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Price-Related Terms in Agreements for the Purchase and Sale of a Business

par

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SOMMAIRE

Dans le présent travail, l'auteur effectue un examen approfondi des conséquences fiscales découlant de certaines clauses commerciales liées au prix, couramment incluses dans des conventions d'achat et de vente d'entreprises.

La première partie discute de la répartition du prix entre les divers actifs dans une vente d'actifs. Une attention particulière est portée sur la possibilité que l'Agence du revenu du Canada puisse, suite à l'application de l'article 68 de la Loi de l'impôt sur le revenu, rétablir une nouvelle répartition du prix entre les actifs. L'auteur fait l'analyse de l'état actuel de la jurisprudence sur cette disposition.

La deuxième partie discute du report de paiement d'une portion du prix afin de garantir les obligations d'indemnisations du vendeur envers l'acheteur. L'auteur fait la comparaison entre les deux modalités de la clause, soit, le «holdback» et l'«escrow», le tout à la lumière de leurs conséquences fiscales.

Finalement, à la dernière partie, l'auteur discute des conséquences fiscales qui découlent des clauses de capacité de gain (soit normale ou renversé), où le prix final est déterminé quelques années après la vente afin d'éviter des difficultés quant à l'évaluation de la valeur de l'achalandage.

Chaque partie commence avec une explication de la nature de la clause en question, son but commercial et ses conséquences légales. Ensuite, l'auteur analyse les conséquences fiscales de la clause pour le vendeur et l'acheteur en soulignant comment ses conséquences peuvent varier en fonction de la structure de la clause.

À noter que le présent travail présume que l'entreprise cible est exploitée au Canada et que la transaction se fait entre des parties sans lien de dépendance.

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INTRODUCTION

There are many considerations to occupy a tax advisor in the context of the purchase and sale of a business: choosing an asset or share deal, safe income strips, use of the capital gains deduction, and acquisition of control issues, to name a few. In addition to handling these issues, the tax advisors are also usually called upon to review the purchase and sale agreement. This task may be given short shrift in light of the prior preoccupations. However, a tax advisor who overlooks it does so at his (and his client's) own peril. Numerous terms that are common in purchase and sale agreements can have significant and often unexpected tax consequences.

This paper addresses the tax implications for the purchaser and vendor of some of these common terms; specifically, it focuses on several terms that relate to the price. Part 1 addresses the allocation of the price to the various assets being sold in an asset deal. Part 2 addresses the deferral of the payment of a portion of the price to secure the indemnification obligations of the vendor—in the form of so-called "holdback" or "escrow" arrangements. Finally, Part 3 addresses earn out mechanisms, under which the final price is only determined after the closing of the deal because of uncertainties in the valuation of goodwill.

Each part begins with an introduction to the particular term, including an explanation of its commercial function and the legal substance of the rights and obligations that it creates. The sections that follow explore the tax implications of the term and illustrate how these implications will vary depending on how it is formulated. Last, the paper offers recommendations for parties contemplating such a term. Note that this paper assumes that the target business is carried on in Canada and that transaction is between private parties dealing at arm's length.

PART 1. ALLOCATION OF THE PRICE IN AN ASSET DEAL

1.1. NATURE OF THE TERM

1.1.1. Generally

When parties negotiate the purchase and sale of a business one of the main considerations is whether to structure the transaction as an asset deal or a share deal.[1] Regardless of the structure that is chosen, the purchaser and vendor normally negotiate a global price for the business. Nevertheless, the actual legal nature of an asset deal is the combined sale of all of the individual assets that together comprise the business. In such a situation, it is therefore necessary for the parties to allocate a portion of the global price to each asset being transferred, such that the entire price is accounted for.

The parties normally negotiate how the price is to be allocated and indicate this allocation in their agreement.[2] The allocation serves multiple purposes. It is used to report the transaction for accounting purposes.[3] It also generally determines the tax consequences for the parties—specifically, it is used to calculate the vendor's income resulting from the sale, as well as to calculate the purchaser's cost base in the assets. Often, the parties also include a covenant in their agreement whereby each obligates itself to prepare its income tax returns on the basis of the agreed-upon allocation.[4] The reason for such a covenant lies in section 68 of the Income Tax Act,[5] which in certain situations empowers the Canada Revenue Agency (CRA) to reallocate the

[1] Generally speaking, the vendor prefers a share deal while the purchaser prefers an asset deal. For a discussion of the considerations affecting the choice of deal structure, see P. Robert Arkin, "Purchase and Sale of a Business – Selected Tax and Legal Considerations," in *2011 Atlantic Provinces Tax Conference* (Halifax: Canadian Tax Foundation, 2011), 2A:1-35 at 1; Marc-André Bélanger, "Preclosing: considérations techniques en pratique," in *Colloque # 185 – Achat/vente et fusion d'entreprises* (Montréal, Association de planification fiscale et financière, 2009), at 1; Vern Krishna, *The Fundamentals of Income Tax Law*, 9th ed. (Toronto: Carswell, 2006), at 1274; and Bill Vienneau, "Purchase and Sale of a Business," in *2011 Atlantic Provinces Tax Conference* (Halifax: Canadian Tax Foundation, 2011), 2B:1-33 at 1. Please note that all pinpoint references to Canadian Tax Foundation publications are based on the pagination in TaxFind Online (www.ctf.ca); all pinpoint references to Association de planification fiscale et financière publications are to section numbers.
[2] See Arkin, supra note 1, at 11.
[3] See Bélanger, supra note 1, at 2.2.
[4] See Blair P. Dwyer, "Allocation of Purchase Price and Transalta," in *2011 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 2011), 9A:1-14 at 1.
[5] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

price among the assets for the purpose of determining the tax consequences to both parties. Where the purchaser and vendor file inconsistent returns, the CRA is more likely to proceed with such a reallocation.[6] In doing so, they might impose an agreed-upon allocation on the party that did not file on that basis, or they might impose a different allocation on both parties. By filing consistent returns, the parties thus increase the chances that their allocation will stand.

1.1.2. Divergent Interests of the Purchaser and Vendor

The parties normally have divergent interests as to the allocation. Several types of property are sold in a normal asset deal, including inventory, depreciable property, capital property, and eligible capital property (ECP). The tax consequences that a given amount of the price will cause for each party will therefore differ depending upon the type of asset to which that amount is allocated. Moreover, an allocation that is advantageous for one party is generally disadvantageous for the other. Accordingly, each party usually negotiates for the allocation that would benefit it.

The vendor's goal in the allocation is to minimize its income resulting from the sale. To accomplish this, it will seek to maximize those receipts that are included in income at a preferential 50% rate and to minimize those receipts that are included at a 100% rate. The way to do this is generally to allocate the highest amount possible to non-depreciable capital property and ECP.[7] The purchaser's goal is to maximize both the amount of the deductions that it will be entitled to take on the purchased assets, as well as the value of those deductions. It will therefore seek to maximize its cost base in whatever property will generate the fastest deductions,

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[6] See McCarthy Tétrault, "68 – Apportionment of Proceeds of Disposition," in *Canada Tax Service*, last updated May 31, 2012, available on *Taxnet.Pro* (Toronto: Carswell) (online database).

[7] See Jack Bernstein, "Valuation and Related Tax Issues, Part 1," in *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 1-31 at 10; see also Krishna, supra note 1, at 1279.

generally by allocating as much as possible to inventory and rapidly depreciable property.[8] The allocation process is thus a zero-sum game, with one party's gain being the other's loss.

That said, the allocation negotiations are not always contentious. In particular, it may be easy to reach an agreement where one of the parties is in a non-taxable position. A party is in a non-taxable position where it has a surplus of tax shelter available to it, in the form of accumulated losses, available deductions or credits, or other similar tax attributes. That party should be more or less indifferent regarding the allocation, because it will not suffer the negative consequences of an unfavourable allocation as much. If the vendor has tax shelter, then it has less need to minimize its income on the sale, because the shelter can be used to at least partially offset the income.[9] Likewise, a purchaser with tax shelter has less need to obtain faster deductions, since present deductions are already available. The extent of a party's indifference will depend upon the amount of shelter that it has. Needless to say, an indifferent party might be willing to accept an allocation that favours the other party, in exchange for some other consideration.

1.1.3. Allocations between Goodwill and Depreciable Property

Allocating an amount of the price alternatively to either goodwill or depreciable property is a common way to provide a tax benefit to either the vendor or purchaser.[10] For accounting purposes, goodwill is valued in an asset deal as the balance of the overall price that remains after all the other assets have been valued.[11] This is known as the residual valuation method. As a

[8] See supra note 7. A faster deduction is better than a slower deduction because it allows for tax to be deferred from a present taxation year to a future one. In other words: "tax deferred is tax saved." See Peter W. Hogg, Joanne E. Magee and Jinyan Li, *Principles of Canadian Income Tax Law*, 7th ed. (Toronto: Carswell, 2010), at 26.

[9] See Arkin, supra note, 1 at 11. Note that if the vendor is a corporation that will not carry on activities following the sale, then this will be its last opportunity to use such shelter.

[10] There is a lot of case law involving CRA challenges to allocations between goodwill and depreciable property. For a list of cases, see McCarthy Tétrault, "68 – Apportionment of Proceeds of Disposition," supra note 6.

[11] See Canadian Institute of Chartered Accountants, *CICA Handbook – Accounting* (Toronto: CICA, 2012), at 1582.34.

result of this method, the parties are always faced with the decision of whether a given amount of price should be allocated to goodwill or to other assets. Allocating an amount to goodwill usually reduces the vendor's recapture on depreciable property and results in a receipt that is included in income at a 50% rate.[12] By contrast, allocating the amount to depreciable property usually allows the purchaser to depreciate this amount faster.[13]

Faced with this option, the parties might often be inclined to allocate more value to goodwill. The vendor and purchaser negotiate the shape of the deal holistically. Within this process, the purchaser might concede a larger allocation to goodwill in order to get the vendor to agree to accept an asset deal over a share deal in the first place.[14]

1.2. POTENTIAL REALLOCATION UNDER SECTION 68

The CRA can apply section 68 to reallocate the price even where the parties file consistent returns.[15] In such a situation, the reallocation would affect both parties.[16] The possibility that the CRA might attempt to apply section 68 and their likelihood of success in doing so should be considered when negotiating the allocation.

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[12] The goodwill of a business qualifies as ECP. The sale price of goodwill is therefore an eligible capital amount (ECA) under element E in the definition "cumulative eligible capital" (CEC) in subsection 14(5). See *Interpretation Bulletin* IT-386R, "Eligible Capital Amounts," October 30, 1992, at paras. 1-2. The net result of an ECA is generally a 50% inclusion under subsection 14(1), which qualifies as business income. The actual amount of the inclusion will depend on the balance in the vendor's CEC. Also, note that if the vendor was depreciating its CEC it will have recapture included at 100% up to the amount of depreciation taken.

[13] The purchase price of goodwill qualifies as an eligible capital expenditure (ECE), as defined in subsection 14(5). See *Interpretation Bulletin* IT-143R3, "Meaning of Eligible Capital Expenditure," August 29, 2002, at paras. 6-7. 75% of an ECE is included under element A in the purchaser's CEC and can therefore be depreciated at an annual rate of 7% under paragraph 20(1)(b). This results in an effective deprecation rate of 5.25% on the actual cost of goodwill, which is less than the rate for many classes of depreciable property. See Dwyer, supra note 4, at 10.

[14] The purchaser prefers an asset deal because it generally allows for more depreciation. The purchaser will pay fair market value (FMV) for the assets regardless of the deal structure. An asset deal allows it to step up its cost basis in the assets to at least partially reflect the excess of their FMV over the vendor's undepreciated cost in them. A higher cost basis means more depreciation. See Leonard Glass, "Sale of a Business – Purchaser and Vendor Issues," in *1999 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 1999), 7:1-50 at 23; see also Bélanger, supra note 1, at 1.5.

[15] See *Interpretation Bulletin* IT-220R2, "Capital Cost Allowance – Proceeds of Disposition of Depreciable Property," May 25, 1990, at para. 5.

[16] See paragraph 68(a).

1.2.1. Leading Case—The *Transalta* Decision

The decision of the Federal Court of Appeal (FCA) in *Transalta Corporation v. R*[17] is the new leading case on section 68. The following sections explore how the provision should apply in light of this decision: section 1.2.2 addresses when section 68 applies generally; section 1.2.3 addresses when section 68 applies to an allocation to goodwill. The analysis also compares the current state of the law to the situation that existed prior. The FCA decision systematizes the approach to section 68 while largely maintaining continuity with the previous case law. It thus provides comfort, particularly when compared to the Tax Court of Canada (TCC) decision.[18] Some commentators were "surprised" by the first instance decision, while others opined that it "challenge[d] the conventional wisdom" regarding section 68.[19] By contrast, the FCA decision assuages the concerns of the tax community.

The facts in *Transalta* were as follows: Transalta Energy Corporation sold its electricity-transmission business to AltaLink Limited Partnership following an auction. In approximate figures, the global price of $818,000,000 was allocated $628,000,000 to current and fixed assets and $190,000,000 to goodwill. The business operated in a regulated industry. The regulations determined the rates that the business was able to charge for its services as a function of the net book value of its assets. In other words, the earnings of the business were effectively fixed as a percentage of the value of its assets. Despite this, Altalink—like the other bidders in the auction—was willing to pay a purchase price in excess of the net book value of the company's assets. At first instance, the TCC reallocated $50,000,000 from goodwill to fixed assets. The FCA

[17] 2012 FCA 20 (herein referred to as "*Transalta FCA*"). The decision was released on January 20, 2012.
[18] 2010 TCC 375 (herein referred to as "*Transalta TCC*").
[19] See Dwyer, supra note 4, at 1; and see Robin MacKnight, "Drafting Commercial Agreements: Everything Old is New Again," (2010) 10:4 *Tax for the Owner Manager*, 4-7 at 1, respectively.

overturned the TCC decision and reinstated the allocation of $190,000,000 to goodwill.[20]

1.2.2. Application of Section 68 Generally

1.2.2.1. The Unreasonableness Test

The condition that must be met in order for section 68 to apply to a taxpayer's allocation is that that allocation must have been unreasonable. The perspective to assume when making this determination is that of the reasonable business person. The test is to ask "if a reasonable business person, with business considerations in mind, would have allocated that amount to that particular property." The business considerations taken into account in answering this question include industry practices, and auditing and valuation standards and practices.[21]

Another factor that is taken into account is how the taxpayer came to its allocation. In particular, the fact that the allocation was agreed upon between the parties to the transaction while dealing at arm's length is an important factor attesting to its reasonableness. The weight given to this factor depends upon whether the parties had divergent interests: if they had divergent interests, the fact of their agreement is given considerable weight; if they did not have divergent interests, then it is given less weight.[22]

Applying this test to the facts before them, the FCA held that the parties' allocation was reasonable, on the basis that it fell within the standard regulatory and industry practice. They reached this conclusion despite finding that the parties did not have divergent interests in negotiating their allocation. There was no divergence because the purchaser's depreciation rate would not have been faster had the parties allocated a greater amount to depreciable property

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[20] See *Transalta FCA*, supra note 17, at paras. 10-50.
[21] Ibid., at para. 75. Note that the court adopted this test from the earlier decision in *Gabco v. MNR*, 68 DTC 5210 (Can Ex Ct), which articulated it in a different context.
[22] See *Transalta FCA,* supra note 17, at paras. 76-77.

instead of goodwill.[23]

This approach to evaluating reasonableness differs considerably from the reasoning in the TCC decision. The TCC's approach would have required that one of four separate analyses of reasonableness be performed, depending on the circumstances surrounding the particular allocation. Moreover, where an allocation was negotiated between arm's length parties who engaged in "hard bargaining" its reasonableness would have been presumed and an analysis would not even have been performed.[24] By contrast, the FCA's approach is far simpler and more straightforward. It implements a single, unified analysis of reasonableness that applies in all circumstances. Furthermore, it generally reaffirms the approach to section 68 developed prior to *Transalta*. Historically, hard bargaining between arm's length parties would not automatically result in a finding that their allocation was reasonable. Rather, this was merely evidence supporting a finding of reasonableness.[25]

One change that arguably does result from the FCA decision is that the actual bargaining that occurred between the parties no longer seems to be a relevant factor. The decision does not refer to hard bargaining; instead, the factor that it focuses on is divergent interests. As stated before, this essentially refers to whether each party had a tax benefit to gain or lose in the allocation and thus had the incentive to bargain for an allocation in its favour. Thus, the analysis is reoriented towards considering how a variation in the allocation would have affected the tax consequences of the transaction for each party. This change is probably for the better, since it avoids the requirement that the taxpayer submit detailed evidence regarding how the negotiation process unfolded, which would have added considerable cost and complexity to section 68

[23] Ibid., at paras. 80-82.
[24] See *Transalta TCC*, supra note 18, at para. 47.
[25] See *Leclerc v. R*, 79 DTC 5440 (FCTD), at para. 7.

disputes.[26]

Prior to *Transalta*, the CRA's administrative position regarding section 68 emphasized the importance of whether the parties dealt at arm's length and whether they engaged in hard bargaining.[27] Most commentators understood this to mean that such factors would reduce the likelihood that the CRA would seek to challenge such an allocation.[28] Post-*Transalta*, taxpayers can probably still rely on this to be the case, albeit with the substitution of divergent interests for hard bargaining. That the CRA chose to challenge the parties' allocation in *Transalta* should not be taken to signal an increased inclination to challenge allocations generally. The facts of *Transalta* were exceptional, and, as addressed in section 1.2.3 below, the dispute essentially related to a disagreement regarding the legal concept of goodwill.

1.2.2.2. Conclusion and Recommendations

The conclusion following *Transalta* is that, while parties may have tax considerations in mind when negotiating the allocation of the price in an asset deal, the reasonableness of their allocation will be analyzed from a purely business perspective. Where their allocation falls within a range that reflects commercial practice and respects the particulars of the industry in which the target business operates, it should ultimately be regarded as reasonable. Moreover, even where the allocation pushes the limits of commercial practice, if the parties have divergent interests it will take some particular and convincing factor to result in a finding of unreasonableness. Therefore, parties should be able to manipulate their allocation to some extent in order to provide a tax benefit to one of them, as long as the other party is truly making a

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[26] Evidence would have been required regarding "[the] parties' positions, importance to the deal, nature of the issue, magnitude of dispute, nature of negotiations, time spent, etc." See *Transalta TCC*, supra note 18, at para. 52.
[27] See IT-220R2, supra note 15, at paras. 4-7; see also IT-143R3, supra note 13, at para. 7.
[28] See Arkin, supra note 1, at 10; Bélanger, supra note 1, at 2.9.5; Bernstein, supra note 7, at 11; and Krishna, supra note 1, at 1279.

concession in doing so. Tax practitioners should advise their clients accordingly.

1.2.3. Application of Section 68 in the Context of Goodwill

The CRA has demonstrated sensitivity to perceived unreasonable allocations to goodwill, because of the ease of manipulating such an allocation to provide a tax benefit to one of the parties.[29] In *Transalta*, they argued that the parties allocated too much to goodwill. The FCA decision lays out the reasoning process for evaluating the reasonableness of an allocation to goodwill. The following sections analyze this reasoning process: section 1.2.3.1 addresses the legal concept of goodwill; section 1.2.3.2 addresses the valuation of goodwill for tax purposes.

1.2.3.1. Legal Concept of Goodwill

An allocation of an amount to goodwill can only be reasonable where goodwill is one of the assets that was sold. Accordingly, the first step in the analysis is to determine whether the target business had any goodwill to sell, and whether it was in fact sold to the purchaser. In *Transalta*, the FCA noted that goodwill is amorphous and that it varies from business to business; in light of this, the court eschewed any attempt to define goodwill. Instead, it developed a test to identify goodwill by observing its characteristic attributes. Under this test, a particular aspect of a business constitutes goodwill if it exhibits the following three attributes:

> (a) goodwill must be an unidentified intangible as opposed to a tangible asset or an identified intangible such as a brand name, a patent or a franchise; (b) it must arise from the expectation of future earnings, returns or other benefits in excess of what would be expected in a comparable business; (c) it must be inseparable from the business to which it belongs and cannot normally be sold apart from the sale of the business as a going concern.[30]

Applying this test to the facts before them, the FCA concluded that Transalta had sold goodwill. The Minister asserted that it did not have any goodwill to sell, and that since its earnings were

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[29] See supra note 10.

[30] See *Transalta FCA*, supra note 17, at paras. 53-54. Note that the court adapted this test from observations made by John W. Durnford in his article "Goodwill in the Law of Income Tax" (1981) 29:6 *Canadian Tax Journal* 759.

basically predetermined as a function of its other assets these were the only things of value that it owned.[31] The court disagreed, identifying numerous aspects of the business that fell within the ambit of goodwill.

The first and third attributes are fairly straightforward. The first attribute simply distinguishes goodwill from other intangibles. The third attribute asserts that it can only be transferred in the sale of the business as a going concern. Accordingly, the sale of all—or mostly all—of the assets should be necessary to transfer goodwill, while a sale of certain specific assets alone should not suffice.

The crux of the legal concept of goodwill resides in its second attribute. By analyzing this attribute and how the FCA applied it it is possible to extrapolate some general notions about what aspects of a business can potentially comprise goodwill. The key is to understand that goodwill relates to an expectation that the business will generate above-average future "earnings", "returns" or "other benefits". The class of factors that can comprise goodwill is thus made up of things that could potentially cause one of these three results.

First, consider the notion of earnings. Earning generally refer to the revenue of a business. Thus, aspects of a business that could give rise to above-average sales can constitute goodwill. This would include the traditional elements of goodwill, such as reputation and customer satisfaction.[32]

Second, consider the notion of returns. Given the way it was applied by the FCA, the notion of returns seems to refer to the shareholder's return on equity. This allows for a wide range of elements to fall within the notion of goodwill. Anything that could result in above-average profit for a business can qualify as goodwill. In particular, this would include anything

[31] See *Transalta TCC*, supra note 18, at para. 35.
[32] See *Transalta FCA*, supra note 17, at para. 55. The traditional conception of goodwill essentially equated it with customer base. See *Muller & Co.'s Margarine v. IRC*, [1901] AC 217 (UKHL).

that could reduce expenses below the level of a comparable business. Thus, efficient management, efficient employees, and cost-control mechanisms can all constitute goodwill.[33] Moreover, something that would not increase profits but that could nevertheless still result in an above-average return on equity can also qualify as goodwill. For example, the capacity to obtain debt financing to leverage the shareholder's equity investment and in so doing increase its return can constitute goodwill.[34] Third, and finally, the notion of "other benefits" would seem to import some flexibility into the test and allow for the identification of new goodwill elements as they arise.

An important feature of this conception of goodwill is that it involves an expectation about how the business will perform *in the future*. It follows that some aspect of the business that exhibits some future potential can qualify as goodwill even where this potential is not being realized at present by the current owner of the business. For example, possible new business opportunities can comprise goodwill.[35]

A future potential can even comprise goodwill for the current owner of the business where the current owner would himself be unable to realize upon it. In the FCA decision, the capacity for leverage was an example of this phenomenon. It was considered to be goodwill belonging to the vendor as "an intangible asset which can be marketed and sold to potential purchasers of a business who have the ability to use it."[36] In this respect, the legal concept of goodwill arguably departs from the accounting concept. To qualify as goodwill for accounting purposes, something must first also qualify as an asset. A thing only qualifies as an asset where

[33] See *Transalta FCA,* supra note 17, at para. 55.
[34] Ibid., at para. 63.
[35] Ibid., at para. 56.
[36] Ibid., at para. 62.

the business can control access to the benefit that it provides.[37] By contrast, for tax purposes, it seems that something can qualify as goodwill of a business for the vendor even where the ability to access the benefit rests only with the purchaser.

The FCA decision considerably expands and modernizes the notion of goodwill. The traditional conception of goodwill basically equated it with customer base.[38] The modern conception allows for many aspects of a business to qualify as goodwill. The court justified this evolution as a necessary response to developments that took place outside of the realm of taxation, in business, accounting, valuation and law.[39]

1.2.3.2. Valuation of Goodwill

Once it has been established that goodwill was actually sold, the reasonableness of the parties' allocation of price to it can be analyzed. This analysis must be based on the proper valuation method for goodwill. In *Transalta*, the FCA affirmed that the residual valuation method, i.e., the method used for accounting purposes, is also the correct method for tax purposes. Under this method, all the other assets of the business are first attributed a FMV, and any amount of the overall price that exceeds the aggregate FMV of these other assets is attributed to goodwill.[40] The residual method is thus an indirect method for measuring goodwill.

The affirmation of the residual method has an important and perhaps surprising implication for the determination of whether an allocation to goodwill is reasonable. Under this method, an amount of price should be allocated to goodwill wherever that amount does not reflect the FMV of some other particular asset of the business. It is entirely possible, therefore, that some premium that a purchaser is willing to pay for a business will be attributed to goodwill

[37] See *CICA Handbook*, supra note 11, at 1000.24-1000.27
[38] See supra note 32.
[39] See *Transalta FCA*, supra note 17, at para. 52.
[40] Ibid., at para. 69.

even though it results from some factor that would not fall within the legal concept of goodwill. The implication is that such an allocation, while perhaps not correct, should nonetheless be considered reasonable for the purposes of section 68. In the court's own words:

> The fact that some intangible elements that do not constitute "goodwill" in the legal sense may be captured through such a valuation method… does not mean that the valuation method is wrong or improper. The method simply reflects the fact that these types of intangibles should be treated as goodwill for all practical purposes – including accounting and taxation purposes – even though they may not squarely fall under the legal concept of goodwill.[41]

The FCA decision reversed the TCC decision regarding the proper approach to valuing goodwill. Under the TCC's approach, the parties would have first had to identify each specific element of the target business that constituted goodwill; they would have then had to determine the particular value of each of these elements and add these values up in order to calculate the overall value of goodwill.[42] The FCA adopted an indirect valuation method precisely because it considered that breaking goodwill up into its constituent parts in this manner would be improper.[43]

The FCA decision provides a great deal of comfort regarding the valuation of goodwill. For one thing, it closes the significant gulf opened up by the TCC decision between the tax analysis and commercial reality. Moreover, in doing so, it saves purchasers and vendors from the complex and potentially impossible task of identifying every aspect that went into the negotiation of the price, classifying these aspects in terms of the assets to which they relate, valuing them individually, and then attributing their value based on that classification.

1.2.3.3. Conclusion and Recommendations

Following *Transalta*, the analysis of whether an allocation of price to goodwill is reasonable should be a fairly straightforward exercise. First, one must determine whether the

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[41] Ibid., at para. 70.
[42] See *Transalta TCC*, supra note 18, at para. 56; see also MacKnight, supra note 19, at 3.
[43] See *Transalta FCA*, supra note 17, at para. 68.

target business actually had any goodwill to sell, and whether it actually did sell it. Given that the new legal concept of goodwill is broad, this should not be overly difficult to establish. Once these questions have been answered in the affirmative, the valuation of goodwill proceeds indirectly. First all the other assets of the business are valued, and then any residual price is allocated to goodwill. It is not necessary to establish that the value attributed to goodwill actually relates to something that falls within the legal concept of goodwill. Accordingly, as long as the parties can establish that the allocations of price to the other assets were reasonable, the allocation to goodwill should also be found to be reasonable.[44]

PART 2. DEFERRAL OF THE PAYMENT OF A PORTION OF THE PRICE AS SECURITY FOR THE INDEMNIFICATION OBLIGATIONS OF THE VENDOR

2.1. NATURE OF THE TERM GENERALLY

In the purchase and sale of a business, the main obligation of the vendor is to transfer ownership of the assets or shares and the main obligation of the purchaser is to pay the price. However, both parties also undertake other, ancillary obligations in their agreement. These are categorized into representations and warranties, on the one hand, and covenants, on the other hand. The first type involves a party obligating itself to the veracity of some fact either as of a given moment or on an ongoing basis. The second type involves a party undertaking either to do something or to refrain from doing something.

While both parties undertake ancillary obligations, those of the vendor are typically more important. The vendor's representations and warranties disclose to the purchaser all of the important information relating to the target business. This includes a detailed, comprehensive

[44] An evaluation of these other assets by professional valuators will bolster the argument that the allocation is reasonable. See Domenico Baruffaldi, "Bénéfices de fabrication et transformation: les principales conséquences fiscales découlant de l'achat ou de la vente d'une entreprise manufacturière au Québec," in *Congrès 1999* (Montréal, Association de planification fiscale et financière, 1999), at 3.1.

statement regarding the business' assets and liabilities; additionally, if the transaction is a share deal, there will be a statement pertaining to the valid constitution and good standing of the target corporation.[45] In terms of covenants, the vendor undertakes to provide the purchaser with access to the business' records before the sale for due diligence purposes, and it also undertakes to operate the business in the "ordinary course" between the moment the agreement is signed and the moment the deal closes, when the two are not contemporaneous. The vendor may also undertake post-closing covenants, such as a confidentiality covenant not to use or disclose information pertaining to the business after the sale or a non-competition covenant not to compete with the business for a period of time following the sale.[46]

If the vendor breaches any of these obligations it can have a significant negative impact upon the purchaser in terms of the value of the business it just purchased. Accordingly, the vendor also undertakes to indemnify the purchaser against loss occasioned by such a breach.[47] Normally, the purchaser's chance of recovering its indemnity would depend upon the solvency of the vendor. However, to better this chance, the purchaser usually insists upon using a portion of the price to secure the vendor's indemnification obligations. The security functions by limiting the vendor's access to the funds, keeping them apart and available to satisfy any indemnification claim. It persists for a number of years following the sale, often until a predetermined time when the purchaser is no longer likely to suffer a loss.[48]

There are two modes of structuring the security that differ in respect of who holds the funds during the indemnification period. The first is known as a "holdback" arrangement. The

[45] For a sample of common vendor representations, see American Bar Association, *Model Asset Purchase Agreement with Commentary* (Chicago: ABA, 2001), at 69-155.
[46] The proposed restrictive covenant rules in section 56.4 of the Act govern the tax treatment relating to such covenants. These rules are very complicated and an analysis of them is beyond the scope of this paper.
[47] See Arkin, supra note 1, at 12. Note that agreements commonly provide that an indemnification is to be treated as a downward adjustment of the price. The issue of whether this treatment should apply for tax purposes is again beyond the scope of this paper.
[48] Ibid., at 15.

second is known as an "escrow" arrangement. While the parties may prefer one type over the other for commercial reasons, they should also take the tax implications into accounts in choosing which structure to implement. Section 2.2 addresses the tax implications of holdbacks; while section 2.3 addresses the tax implications of escrows.

2.2. "HOLDBACK" OF A PORTION OF THE PURCHASE PRICE BY THE PURCHASER

In a holdback, the purchaser does not pay the full price to the vendor at closing. Instead, it pays one portion at this time, while retaining another portion to stand as the security. The purchaser remains obligated to pay this amount, however it only becomes due at the end of the indemnification period and then only to the extent that it exceeds the amount of indemnity claimed. The purchaser often issues a promissory note to the vendor in respect of the retained amount. Also, regardless of whether a note is issued, the parties usually stipulate that interest is to accrue in respect of this amount from closing until it is finally paid.

Holdbacks are problematic from the vendor's perspective. Normally, the vendor is certain of receiving the entire price, since it is paid at the same moment that the vendor transfers the assets or shares. Under a holdback, however, the vendor's chance of receiving the retained amount becomes dependent upon the continuing solvency of the purchaser after the sale, which in turn may depend upon the purchaser's successful operation of its new business. By contrast, a holdback may offer an advantage for the purchaser where it has trouble obtaining financing for the acquisition. Effectively, the vendor partially finances the acquisition by agreeing to a holdback.[49] The purchaser does not need to raise the funds necessary to pay the entire price at closing. Instead, it need only raise those funds due at closing, and it can use the returns generated by the business to eventually pay the retained amount.

[49] See Anne-Marie Dupras, "Structures d’acquisition," in *Colloque # 174 – Incidences fiscales des réorganisations corporatives* (Montréal, Association de planification fiscale et financière, 2008), at 2.2.

There are two principal tax implications of implementing a holdback. The first is the availability of reserves to allow the vendor to defer the tax on some of the income realized on the sale, addressed in section 2.2.1. The second is the tax treatment of the interest on the retained amount for both the vendor and purchaser, addressed in section 2.2.2.

2.2.1. Availability of Reserves for the Vendor

2.2.1.1. Share Deals — the Capital Gains Reserve

When the vendor sell shares with a holdback it realizes the capital gain in the taxation year in which the closing occurs. Under paragraph 39(1)(a), a capital gain is brought into account when the disposition of the property takes place. The disposition occurs at the moment when the vendor has the right to be paid the sale price, regardless of whether this right is immediately exigible.[50] It is the CRA's administrative position that where the purchaser retains a portion of the price to secure the indemnification obligations of the vendor, the vendor has the right to be paid the price as of the closing; the holdback is simply a term of payment, under which the right to be paid the retained amount does not become exigible until the end of the indemnification period.[51]

The proceeds of disposition used to calculate the capital gain in the year of sale is equal to the entire price, despite the fact that the vendor has not yet received the retained amount.[52] However, the vendor may nonetheless be able to defer the inclusion of a portion of the capital gain to subsequent taxation years. Specifically, in certain circumstances, a reserve may be deducted from the capital gain under subparagraph 40(1)(a)(iii) in respect of the retained amount. A reserve deducted in a given year must be reincluded in the subsequent year. This deferral

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[50] See *Interpretation Bulletin* IT-170R, "Sale of Property – When Included in Income Computation," August 25, 1980, at paras. 2-5.

[51] See CRA document no. 2000-0038005, October 6, 2000.

[52] Paragraph (a) in the definition "proceeds of disposition" in section 54 refers to "the sale price of property that has been sold." Thus, once the shares are sold the entire sale price is included in the proceeds of disposition, regardless of whether it has been received by the vendor.

mitigates the cash-flow issue that might be faced where the tax liability is crystallized before all the proceeds are received.[53] The vendor has the option of taking the reserve or not, although the deferral is generally desirable even where there is sufficient cash flow, unless tax shelter is available to offset the inclusion.

There are limitations upon the amount that the vendor can deduct as a reserve. First, the reserve is limited to a reasonable amount. The CRA's administrative position is that a reserve is reasonable where it does not exceed that amount of the capital gain that reflects the percentage of the overall proceeds of disposition payable after the end of the year.[54] That said, it is possible that a larger reserve may also be reasonable.[55] Second, a ceiling placed on the reserve results in the vendor being required to include at least 20% of the capital gain in the year of sale and in each subsequent year. Thus, the entire capital gain is recognized within five years of the sale.

Non-resident vendors cannot claim the reserve.[56] Thus, where a non-resident vendor is liable to tax on a share sale the entire capital gain is taxed in the year of sale. A non-resident is only liable to tax on capital gains realized on property that qualifies as taxable Canadian property (TCP).[57] Generally speaking, shares do not qualify as TCP unless more than 50% of the FMV of the corporation was derived from real or immovable property, Canadian resource properties, or timber resource properties at any moment within the five years preceding the sale.[58] If the shares qualify as TCP, the vendor must also obtain a certificate under section 116 before the sale or else face a withholding by the purchaser of 25% of the sale price.[59]

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[53] See Krishna, supra note 1, at 448.
[54] See *Interpretation Bulletin* IT-236R4, "Reserves – Disposition of Capital Property," July 30, 1999, at para. 4.
[55] See *Ennisclare Corp. v. R*, 84 DTC 6262 (FCA), where the court held that the reserve claimed by the taxpayer under a different provision of the Act was reasonable even though it was calculated in a different manner. The CRA requires taxpayers to justify the reasonableness of a larger reserve. See ibid., at para. 4.
[56] See subparagraph 40(2)(a)(i).
[57] See paragraph 2(3)(c).
[58] See paragraph (d) in the definition "taxable Canadian property" in subsection 248(1).
[59] For a general discussion of section 116 in the context of the sale of a business, see Arkin, supra note 1, at 15. In

The condition for taking the reserve is that a portion of the proceeds of disposition must be "*payable* to the taxpayer after the end of the year."[60] The term "payable" has been interpreted differently in different contexts throughout the Act. In this context, an amount is considered to be payable where the vendor has the absolute right to be paid; this right need not be immediately exigible.[61]

The vendor should qualify for the reserve under a holdback. Its right to be paid the retained amount should be considered to be absolute. An absolute right is distinguished from a conditional or contingent right. In *Winter v. IRC*, the House of Lords established the notion of contingency as follows:

> I should define a contingency as an event which may or may not occur and a contingent liability as a liability which depends for its existence upon an event which may or may not happen.[62]

A contingent right is therefore a right the existence of which depends upon some future event that may or may not happen. It is true that under a holdback the vendor might not ultimately receive the retained amount. However, this does not mean that its right to payment is conditional. The retained amount forms part of the vendor's consideration for transferring its shares to the purchaser; accordingly, the right to be paid this amount should be considered to come into existence at closing, when the shares are transferred. The CRA has confirmed that this interpretation is correct. In its view, the vendor's right to the retained amount is absolute, yet it only becomes exigible at the end of the indemnification period.[63]

Quebec, the analogous withholding rate is 12%; see section 1101 of the Taxation Act, RSQ, c I-3.

60 See clause 40(1)(a)(iii)(C) [emphasis added.]

61 See *J. L. Guay Ltée v. MNR,* 71 DTC 5423 (FCTD), at para. 6, aff'd. 73 DTC 5373 (FCA), aff'd. 75 DTC 5094 (SCC); see also CRA document no. 2005-0130461I7, January 19, 2006.

62 [1963] AC 235 at 262. The notion of a conditional obligation in civil law is essentially the same. See article 1497 C.C.Q.

63 See 2000-0038005, supra note 51. The CRA indicates that the amount is only considered payable where it does not already belong to the vendor. Therefore, in order to reinforce the vendor's claim to the reserve, the agreement should make clear that the purchaser has not satisfied its obligation to pay the retained amount until the funds are disbursed at the end of the indemnification period.

It follows from this analysis that a breach of the vendor's obligations would comprise a subsequent event that would have the effect of extinguishing the vendor's erstwhile right to be paid the retained amount. Such a breach would give rise to a right on the part of the purchaser to be indemnified. Accordingly, the purchaser and vendor would then each have a right to be paid a sum of money by the other. The result is that these reciprocal rights would be extinguished, and the purchaser would simply keep the amount it retained under the holdback.[64]

Where the purchaser issues a promissory note for the retained amount this can impact the vendor's right to the reserve. A promissory note is considered to do one of two things: it either comprises evidence of the existence of the debt, referred to as a "conditional payment", or it comprises the actual payment of the debt, referred as an "absolute payment.[65] In the first case, the payment by way of the note is subject to the condition that the purchaser will actually honour the note at maturity. Thus, the vendor is only paid when the note is honoured, and the reserve is therefore available.[66] By contrast, in the second case the debt is considered to be fully paid by the issuance of the note, and the reserve is therefore not available. The CRA's administrative position is that a promissory note normally serves an evidentiary function, unless the intent of the parties suggests otherwise.[67] So, to ensure the availability of the reserve, both the agreement and the promissory note itself should indicate that the note is being issued as evidence of the outstanding debt for the retained amount, and all language of the note as constituting payment should be assiduously avoided.[68]

Where the vendor enters into subsequent transactions in respect of such a promissory

[64] In common law this is known as "set-off"; in civil law it is known as "compensation". See article 1672 C.C.Q.
[65] See *Interpretation Bulletin* IT-436R, "Reserves – Where Promissory Notes Are Included in Disposal Proceeds," November 24, 1983, at para. 2. Although this interpretation bulletin was cancelled on December 31, 1999, the CRA has subsequently issued administrative positions that reaffirm this analysis, see infra note 66.
[66] See CRA document no. 2002-0161395, January 8, 2003.
[67] See IT-436R, supra note 65, at para. 3; see also *Pineo v. R,* 86 DTC 6322 (FCTD), where the court simply held that a promissory note evidenced a debt without any supporting reasoning.
[68] See Glass, supra note 14, at 26.

note this also affect its right to the reserve. The reserve is not available where the purchaser no longer owes any amount to the vendor. This will generally be the case where the vendor assigns the note to a third party, even where the consideration that the vendor receives is another debt owed by the third party, because no amount will remain owed by the purchaser to the vendor.[69]

2.2.1.2. Asset Deals — Various Reserves

In an asset deal with a holdback the vendor must claim reserves in respect of the particular assets that it sold. A reserve is usually available in respect of certain assets, but not others. Thus, the vendor must determine what amount remains unpaid in respect of each distinct asset. In practice, the payment section of the agreement is usually drafted to indicate a global price for all the assets, with a portion of this overall price to be retained under the holdback. It would arguably be reasonable to pro-rate the amounts outstanding in respect of the sale price of each asset based on the percentage of the retained amount to the overall price. Alternatively, some commentators have suggested that the breakdown of the amounts outstanding can vary asset by asset. For example, the cash paid at closing can be identified as the consideration for certain assets, and the retained amount can be identified as consideration for other assets. Attributing the retained amount to those assets in respect of which a reserve is available would benefit the vendor, by allowing it to defer a larger amount of the overall tax liability.[70] To reinforce the vendor's claims to reserves, the parties should indicate the breakdown in their agreement.

As mentioned, reserves are usually only available in respect of certain assets. A reserve is of course available in respect of the capital gains realized on capital property. As well, if certain conditions are met a reserve may be available in respect of business income realized on

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[69] See IT-436R, supra note 65, at para. 7; see also CRA document no. 2003-0001295, March 7, 2003.
[70] See Bélanger, supra note 1, at 2.9-2.9.4.

inventory.[71] By contrast, no reserve is available in respect of recapture on depreciable property. Last, and, most significantly, the vendor is not able to claim a reserve in respect of the gain on goodwill. Recall that goodwill qualifies as ECP and that the sale price of goodwill is therefore an ECA.[72] No reserve is available in respect of the inclusion for an ECA. It is true that where a taxpayer disposes of ECP an election is normally available to treat it as a disposition of ordinary capital property instead; further, where a taxpayer makes such an election the capital gains reserve is generally available.[73] However, the election is not available on a disposition of goodwill.[74] This is particularly unfortunate, as the gain on goodwill usually comprises a significant portion of the overall gain realized on the sale, and therefore generates a significant portion of the overall tax liability that then cannot be deferred. If the vendor faces cash-flow issues, the unavailability of a reserve in respect of goodwill can be an important consideration when deciding whether to accept an asset deal structure in the first place.[75]

2.2.2. Tax Treatment of Interest

The tax treatment of interest under a holdback generally depends upon whether the amounts qualify as interest for tax purposes. There are three criteria that must be met in order an amount to qualify as interest:

> (1) it must be calculated on a (day by day) accrual basis; (2) it must be calculated on a principal sum or a right to a principal sum; and (3) it must be compensation for the use of the principal sum or the right to the principal sum.[76]

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[71] See paragraph 20(1)(n). The reserve is only available where a portion of the sale price is not due until at least two years from the moment of the sale. Also, subsection 20(8) limits the reserve to taxation years ending less than 36 months from the date of sale, which practically implies a maximum reserve of three years. See *Interpretation Bulletin* IT-154R, "Special Reserves," February 19, 1988, at paras. 10-13.
[72] See supra note 12.
[73] See subsection 14(1.01); see also CRA document no. 2002-0133797, April 18, 2002.
[74] See subsection 14(1.03).
[75] Note that, while a reserve is unavailable in respect of the gain on goodwill, the vendor would be entitled to a deduction in a subsequent taxation year if it established that its right to receive the sale price of such goodwill had become a bad debt in that year; see subsection 20(4.2).
[76] See *Miller v. MNR,* 85 DTC 5354 (FCTD), at para. 8; see also *Interpretation Bulletin* IT-533, "Interest Deductibility

Interest on a holdback should meet these three criteria: it is calculated on an accrual basis as of the date of closing; it is calculated on a principal sum, being the retained amount; and, it is compensation for the purchaser's retention of this amount, which would normally have been paid to the vendor at closing.

2.2.2.1. Treatment for the Vendor

The vendor will be required to include this interest in its income under paragraph 12(1)(c). The timing of the inclusions will vary depending on the vendor. If the vendor is a corporation, subsection 12(3) requires that it include the interest on an accrual basis. If the vendor is an individual, he will be required to include the interest on what amounts to a modified accrual basis. Paragraph 12(1)(c) generally allows a taxpayer to choose to include interest on either a received basis or a receivable basis. Under the first method, the taxpayer only includes interest when the amounts are paid; under the second, he includes them when they become payable.[77] However, even where a taxpayer chooses the first method, subsection 12(4) requires the inclusion in a taxation year of all of the interest to have accrued as of the anniversary day of the debt, unless the amount was included in a previous taxation year.[78] This basically requires annual inclusions of the interest as it accrues. Note that the recognition of interest income on an accrual basis can cause cash-flow issues where the interest is not paid out regularly. Assuming that the vendor is a corporation, it may even be necessary for it to refrain from distributing some of the cash it receives on closing to its shareholders, in order to be able to service the tax liabilities generated by the ongoing accrual of interest.

If the vendor is a non-resident, then Part XIII of the Act must be considered. Paragraph

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and Related Issues," October 31, 2003, at para. 1.

[77] See *Interpretation Bulletin* IT-396R, "Interest Income," May 29, 1984, at paras. 2-4, 6.

[78] This is the annual anniversary of the day on which the debt came into existence. See the definition "anniversary day" in subsection 12(11).

212(1)(b) provides for a 25% withholding on interest paid by a Canadian resident to a non-resident in certain situations. However, since we have assumed that the purchaser and vendor are dealing at arm's length and would normally expect any interest paid not to constitute "participating debt interest", no withholding should apply.[79]

2.2.2.2. Treatment for the Purchaser

Subparagraph 20(1)(c)(ii) should allow the purchaser to deduct the interest under a holdback. It reads as follows:

> 20(1) … there may be deducted … the following amounts …
> (c) an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on …
> (ii) an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business.

The interest should meet all the conditions to be deductible. First, the purchaser should be under a legal obligation to pay the interest pursuant to the agreement. Second, the purpose test in respect of the property should be met in both an asset deal and a share deal. This condition is met where the purchaser had a reasonable expectation of earning gross income from the property.[80] In an asset deal, the purchaser generally has a reasonable expectation that the assets will generate business income. In a share deal, the CRA generally considers that there is a reasonable expectation of earning dividend income on common shares.[81]

The purchaser's normal method of computing its income determines the timing of the deductions. The phrase "paid in the year" refers to the cash basis of computing income. Purchasers using this method are able to deduct the interest in the year in which it is paid. The phrase "payable in respect of the year" refers to the accrual basis of computing income. For these

[79] See subsection 212(3) for the definition of "participating debt interest".
[80] See *Ludmer v. MNR,* 2001 SCC 62, at paras. 54-56, 59.
[81] See IT-533, supra note 76, at para. 31.

purchasers, the interest is deductible in the year in which it accrues, regardless of when it is paid. However, if it is not deducted in this year, it will not be deductible in any subsequent year.[82]

2.2.2.3. Where No Interest Accrues—Possible Application of Subsection 16(1)

Normally, the vendor insists that the retained amount must accrue interest as of the closing date as compensation for the fact that it must wait to receive this amount. However, it is possible that the parties may not stipulate interest in their agreement. In such cases, subsection 16(1) may apply to deem a portion of the retained amount itself to be interest. This provision is designed to prevent amounts from masquerading as capital where they function economically like interest. It applies where the price for the business exceeds its FMV at the moment of sale; in such cases, the excess can reasonably be regarded as interest.[83] The recharacterization of the excess amount as interest applies to both the vendor and the purchaser, requiring an inclusion for the former and potentially allowing a deduction for the latter.[84] Recharacterized amounts should arguably no longer be considered part of the price for tax purposes. Accordingly, adjustments should be made to the vendor's proceeds of disposition and the purchaser's cost basis in the property.

2.3. PLACEMENT OF A PORTION OF THE PURCHASE PRICE WITH AN ESCROW AGENT

An escrow is another mode of structuring the security for the vendor's indemnification obligations. Instead of retaining a portion of the price itself, the purchaser transfers it at closing

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[82] See *Mid-West Abrasive Co. v. MNR*, 73 DTC 5429 (FCTD), at para. 26; see also IT-533, supra note 76, at para. 5-6; and CRA document no. 9811140, May 27, 1998.
[83] See *Groulx v. MNR,* 67 DTC 5284 (SCC), at para. 6; see also Stephen R. Richardson, "Purchase and Sale of a Business: Income Tax Aspects of Warranties, Price Adjustments, and Earn-Outs," in *Corporate Management Tax Conference 1990* (Toronto: Canadian Tax Foundation, 1990), 10:1-23 at 10:8-10:9.
[84] See McCarthy Tétrault, "16(1) – Income and Capital Combined," in *Canada Tax Service*, last updated February 27, 2009, available on *Taxnet.Pro* (Toronto: Carswell) (online database). Note that under the previous version of subsection 16(1) the purchaser was not entitled to the deduction. See Richardson, supra note 83, at 10:8.

to a designated third party—referred to as an "escrow agent". The agent's handling of the funds is governed by a separate agreement entered into between the purchaser, the vendor, and the agent at the same time as the purchase and sale agreement. Under the escrow agreement, the agent usually deposits the funds into an interest-bearing account. It will only release the funds as follows: where the purchaser makes a claim for indemnification that is approved, the agent will release a portion of the funds to it in satisfaction of this claim; at the end of the indemnification period, whatever funds remain will be released to the vendor.

The vendor prefers an escrow to a holdback. Since the purchaser does not have possession of the funds, the risk that it may become insolvent will not affect the vendor's chance of eventually being paid. Placing the funds with a third party thus strikes a middle ground between each party's concerns regarding the other's solvency. The purchaser, by contrast, does not necessarily prefer one arrangement to the other. As mentioned, a holdback reduces the purchaser's need for outside financing. However, assuming that the purchaser has easy access to outside capital, its ultimate preference should depend upon a comparison of the financing rates that would be charged by the vendor versus a commercial lender.

As under a holdback, the two main tax implications of an escrow are the availability of reserves for the vendor and the tax treatment applicable to the interest earned on the escrow funds. The tax treatment of the interest is more straightforward and so it is addressed first, in section 2.3.1. The availability of the capital gains reserve for the vendor in a share deal is addressed in section 2.3.2. Note that the availability of reserves in an asset deal is omitted here to avoid redundancy, since the applicable principles are largely the same as under a holdback.[85]

2.3.1. Tax Treatment of Interest for the Purchaser and Vendor

[85] See section 2.2.1.2.

Once the escrow agent deposits the funds they will begin to earn interest. Either the vendor or purchaser must include this interest in its income under paragraph 12(1)(c). The escrow agreement should specify how the interest is to be treated. The common practice is that each party must include in its income for a given year any interest that is earned on principal amounts that are paid out to it in the year. The interest that accrues on principal not paid out in the year is more problematic, since it is not yet certain which party will ultimately receive these amounts. That said, in all of the escrow agreements analyzed while researching this paper, the vendor was the one required to include these amounts.[86]

2.3.2. Availability of the Capital Gains Reserve for the Vendor in a Share Deal

As previously stated, the capital gains reserve is available where a portion of the proceeds of disposition are payable to the vendor after the end of the year. In a share deal with an escrow, the availability of the reserve therefore depends upon whether the vendor is paid the funds at the moment when the purchaser transfers them to the agent. According to the CRA, in such situations the vendor should be considered to have been paid any "amount belonging to the [vendor] (which he is deemed to have received) and that he voluntarily gave to the purchaser to cover the warranty that was provided."[87] To phrase the language of "belonging" in legal terms, the reserve should only be available where the vendor is not the owner of the funds while they remain in the agent's possession.

[86] Note that the agent must file a T-5 information return and issue T-5 slips to each party in respect of any interest earned for that party's benefit. See Regulations 204 and 209. Where a lawyer holds funds in the context of a litigation and the disposition of such funds is to be determined by the outcome of the litigation, the CRA generally defers the assessment of any interest income until the recipient of the funds is determined; see Robert M. Beith, E.H. Gauthier, Carole Gouin-Toussaint and Robin J.L. Read, "Revenue Canada Round Table," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto, Canadian Tax Foundation, 1991) 1-33. This situation is similar to an escrow situation, such that the same deferral ought to be available.

[87] See 2000-0038005, supra note 51. The CRA's reference to "deemed receipt" is question begging, as there is no legislative basis to deem that the vendor has received amounts that it has not. One way to make sense of this statement is interpret it to mean that the vendor may be considered to the owner of the funds—and thus to have received them for the purposes of payment—despite the fact that he has not yet taken possession of them.

The legal substance of the parties' agreements will determine which of them owns the escrow funds.[88] Usually there is no stipulation as to who is the owner of the funds, which obviously complicates the analysis. The terms of the particular agreements should therefore be analyzed carefully. The availability of the reserve may vary on a case-by-case basis; that said, a certain amount of generalization is possible in light of common drafting conventions.

One such drafting convention is that the third party that holds the funds is usually referred to as an "agent." This is the case with agreements governed both by common law and by civil law. Arguably, the use of the term "agent" should be sufficient to establish that the escrow does not constitute a trust under either legal system, and that the ownership of the funds therefore lies with either the purchaser or vendor.

In common law, agency and trust relationships are somewhat similar, in that each imposes a fiduciary obligation on the agent or trustee to act in the best interests of the principal or beneficiary. However, one critical distinction between them is that in an agency relationship the principal retains both legal and beneficial ownership of property, whereas in a trust relationship the legal ownership of the property vests in the trustee.[89] Therefore, in an agreement governed by common law the fact that the third party is referred to as an agent means it should not be considered a trustee, and that it therefore is not the owner of the funds in its possession.

By contrast, the term "agent" is not native to civil law. Escrow agreements governed by civil law thus likely use it as a convention because of its relevance in common law. This convention expresses the common intent of the parties that their agreement should function in a way similar to how it would under common law. The agreement must be interpreted for civil law

[88] See Ibid.
[89] See D.W.M. Waters, *The Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), at 668.

purposes in light of this common intent, which is known as "usage".[90] Accordingly, an escrow agreement governed by civil law should likewise not be construed as a trust. Other possible characterizations for the agreement include a mandate relationship or a deposit relationship. In either case, one of the parties must be the owner of the funds.[91]

So, who owns the escrow funds: the purchaser or the vendor? The CRA has considered this question in a similar hypothetical context. In the facts presented to them, the price to be held in escrow would have been comprised of units of a mutual fund trust to be issued at closing. The vendor would have been the registered owner of the units. It would have had the right to receive all of the income generated by the units while in escrow, and would have likewise been entitled to exercise their voting rights. The only restrictions would have been that while the units would be held in escrow the vendor would be unable to sell them or grant security upon them to another party. In that situation, the CRA considered that these factors implied that the vendor would be the owner of the units held in escrow. As a result, they concluded that the transfer of the units to the escrow agent would constitute payment of the price, and that as a result the vendor would not be entitled to claim the capital gains reserve.[92]

This hypothetical scenario is not totally assimilable to the situation where cash is placed in escrow. However, by analogy, the following factors should be relevant in determining who would be the owner such funds. First, the phrasing of the payment section of the purchase and sale agreement is paramount. This section usually indicates that the purchaser pays the purchase price upon transferring a portion of it to the vendor and the remaining portion to the escrow

[90] This is a basic interpretive principle in civil law. See article 1426 C.C.Q.
[91] The mandate relationship is probably the closest analogy in civil law to a common law agency relationship. See articles 2130-2185 C.C.Q. However, the deposit relationship also reflects the substance of the escrow arrangement, since it involves the owner of property placing possession of it with another party. See articles 2280-2311 C.C.Q.
[92] See 2002-0161395, supra note 66.

agent.[93] Thus, the vendor would no longer have a right to be paid under the agreement once the purchaser transfers the funds. The capital gains reserve should therefore not be available. Second, the treatment of the interest earned on the funds may also be relevant. If the vendor were the sole beneficiary of all the interest, this would strongly suggest it were the owner of the funds. However, to the extent that the purchaser may at times be the beneficiary of the interest this undermines the argument that the vendor is the owner. Note that, in contrast to the scenario presented to the CRA, the vendor would not be registered as the owner of the funds, which might make a difference in the determination.

To summarize, the vendor should probably not be able to claim a reserve where the funds are held in escrow. Depending on the particulars of the parties' agreements, it may be possible in certain situations to argue the contrary position. However, common drafting conventions would have to be avoided in order to plausibly assert that payment only occurs when the funds are released from escrow. Moreover, this is probably not feasible as the purchaser will specifically want to prevent the vendor from having any claim against it once it transfers the funds to the agent. Last, the CRA's administrative position, though perhaps distinguishable, presents a risk that such a position would be challenged.

2.4. CONCLUSION AND RECOMMENDATIONS

The parties have distinct commercial preferences in choosing how to structure the security for the vendor's indemnification obligations. However, the tax implications of the choice should also be taken into account. The purchaser's preference will depend upon its financing situation, and the tax treatment of the interest on the secured funds should not have an impact upon this preference. By contrast, the vendor has a strong commercial preference for an escrow

[93] See *Model Asset Purchase Agreement with Commentary*, supra note 45, at 46.

over a holdback. The availability of reserves, however, will have a countervailing effect, as under a holdback the vendor's right to a reserve is likely while under an escrow it is unlikely. In deciding which structure it prefers, the vendor should both assess the risk of the purchaser defaulting and weigh the benefit of the deferral of tax under the reserve. Ultimately, unless the vendor is facing a serious cash-flow issue, the reserve may need to be sacrificed in order to ensure the payment of the price.

PART 3. DETERMINATION OF THE PRICE AFTER THE SALE TO RESOLVE UNCERTAINTIES IN THE VALUATION OF GOODWILL

3.1. NATURE OF THE TERM

3.1.1. Generally

Goodwill is one of the most important assets that the parties must evaluate when negotiating the price for the purchase and sale of a business. Since the asset relates to the future performance of the business, in order to value it the parties must come to an agreement about how they expect the business to perform after the sale. Normal commercial practice is to value goodwill as a multiple of the EBITDA of the business for a period before the sale.[94] The expectation for the future is thus expressed in terms of how it relates to the past. The main object of the parties' negotiations is to determine what multiple reflects the most accurate expectation. Since the future performance depends upon factors that are both specific to the target business and general to the sector in which it operates, the chosen multiple usually falls somewhere within a range common to that sector.[95]

The parties face an inherent problem when attempting to value goodwill: they must set a

[94] See Dupras, supra note 49, at 2.1. EBITDA is a measure of the operating performance of the business. It stands for "Earnings Before Interest, Taxes, Depreciation and Amortization", however, the parties may negotiate a somewhat different measure based on the particulars of the business and industry.
[95] See Michel Martineau, "Évaluation des sociétés privées – 'règles du pouce' en évaluation d'entreprises: utiles ou futiles?," in *Congrès 2008* (Montréal, Association de planification fiscale et financière, 2008), at 6-6.2.

value in the present, when the actual value will only be measurable in the future.[96] This problem is compounded by their naturally divergent expectations for the business. The vendor will be optimistic about the future and seek a high multiple as compensation for relinquishing its investment, while the purchaser, who is undertaking new and unfamiliar risks, will be more cautious and seek a lower multiple.[97] A fundamental disagreement as to the value of goodwill can be significant enough to prevent a deal.

The parties can implement an earn out mechanism to circumvent such an obstacle. The basic function of an earn out is to defer the valuation of goodwill to a time when the post-sale performance figures are available and its value can therefore be established as a certainty.[98] Accordingly, where an earn out is implemented the price for the business will only determined some time after it has been sold. A distinction must be drawn between an earn out and a term of payment. In the former, the price varies based on the post-sale performance; in the latter, the price remains fixed, but the timing of the payments may vary based on this performance.[99] There are two types of earn out mechanisms: conventional earn outs and reverse earn outs.

3.1.2. Conventional Earn Out Mechanisms

In a conventional earn out the price usually has two components: a fixed amount paid at closing and additional earn out amounts that may be paid later if the business meets certain performance targets. The fixed amount reflects the value of the other assets of the business; it

[96] See Vienneau, supra note 1, at 12; see also Dupras, supra note 49, at 2.3.
[97] Note that this divergence is widest for businesses with a high growth potential, where the future performance may be significantly better than the past performance. See André Paquette, "D'ajustement basée sur la performance (earn-out)," in *Congrès 2006* (Montréal, Association de planification fiscale et financière, 2006), at Introduction.
[98] See Glass, supra note 14, at 19.
[99] See *Interpretation Bulletin* IT-426R, "Shares Sold Subject to an Earnout Agreement," September 28, 2004, at para. 8. Note that the purpose of a term of payment is generally to allow the purchaser to pay the price out of the business' post-sale profits. In order to truly qualify as a term of payment and not as an earn out it must be certain that the vendor will be paid the entire price. Accordingly, the clause must provide that at a certain moment all amounts of price will become due, regardless of the business' performance.

may also reflect a portion of the value of goodwill, about which the parties are able to agree. The earn out amounts reflect the uncertain value of goodwill. Normally, these amounts will be determined over a three to five year period following the sale. The performance factor used to determine these amounts is also usually EBITDA; however, other factors can be used, such as sales, or gross or net margin.[100] The choice of performance factor is important. The purchaser will control the financial reporting of the business after the sale. It can therefore manipulate the results to reduce the earn out payments, particularly through accounting rules that involve an element of discretion.[101] A common way to prevent this is for the parties to set out the pertinent accounting conventions in their agreement. Alternatively, there is little room for manipulation where the earn out amounts are based on the business' sales.[102] The earn out amounts will either be paid out periodically based on the business' annual performance, or as a lump sum based on its cumulative performance for the entire earn out period.[103]

3.1.3. Reverse Earn Out Mechanisms

In a reverse earn out the price is set at an initial maximum amount, subject to subsequent reductions if the performance targets are not met. It is common practice that the "reducible" amounts are not paid until it is certain they will not be reduced.[104] Thus, the payments schedules are usually the same under conventional and reverse earn outs. The difference between the two is

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[100] See Peter H. Baek, "Purchase and Sale of a Business: Selected Purchaser Issues," in *Report of Proceedings of the Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto, Canadian Tax Foundation, 2003), 40:1-19 at 10.
[101] See Arkin, supra note 1, at 11.
[102] See Paquette, supra note 97, at 3.1.1.
[103] See ibid., at 1.1; see also Baek, supra note 100, at 10; and Vienneau, supra note 1, at 12-13. Two formulas are commonly used for periodic earn outs. The first is the base-period formula, where the amount for a given period is determined by comparing the performance for that period against that for a given, "base" period, usually the year before the sale. The second is the incremental formula, where the amount for a given period is determined by comparing the performance for that period against that for the immediately preceding period. Note that the incremental formula only pays out where the business grows progressively year over year.
[104] See Baek, supra note 100, at 11; see also Richard Gauthier, "Achat, vente d'entreprise, réorganisation – clauses particulières," in *Colloque # 133 – Achat et vente d'entreprise – réorganisation d'entreprise* (Montréal, Association de planification fiscale et financière, 2003), at 3.

therefore largely one of formulation. In each the price varies with the future performance, but in one amounts are added while in the other they are subtracted. Accordingly, the parties should be commercially indifferent as to which type to use.[105] One real difference between, however, is that in a reverse earn out the price is capped, while in a conventional earn out it need not be. Note that where the vendor expects the business to grow significantly in the future, such as with a start-up, it will strongly resist such a cap.

3.1.4. Interest on Unpaid Amounts of Price

As mentioned, under both types of earn out a portion of the price is usually only paid some time after the closing. Accordingly, the parties normally stipulate that interest is to accrue on such amounts from the date of closing until they are paid. This interest will only be calculable once these amounts of price become certain.

3.1.5. Commercial Considerations

Living with an earn out is not an ideal situation for either party. The purchaser will dislike sharing the business' post-sale profits with the vendor. The vendor will dislike its price being vulnerable to the host of risks that might affect the business after the sale, chief among which is the possibility of mismanagement by the purchaser.[106] In light of these concerns, an earn out is generally only implemented where it is necessary to allow the parties to reach a deal.

When deciding whether and how to implement an earn out, the parties should pay careful attention to the tax implications, which are addressed in the following sections. Section 3.2 addresses the implications of conventional earn outs; section 3.3 addresses the implications of reverse earn outs; last, section 3.4 addresses the implications of interest accruing on earn outs.

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[105] For a contrary view, see Baek supra note 100, at 11.

[106] For a good discussion of the commercial issues respecting earn outs, see Paquette, supra note 97, at 1.2-2. One solution to the latter concern is for the vendor to retain a limited veto over certain business decisions during the earn out period; however, note that the purchaser will strongly resist this. See Dupras, supra note 49, at 2.3.

3.2. TAX TREATMENT OF CONVENTIONAL EARN OUTS

The tax treatment of conventional earn outs is broken down as follows: section 3.2.1 addresses the treatment for the vendor in an asset deal; section 3.2.2 addresses the treatment for the vendor in a share deal; last, section 3.2.3 addresses the treatment for the purchaser in either type of deal.

3.2.1. Treatment for the Vendor in an Asset Deal

It is helpful to recall the normal consequences of the sale of goodwill in an asset deal in order to appreciate the impact of implementing an earn out. Goodwill qualifies as ECP; where it is sold, the proceeds of disposition constitutes an ECA. The result is generally that the vendor includes these proceeds in its income at a 50% rate in the year of sale, which inclusion qualifies as business income.[107]

Where an earn out is implemented, paragraph 12(1)(g) results in a different treatment. The provision reads as follows:

> 12(1) There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property …
>
> (g) any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property.

The gist of this provision is that any amount received by a taxpayer that can be considered to be dependent on the use of or production from property must be included in income in the year it was received, at a 100% rate, regardless of the treatment that would otherwise normally apply to it. *289018 Ontario Ltd. v. MNR* is the leading case on the application of paragraph 12(1)(g) in a situation where a conventional earn out is implemented in an asset deal. In that case, the court held that the earn out amounts paid to the vendor fell within the ambit of the provision; since their value would vary with the performance of the business, they were essentially dependent on

[107] See supra note 12.

the production from its goodwill.[108]

Accordingly, in such a situation, the overall treatment for the vendor is as follows. The fixed amount of sale price is treated normally, as the proceeds of disposition of the assets, and any portion allocated to goodwill is included in income at a 50% rate in the year of sale. By contrast, the earn out amounts are included in income under paragraph 12(1)(g) at a 100% rate in the year when they are received.[109] Because they are included in income, these amounts are excluded in the calculation of the ECA in respect of the goodwill.[110]

The effect of paragraph 12(1)(g) is not necessarily disadvantageous. Normally, the vendor would have an immediate 50% inclusion for the sale price of goodwill; instead, it has a 100% inclusion that is deferred until the amounts are received.[111] One would need to weigh the benefit of the tax deferral in order to determine which treatment is preferable. That said, given that most earn outs last from somewhere between three to five years, the deferral will likely be minimal, such that the paragraph 12(1)(g) treatment should in most cases prove disadvantageous.

The earn out clause must be drafted with care to ensure that the fixed amount of sale price receives the normal treatment. The total price should be expressed as being comprised of two amounts: the fixed amount plus the earn out amount, with only the latter depending on the business' performance. By contrast, if the price is expressed as a single amount that is dependent on the business' performance, with a guaranteed minimum amount, the CRA considers that if the

[108] 87 DTC 38 (TCC), at para. 26. For an arguably contrary decision, see *Rouleau v. MNR,* 91 DTC 120 (TCC). Note that the CRA considers that the former case is the controlling precedent. See CRA document no. 2004-0098121E5, December 16, 2004; and CRA document no. 2003-0183675, July 9, 2003. The recent case of *Smith v. R,* 2011 TCC 461, confirms the CRA's position.

[109] See *Interpretation Bulletin* IT-462, "Payments Based on Production or Use," October 27, 1980, at paras. 5-7.

[110] Subparagraph (a)(i) of element E in the definition "cumulative eligible capital" in subsection 14(5) excludes from the computation of an ECA any amount that was otherwise included in income. See IT-386R, supra note 12, at para. 6; see also CRA document no. 9719827F, January 15, 1998.

[111] See supra note 12. Proceeds of disposition of goodwill are brought into account as an ECA under element E in the definition "cumulative eligible capital" in subsection 14(5) once the vendor "has or may become entitled to receive" the amount. Thus, the inclusion would occur in the vendor's taxation year in which the sale closed.

performance targets are met paragraph 12(1)(g) applies to the entire price.[112]

The consequences for a non-resident vendor require a separate analysis. Normally, where a non-resident carries on a business in Canada and then sells its assets, it is liable to tax under Part I on the disposition of goodwill, since ECP in respect of a business carried on in Canada qualifies as TCP.[113] Further, no treaty relief should be available in respect of the tax on such a disposition.[114] For example, Article VII of the Canada-US treaty, dealing with business profits, is the provision that would apply to the gain on goodwill. The term "business profits" is not defined in the treaty. Any such undefined term is to be given the same meaning that it has under Canadian tax law.[115] Since the gain on goodwill qualifies as business income under the Act, it would therefore also qualify as business profits under the treaty.[116] Article VII entitles Canada to tax the business profits of a non-resident that are attributable to a permanent establishment in Canada through which the non-resident "carries on, or has carried on" business.[117] Thus, assuming that the business operated through such a permanent establishment, the gain would be

[112] See IT-462, supra note 109, at para. 5.

[113] See paragraph (b) in the definition "taxable Canadian property" in subsection 248(1). Recall that the vendor must obtain a section 116 certificate in respect of the disposition or else face a withholding by the purchaser of 25% of the proceeds. That said, a two-step sale structure can avoid the issue of withholding by the purchaser. First, the vendor would transfer its assets to a subsidiary newly incorporated under Canadian law on a fully-taxable basis; second, the subsidiary would sell the assets to the purchaser. The initial transfer would generate the same tax consequences for the vendor as in a direct sale to the purchaser. The subsequent transfer would not generate any additional tax, as the subsidiary's cost basis in the assets would be equal to their proceeds of disposition. Further, section 116 would not apply to the subsequent transfer, as under paragraph 250(4)(a) the subsidiary would be deemed to be a resident of Canada.

[114] This paper performs a sample treaty analysis using the provisions of The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US Treaty").

[115] See ibid., article III(2); see also Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, section 3 (herein referred to as "the ITCIA").

[116] The CRA has confirmed this in the context of the sale of a trade mark, which also qualifies as ECP. See CRA document no. rrrr122, May 24, 1988.

[117] This phrasing makes clear that where a non-resident carried on business in Canada through a permanent establishment, Canada may tax the business profits attributable to that business establishment even if it no longer exists at the time when such profits are received. See United States, Department of the Treasury, *Technical Explanations of the Convention (April 26, 1984)* (Washington, DC: Department of the Treasury, 1984) (herein referred to as "*Technical Explanations, 1984*").

fully taxable.

Where a non-resident sells its assets under an earn out, however, the treatment is once again different. The fixed amount is again treated as the proceeds of disposition of the assets. The earn out amounts, however, are subject to a withholding under Part XIII. Subparagraph 212(1)(d)(v) imposes this withholding upon amounts paid to a non-resident that meet essentially the same condition as the one found under paragraph 12(1)(g).[118] Accordingly, the consequences of implementing an earn out are largely the same for a non-resident vendor as for a Canadian resident vendor. The portion of the fixed amount that is allocated to goodwill is brought into account in the year of sale at a 50% rate, while the earn out amounts are brought into account when they are received at a 100% rate. Note that, dollar for dollar, the rates of tax applicable under Part I and Part XIII are comparable.[119]

No treaty relief should be available in respect of the Part XIII withholding on the earn out amounts. It is not certain which treaty provision should apply to these amounts. An important factor to consider in making this determination is how the amounts are regarded under the Act.[120] The legal nature of the earn out amounts is as part of the sale price of the goodwill. Accordingly, they would initially be regarded as capital amounts under the Act. The fact that the amounts are dependent on the performance of the business would not in itself suffice to recharacterize them as income amounts.[121] That said, the fact that the amounts must be included in income under

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[118] Note that the provision only imposes this withholding on amounts that are dependent on the production from property in Canada. Since we have assumed that the target corporation carries on its business in Canada, the amounts would be captured. The CRA was asked to comment on how this provision would apply where the target corporation also carried on business outside of Canada, but they declined to answer. See CRA document no. 2005-0145311C6, October 7, 2005.

[119] Under Part I the combined federal and provincial rates for corporations varies between 25-31% in 2013. Under Part XIII the withholding rate is 25%, and there is no comparable provincial withholding.

[120] See supra note 115.

[121] The first case to consider this issue was the English case of *Jones v. IRC*, [1920] 1 KB 711, at 174. In that case, the court held that the sale price of a capital asset could be converted into income in certain situations, but that this would generally not be the case where the amounts either were to be paid over a fixed duration or were capped at a

paragraph 12(1)(g) might imply such a recharacterization. Bloom argues that this is not the case and that the amounts retain their capital nature. His reasoning is that paragraph 12(1)(g) does not deem the amounts to be something other than sale price for the purposes of the Act, and that its effects are therefore limited to computation.[122] However, the case law arguably suggests otherwise. *Wain-Town Gas & Oil Co. v. MNR* was the first case to apply the provision that was the precursor to paragraph 12(1)(g). In it, the majority of the Supreme Court held that the effect of this provision was that "receipts … which might ordinarily be termed capital, shall be treated as income for the purposes of the Act."[123] If the amounts are treated as income for the purposes of the Act in its entirety, then they arguably no longer qualify as capital amounts.

Article XII is the treaty provision dealing with royalties. The earn out amounts do fall within the general concept of a royalty.[124] However, this provision should not apply to them, regardless of whether they are recharacterized as income for the purposes of the Act, as article XII(4) defines the term "royalties" for the purpose of the provision to only include amounts that relate to specific types of property listed in that article, of which goodwill is not one.

Article VII should also not apply to the earn out amounts. Assuming that the amounts are recharacterized as income under the Act, they would still not qualify as business profits under the treaty. Amounts included under subsection 12(1) qualify either as income from a business or income from property. These two types of income are distinguished by the degree of activity undertaken by the taxpayer in order to earn them: business income is active, while property

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maximum amount. In *Spooner v. MNR*, [1931] SCR 399, at paras. 14-16, aff'd. (1933) 1 DTC 258 (PC), the Supreme Court of Canada essentially rejected this analysis and found that the amounts would always maintain their capital nature. This reasoning was reaffirmed by the majority of the Supreme Court in *Wilder v. MNR,* [1952] 1 SCR 123, at para. 7. The CRA has also accepted it. See CRA document no. rrr2, June 20, 1988. Note that even under the reasoning in *Jones* the earn out amounts would likely still be considered to be capital because of their fixed duration. For a thorough discussion of this issue, see Richardson, supra note 83, at 10:12-10:15.

[122] See Brian Bloom, "A 'Pot-Pourri' of Issues," in *2003 Journée d'études fiscales* (Montréal: L'Association canadienne d'études fiscales, 2003), 5E:1-34 at 11.

[123] [1952] 2 SCR 377, at para. 4.

[124] Ibid., at paras. 5, 15-17; see also rrr2, supra note 121.

income is passive.[125] During the period to which the earn out amounts pertain, i.e., following the sale of the business, the purchaser operates the business, while the vendor does nothing. Accordingly, the amounts would likely qualify as property income for the vendor under the Act, and therefore not as business profits under the treaty.

Article XIII, the treaty provision dealing with gains from the alienation of property, might apply to the earn out amounts. Assuming that the amounts are not recharacterized as income under the Act, they retain their nature as capital amounts received on the disposition of goodwill. Accordingly, they would arguably qualify as gains from the alienation of property under Article XIII. That said, it is the CRA's administrative position that the word "gains" in Article XIII refers only to capital gains.[126] On this view, since the disposition of goodwill does not give rise to a capital gain, the earn out amounts would not fall under the article. However, even if the article did apply it would likely not provide any relief, as Article XIII(2) entitles Canada to tax a non-resident's gain on the business property of a permanent establishment in Canada.

Finally, Article XXII applies to an item of income to which no other article applies. Therefore, assuming that Article XIII does not apply to the earn out amounts, Article XXII will. Under Article XXII amounts are taxable in Canada where they arise in Canada—i.e., where their geographic source is in Canada.[127] If the amounts are recharacterized as income under the Act, then the most pertinent sourcing rule would likely be the one that applies to royalties. A royalty is generally considered to arise in the place where the related right is used.[128] By analogy, an earn out on goodwill would be sourced in the place where the goodwill is used, which in this

[125] See Krishna, supra note 1, at 278-280.
[126] See CRA document no. 9518087, September 13, 1995.
[127] The Canadian sourcing rules apply to make this determination. See *Technical Explanations, 1984*, supra note 117.
[128] See *Interpretation Bulletin* IT-270R3, "Foreign Tax Credit," November 25, 2004, at para. 29.

case would be Canada. On the other hand, if the amounts are not recharacterized as income they would likely be deemed to arise in Canada, as gains from the disposition of TCP.[129] Either way, Article XXII would also not provide any relief.

3.2.2. Treatment for the Vendor in a Share Deal

3.2.2.1. Uncertainty — Which Treatment Applies?

In a share deal with a conventional earn out there are three potential treatments that might apply to the vendor. This section addresses which of these treatments should apply and under what circumstances. The sections that follow address in closer detail the consequences entailed by each treatment. Section 3.2.2.2 addresses the consequences of the "12(1)(g) method"; section 3.2.2.3 addresses the consequences of the "estimated proceeds of disposition method"; and section 3.2.2.4 addresses the consequences of the "cost recovery method", all as herein described.

It is uncertain whether paragraph 12(1)(g) applies to earn out amounts in a share deal. Some commentators have simply assumed that it applies.[130] However, it has never been held to apply by a court. The CRA, for its part, has made varying statements regarding its application. In IT-426R, they state that "*it is possible* that paragraph 12(1)(g) would apply to all payments made under the earnout clause."[131] By contrast, in technical interpretation 2000-0051115 they state that "any amount received pursuant to the earnout agreement … *will* be included … pursuant to paragraph 12(1)(g)."[132] One way to reconcile these statements is to conclude that while the CRA recognizes the uncertainty they will nonetheless seek to apply the provision.

However, paragraph 12(1)(g) arguably should not apply in a share deal. Consider the

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[129] See ITCIA, supra note 115, section 6.3.

[130] See Gaétan Bisson, "Structures d'acquisitions d'entreprise," in *Congrès 2005* (Montréal, Association de planification fiscale et financière, 2005), at 1.2.5; see also Dupras, supra note 49, at 2.3; and Claudine Puglièse, "Structures de réorganisation corporative," in *Congrès 2005* (Montréal, Association de planification fiscale et financière, 2005), at 1.1.1.

[131] Supra note 99, at para. 1 [emphasis added].

[132] April 19, 2001 [emphasis added].

wording of the provision, which requires the inclusion in income of

> any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property.

The issue in a share deal is that the amount in question is an instalment on the sale price of one property, the shares of the target corporation, but it is dependent on the production from another property, the corporation's goodwill. Yet paragraph 12(1)(g) arguably should be interpreted as to only apply to an amount of sale price where the amount is dependent on the production from the particular property that was sold.[133] Two lines of reasoning support this interpretation. The first turns upon the use of the word "the" in the phrase "sale price of *the* property." The definite article is used grammatically to refer to a specific object that has already been mentioned.[134] The only property previously mentioned in the provision is the property upon whose production the amount is dependent. Thus, the property that was sold and the property whose productivity determines the sale price must be one and the same for paragraph 12(1)(g) to apply. The second line of reasoning is historical. It is well known that the precursor to paragraph 12(1)(g) was enacted in response to the decision in *Spooner v. MNR*.[135] In that case, the taxpayer sold land for consideration comprised in part by a right to receive 10% of the gross income from oil production on that land. Since the provision was designed to respond to this particular type of situation, it should not be extended to structurally different situations.[136]

If paragraph 12(1)(g) is inapplicable, then the earn out amounts would form part of the vendor's proceeds of disposition on the shares and need to be included when computing the capital gain. This would create a timing issue: the capital gain is brought into account in the year

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[133] See Jeffrey H. Berliner, "Selected Aspects of the Purchase and Sale of a Business," in *2006 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2006), 10:1-25 at 8; see also Bloom, supra note 122, at 9; and Glass, supra note 14, at 19.
[134] See *Oxford English Dictionary*, 2d ed.
[135] Supra note 121. See *Wain-Town*, supra note 123, at para. 4; see also Richardson, supra note 83, at 10:14-10:15.
[136] See Bloom, supra note 122, at 9-10.

of sale, when the earn out amounts are still contingent and thus not yet ascertainable. Accordingly, the vendor would be required to estimate the amounts it is likely to receive in order to determine the proceeds of disposition at that time.

The CRA recognizes that neither the 12(1)(g) method nor the estimated proceeds of disposition method are ideal. Accordingly, they allow a third method, known as the cost recovery method, to be used where the following conditions are met:

> (a) The vendor and purchaser are dealing with each other at arm's length.
> (b) The gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature.
> (c) It is reasonable to assume that the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale.
> (d) The earnout feature in the sale agreement must end no later than 5 years after the date of the end of the taxation year of the corporation (whose shares are sold) in which the shares are sold. For the purposes of this condition, the CRA considers that an earnout feature in a sale agreement ends at the time the last contingent amount may become payable pursuant to the sale agreement.
> (e) The vendor submits, with his return of income for the year in which the shares were disposed of, a copy of the sale agreement. He also submits with that return a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined below.
> (f) The vendor is a person resident in Canada for the purpose of the Act.[137]

A vendor wishing to use this method should make certain that these conditions will be met before entering into the transaction. In particular, conditions (c) and (d) impose substantive requirements upon the earn out clause. Condition (c) requires that the earn out relate to the business' goodwill. Where the earn out formula is based on the business' future performance this indicates that it is at least somewhat related to goodwill. Further, if the sale price includes a fixed amount that is at least equal to the net value of the target's other assets this indicates that the earn out relates exclusively to goodwill.[138]

The timing requirement in condition (d) must be carefully considered. The earn out must

[137] See IT-426R, supra note 99, at para. 1. The first method is problematic for the vendor because it converts a 50% inclusion into a 100% inclusion. The second method is problematic for the CRA because it would be difficult to administer. The estimation of what amounts a vendor is likely to receive under an earn out would be complex, take into account many factors, and give rise to a wide range of plausible results.
[138] See Glass, supra note 14, at 20. For examples of deferred payments of sale price that do not satisfy condition (c), see CRA document no. 2003-0030035F, October 10, 2003.

end sometime within a five year period that begins at the end of the taxation year of the target corporation in which the shares are sold. The sale should normally comprise an acquisition of control of the target corporation. This would cause a deemed taxation year end for the corporation at the moment before the acquisition of control. As a result, the sale should occur in the first moment of the new taxation year, and the five-year period should therefore begin at the end of this new taxation year.[139]

The earn out is considered to end at the moment when the last contingent amounts may become payable. This should occur at the end of the last relevant financial period under the earn out formula. Recall that an amount becomes payable when a taxpayer has the absolute right to receive it. At the end of the last financial period the final event that might give rise to a right to receive an amount has occurred, namely, the performance for that period. Note that the amounts will only be calculable sometime later, when the business' performance is reported. However, an amount need not be calculable to be considered payable. By contrast, an amount is only considered "determinable" once it is both payable and calculable.[140]

3.2.2.2. Potential Treatment #1 – 12(1)(g) Method

Assuming that paragraph 12(1)(g) does apply in a share deal, the treatment would be similar to the treatment in an asset deal. The fixed amount would be treated normally as the proceeds of disposition of the shares. The earn out amounts would be included in income under paragraph 12(1)(g) when they were received. Because they would be included in income, they would be excluded from the calculation of the proceeds of disposition.[141] Accordingly, as in an

[139] See subsection 249(4). Note that the overall amount of time available for the earn out could therefore be up to six years from the moment of the sale, depending on how the target corporation sets its new taxation year end.
[140] See IT-426R, supra note 99, at para. 5. Note that the CRA's previous position was that the earn out only ended when the amounts became calculable. See CRA document no. 2001-0114435, December 18, 2001.
[141] See paragraph 39(1)(a).

asset deal, paragraph 12(1)(g) would convert what would otherwise be an immediate inclusion at a 50% rate into a deferred inclusion at a 100% rate, likely to the vendor's disadvantage.

The treatment for a non-resident vendor would again need to be analyzed separately. Where a non-resident vendor sells shares it is usually not liable to tax as shares only qualify as TCP exceptionally, such as where their value is derived principally from real property in Canada.[142] On the other hand, where the shares do qualify as TCP, the vendor is not only liable to tax, but it is also not entitled to any treaty relief. Article XIII is the treaty provision applicable to capital gains.[143] Article XIII(1) entitles Canada to tax gains from the alienation of real property situated in Canada; article XIII(3)(b)(ii) defines real property situated in Canada to include a share of a Canadian resident company that derives its value principally from other real property situated in Canada. Accordingly, if the shares qualify as TCP the gain on them should be taxable in Canada under the treaty.

Where a non-resident vendor sells shares under an earn out the treatment would be as follows. The fixed amount would be treated as the proceeds of disposition of the shares, and would not be subject to any tax assuming that the shares do not qualify as TCP. The earn out amounts, however, would be subject to a Part XIII withholding. Thus, in most cases, implementing an earn out would result in a highly disadvantageous treatment from a purely Canadian tax perspective: the earn out amounts would be subject to Part XIII withholding, where the entire sale price would usually be a tax-free receipt. That said, foreign tax credits or a similar mechanism in the vendor's country of residence might reduce the tax payable in that country to take into account the Canadian tax paid, and so mitigate the disadvantage.

As in an asset deal, it is not certain which treaty provision would apply to the earn out

[142] See the text accompanying note 58. Note that the vendor generally needs to warrant in the agreement that the shares do not qualify as TCP in order to avoid a withholding by the purchaser under section 116.
[143] See 9518087, supra note 126.

amounts in a share deal.[144] Unlike in an asset deal, however, treaty relief would possibly be available. Article XII would again not apply to the earn out amounts, as shares are not one of the types of property listed in article XII(4). Article VII would also likely not apply, as if the earn out amounts were recharacterized as income under the Act they would again likely qualify as property income, and thus would not qualify as business profits under the treaty.

Article XIII might apply to the earn out amounts. The same reasoning would apply as in an asset deal: assuming that the amounts were not recharacterized as income under the Act, they would retain their nature as capital amounts received on the disposition of the shares. Accordingly, they would arguably qualify as gains from the alienation of property. That said, the CRA's position that the word "gains" in this article refers only to capital gains would once again prevent it from applying, since the earn out amounts would be excluded from the computation of the capital gain on the shares.[145] If article XIII did apply to the earn out amounts, then relief would likely be available. Article XIII(4) denies Canada the right to tax a non-resident's gain on the alienation of any property that is neither real property in Canada nor business property of a permanent establishment in Canada. Since shares usually do not qualify as either (unless they are TCP), the Part XIII withholding would likely not apply.

Again, article XXII would apply if article XIII did not. Recall that article XXII only allows Canada to tax an item of income that arises in Canada. If the earn out amounts were recharacterized as income under the Act, they would likely be sourced in the place where the underlying goodwill were used—i.e., in Canada. If the amounts retained their capital nature under the Act, then they would generally be sourced at the location where the sale of the shares occurred. The CRA indicates that this location should be determined by considering the place of

[144] The CRA was asked to comment on this issue but they declined to answer. See 2005-0145311C6, supra note 118.
[145] See 9518087, supra note 126; see also Bloom, supra note 122, at 11.

business of the target corporation as well as the location of the vendor. Alternatively, some commentators have interpreted this location as being the place where the contract of sale was completed.[146] Thus, the amounts might be sourced outside of Canada, such that article XXII would eliminate the part XIII withholding.

3.2.2.3. Potential Treatment #2 – Estimated Proceeds of Disposition Method

Assuming that paragraph 12(1)(g) does not apply in a share deal, the entire sale price—both fixed amounts and earn out amounts—would comprise the vendor's proceeds of disposition of the shares. However, it is not entirely certain what ought to be included in respect of the earn out amounts when calculating the vendor's capital gain in the year of sale. Some commentators have suggested that no amount would need to be included.[147] However, the better answer seems to be that some amount ought indeed to be included. The vendor's contingent right to receive earn out amounts can be regarded as a distinct property (specifically a debt) that it received as part of the sale price. Accordingly, the CRA's position is that the proceeds of disposition would need to include the FMV of this right as of the moment of the disposition.[148] The notion of FMV generally refers to the price that an informed arm's length buyer would be willing to pay.[149] Arguably, an informed buyer would consider the following factors when valuing the earn out rights: first, the amounts likely to become payable; second, the likelihood of collection; and, third, the rate of interest. This treatment would therefore result in an estimate of the overall capital gain being included immediately in the vendor's income at a 50% rate.

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[146] See *Interpretation Bulletin* IT-395R2, "Foreign Tax Credit – Foreign Source Capital Gains and Losses," August 21, 2002, at paras. 3-4; see also Bloom, supra note 122, at 11. Recall that if the shares qualify as TCP, the gain is deemed to arise in Canada. See supra note 129.
[147] See Glass, supra note 14, at 19.
[148] See IT-426R, supra note 99, at para. 1; see also CRA document no. 9403435, August 4, 1994.
[149] In *Re Mann Estate*, [1972] 5 WWR 23 (BCSC), at para. 13, FMV was defined as "the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing, knowledgable purchaser acting at arm's length."

The vendor would likely not be entitled to deduct a reserve from the capital gain in respect of the earn out amounts. Recall that the reserve is available where an amount of the proceeds of disposition is payable after the end of the year, which is only the case where the vendor has an absolute right to the amount. Since the vendor's right to the earn out amounts is contingent, no reserve would be available.[150]

Since the vendor would be required to calculate its capital gain based on an estimate of the earn out amounts, there ought to be an adjustment where the actual amounts vary from the estimate. The CRA's solution to this would not be an adjustment of the capital gain on the shares, but rather a separate capital gain or loss realized when the earn out amounts become certain. Recall that the earn out rights would comprise a separate capital property of the vendor. The vendor's cost in these rights would be equal to their FMV when they were acquired—i.e., the same as the estimated amount included in the proceeds of disposition of the shares. Where an earn out amount would become payable, the corresponding right would be considered to have been disposed of for the amount payable. Accordingly, the difference between the amount ultimately payable and the initial estimate would be a capital gain or loss realized at that time.[151] An underestimate in the year of sale would give rise to a later capital gain, while an overestimate would give rise to a capital loss.

There are two issues with this approach. First, since an underestimate would effectively shift capital gains from the year of sale until the year the amounts became certain, the vendor could manipulate the estimate to obtain a deferral of tax. This would obviously be problematic from the CRA's perspective, and would require that the estimates be policed carefully. Second, where an overestimate would give rise to a subsequent capital loss it might be of little use to the

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[150] See 2000-0051115, supra note 132.

[151] See 9403435, supra note 148. Arguably, the rights ought to only be considered disposed of when the amounts were actually paid, because the vendor would still own them until that time.

vendor. This loss could only be carried back against the original capital gain on the shares where it were realized within three years following the sale.[152] Otherwise, it could only be used against capital gains that might be realized subsequently.

To avoid this issue, the vendor could pay the tax for the year of sale based on an estimate of the earn out amounts, but delay filing its returns. It would then file the returns based on the actual amounts once they became certain. The adjustment would thus take the form of a refund of tax (in an overestimation) or a payment of additional tax (in an underestimation). Note that under paragraph 164(1)(b) a taxpayer is only entitled to a refund for an overpayment of tax where it files its return within three years of the end of the relevant taxation year. That said, under subsection 164(1.5), where the taxpayer is an individual (other than a trust), the Minister may issue a refund where the return is filed within ten years of the end of the relevant taxation year. Thus, where the vendor is an individual, filing late returns and claiming a refund may be a useful alternative to avoid the loss carry back limitation in the context of an earn out exceeding three years. Obviously, interest would accrue on any additional tax owing, so a vendor choosing to delay filing its return might be wise to err on the side of overestimation. Also, when weighing this option, the vendor ought to consider the penalties involved in a late filing of returns.

Where a non-resident vendor were liable to tax on the sale of shares the same method of estimating the proceeds of disposition would be used both for the purpose of calculating the capital gain under Part I and for the purpose of section 116.[153] However, no adjustment would likely be available where the actual earn out amounts varied from the estimate. The earn out rights would not qualify as TCP; as a result, the non-resident vendor would not be liable to tax in respect of their disposition, and so it would not realize either a capital gain or capital loss when

[152] See paragraph 111(1)(b). To ensure a carry back the vendor would normally need to insist that the earn out period not exceed three years. See Berliner, supra note 133, at 9.
[153] See 2005-0145311C6, supra note 118.

the earn out amounts became payable.[154] Thus, an overestimate would give rise to a permanent overpayment of tax, while an underestimate would give rise to a tax-free receipt. Regarding section 116, where a purchaser were required to withhold in the year of sale it would need to do so based on an estimate of the entire sale price.[155]

3.2.2.4. Potential Treatment #3 – Cost Recovery Method

Where the vendor meets the conditions for the cost recovery method, the entire sale price—fixed amounts and earn out amounts—is again treated as the proceeds of disposition of the shares. However, the earn out amounts are only brought into account once they become certain. The method operates as follows. The vendor begins with his adjusted cost base (ACB) on the shares at the moment of the sale. As amounts of sale price become determinable, they reduce the vendor's ACB. Recall that an amount is determinable when it is both payable and calculable. Thus, the fixed amount is determinable at the moment of the sale, while earn out amounts become determinable as the financial reports for the pertinent period are prepared. Once the vendor's ACB is reduced to nil, any additional amount of sale price is recognized as a capital gain in the year in which it becomes determinable. Once a capital gain is realized, if the corresponding amount of sale price remains payable after the end of the year a reserve is available. After the earn out period ends, if the vendor's ACB remains positive, that positive amount is realized as a capital loss in that year.[156]

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[154] The CRA has taken this position in respect of rights under a reverse earn out. See CRA document no. 2006-0196211C6, October 6, 2006.

[155] Note that this withholding could theoretically exceed the amount actually payable in the year of sale, creating a significant cash-flow issue. The CRA previously had a policy of allowing withholdings in the year of sale based on only the amounts immediately payable, with subsequent withholdings required on amounts as they became payable. See Baek, supra note 100, at 13. This policy would seem to no longer apply, given the more recent pronouncements. See supra note 153.

[156] See IT-426R, supra note 99, at paras. 3-7. For an example of how to calculate the reserve, see François Auger, "Considérations fiscales d'une vente d'actions pour le vendeur," in *Colloque # 133 – Achat et vente d'entreprise – réorganisations d'entreprise* (Montréal, Association de planification fiscale et financière, 2003), at 7.

This method results in the optimal tax treatment for the vendor. It is better than the 12(1)(g) method because it allows for the earn out amounts to be included in income as part of the capital gain at a 50% rate. It is also better than the estimated proceeds of disposition method because it only brings these amounts into account later when they become certain.

The cost recovery method is not available for non-resident vendors.[157] However, the CRA does have an administrative policy designed to alleviate the uncertainty these vendors face regarding which of the other two methods should apply. A non-resident vendor may rely upon this policy where the shares that are sold qualify as TCP and the first four conditions applicable to the cost recovery method are met. In such cases, the policy simply allows the vendor to apply the estimated proceeds of disposition method.[158] The implication behind this policy is that where these conditions are not met, such as where the shares are not TCP, the CRA will seek to apply subparagraph 212(1)(d)(v).

3.2.3. Treatment for the Purchaser

There is no provision analogous to paragraph 12(1)(g) that applies to the purchaser. As a result, its treatment should be based on general principles. The cost of property for a purchaser is the consideration that it gave up to acquire the property.[159] In an earn out, the legal nature of both the fixed amount and the earn out amounts is as part of the purchase price. Accordingly, both amounts form part of the cost.[160] In a share deal, the amounts comprise the ACB of the shares. In an asset deal, the amounts must be allocated as part of the cost of the various assets. Arguably, since the earn out amounts relate to the value of goodwill, they should be allocated entirely to it.

[157] The CRA implemented this restriction when they released the updated IT-426R, supra note 99. Their rationale for doing so was that it would be inappropriate to allow non-residents to obtain a deferral of tax under the method, since they are denied such a deferral under the capital gains reserve. See 2005-0145311C6, supra note 118.
[158] See 2006-0196211C6, supra note 154.
[159] See *Stirling v. R*, 85 DTC 5199 (FCA), at para. 3.
[160] See IT-462, supra note 109, at para. 2. Note that laypersons might wrongly assume that the earn out amounts would be deductible as a current expense, because they resemble a royalty. See Berliner, supra note 133, at 9.

Some commentators, however, indicate that the earn out amounts should be allocated to the assets in a reasonable way, suggesting that a portion of them might be allocated to assets other than goodwill.[161]

An amount of purchase price is only capitalized into the cost of property once the obligation to pay that amount is absolute.[162] The fixed amount is therefore capitalized at the moment of sale. By contrast, since the purchaser's obligation to pay the earn out amounts is initially contingent, these amounts should only be capitalized once the obligation to pay them becomes absolute.[163] In an asset deal, this timing can affect the purchaser's depreciation of the goodwill. In a share deal it usually does not have a practical impact.

3.3. TAX TREATMENT OF REVERSE EARN OUTS

3.3.1. Treatment for the Vendor

Paragraph 12(1)(g) does not apply to reverse earn outs. In *Pacific Pine Co. Ltd. v. MNR*, the Tax Appeal Board held that the reducible amounts in a reverse earn out are not considered to be dependent on the use of or production from property.[164] The CRA has generally accepted this conclusion.[165] As a result, where a business is sold under a reverse earn out the initial maximum amount of sale price comprises the vendor's proceeds of disposition for the assets or shares. Thus, in either deal structure the entire gain relating to the underlying goodwill is included in income at a 50% rate in the year of sale. Note that the treatment of reverse earn outs is similar to the treatment of conventional earn outs under the estimated proceeds of disposition method, with the main difference being that under a reverse earn out no estimation is necessary.

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[161] See Baek, supra note 100, at 12.
[162] See *Mandel v. R*, 78 DTC 6518 (FCA), at para. 22, aff'd. [1980] 1 SCR 318.
[163] See Marie-Andrée Côté, Jean-Luc Fréchette, Richard Gagné and Catherine Lapointe, "Étude de cas – achat d'une entreprise," in *Congrès 2003* (Montréal, Association de planification fiscale et financière, 2003), at 10.5; see also Gauthier, supra note 104, at 3.
[164] 61 DTC 95, at para. 11.
[165] See IT-462, supra note 109, at paras. 9-10.

There is one caveat. The CRA indicates that it only considers the vendor's proceeds of disposition to be equal to the maximum amount where there is a reasonable expectation that the performance targets will be met.[166] The underlying concern here is likely to prevent loss refreshing. If a vendor had accumulated losses that were about to expire, these losses could be utilized in the year of sale to offset an unreasonably high maximum amount; when the performance targets were not met, the resulting reduction in sale price would give rise to a fresh capital loss for the vendor (as is explained below.) Given that the new losses would be capital losses, however, such a strategy would likely only be of interest only where the vendor had expiring capital losses in the context of a share deal.

The CRA goes on to state that if the maximum amount is unreasonable it considers that paragraph 12(1)(g) applies to the entire sale price.[167] There is no basis for this position, as the case law has unequivocally held that this provision does not apply to reverse earn outs. Therefore, the vendor's proceeds of disposition should be equal to the maximum amount regardless. However, it is always possible that an unreasonable maximum amount might be successfully challenged under the general anti-avoidance rule in section 245.

No reserve should be available in respect of reducible amounts not paid in the year of sale. In an asset deal, the reducible amounts should be allocated entirely to goodwill, and no reserve is available on the disposition of ECP. In a share deal, the capital gains reserve should not be available: the reducible amounts should not be considered to be payable after the end of the year, in that the vendor's right to these amounts is arguably contingent, not absolute.

Commentators disagree on whether the vendor's right to the reducible amounts is

[166] Ibid.
[167] Ibid.

contingent or not.[168] Recall that a right is contingent where its existence depends upon some future event that may or may not happen. Applying this concept, the reverse earn out may be viewed in one of two ways. In the first view, the vendor's right to the reducible amounts would be contingent at closing; this right would only become absolute later if the business met the targets. In the second view, the vendor's right to the reducible amounts would be absolute at closing; the failure to meet the performance targets would therefore be a subsequent event causing this absolute right to be extinguished. The case law indicates that the first view is the correct one. In *Mandel*, the taxpayer purchased a film under a reverse earn out. The court held that its obligation to pay the reducible amounts was contingent upon the business' performance.[169] This means that the vendor's right to receive these amounts was equally contingent. Moreover, there is no sound basis to distinguish between the two types of earn out. In a conventional earn out, the vendor's right to the earn out amounts is phrased as "you must pay me, *if*…"; in a reverse earn out, the right to the reducible amounts is phrased as "you must pay me, *unless*…" In both, the rights are equally conditional.[170]

Where the performance targets are not met and the sale price is reduced, the vendor should be entitled to an adjustment.[171] This adjustment takes a form similar to the adjustment in a conventional earn out under the estimated proceeds of disposition method. The vendor's right to receive the reducible amounts is a capital property; when the reduction occurs, this right is

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[168] Krishna, supra note 1, at 1301, implies that the amounts are contingent; by contrast, the following commentators contend that the amounts are absolute, albeit without any supporting authority: Baek, supra note 100, at 12; Côté, supra note 163, at 10.5; and Gauthier, supra note 104, at 3.
[169] Supra note 162, at para. 15.
[170] The CRA indicates that where property is sold for a given sale price and a subsequent event causes that price to be adjusted, the vendor's right to the price is generally considered to have been absolute from the moment of the sale. See IT-170R, supra note 50, at para. 5. This suggests that they would adopt the second view regarding the reverse earn out. However, the case law clearly adopts the first view. Further, note that the CRA's reasoning is predicated upon the distinction between a condition precedent and a condition subsequent in common law. This reasoning should therefore not apply to an agreement governed by the civil law, where such a distinction does not exist. See articles 1497-1507 C.C.Q.
[171] See IT-462, supra note 109, at para. 9.

disposed of and the vendor realizes a capital loss equal to the amount of the reduction.[172] However, no adjustment should be available where the reducible amounts are paid to the vendor at closing and some portion is later refunded. In this case, after the closing the vendor no longer has a right to receive any amount, and so there is no property upon which a capital loss can be recognized.[173]

This capital loss may again be of little use. The concerns regarding the utility of the loss in a share deal have already been noted.[174] In an asset deal, this utility is even more doubtful. Even where the loss can be carried back into the year of sale it could very easily exceed the capital gains realized in that year. The sale of the business' fixed assets is likely to have generated some capital gains, however the gain on the sale of goodwill qualifies as business income, and so the capital loss cannot be offset against it.[175] Thus, a portion of the capital loss may only be useful if the vendor corporation reinvests the sale proceeds and realizes subsequent capital gains. However, the vendor's shareholders might have other designs in mind for these funds. Once again, an alternative would be for the vendor to pay the tax for the year of sale based on the maximum amount of sale price, but delay filing its returns until the final price is certain.[176] Recall that in this case the adjustment would take the form of a refund of tax for the year of sale.

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[172] See CRA document no. 2009-0337651R3.
[173] See 2006-0196211C6, supra note 154.
[174] See the discussion in section 3.2.2.3 of the adjustment in a conventional earn out under the estimated proceeds of disposition method.
[175] See subsection 111(1.1).
[176] Another alternative may be possible. Recall that the proceeds of disposition of goodwill are initially brought into account as an ECA when the vendor "has or may become entitled to receive" the amount. See supra note 111. It is this author's understanding that certain practitioners take the view that once the sale price is reduced under a reverse earn out, the calculation from that moment of element E in the definition "cumulative eligible capital" should be reduced accordingly, as the vendor has not received and can no longer become entitled to receive the reducible amounts. This would ultimately result in the vendor's CEC reflecting a positive amount, which would be available to claim as a terminal loss. Note that, under subsection 24(1), in order to claim this terminal loss the vendor would need to retain ownership of an item of ECP in respect of the sold business until the year of the reduction, and then subsequently dispose of it.

A non-resident vendor that sells property under a reverse earn out should not be subject to Part XIII withholding. Subparagraph 212(1)(d)(v) should not apply, in that paragraph 12(1)(g) has been held not to apply. If the property sold qualifies as TCP, then the maximum amount of sale price comprises the proceeds of disposition for the purposes of both Part I and section 116. No adjustment should be available where the sale price is reduced: since the right to receive the reducible amounts does not qualify as TCP, its disposition does not give rise to a capital loss.[177]

3.3.2. Treatment for the Purchaser

The treatment for the purchaser under a reverse earn out should be essentially the same as the treatment under a conventional earn out. The entire purchase price should be capitalized in the cost of the purchased assets or shares. An amount should only be capitalized once the obligation to pay that amount is absolute. Thus, while the irreducible amounts of purchase price should be capitalized at the moment of the sale, given that the purchaser's obligation to pay the reducible amounts is arguably contingent, these amounts should only be capitalized once it is certain that they will not be reduced. This could cause additional tax where the purchaser subsequently sells the business to another purchaser before the end of the earn out period. To avoid this, the earn out formula should stipulate that in the event of a subsequent sale the earn out period terminates and an appropriate portion of the reducible amount of purchase price becomes immediately payable.

3.4. TAX TREATMENT OF INTEREST ON EARN OUTS

3.4.1. Treatment for the Vendor

The vendor should be required to include in its income under paragraph 12(1)(c) any interest that accrues on unpaid amounts under either a conventional or reverse earn out.

[177] See 2006-0196211C6, supra note 154.

Specifically, this interest should qualify as interest for tax purposes. Recall that an amount qualifies as interest where it accrues on a principal sum and is compensation for the use of that principal sum.[178] Thus, the party obligated to pay the interest must have also been under an obligation to pay a principal sum.[179] The complication is that under both types of earn out the obligation to pay the unpaid amounts is contingent upon the business meeting the performance targets. One might therefore consider that there is no principal sum upon which the interest accrues during the period from the closing date until the targets are met. However, the case law has held otherwise. In *Perini Estate v. MNR*, the vendor sold shares under a conventional earn out. The court held that the stipulation that interest was to accrue as of the closing date expressed the parties' intention that should the performance targets be met the obligation to pay the earn out amounts would become absolute with retroactive effect.[180] In other words, once the performance targets in an earn out are met the obligation to pay the earn out amounts is considered to have always been absolute; therefore, the interest is considered to have always accrued on a principal sum. Note that this principle of retroactivity should apply to agreements governed by both common law and civil law. In *Perini Estate*, the agreement was governed by common law; moreover, retroactivity is a general principle of conditional obligations in civil law.[181]

3.4.2. Treatment for the Purchaser

While the vendor must include all the interest that accrues under an earn out in its income,

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[178] See supra note 76.

[179] In *Reference as to the Validity of the Farm Security Act, 1944, of the Province of Saskatchewan*, [1947] SCR 394, at 412 and 417, respectively, Rand J. held that "interest is referrable to a principal in money or an obligation to pay money," while Kellock J. held that "[t]here can be no such thing as interest on principal which is non-existent."

[180] 82 DTC 6080 (FCA), at paras. 15-17. For a discussion of this case, see Norman C. Loveland and Jack A. Silverson, "The Purchase and Sale of Shares: Preserving Tax Basis and Other Planning Considerations," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-US Expansion of a Business*, 1998 Corporate Tax Management Conference (Toronto: Canadian Tax Foundation, 1996), 2:1-44 at 23. See also *Smith*, supra note 108, at para. 16, where the interest under a conventional earn out was included in the vendor's income under paragraph 12(1)(c) without any overt consideration of these issues.

[181] See article 1506 C.C.Q.

the purchaser faces a timing issue that may prevent it from deducting some of this interest from its own income. Recall that for a purchaser that reports its income under the accrual method interest is only deductible under subparagraph 20(1)(c)(ii) in the year in which it accrues.[182] Moreover, the interest is only deductible in that year if there is an absolute obligation to pay it.[183] In an earn out, the purchaser's obligation to pay interest is contingent upon there being an obligation to pay the earn out amounts; thus, once the performance targets are met, both obligations should become absolute with retroactive effect. When this occurs, certain amounts of interest may come to accrue retroactively in respect of a prior year. This interest may never be deductible.[184] In the prior year, the purchaser is not able to claim a deduction because when it files its returns for that year there is not yet an absolute obligation to pay this interest.[185] In the subsequent year, any interest that comes to accrue in respect of a prior year is not deductible, precisely because it does not accrue in respect of that subsequent year.

Consider the following example: in year 1 a purchaser buys a business under a conventional earn out. The formula for the earn out amounts is based on the cumulative performance of the business through the end of year 4. Interest is to accrue on these amounts from the date of closing until they are paid. In years 1-3 the purchaser cannot claim an interest deduction, as when it files its returns for these years there is not yet an absolute obligation to pay any interest, since the earn out amounts are still contingent. Then, in year 4 an earn out amount becomes payable. In this year the purchaser can only claim a deduction for the interest that accrued from the beginning of the year; all interest that accrued retroactively in respect of years

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[182] See supra note 82.

[183] See *Barbican Properties Inc. v. R,* 97 DTC 122 (TCC), at paras. 62-64, aff'd. 97 DTC 5008 (FCA); see also *Redclay Holdings Ltd. v. R,* 96 DTC 1207 (TCC), at paras. 3-5. The CRA has confirmed this principle. See IT-533, supra note 76, at para. 6; see also CRA document no. 9729670, December 9, 1997; and CRA document no. 2006-0190791I7, June 29, 2006.

[184] See Loveland, supra note 180, at 24-25; see also Nicole Prieur, "Le financement de l'acquisition d'une entreprise," in *Revues 19:3* (Montréal, Association de planification fiscale et financière, 1997), at 2.1.3.

[185] The purchaser cannot even determine what amounts of interest to deduct, because the principal is unknown.

1-3 cannot be deducted in year 4 because it did not accrue in respect of year 4.

There are several potential solutions to this issue. The first option is that when amounts of interest come to accrue retroactively in respect of prior years the purchaser could simply file amended returns and claim deductions from its income for these prior years. This option seems appropriate insofar as it involves a retroactive filing to address retroactive interest. There is no reason why the retroactivity should suffice to require the vendor to include the interest in its income, but not to allow the purchaser to deduct it from its income. That said, the CRA has the discretion to refuse an amended return and it is by no means certain that they would allow the deduction. Also, note that the amended return would have to be filed within the normal reassessment period for that year, unless the taxpayer waived the limitation.[186] The second option is that the purchaser could once again delay filing its returns for the prior years until the obligation to pay the interest becomes absolute. It would pay its tax for these years without taking any interest deductions into account, and then later file the returns to claim the deductions and a refund on the tax paid. However, given the interplay between paragraph 164(1)(b) and subsection 164(1.5), this would only increase the period of time in which to claim the deductions where the taxpayer is an individual. The final option is that the parties could simply stipulate in their agreement that no interest is to accrue retroactively in respect of prior years.[187] While this alternative has the advantage of avoiding the problem altogether, it will likely be commercially unacceptable to the vendor.

3.5. CONCLUSION AND RECOMMENDATIONS

Parties negotiating the purchase and sale of a business might consider implementing an earn out where they are unable to agree upon the value of the business' goodwill. This decision

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[186] See *Information Circular* 75-7R3, "Reassessment of a Return of Income," July 9, 1984, at paras. 4-5.
[187] See Loveland, supra note 180, at 25.

should involve a close consideration of the tax consequences. Ultimately, these consequences lead to the conclusion that an earn out should only be implemented where it is absolutely necessary to reach a deal. If the parties do decide to implement an earn out, it should be structured insofar as is commercially practicable to optimize the tax treatment for the vendor, as the treatment for the purchaser is essentially the same regardless of the deal structure. Table 1 provides a summary of the tax consequences that can apply to the vendor under the various earn out structures. Additionally, the following are some general prescriptions regarding which earn out type is preferable in which situation.

For a Canadian resident vendor in an asset deal a reverse earn out is probably preferable to a conventional one, because the variable amounts would be be included in income at a 50% rate instead of a 100% rate. However, if the vendor expects significant reductions to the sale price, then the potential uselessness of the capital loss adjustments might imply that a conventional earn out would be preferable. In a share deal, as long as the conditions to use the cost recovery method would be met, a conventional earn out would be preferable. If these conditions would not be met, however, then a reverse earn out would be preferable in the same way as in an asset deal. To ensure that the capital loss adjustments would be useful the earn out period should not exceed three years.

For a non-resident vendor, the prescriptions are largely the same from a purely Canadian tax perspective. In an asset deal, as long as the vendor does not expect significant reductions to the sale price, a reverse earn out would be preferable to obtain the 50% rate. Otherwise, the complete lack of adjustments means that a conventional earn out would probably be preferable. In a share deal, if the vendor is not liable to tax then the reverse earn out would be optimal, as there would be no tax. If the vendor is liable to tax, then a reverse earn out would still be preferable, again as long as significant reductions are not expected. Alternatively, a conventional earn out would produce the same result if the vendor met the cost recovery method conditions under which the CRA allows the estimated proceeds of disposition method to apply. In any case, if foreign tax credits in the vendor's country of residence will fully offset the Canadian tax paid, the vendor should be indifferent as to the type of earn out implemented.

CONCLUSION

For a tax advisor working on the purchase and sale of a business reviewing the draft agreement will be but one of many tasks. However, it remains an important task. The parties will seek to implement terms that serve their respective commercial interests, and it is the role of the tax advisor to ensure that they make their decisions with a proper appreciation of the attendant tax consequences. Price-related terms can have particularly significant tax consequences. This paper has attempted to provide an in-depth exploration of three such terms. The starting point is always to understand how the terms function both commercially and legally. Once this is firmly grasped, the tax consequences can then be determined. An understanding of these consequences, and especially of how to manipulate them, will allow the tax advisor to ensure that his client makes optimal decisions.

TABLE 1 – SUMMARY OF VENDOR TAX TREATMENT UNDER VARIOUS EARN OUT STRUCTURES

			Canadian Resident	**Non-Resident**
Normal Sale	Assets		• Disposition of distinct assets • PD allocated to each asset • Gain on goodwill included at a 50% rate in year of sale	• Liable to tax under Part I • Gain on goodwill included at a 50% rate in year of sale • No treaty relief
	Shares		• Gain on shares included at a 50% rate in year of sale	• Usually not liable to tax under Part I (shares rarely TCP) • Gain included at a 50% rate in year of sale (if no treaty relief)
Earn Out	Assets		Fixed Amount See Normal/ Assets/ Resident Earn Out Amount • 12(1)(g) applicable • Amounts included at a 100% rate when received	Fixed Amount See Normal /Assets/ N-R Earn Out Amount • 212(1)(d)(v) applicable • Part XIII withholding when amounts paid • No treaty relief
	Shares	*12(1)(g) Method*	Fixed Amount See Normal/ Shares/ Resident Earn Out Amount • 12(1)(g) applicable • Amounts included at a 100% rate when received	Fixed Amount See Normal/ Shares/ N-R Earn Out Amount • 212(1)(d)(v) applicable • Part XIII withholding when amounts paid • Possible treaty relief
		Estimated PD Method	See Normal/ Shares/ Resident • 12(1)(g) inapplicable • PD = fixed amount + FMV earn out rights • CG reserve unavailable • Subsequent adjustment (CG/CL in year earn out amounts payable)	See Normal/ Shares/ N-R • 212(1)(d)(v) inapplicable • PD = fixed amount + FMV earn out rights (Part I & section 116) • No subsequent adjustment
		Cost Recovery Method	• 12(1)(g) inapplicable • Gain on shares included at a 50% rate in year amounts determinable • CG reserve available	• Cost recovery method not applicable for N-Rs • If certain conditions met, CRA will apply Estimated PD Method
Reverse Earn Out	Assets		See Normal/ Assets/ Resident • 12(1)(g) inapplicable • PD = max amount • No reserves • Subsequent adjustment (CL in year reductions determined)	See Normal /Assets/ N-R • 212(1)(d)(v) inapplicable • PD = max amount (Part I & section 116) • No subsequent adjustment
	Shares		See Normal/ Shares/ Resident • 12(1)(g) inapplicable • PD = max amount • CG reserve unavailable • Subsequent adjustment (CL in year reductions determined)	See Normal/ Shares/ N-R • 212(1)(d)(v) inapplicable • PD = max amount (Part I & section 116) • No subsequent adjustment

SCHEDULE 1

LIST OF ABBREVIATIONS

ACB – Adjusted Cost Base

BCSC – British Columbia Supreme Court

CRA – Canada Revenue Agency

ECA – Eligible Capital Amount

ECE – Eligible Capital Expenditure

ECP – Eligible Capital Property

FCA – Federal Court of Appeal

FMV – Fair Market Value

ITCIA – Income Tax Conventions Interpretation Act

PC – Privy Council

SCC – Supreme Court of Canada

TAB – Tax Appeal Board

TCC – Tax Court of Canada

TCP – Taxable Canadian Property

UHKL – United Kingdom House of Lords

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