Sale of a Business: New Tax Planning Option

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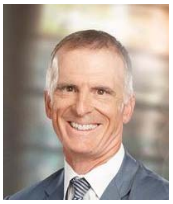

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The sale of a business is often the most significant business transaction in an entrepreneur's life. In addition, the net proceeds from such a sale often represent an entrepreneur's only retirement fund. Therefore, it is crucial to maximize such proceeds by reducing or deferring the taxes resulting from the transaction as much as possible.

The Canada Revenue Agency ("**CRA**") recently reversed an administrative position that it had expressed in 2002 with respect to beneficial tax planning as part of the sale of a business. This change in its rather technical administrative position opens the door to very effective tax planning that offers real tax deferral opportunities to business owners wishing to sell their business.

Consider the following example:

Sale of 100% of shares to a third party without prior planning

Ms. Tremblay wishes to sell 100% of the shares of her company ("**Opco**") to a third party for their fair market value ("**FMV**") of $10 million. These shares have an adjusted cost base of $1.00. Ms. Tremblay's direct sale of 100% of Opco shares to a third party would result in a capital gain of approximately $10 million and total income taxes of approximately $2.7 million, assuming that her capital gain is not eligible for the capital gains exemption. In this scenario, Ms. Tremblay would be left with a sum of approximately $7.3 million after taxes.

Sale of shares with the newly approved prior tax planning

In the second scenario, prior to the sale to the third party, Ms. Tremblay would create a management company ("**Gesco"**) and transfer 50% of Opco shares to it on a rollover basis, with no immediate tax consequences.

Gesco would then internally exchange Opco shares in order to realize a $5 million capital gain within Gesco, resulting in income taxes of approximately $1.26 million for Gesco, a portion of which would later be refunded through the use of a non-eligible refundable dividend tax on hand account.

Subsequently, Ms. Tremblay would sell her remaining 50% of Opco shares to Gesco in two transactions of 25% each, both payable by a promissory note equal to the FMV of the shares—in our example, $2.5 million per transaction. Ms. Tremblay would then be deemed to have received two dividends of $2.5 million each. The first would be designated as a capital dividend by Gesco and would therefore be tax-free for Ms. Tremblay. The second would be designated as an ordinary (non-eligible) dividend, resulting in total income taxes of approximately $1.18 million for Ms. Tremblay.

The designation of the second dividend as an ordinary dividend would result in a refundable dividend tax on hand for Gesco of approximately $766,000.

Gesco, owning 100% of Opco shares having an adjusted cost base equal to their FMV, would sell them to a third party for a sum of $10 million, generating no additional capital gain within Gesco.

By using the tax mechanisms of a capital dividend account and a non-eligible refundable dividend tax on hand account, the sale of Opco shares would result in total income taxes of approximately $1.67 million, split between Ms. Tremblay and Gesco.

Ms. Tremblay would then be left with proceeds of $3.82 million after taxes, while Gesco would be left with $4.51 million after taxes.

Given that Ms.Tremblay would keep funds within Gesco, she would be able to defer the time at which she would be taxed on them, that is, when Gesco would pay her a dividend. In the meantime, she could make investments through Gesco.

This type of planning would result in a tax deferral of almost 38% of the income taxes that, without prior planning, would have been payable on the sale of the shares.

Our taxation team will be happy to answer all your questions and advise you on the most appropriate tax planning for your business.

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