government as a means of encouraging small business investments by individuals, the gains deferral available in respect of the disposition of Eligible Small Business Corporation ("**ESBC**") shares is an additional planning opportunity that should be considered by vendors undertaking a Share Sale.

An ESBC is a CCPC, all or substantially all of the fair market value of the assets of which is attributable to: (i) assets used principally in an active business carried on primarily in Canada by the corporation (or a related ESBC); or (ii) shares issued, or a debt owing, by a related ESBC. An ESBC share is generally a common share acquired from the treasury of an ESBC[70] where the total carrying value of the ESBC's assets (and those of certain related corporations) does not exceed $50 million.

The ESBC gains deferral is available where an individual, other than a trust, makes a "qualifying disposition" which generally captures dispositions of certain shares of "active business corporations" held for a stipulated minimum period of time. The ESBC gains deferral permits an individual to defer the taxation of the capital gain arising on the disposition of shares, subject to the proceeds being invested in qualifying "replacement shares". In order to receive the deferral, the replacement shares must be acquired by the individual in the same year as the disposition, or within 120 days after the end of the year, and the shares must be designated in the individual's tax return as replacement shares in respect of the qualifying disposition. Provided the individual meets these requirements, the capital gain arising on the disposition is reduced by the amount of the "permitted deferral".[71]

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70 Note that shares acquired by an individual from the original investor will not qualify for the ESBC gains deferral.

71 Vendors should be aware of subsection 44.1(12) of the Tax Act, which is an anti-avoidance provision aimed at precluding taxpayers from increasing the amount of the permitted deferral through an internal reorganization.

(h) Domestic Reorganization Transactions

The Tax Act contains a variety of provisions designed to facilitate various types of corporate reorganizations on a tax-deferred basis, including business combinations by way of merger or amalgamation, business divestitures or spin-offs using so-called "butterfly" transactions, tax-deferred share transfers or exchanges, and business liquidations and wind-ups. The following discussion provides an overview of some of the more common reorganization techniques, along with certain associated tax planning opportunities and traps.

(i) Amalgamations

Corporate statutes at both the federal and provincial level generally allow two or more corporations (existing under the same statute) to "amalgamate" to form a single corporation. The Tax Act contains special rules that apply to the amalgamation of two or more "taxable Canadian corporations"[72] where all of the shareholders of the predecessor corporations (except for the predecessor corporations themselves) receive shares of the amalgamated entity. The entity arising from such an amalgamation (an "**Amalco**") is deemed to be a new corporation for the purposes of the Tax Act, and all properties and liabilities of the predecessor corporations are deemed to become those of the Amalco. The first taxation year of an Amalco is deemed to commence at the time the amalgamation is effective under corporate law,[73] while the taxation years of the predecessor corporations are deemed to terminate immediately before that time.

The Tax Act generally provides a tax deferral to most shareholders or predecessor corporations that are involved in a qualifying amalgamation, deeming predecessor company shares to have been disposed of at their tax cost and Amalco shares to have been acquired for an identical amount. From an Amalco's perspective, the rules in the Tax Act generally preserve (or allow for a carryover of) many of the tax attributes of the predecessor corporations.[74]

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72 "Taxable Canadian corporations" are generally defined as corporations that, at the relevant time, are "Canadian corporations" which are not exempt from tax under Part I of the Tax Act.

73 Note that the Tax Act is silent as to the specific time at which an amalgamation occurs. In *Interpretation Bulletin* IT-474R, "Amalgamations of Canadian Corporations" (14 March 1986), the CRA takes the position that, unless a time is specified on a certificate of amalgamation, an Amalco's taxation year begins on the earliest moment of the day the relevant certificate is issued.

74 For example, subject to the rules relating to acquisitions of control (discussed above), the losses of a predecessor corporation can generally be carried forward by an Amalco to subsequent taxation years.

An amalgamation will result in a shortened taxation year for a predecessor corporation where the deemed year-end resulting from the amalgamation occurs before the predecessor corporation's regular year-end. Such shortened taxation years can reduce the time period during which an Amalco may utilize a predecessor corporation's loss carry-forwards. As well, a shortened taxation year may reduce the amount of CCA that a predecessor corporation may claim in respect of its final taxation year. For these reasons, it is generally advisable to attempt to have an amalgamation take effect on a date that does not unduly shorten the taxation years of one or more of the participating predecessor corporations.

(j) Wind-ups

The wind-up of a corporation generally refers to the series of events that lead to the termination of the corporation's existence. While the applicable corporate law governs the specific procedures and requirements by which a corporation is wound-up, the Tax Act determines the resulting federal income tax consequences.

(i) Wind-Up of 90%-Owned Subsidiaries

The Tax Act generally permits a tax-free transfer of the assets of a subsidiary corporation to its parent corporation on a wind-up that satisfies certain criteria.[75] In general, property of the subsidiary that is distributed to the parent corporation on a qualified wind-up is deemed to have been disposed of by the subsidiary for proceeds of disposition equal to the tax cost of the property. The parent corporation is generally deemed to acquire such property for an amount equal to the subsidiary's proceeds of disposition, although, as discussed below, the parent corporation may be entitled to "bump" the tax cost of certain qualifying property if certain conditions are satisfied.

On the wind-up of a 90%-owned subsidiary (or on an amalgamation of a wholly-owned subsidiary with its parent), the tax cost of the subsidiary's non-depreciable assets may be "bumped" to the fair market value of such assets, provided all of the conditions set out in paragraph 88(1)(c) of the Tax Act are satisfied. Generally, the amount of the available bump is equal to the excess (if any) of the adjusted cost base to the parent of the shares of the subsidiary

75 A tax-deferred wind-up will generally be available where the parent owns at least 90% of the capital stock of the subsidiary and both the parent and the subsidiary are "taxable Canadian corporations".

immediately before the wind-up (or amalgamation) over the aggregate net tax cost of the subsidiary's assets.

The property sought to be bumped must be non-depreciable capital property of the subsidiary (such as shares) at the time the parent last acquired control of the subsidiary. The property must also have been continuously owned by the subsidiary from the time the parent last acquired control of the subsidiary until the wind-up (or amalgamation).

Further, the property must not be "ineligible property". Ineligible property includes, among other things, depreciable property and certain property transferred as part of a "butterfly" transaction. Ineligible property can also include property acquired by certain "prohibited persons", such as former shareholders of the subsidiary, as part of the series of transactions which includes the wind-up (or amalgamation).

(ii) Other Wind-Ups

Outside of the exception noted above for 90%-owned subsidiaries, the wind-up of a corporation generally may not be effected on a tax-deferred basis. Specifically, when a corporation is wound-up and its assets are distributed to its shareholders, a disposition of the corporation's assets is generally deemed to occur for the proceeds of disposition equal to their fair market value. The wind-up can also result in a deemed dividend to shareholders equal to the amount by which the value of the distributed assets exceeds the paid-up capital of the corporation's shares.[76]

(k) Butterfly Transactions

In very general terms, a "butterfly" transaction is a type of divisive reorganization under which a corporation distributes (or otherwise divests itself) of all or a portion of its assets to shareholders on a tax-deferred basis.[77] The rules governing butterfly transactions are particularly complex and advance income tax rulings are frequently obtained from the CRA to confirm the efficacy of such transactions.

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76 In simplified terms, the "paid-up capital" or "PUC" of a corporation's shares equals the stated capital of such shares for corporate law purposes, adjusted in accordance with specific provisions of the Tax Act. For more information, see *Interpretation Bulletin* IT-463R2, "Paid-up Capital" (8 September 1995).

77 The "butterfly" label is derived from the fact that when one draws out the transaction steps that are involved in a butterfly transaction, the resulting diagram resembles a butterfly.

Most butterfly transactions make use of the tax-deferred asset transfer provisions in section 85 of the Tax Act, along with the general deduction available in respect of dividends paid between Canadian corporations. However, the availability of the inter-corporate dividend deduction is compromised if the particular dividend is recharacterized as proceeds of disposition under subsection 55(2)[78] of the Tax Act (avoidance of this subsection is critical to successfully executing a butterfly transaction).

The applicable rules that must be satisfied in respect of a particular butterfly structure will depend, in part, on the relationship among the participants involved in the transaction (generally speaking, butterflies involving shareholders that deal with one another at arm's length[79] must satisfy a number of additional requirements[80] relative to those involving exclusively-related parties). In addition, there are special rules that apply where the "distributing" entity is a public corporation, as was the case in the well-known spin-off of Nortel Networks Corporation by BCE Inc. to its shareholders. Finally, it should be noted that the butterfly rules make extensive use of the broadly construed "series of transactions" concept to restrict the circumstances under which a butterfly transaction will be feasible, including in connection with certain shareholder continuity requirements and property transfer and acquisition restrictions.

(I) Section 85 Rollovers

Section 85 of the Tax Act permits a taxpayer or a partnership to elect to dispose of most types of property to a taxable Canadian corporation in return for shares and certain other consideration without the immediate income tax consequences that would ordinarily result from a disposition of property.

(i) Conditions for Application

A taxpayer who disposes of "eligible property" to a "taxable Canadian corporation" and receives at least one share in return may secure the benefits

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78 As noted earlier in this chapter, subsection 55(2) is applicable where an inter-corporate dividend is received "as part of a transaction or event or a series of transactions or events" where there is "a significant reduction in the portion of the capital gain that, but for the dividend, would have been realized on a disposition at fair market value of any share of capital stock immediately before the dividend. . .".

79 The meaning of "arm's length" is altered for purposes of the butterfly rules (see subparagraphs 55(5)(e)(i), (ii), (iii) and (iv) and subsection 55(4) of the Tax Act).

80 For example, in certain cases, the subject corporation's different types of property must be distributed on a *pro rata* basis amongst shareholders.

of section 85 of the Tax Act, provided the transacting parties properly execute a joint election.[81] Section 85 is generally available to Canadian residents and non-residents alike.[82]

Subsection 85(1.1) defines "eligible property" as, among other things, capital property (other than certain real property, interests in real property, or options in respect of real property owned by a non-resident person), eligible capital property, and inventory (other than real property, an interest in real property, or an option in respect of real property).

(ii) Elected Amount

Fundamental to the operation of section 85 is the joint election made by the parties to the transaction, wherein the parties stipulate the disposition amounts in respect of each property being transferred. These elected amounts will, subject to certain required adjustments, be deemed to be the disposing party's proceeds of disposition and the corporation's cost of the transferred properties. To avoid the immediate taxation of capital gains, the elected amount will typically be set at the tax cost of the subject property to the transferor.[83]

(iii) Tax Attributes of the New Shares

The adjusted cost base of the shares received by the vendor on a section 85 rollover will be determined pursuant to paragraphs 85(l)(g) and (h) of the Tax Act. The application of these provisions results in an allocation of the vendor's proceeds of disposition (less non-share consideration) in respect of the transferred assets – first to any new preferred shares, and then to any new common shares received by the vendor. Assuming the vendor does not receive any non-share consideration in connection with a transfer, and only receives shares of one class of the capital stock of the corporation, the vendor's adjusted

81 Form T2057, "Election on Disposition of Property by a Taxpayer to a Taxable Canadian Corporation".

82 It should be noted, however, that non-residents generally cannot elect under section 85 in respect of dispositions of real property, interests in real property, or options in respect of real property unless certain conditions are satisfied.

83 This assumes that the fair market value of the transferred property exceeds its tax cost. It should be noted that the elected amount may not be less than the fair market value of any non-share consideration received by the transferor from the corporation. Moreover, where the fair market value of the transferred property is less than the transferor's cost, the elected amount will be deemed to be the fair market value of the transferred property. Any resulting capital losses may be denied by virtue of the various "stop-loss" rules contained in the Tax Act.

cost base per share received on the rollover will essentially be calculated by dividing the number of shares received by the elected amount.

The operation of paragraphs 85(1)(g) and (h) may present significant deferral opportunities in situations where a vendor wishes to sell only a portion of its shares to a third party. Specifically, these provisions may facilitate the "streaming" of a vendor's cost in its existing shares to a new class of shares (which are earmarked for sale to a third party). For example, the vendor could transfer its existing shares in the subject corporation to the corporation in return for a combination of preferred and common shares, such combination being dependent on the percentage of existing shares that the vendor wishes to sell. The new preferred shares would have an adjusted cost base to the vendor equal to the lesser of the aggregate cost base of the old shares and the fair market value of the new preferred shares, thereby potentially reducing or eliminating the gain that would otherwise result upon the contemplated third-party sale.

In computing the paid-up capital of the vendor's new shares, reference should be made to the anti-avoidance rules contained in section 84.1[84] and subsection 85(2.1) of the Tax Act, both of which aim to prevent the removal of corporate surplus on a tax-free basis. Section 84.1 may apply in circumstances where the vendor transfers the shares of a corporation (the "subject corporation") to another corporation which:

- does not deal with the vendor at arm's length; and
- is "connected" with the subject corporation immediately after the disposition.

In general, the application of section 84.1 ensures that the paid-up capital of the transferor's newly issued shares in the transferee corporation does not exceed the paid-up capital of the transferred shares. The section also operates to ensure that where the value of any non-share consideration received exceeds the paid-up capital of the transferred shares, a deemed dividend will result at the time of the disposition.

The paid-up capital of shares received on a transfer may also be reduced by virtue of subsection 85(2.1) in circumstances where section 84.1 does not apply. Specifically, subsection 85(2.1) can apply where property is transferred to a corporation pursuant to subsection 85(1), and the paid-up capital ascribed to the newly-issued shares exceeds the cost to the corporation of the transferred property less the fair market value of any non-share consideration received. In any such case, subsection 85(2.1) requires the paid-up capital of the newly issued shares to be reduced by the excess.

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84 For non-residents, see section 212.1 of the Tax Act.

Section 85 may assist in facilitating a crystallization of the LCGE (discussed above) by allowing the vendor and the transferee corporation to select a transfer price (i.e. the elected amount) equal to the vendor's adjusted cost base of the shares plus the amount of the available exemption. This may make particular sense where, for example, there is a perceived risk that the subject shares may go "off-side" the LCGE requirements in the future.

(m) Section 86 Reorganizations

Section 86 of the Tax Act allows for a tax-free reorganization of a corporation's share capital under certain circumstances.

(i) Conditions for Application

Subsection 86(1) of the Tax Act provides for a tax-deferred rollover in circumstances where, under a reorganization of the capital structure of a corporation, a taxpayer disposes of capital property which consists of all of the taxpayer's shares of a particular class of the capital stock of the corporation, and receives, as consideration, property from the corporation which includes other shares of the corporation (not of the same class).[85] This provision is available to both resident and non-resident shareholders, and applies to shares held in any corporate entity (i.e. it is not necessary that the corporation itself be resident in Canada).

Where section 86 applies, a taxpayer will be deemed to have disposed of its old shares for proceeds equal to the greater of its adjusted cost base in the old shares or the fair market value of any non-share consideration received.[86] Thus, to avoid immediate tax consequences, the fair market value of any non-share consideration received should not exceed the adjusted cost base of the old shares.

85 No election is required where the provisions of section 86 apply. While the application of subsection 86(1) is essentially a question of fact (i.e. whether there has been a "reorganization of capital"), section 86 will not apply where an election under section 85 has been made.

86 It is important to note that section 85 may be employed in the same manner (i.e. a taxpayer may transfer shares to the issuing corporation pursuant to section 85). It may be necessary to utilize a section 85 rollover, rather than a section 86 reorganization, where the transferor does not wish to dispose of *all* of the shares of a particular class of the capital stock of the subject corporation.

(ii) Tax Attributes of the New Shares

The aggregate adjusted cost base of the newly acquired shares will be the same as that of the old shares, unless the shareholder receives non-share consideration. Unlike reorganizations under section 85 of the Tax Act, the cost base of the old shares (less non-share consideration) is allocated to each class of new shares based on the proportion of the fair market value of the shares of such class to the fair market value of all new shares, without any distinction or priority between preferred and common shares.

Subsection 86(2.1) provides rules for the computation of the paid-up capital of the shares received on an exchange to which subsection 86(1) applied. In general terms, the paid-up capital of the new shares issued on the exchange is limited to the paid-up capital of the old shares, less any non-share consideration received on the reorganization.

(n) Section 51 Share Exchanges

Another method of effecting a tax-deferred share exchange is found in section 51 of the Tax Act, which allows a taxpayer to exchange capital property consisting of shares in a corporation for other shares of the corporation. Unlike the rollover provisions in sections 85 and 86, no consideration other than the new shares may be received by the transferor on the exchange.

Where shares are exchanged pursuant to section 51, the exchange is deemed not to be a "disposition" of the exchanged shares for most purposes of the Tax Act. The aggregate adjusted cost base of the newly acquired shares will be the same as the adjusted cost base of the old shares transferred to the corporation on the exchange, and will be allocated to the various classes of new shares based on the ratio of the fair market value, immediately after the exchange, of all new shares of a particular class received on the exchange, to the fair market value, immediately after the exchange, of all new shares received on the exchange. In general terms, the paid-up capital of the new shares issued on the exchange is limited to the paid-up capital of the old shares.

(o) General Considerations Relating to the Use of Sections 85, 86 and 51 of the Tax Act

Where the value of the shares received by a taxpayer (along with any non-share consideration) is less than the value of the old shares (or other assets transferred to the transferee corporation), and it is reasonable to consider the difference to be a benefit that the taxpayer intended to confer on a person

related to the taxpayer, paragraph 85(l)(e.2), subsection 86(2) or subsection 51(2) of the Tax Act (as the case may be) may apply to deem the excess portion to be a capital gain of the taxpayer. These provisions can operate to penalize taxpayers by creating an immediate tax liability (with respect to the deemed capital gain) without providing a corresponding "step-up" in the adjusted cost base of the shares received.

To avoid the application of these anti-avoidance provisions, it is essential to ensure that an accurate assessment of the fair market value of the transferred property is obtained. In many cases, this will require a professional valuation. As an extra measure of protection in the event a later disagreement arises with the CRA, it may be appropriate in certain circumstances to insert a price adjustment clause in the relevant share conditions or the operative transfer agreement (as the case may be).[87]

V. INTERNATIONAL TAX CONSIDERATIONS

A host of unique tax issues arise in the context of cross-border transactions. While a comprehensive discussion of each of the Canadian tax considerations that are relevant to commercial transactions involving non-residents is beyond the scope of this chapter, the following sections provide a brief overview of some of the key considerations associated with the structuring of non-resident investments in Canada and with the operation of Canadian-owned enterprises abroad.

(a) Canadian International Treaty Network

The Canadian government has entered into a large number of Treaties to alleviate the incidence of double taxation and to facilitate the collection of information on the activities of taxpayers who are employed or transact business on a cross-border basis. Currently, Canada is a party to 86 Treaties, has signed six new Treaties that are not yet in force, and is in the process of negotiating or renegotiating 14 other Treaties.

(b) Non-Resident Withholding Tax

Certain amounts paid or credited by a Canadian resident to a non-resident are subject to Canadian withholding tax. These amounts include dividends,

87 See M.N.R., *Interpretation Bulletin* IT-169, "Price adjustment clauses" (6 August 1974). Often, taxpayers unwisely execute such clauses without taking the further steps set out in IT-169, including notifying the CRA of the price adjustment arrangements.

interest, certain royalties, and management and administration fees. Although the ultimate liability for Canadian withholding tax is imposed on the non-resident recipient of the subject payments, it is the Canadian-resident payer that has the obligation to withhold and remit such tax on behalf of the non-resident.

The general rate of non-resident withholding tax imposed under the Tax Act is 25%, but the applicable rate may be reduced by the terms of a Treaty. For example, under most Treaties, dividends and royalties paid by a Canadian resident are generally subject to withholding tax at a rate of between 5-15%. Similarly, withholding tax on interest paid to a non-resident who is entitled to the benefits of a Treaty is typically reduced to a rate of between 10-15%.[88]

Interest payments made to an arm's length non-resident lender in respect of long-term debt may be exempt from withholding tax entirely if certain requirements are met. To qualify for this exemption, the borrower cannot be required to repay more than 25% of the principal amount of the obligation within the first five years of the issuance of the obligation, except in very limited circumstances (e.g. a commercially reasonable event of default under the relevant borrowing agreement).

The Tax Act also deems certain types of payments to be interest for non-resident withholding tax purposes, including payments made in respect of guarantees and standby fees.

Withholding tax implications are often a critical consideration when structuring a Canadian investment. The use of holding entities in an appropriate intermediary jurisdiction may serve to reduce the withholding tax burdens associated with a particular stream of income. Intermediary entities may also be useful where investors are sensitive to Canadian tax compliance costs or reside in jurisdictions with which Canada has not entered into a Treaty.[89]

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88 In its budget for 2007, the federal government announced that Canada and the U.S. have agreed in principle on the major elements of an updated Treaty. Under the proposed changes, withholding tax on interest payments between arm's length parties will be eliminated as of the first calendar year following the entry into force of the relevant Treaty changes. The elimination of Canadian withholding tax on interest payments between non-arm's length residents of the respective countries will also reportedly be phased out upon the enactment of the new Treaty over a three year period. Finally, contingent on the enactment of a new Canada-U.S. Treaty, the Canadian government has proposed to eventually repeal the withholding tax exigible on interest paid to all arm's length non-residents.

89 However, caution should be exercised prior to simply locating an intermediary holding entity in a jurisdiction of "convenience". See C.R.A., *Technical News No. 35* (26 February, 2007).

(c) Branch Profits Tax

In addition to basic corporate income taxes, non-resident corporations that operate branches in Canada are also liable to pay a federal "branch profits tax". Broadly speaking, the federal branch profits tax applies to the after-tax Canadian-sourced profits earned by a non-resident branch in a year, which are not reinvested in Canada. The branch profits tax is designed to equal the withholding tax that would have been levied if: (i) a wholly-owned Canadian subsidiary had been used to conduct the non-resident's Canadian activities instead of the branch; and (ii) all after-tax profits of the subsidiary had been distributed to the non-resident by way of dividend.

Under certain of Canada's Treaties, including those entered into with the United States and Germany, the first $500,000 of income earned by a Canadian branch of a non-resident corporation is exempt from Canadian branch profits tax (representing a potential savings of approximately $25,000).

(d) Disposition of Canadian Business Assets or Shares of a Canadian Corporation

As described above, non-residents of Canada that dispose of Taxable Canadian Property in a particular taxation year are, subject to the application of the relieving provisions of a Treaty, generally liable for Canadian income tax in respect of any gains that arise on the disposition of such property. Many of Canada's Treaties override the general provisions of the Tax Act and provide that gains derived by a non-resident from the disposition of Taxable Canadian Property will not be subject to Canadian taxation, except in certain enumerated circumstances.

While the range of available tax exemptions varies depending on the terms of the applicable Treaty, most Treaties expressly stipulate that gains derived by a non-resident from the sale of "immovable property" situated in Canada may be subject to tax in Canada.[90] Many Treaties also provide that gains arising from the sale of corporate shares which derive their value principally from "immovable property" situated in Canada, or the sale of "movable property" that forms part of the business property of a permanent establishment of a non-resident in Canada, may also be subject to Canadian tax.

When establishing or acquiring a business in Canada, non-residents are always well advised to consider potential disposition strategies and to structure

90 The applicable definition of "immovable property" generally tracks the meaning of the phrase for Canadian tax purposes and, more particularly, includes real property situated in Canada and certain natural resource rights.

their Canadian affairs so as to ensure maximum access to the relieving provisions of an applicable Treaty. For instance, a non-resident purchaser may wish to acquire the real property and the other business assets of a particular Canadian enterprise (i.e. non-"immovable property") through separate corporate entities if it might be possible to avoid the imposition of Canadian tax on the later sale of the shares of the company holding the non-"immovable property".

(e) Management Service and Royalty Arrangements

The purchaser of a Canadian business may wish to consider the use of management service agreements or royalty arrangements as a means of shifting income from Canada to other lower-tax jurisdictions. To effectively achieve this objective, such service or royalty arrangements must be *bona fide* and able to withstand the scrutiny of the Canadian transfer pricing rules (i.e. the arrangements must be priced on an arm's length basis).

Required withholdings in respect of the subject payments may be avoided in the case of services, if the services are not delivered in Canada or, in the case of royalties, if access to an exemption is available under an applicable Treaty (such as Canada's Treaty with the United States, which generally exempts computer software-related royalties and payments in respect of commercial, scientific or industrial information (i.e. know-how) from withholding tax).

(f) Choice of Canadian Business Vehicle

Foreign investment in Canada assumes a variety of forms. While some non-resident investors opt to directly conduct business in Canada and bear the broad imposition of Canadian income and sales taxes, others prefer to insulate themselves from Canadian tax and filing obligations by utilizing separate Canadian business vehicles and holding entities. Similarly, non-resident enterprises that wish to borrow or lend funds in Canada frequently establish Canadian holding vehicles to structure such activities in a manner that yields tax-efficient results.

Historically, the selection of viable business vehicles was generally limited to trusts,[91] partnerships, and corporations with limited liability. In the early

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91 In highly simplified terms, trusts are arrangements where "legal" title of certain property is vested with a trustee, while beneficial ownership of the property rests with the beneficiaries of the trust. Detailed provisions of the Tax Act govern the taxation of trusts. *Inter vivos* trusts are normally subject to tax at the highest marginal tax rate applicable to individual taxpayers, although such trusts are frequently entitled to claim a deduction in respect of the income of

1990s, U.S. investors began to recognize that a host of Canadian and foreign income tax benefits could be captured by structuring their Canadian activities through one or more "unlimited liability companies" ("**ULCs**") formed under the laws of the Province of Nova Scotia ("**NSULCs**"). The use of NSULCs as a tax-efficient means of establishing a commercial presence in Canada has proven to be of interest to both U.S. resident enterprises and investors based outside of North America that wish to hold their Canadian investments through entities located in the U.S. In fact, the use of NSULCs has become so prevalent that one Canadian province (Alberta) recently amended its corporate legislation to allow for the formation of ULCs, and legislative discussions are ongoing in other provinces, including Ontario, with a view to potentially enacting ULC legislation.

(i) The Rise of the NSULC

For many years, NSULCs were simply regarded as an archaic relic of the old United Kingdom *Companies Act*. However, in the early 1990s, US tax practitioners realized that by structuring cross-border investments in Canada through an NSULC, U.S.-resident investors could simultaneously enjoy the Canadian advantages of investing through a Canadian-resident corporation, while retaining many of the foreign tax-related benefits that would typically only arise if they had chosen to directly invest or conduct business in Canada.

The potential benefits afforded by the use of an NSULC stem from the fact that NSULCs are treated as corporations for Canadian tax purposes, yet may be treated as "pass-through entities" (i.e. partnerships or "disregarded entities"/branches) for U.S. federal income tax purposes according to the U.S. entity classification regime (commonly known as the "Check-the-Box" rules). As a result, U.S.-resident investors that hold their Canadian investments through an NSULC may generally elect[92] to consolidate the profits and losses (including start-up losses) of their Canadian operations with those of the other members of their corporate group when computing their U.S. tax liabilities, while preserving the benefits associated with maintaining a separate corporate existence in Canada. U.S. taxpayers may also achieve U.S. foreign tax credit

the trust that is paid or payable to beneficiaries in a particular taxation year. Trusts are often used as holding vehicles to achieve specific tax-advantaged results (e.g. trusts are generally not subject to provincial capital taxes).

92 Pursuant to the Check-the-Box rules, an NSULC is generally considered to be a pass-through entity unless an election is made to treat the entity as a corporation for U.S. federal income tax purposes. If such an election is not made, the profits and losses of the NSULC will generally pass-through to the owner(s) of the NSULC, provided the losses are not otherwise disallowed from a U.S. federal income tax perspective (e.g. due to the application of the U.S. dual consolidated loss rules).

benefits through the use of an NSULC. For example, if a U.S. individual or pass-through entity owns a Canadian entity ("**Canco**") that is treated as a corporation for U.S. federal tax purposes, and Canco pays income taxes on its non-U.S. earnings, the U.S. taxpayer will be ineligible to receive a foreign tax credit in the U.S. for those foreign taxes paid.[93] Yet, if that same U.S. taxpayer established Canco as an NSULC and did not check-the-box to treat Canco as a corporation for U.S. federal tax purposes, a U.S. foreign tax credit should be available since the Canadian income taxes paid by the NSULC would pass-through to the U.S. taxpayer, along with the Canadian earnings that will thereafter be subject to U.S. federal income tax.

(ii) The Emergence of Alberta Unlimited Liability Corporations

Historically, the Province of Nova Scotia was the only jurisdiction in Canada in which a ULC could be formed. However, in 2005, the Province of Alberta amended its *Business Corporations Act* (the "**ABCA**") to permit the formation of Alberta unlimited liability corporations ("**ABULCs**").

The new Alberta corporate law regime, as it relates to the formation of ABULCs, differs significantly from that found in Nova Scotia. In contrast to the Nova Scotia *Companies Act* (the "**NSCA**"), the ABCA is a modern corporate statute that may be preferable to the NSCA in a number of key respects. For instance, the ABCA contains streamlined rules governing corporate reorganizations and imposes significantly lower filing fees on incorporations. (The fee for forming an ABULC is currently only $100. By comparison, the cost of incorporating an NSULC is $6,000. NSULCs are also required to pay an annual registration fee of $2,000). Conversely, the new ABULC legislation has its own drawbacks, such as potentially more expansive shareholder liability provisions, which should carefully be considered in the context of any contemplated transaction.

There are also a number of more subtle differences between the NSCA and the ABCA that should be assessed before deciding whether to utilize an NSULC or an ABULC under a particular set of circumstances.

93 Subject to certain limitations, a U.S. foreign tax credit is generally available for foreign withholding taxes applied to payments (e.g. interest, dividends) made to the U.S./ taxpayer by a Canco.

(g) Transfer Pricing Regulation

In the absence of comprehensive transfer pricing rules, multinational corporate groups could effectively shift taxable income from high-tax jurisdictions to low-tax jurisdictions by manipulating the prices at which goods or services are transferred between related members of the group. For example, a Canadian member of a corporate group could sell goods at a price well below their cost to another member of the group that is resident in a low-tax jurisdiction. Conversely, a Canadian taxpayer could pay an excessive amount for services provided by an affiliate that resides in a tax haven. In either case, the income of the Canadian taxpayer is reduced (while the income of a related party in the other jurisdiction is increased).

The Tax Act contains a special set of statutory rules that operate to impute "arm's length" prices to cross-border transactions entered into between Canadian taxpayers and non-residents with which they do not deal at arm's length. Canadian taxpayers that enter into such transactions must use an appropriate pricing methodology to determine the prices at which the relevant transactions would have been entered into by arm's length parties.

Canadian taxpayers that do not comply with the transfer pricing rules contained in the Tax Act are generally required to pay:

- tax on the amount of any additional income that is found to have been earned in a year as a result of a transfer pricing adjustment;
- interest on any additional tax payable by virtue of a transfer pricing adjustment; and
- penalties.

A transfer pricing penalty equal to 10% of the amount of any unfavourable annual net adjustment to a taxpayer's income or expenses for a year may be levied if the unfavourable net adjustment exceeds a statutory "safe harbour". The statutory "safe harbour" is equal to the lesser of:

- $5,000,000; and
- 10% of the taxpayer's gross revenue.

Transfer pricing penalties are not applicable where a taxpayer has "made reasonable efforts to determine arm's length transfer prices". However, a taxpayer is deemed <u>not</u> to have made such efforts where it has not maintained "contemporaneous documentation" to support the pricing of the subject transactions. The Tax Act provides that "contemporaneous documentation" includes records or documents which provide a complete and accurate description of:

- the property or service to which the transaction(s) at issue relate;

- the key terms and conditions of the relevant transaction(s) and the relationship between the contracting parties;
- the functions performed, the property used, and the risks assumed by each party to the transaction(s) at issue;
- the data and methods considered, and the analysis performed, to determine acceptable arm's length transfer prices; and
- the assumptions, strategies and policies that influenced the determination of the appropriate transfer prices.

To preclude the application of a potential transfer-pricing penalty, Canadian taxpayers are required to make or obtain contemporaneous documentation for a particular taxation year no later than the due date for filing their Canadian income tax returns for the particular year. The Canadian transfer pricing rules also require parties to file detailed transfer pricing returns with the CRA on an annual basis.[94]

In order to minimize the risk of a transfer pricing assessment, taxpayers can obtain assurances that their practices do not contravene the Canadian transfer pricing rules by entering into an Advance Pricing Arrangement ("**APA**") with the CRA. APAs stipulate the agreed transfer pricing methodology to be used in order to determine acceptable transfer prices for international transactions to be completed in the future. APAs are binding on the CRA. In addition, APAs can often be entered into with foreign tax authorities on a multilateral basis. Unfortunately, APAs are costly and time-consuming to negotiate and, as such, are generally only entered into by large corporate taxpayers.[95]

(h) Outbound Structuring Considerations

Canadian corporations wishing to acquire and operate businesses abroad may find that it is more tax-efficient to effect such investments indirectly through an intermediary holding corporation, rather than to directly subscribe for (or acquire) shares or other interests in the particular operating entity.

Several advantages of utilizing an intermediary holding structure (in addition to the potential withholding and capital gains tax advantages described above) may be available. For example, an intermediary holding company could serve as the recipient of excess cash that may be available in a foreign operating entity, thereby helping to satisfy creditor protection objectives on a tax-neutral

94 For more information see M.N.R., *Information Circular* 87-2R, "International Transfer Pricing" (27 September 1999).

95 However, the CRA recently introduced a special, small business APA program in an attempt to meet the needs of taxpayers with less expansive operations.

basis. In addition, an intermediary holding structure may also assist in facilitating a tax-efficient redeployment of proceeds arising from a sale of the shares or assets of a foreign operating entity by serving as a "buffer" and effectively shielding gains on the sale from immediate Canadian taxation.

In order to obtain the desired tax treatment of an intermediary holding structure, it is critical that all intermediary holding entities have a substantive presence in their jurisdictions of residence. For example, it is generally advisable that: (i) at least one director of the entity be resident in the chosen jurisdiction; (ii) the entity have a registered office in the chosen jurisdiction; (iii) all commercial activities and directors meetings of the entity take place in the entity's jurisdiction of residence; and (iv) books and records of the entity be maintained in the entity's jurisdiction of residence.

(i) Foreign Affiliate Regime: An Overview

The Tax Act contains a complicated set of provisions (known as the "foreign affiliate rules"), which are designed to govern the taxation of Canadian taxpayers that directly or indirectly hold significant interests in foreign corporations. On the basis of the foreign affiliate rules, taxpayers may be subject to Canadian tax on an accrual basis in respect of all or a portion of the earnings of certain foreign corporations in which they hold a significant interest. In other circumstances, the earnings of certain foreign corporations may escape Canadian taxation entirely, including upon the repatriation of such earnings to Canada.

In highly simplified terms, a foreign corporation is considered to be a "foreign affiliate" of a Canadian taxpayer where the following criteria are satisfied:

- the foreign corporation is not resident in Canada for the purposes of the Tax Act;
- the Canadian taxpayer owns, directly or indirectly, at least 1% of any class of shares of the foreign corporation; and
- the Canadian taxpayer, either alone or together with certain related persons, owns, directly or indirectly, at least 10% of any class of shares of the foreign corporation.

Where a foreign corporation is considered to be a "foreign affiliate" of a Canadian taxpayer, the earnings of the foreign affiliate are allocated to different specialized accounts for Canadian tax purposes. In very general terms, the net earnings of a foreign affiliate resident in a "designated treaty country" derived from an "active business" carried on by the foreign affiliate in a "designated treaty country", are generally added to the "exempt surplus" account of the

foreign affiliate for Canadian tax purposes. Where a Canadian corporation receives a dividend from a foreign affiliate that is deemed to have been paid out of the affiliate's "exempt surplus" account, the corporation will generally be entitled to deduct the amount of the dividend when computing its taxable income for Canadian purposes. As a result, Canadian corporations are generally not required to pay additional Canadian income tax in respect of the receipt of "exempt surplus" dividends. However, a Canadian corporation that receives an exempt surplus dividend is generally not entitled to claim a credit or deduction in respect of foreign taxes (including withholding taxes) that are levied on the dividend or in respect of the underlying earnings of the corporation.

(i) Controlled Foreign Affiliates and FAPI

In contrast to active business income, income of a foreign affiliate that is derived from property or a business other than an active business will generally (absent a deeming rule to the contrary), be considered to constitute "foreign accrual property income" ("**FAPI**"). Passive investment income that is unrelated to the active business operations of a foreign affiliate, such as interest payable on certain investments, is an example of income that may constitute FAPI.[96] In addition, taxable capital gains from the disposition of property, other than "excluded property", are also included in the computation of the FAPI of a foreign affiliate.

Where a foreign affiliate is considered to be a "controlled foreign affiliate" (a "**CFA**") of a Canadian taxpayer for the purposes of the Tax Act, the Canadian taxpayer may be required to include certain of the FAPI earned by the CFA in its own income on an accrual basis for Canadian tax purposes (with a deduction generally available to the Canadian taxpayer for any income tax paid by the foreign affiliate).

(ii) Excluded Property

When computing the FAPI of a foreign affiliate, gains arising from the sale of "excluded property" are generally not included in the required computation.[97] The "excluded property" of a foreign affiliate includes:

(a) property used or held by the foreign affiliate principally for the purpose

96 Dividends received by a foreign affiliate from other foreign affiliates of a Canadian company are generally excluded in computing the FAPI of a particular foreign affiliate.

97 New amendments, if enacted, may alter this rule in certain circumstances involving, among other things, certain related-party transfers.

of gaining or producing income from an active business carried on by it;

(b) shares of another foreign affiliate of the Canadian taxpayer where all or substantially all of the fair market value of the property of the other foreign affiliate is attributable to property of that other foreign affiliate that is "excluded property";

(c) property, all or substantially all of the income from which is, or would be if there was income from the property, income from an active business; and

(d) property arising under or as a result of an agreement that: (i) provides for the purchase, sale or exchange of currency; and (ii) can reasonably be considered to have been made by the foreign affiliate to reduce its risk, with respect to an amount that was receivable under an agreement that relates to the sale of excluded property or with respect to an amount that was receivable and was a property described in paragraph (c), of fluctuations in the value of the currency in which the amount receivable was denominated.[98]

(j) Proposed Foreign Investment Entity Rules: An Overview

The Canadian government has proposed to enact highly technical foreign investment entity rules ("**FIE Rules**") as a means of immediately taxing certain investment income of Canadian taxpayers that accumulates offshore. Very generally speaking, the FIE Rules may operate to tax the income of a "foreign investment entity" (an "**FIE**") when it is earned or accrues, as opposed to when the income is distributed to a Canadian taxpayer that has an interest in the relevant FIE.

The federal Department of Finance has revised the proposed FIE Rules several times since the original legislative initiative was first announced in 1999. The latest draft of the rules was released to the public in November, 2006. If enacted, it is understood that the FIE Rules will have retroactive application (subject to certain potential relief) to all taxation years commencing after 2006.

The latest iteration of the FIE Rules stipulates that the rules may potentially apply to taxpayers that are not "exempt taxpayers" and which hold a "partici-

98 Paragraph (d) is designed to ensure that the income or loss derived from a hedge transaction entered into by a foreign affiliate in respect of an amount receivable from the sale of excluded property is characterized in an identical manner to the income or loss from the property being hedged.

pating interest"[99] in a "non-resident entity". If applicable, the rules may require the subject investor to include in income for each year: (i) an amount equal to a prescribed percentage of the investor's "designated cost" of its participating interest in the FIE; (ii) if the investor so elects and certain other conditions are met, any gains and losses in respect of such securities for the year measured on a mark-to-market basis (whether or not such gains or losses have been realized); or (iii) if the investor so elects and certain other conditions are met, the investor's proportionate share of the FIE's income (or loss) in respect of the year.

Taxpayers should also be aware that the FIE Rules may overlap in some respects with the foreign affiliate rules and certain newly proposed rules relating to the taxation of foreign trusts. Accordingly, any particular foreign investment should only be undertaken after careful consideration of all of the potentially relevant provisions of the Tax Act, including the FIE Rules and the foreign affiliate rules.

VI. ADMINISTRATIVE PLANNING TOOLS

(a) Advance Income Tax Rulings

Taxpayers that wish to obtain greater certainty regarding the Canadian income tax treatment of a particular transaction or series of transactions may be entitled to obtain an advance income tax ruling from the CRA (a "**Ruling**"). Taxpayers that wish to obtain a Ruling are required to submit a formal Ruling request to the Income Tax Rulings Directorate of the CRA (the "**Directorate**"), detailing all of the facts relating to the proposed transaction(s), the particular income tax issues that the taxpayer wishes the CRA to address in the Ruling, and the taxpayer's views on the appropriate application of the Tax Act to the proposed transaction(s).

The CRA has publicly indicated that it will not issue Rulings where:

(a) the essential tax issue which the requested Ruling will address is before the courts;

(b) the proposed transaction is to be completed at some indefinite future time or where satisfactory evidence is lacking such that the proposed transaction is being seriously contemplated by the taxpayer;

99 A "participating interest" is broadly defined to include, among other things, a share of the capital stock of a corporation, a "specified interest" in a trust, and property that is convertible into, exchangeable for, or a right to acquire, directly or indirectly, an interest in these properties.

(c) the matter underlying the Ruling request involves the determination of the fair market value of property; or

(d) the issuance of the Ruling would require the CRA to provide an opinion or interpretation of a foreign law.[100]

Historically, Rulings have only been issued by the CRA in respect of proposed transactions that have yet to be undertaken. However, the CRA recently confirmed that it would begin to issue Rulings in respect of certain completed or partially completed transactions, provided:

(i) the Ruling is formally requested before the transactions in question are completed; and

(ii) the transactions at issue are not currently being audited.[101]

Taxpayers are required to cover the CRA's costs in considering a Ruling request.[102] While the amount of time required for the CRA to issue a Ruling is highly dependant on the complexity of the transactions at issue and the volume of Ruling requests currently before the Directorate, the CRA's stated goal is to issue Rulings within an average of 60 days of "controllable time" (i.e. excluding periods during which the CRA is waiting for further information from a taxpayer).[103]

The Directorate will also issue technical interpretations to taxpayers, without charge, in response to written requests. Technical interpretations are not binding on the CRA, but typically provide a good indication of the CRA's views on a particular issue.[104]

(b) Voluntary Disclosures

The CRA and many provincial revenue authorities operate specialized voluntary disclosure programs that allow taxpayers to voluntarily disclose inaccurate or incomplete information in connection with their historical tax filings. Taxpayers that make valid voluntary disclosures (and pay all related

100 For more information, see M.N.R., *Information Circular* 70-6R5, "Advance Income Tax Rulings" (17 May 2002).

101 CRA, *Income Tax Technical News* #34 (27 April 2006) at 14.

102 As of April, 2007, the CRA charged taxpayers $100 plus GST for each of the first 10 hours spent by a CRA Rulings officer considering a Ruling request and $155 plus GST for each subsequent hour spent considering the Ruling request.

103 Upon the issuance of a Ruling, a version that excludes all information that could be used to identify the taxpayer who requested the Ruling is released for public reference.

104 Taxpayers are also entitled to make informal, verbal inquiries with the Directorate by telephone. The automated telephone service of the Directorate can be accessed by dialling 613.957.8953.

outstanding taxes and interest charges) are generally entitled to a waiver of the penalties that would otherwise have applied with respect to such historical filings.

The CRA will only consider a voluntary disclosure to be "valid" if the following four conditions are satisfied:

(a) the disclosure is truly voluntary (i.e. it is not made with the knowledge of any audit, investigation, or other enforcement action initiated by the CRA or a provincial revenue authority);

(b) the disclosure is complete (i.e. material information relating to the matter being disclosed has not been withheld by the taxpayer);

(c) the disclosure involves a matter that would give rise to a penalty; and

(d) the disclosure includes information that is either at least one year past due or, if less than one year past due, and not provided simply to avoid late filing or instalment penalties.

Taxpayers are generally entitled to initiate a voluntary disclosure on a "no-names" basis and can, in many circumstances, determine whether the CRA will be willing to provide voluntary disclosure relief prior to divulging their identity. A voluntary disclosure will generally not be considered to be invalid if a formal tax audit is commenced between the time the initial "no-names" disclosure is made and the time at which all pertinent details relating to the disclosure are provided to the CRA.[105]

In the context of an Asset Sale or a Share Sale, a voluntary disclosure can be a useful tool in minimizing the negative impact of past tax deficiencies, and in allowing the parties to a transaction to more accurately quantify the tax-related liabilities of a target entity.

As detailed throughout this chapter, Canadian tax considerations touch upon virtually every aspect of business operations in Canada. Accordingly, tax considerations should always be addressed at the early stages of a transaction or business cycle so as to position an enterprise to properly mitigate its tax risks and to best exploit its tax planning efforts. With proper planning, the Canadian tax exposure and liabilities of a venture can be effectively managed to the benefit of the entire business and its owners.

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105 The CRA has recently been concerned with perceived abuses of its "no-names" voluntary disclosure policy. Accordingly, taxpayers should exercise caution when making "no-names" voluntary disclosures.