Canadian CBI Review

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Differences

- There are many differences between USA and Canada re tax, law, corporate structures, accounting, inventory valuation, market value of businesses, reporting requirements, financing available, licensing requirements, the role of lawyers, etc.
- We shall review some of these issues in this presentation.

Market Value of a Business

- Canadian businesses generally sell for less than the equivalent USA business
  - Smaller market of potential buyers
  - Access to capital to finance the purchase is more limited. No SBA in Canada
  - Income taxes, corporate and personal, in Canada are higher than in the USA
  - Canadians are not as entrepreneurial as Americans

Corporate Structures

- We do not have S-Corps in Canada
- We do have a Sole Proprietor –profits are taxed to the individual
- Partnership – Not taxed but profits are allocated to the partners and taxed to the individuals
- Corporation-Taxed Directly
- REIT or Trust –Flow through and not taxed

Lifetime Capital Tax Exemption

- Available on the sale of shares in an Qualified Small Business Canadian corporation
- Currently $800,000+ per person
- To qualify the seller must have held ownership for 24 months, over the past 24 months 50% of the assets of the corporation must have been actively used in its operation (active business assets), at time of disposition 90% of assets must be active business assets

Lifetime Capital Tax Exemption

- What are not Active Business Assets
  - Real Estate that is leased to others
  - Investments in stocks, bonds, etc.
  - Cash that is surplus to the companies operating needs

What are Active Business Assets

Prepaid expenses, inventory, goodwill, receivables, furniture, fixtures and equipment used by the business, real estate used in the business, cash required to operate the business, etc.

Accounting

- Cash accounting is not legal in Canada only accrual accounting
  - This causes many small businesses to pay HST, QST, GST, Etc. on money they have not received and may increase the need for working capital.
  - It also causes us to pay income tax on profits which may not be real and CCRA can disallow bad debt write offs unless you can prove that you used every legal measure to collect.

The only inventory system acceptable in Canada is First In First Out however many of our clients use WIFL

Dividends

- Paid to share holders – must pay the proportionate amount based upon share holding
- Taxed at a lower rate than salaries received because the Corporation has already paid corporate tax on the profit and dividend payments are not tax deductible to the corporation. The personal tax on dividends received above a threshold are taxed at a rate which, combined with the corporate tax, is roughly equivalent to tax on personal income.

Dividends

- There is no tax on dividends paid to a holding company that owns the corporation.
- This can be used as a strategy in purifying a company as can paying dividends which are below the threshold to shareholders. Current threshold is around $30,000

Purifying A Company

- Purifying usually includes stripping out the personal (non operating) assets prior to a sale of the company
- It usually includes steps to ensure the company is a Qualified Small Canadian Corporation – This may include removing cash by paying down liabilities, paying dividends, paying salaries to owner managers, investing in active business assets, paying into IPP's or RCA's for the owner managers in order to remove cash without causing taxation.

Tax Deductible Expenses

- To be tax deductible an expense must
  - Be paid in order to earn income
  - Be reasonable in nature
  - Must be an operating (not Capital) expense
  - Interest, Fees, and Penalties paid to CRA are not tax deductible.

Tax on a sale of a Business

- There are 2 types of sale transactions
  - An **asset sale** where all of the tangible and intangible assets of the company are sold by the company. The corporation is still owned by the shareholders and tax is applicable to the corporation that sold the assets based upon the recapture of depreciation on the assets and the capital gain. The shareholders still have their money inside the corporation and it may be taxable when they try to remove it for their personal use. The cost base of each type of asset is required to calculate the recapture and the total cost base is required to calculate the capital gain or loss. Losses carry forward are also used in calculating the tax payable so this is a complex calculation.

Tax on a sale of a Business

- The second type is a **Share Sale** where the shareholders sell the shares of the existing corporation. This is favoured in Canada as it allows the seller to take advantage of the Lifetime Capital Gain Tax Exemption. There is no corporate tax calculation as the money went to the shareholders and if they use the LCGTE they may not be taxable. Many owners use a family trust as the owner of the shares so they can take advantage of multiple LCGTE`s eg. Spouse and 3 children plus owner means the gain could be $4M and no tax.

Share Sale VS Asset Sale

- Purchasers prefer an asset purchase as they will not be responsible for many of the corporations liabilities eg. law suites, audits and tax reassessment, environmental liabilities, etc.
- Sellers prefer a share sale as they may pay less or no tax and the calculations are easier
- A balance can be struck in many cases where a significant Vendor financing with a right of offset can mitigate the purchasers risk with a share purchase. Share purchases are not eligible for financing through the Canada Small Business Financing Program.

Capital Cost Allowance

- This is a tax deduction allowed per year to a business based upon the loss in value of capital assets due to wear and tear or obsolescence. – Depreciation
- When doing an asset sale the purchase price is allocated based upon the fair market value of the assets with the remainder attributed to Goodwill.
- This causes the tax on recapture of depreciation to the seller but allows the purchaser to record the assets at fair market value and depreciate them again. The goodwill is treated as a capital asset and becomes eligible capital property and is depreciated as well.

Asset Vs Share Sale

- Advantages to the vendor are generally disadvantages to the purchaser and visa versa
- In Canada the advantages of a share transaction often outweigh the risks
- In the USA this is not the case and most transactions are asset sales.
- Other considerations would include license transfers or assumptions, reliability of the companies past tax returns, etc.

Tax System

- Canada has a progressive tax system for individuals where the higher your taxable income the higher the tax rate
- We have a tiered system for businesses where the tax rate is fixed for large businesses and small businesses pay a lower rate on their income. It is progressive in this manner.

Share and Asset Sale

- When selling a business the purchase price and valuation is generally based upon the value of the entire business as that is what we are selling.
- The price can and generally does take into consideration the tax impact on the purchaser and seller but it is based upon the entire business hence we can use the HST/GST/QST exemption so that tax does not go round in a circle.
- A sale of less than the entire business may trigger HST, GST, QST, etc. Most sales trigger federal and provincial income tax.

Capital Dividend Account

- A notational account that tracks tax free amounts for income tax purposes and allows these to be passed to shareholders as tax free dividends. The purpose is to integrate tax so a shareholder would not pay more tax than if the benefit was received directly. Eg. A life insurance payment.
- The account does not appear on the books of the company and is complex to calculate.
- A CDA tracks non-taxable portion of gains realized by the corporation on the disposition of capital property as well as tracking capital gains.

Keeping the real estate

- This is a common objective of sellers however they want a share sale to take advantage of the LCGE. How do you remove the real estate?
  - Purchase the real estate personally from the company
  - Dividend the real estate to a hold co. –tax free
  - If time permits do a butterfly

Keeping A Piece

- Can the seller retain a piece of the company or give it to a key employee when selling
  - Yes, but there may be tax implications
    - A more common approach is to sell the company and be part of the purchasing group if the goal is to keep a piece.

Dealing with HR Issues

- Provincial labour laws dictate how termination or severance is handled in an asset sale
- Share sales do not require severance as the employees are retained by the corporation. Only the ownership of the shares has changed
- Termination of employees requires notice and severance is generally optional
- Asset sales generally require termination and rehiring

Financing the Deal

- Canadian Banks generally do not lend money to purchase a business
  - Exception is the Canada small business financing program. Must be an asset purchase. Limited to $350,000 and must be not more than 90% of the value of FF&E. If real estate is included can go to $1,000,000. For restaurants limit is $250,000 and 60% of FF&E if purchased by an experienced buyer

Financing the Deal

- Business Development Bank will lend money to purchase a business – sometimes. Approval rate last year was 14% however new policies that came into effect last June are making them more aggressive, and less expensive.
- BDC provides business consultancy and will finance the fees.
- BDC will finance land and buildings, equipment, working capital, etc. however they do not provide Lines of credit

Risk to Buyer

- Canadians are generally not as litigious as the USA so very few disagreements end up in court. Seller financing with a right of offset also helps to reduce risk to the buyer. The offset is against hidden or unknown liabilities and against misrepresentation.
- This, combined with the Life Time Capital Gains Exemption results in a higher level of share sales.

Entities

- Partnerships and sole proprietorships are not taxable entities – profits flow through and are taxed in the hands of the owner or partners.
- A Canadian controlled private corporation is not controlled by non-residents and is not a public corporation.
- Corporations do not pay Personal Income tax but may pay payroll tax, property tax, corporate income tax, sales tax, etc.

Licensing

- Some provinces require real estate licenses to sell businesses and all require a license to sell real estate.
- Benefits of being licensed
  - The brokerage Trust Fund is insured by Province
  - Mandatory training insures understanding of agency law and contract law
  - Ability to sell real estate
  - Mandatory insurance re errors and omissions is provided through the real estate association

Licensing

INTERNATIONAL BUSINESS BROKERS ASSOCIATION, INC.®

- Real estate license does not allow us to sell less than control of a corporation. Must have a securities license.
- Periodic inspections and audits ensure that clients money is protected from misuse.
- Licensing process eliminates some people with previous fraud, license abuse, and various criminal or anti-social behaviors.

Summary

- The differences between the USA and Canada that affects business brokerage are significant and Canadian Business Brokers need to be aware and knowledgeable.
- You are not accountants, lawyers, or wealth planners – Use the professional advisors in your community who are good at what they do but be sufficiently aware to alert clients to the need for professional help

Exam

- Read the questions diligently.
- Good luck to you.