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Buying or Selling a Business?

Consider the Tax Elections

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Throughout the COVID-19 pandemic, it seems that the world has slowed down to the point where every decision we make is viewed as one that shapes the future. As businesses either struggle to remain afloat, or crumble from the immense amount of financial pressure, one aspect remains constant: mergers and acquisitions continue to take place.

As some industries begin to recover from the financial hardship that the pandemic has brought on, mergers and acquisitions may prove a useful tool for businesses to ensure survival. While there are many moving parts in negotiating a deal to buy or sell a business, tax elections that may be beneficial to both parties are certainly worthy of consideration. Below we briefly discuss some of the key tax election forms that should be considered when there is a purchase and sale involving business assets. It should be noted that many of these elections may not be applicable where a business' shares are being sold.

1. GST/HST

One of the key election forms is relating to GST/HST. Under section 167 of the Excise Tax Act, a joint election between the vendor and purchaser can be made so that the transfer of business assets takes place on a tax-free basis. The election form relieves the vendor from being required to collect and remit GST/HST on the sale of certain assets of the business.

Similarly, the purchaser would not need to pay nor need to claim GST/HST input tax credits on the purchase of these assets. Certain conditions will need to be met to ensure eligibility for the election. The joint election requires Form GST44, *GST/HST Election Concerning the Acquisition of a Business or Part of a Business*, to be completed and signed by both parties and filed with the Canada Revenue Agency ("CRA") on a timely basis.

2. Accounts Receivable

Typically, accounts receivable is an asset that is treated on account of income. However, on the sale of accounts receivable, the asset may be treated as a capital asset. This would result in a disadvantage to the seller as any bad debt allowances claimed will need to be included in income on the sale, and any realized loss on the sale of the accounts receivable would be considered a capital loss, only 50 per cent of which would be deductible and only against capital gains. The purchaser would also be at a disadvantage

as it would not be able claim any bad debt allowances against the accounts receivable as it did not carry on the business that gave rise to the accounts receivable purchased. A joint election under section 22 of the *Income Tax Act* may be available to relieve both parties of these unwarranted tax consequences. The election requires Form T2022, *Election in Respect of the Sale of Debts Receivable*, to be completed and signed by both parties, and two copies will need to be filed with the CRA on a timely basis.

3. Future Obligations

Not all sale transactions involve the assumption of future obligations by the purchaser, however, a beneficial election to both parties may be available if compensation is provided by the vendor to the purchaser (i.e., in the form of a reduced total purchase price of the business) for the future obligation taken on by the purchaser. A common future obligation is unearned revenue (i.e., an obligation to perform services or deliver goods to customers in the future for which the vendor has already received payment up-front

from its customers). A valid joint election under subsection 20(24) of the *Income Tax Act* allows the vendor to deduct the amount paid to the purchaser for taking on the future obligation, effectively offsetting the income that the vendor was required to include for the upfront cash received from its customers. On the purchaser side, although the purchaser would need to include this amount in income, it may be able to claim an annual reserve against this income for services not provided or goods not delivered at year-end. Further, the purchaser would be able to deduct expenses incurred to service the obligation. Although there is no prescribed form for this election, it must be agreed upon by both parties by way of a letter and filed with the CRA on a timely basis.

4. Restrictive Covenants

Some deals include restrictive covenants such as non-compete agreements whereby the vendor is restricted from engaging in similar business activities in the future. This is beneficial to purchasers to protect the business that they are acquiring. Generally, there could be a value associated with these non-compete agreements, and on the sale of the business, the vendor

will be fully taxable on these proceeds as regular income (i.e., it will not be entitled to capital gain treatment). If no value is allocated to the non-compete agreement in the purchase and sale documents, the CRA has a right to allocate a value to the non-compete agreement as they see fit. If certain conditions are met, an election under section 56.4 of the *Income Tax Act* may be available to eliminate the CRA's right to allocate a value to the non-compete agreement. This could allow the vendor to maintain capital gains treatment on the sale of the business. Similar to the subsection 20(24) election, there is no prescribed form for this election and as a result, a letter providing detailed information must be signed by both parties and filed with the CRA on a timely basis.

Conclusion

As good practice, it may be beneficial to add clauses on these elections in the agreement of purchase and sale to ensure that both parties agree to each election that is to be filed. It may also be beneficial to have the election forms and letters prepared in advance of closing, so that all documents can be signed on the date of closing. This will also minimize the risk that any elections are filed late.

It is important to note that the above list of elections is not exhaustive; there may be additional elections available depending on the particulars of the transaction. In addition, the elections mentioned above only refer to required filings with the federal government. Some provinces such as Quebec and Alberta may require similar elections to be filed. Different forms may have to be completed and submitted to these provinces.

This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.

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