



## THE LEGAL INSIDER

of Mr. Alain P. Lecours

### COMMERCIAL LAW

#### Negotiating the sale of a business: The issues at stake

The sale of a business constitutes a complex operation; in addition to multiple strategic and financial considerations, both the seller and the buyer must also take into account the fiscal and legal aspects. When the business is embodied by a corporation whose shares are held by an individual, and when a capital gain ensues from the sale of that business, the selection of the transactional vehicle to be used (that is, whether through a sale of shares or a sale of assets), becomes a major issue in the negotiations between the parties.

When the buyer acquires the shares of the corporation held by the seller, he acquires the business indirectly, assets and liabilities included. When the parties carry out a sale of assets, it is the corporation itself that sells to the buyer the assets constituting the business, to the exclusion of the corporation's liabilities from the transaction.

Each type of transaction presents advantages for one or the other of the parties; considering the stakes at the table, the negotiations surrounding the sale of a business lead to a constant debate between the buyer and the seller as to the choice of proceeding via a sale of shares or a sale of assets.

#### Sale of Shares

Under the fiscal laws of both Canada and the Province of Québec, a individual (natural person) may take advantage of a \$500,000 lifetime fiscal exemption on capital gains (barring the application of certain guidelines). Hence, the first \$500,000 of capital gains realized by an individual in his lifetime are not taxed; an individual may thus achieve important fiscal savings on the sale of his shares. However, this fiscal exemption does not apply to legal persons such as corporations. This way, when the corporation sells its assets, as opposed to a sale of its shares detained by an individual, it shall not reap any fiscal advantage.

When a business is sold, it is thus much more profitable, fiscally-speaking, for the seller to carry out a sale of shares. Indeed, it is then the seller himself that realizes the capital gain through the sell of the shares he holds. He may take full advantage of the fiscal exemption and thus realize a greater after-tax profit.

On the other hand, the sale of shares implies that the buyer acquires the corporation as a whole. By buying the corporation, the buyer acquires not only its assets, but also its liabilities, actual and latent, known and unknown. Indeed, the corporation may possess hidden liabilities, which the seller would have not disclosed (whether by ignorance or by misrepresentation).

*As an example, the corporation could be sued after the transaction over defective products that would have been sold before the buyer even acquired the shares. Likewise, a fiscal inspection of the last five financial years, carried out after the sale of shares, could reveal a tax debt.*

To protect himself against such hidden liabilities, the wise buyer shall require additional guaranties from the seller. A first mechanism consist in a personal pledge from the seller, guaranteeing that the financial statements presented to the buyer in the scope of the transaction are in conformity with reality and that there are no undisclosed obligations. A second mechanism consists in the seller retaining a balance of the sale price, for a pre-established time, until the risk of encountering hidden liabilities or obligations has passed. In this fashion, if that risk materializes, the seller would be able to petition the court for a reduction of the shares' sale price, and then operate compensation upon the balance owing. These two mechanisms are habitually used in concert.

## The Sale of Assets

The sale of assets is a transaction through which the buyer acquires, directly from the corporation, the assets that constitute the business. This mode of acquisition allows him to acquire, in whole or in part, the corporation's assets (goodwill, receivable accounts, immovable and movable property, stock, etc.) without assuming the corporation's liabilities (apparent and hidden). The sale of assets is thus a most favourable transactional vehicle for the buyer, as it eliminates the risks pertaining to hidden liabilities. Furthermore, this type of transaction may present fiscal advantages to the buyer, depending on the nature of the transacted assets. However, the sale of assets is much less fiscally interesting to the seller than the sale of shares.

The main advantage that the buyer shall obtain from the sale of assets is that he needs not acquire the corporation's liabilities both apparent and occult. Indeed, the various assets transacted are treated as simple goods that are alienated from the corporation's patrimony. The corporation's debts remain its own.

For the seller, the sale of assets is more problematic. Indeed, it is the corporation, rather than he personally, that sells its assets. It is thus the corporation itself that realizes a capital gain. In addition to the absence of a fiscal exemption for corporations, the seller may face other complications when he intends to use the capitals originating from the sale, as the corporation may not simply issue these capitals to its shareholders without them being taxed again. The seller shall thus maintain the existence of the corporation so as to re-use and invest the proceeds of the sale through its agency.

When the parties carry out an allocation of the sale price between the various assets transferred, there is again the presence of diverging interests between the buyer and the seller. On one hand, the seller will favour the allocation of a greater amount to simple expenses (which can be claimed as such during the next fiscal year) by opposition to eligible capital expenditure that must be amortized or depreciated over multiple years. On the other hand, the seller will favour an allocation plan that would have for effect to attenuate the capital gains on each of the assets transacted.

## Conclusion

To carry out the sale of a business operated through a corporation, the parties may opt for a sale of shares or a sale of assets. The sale of shares presents an important fiscal advantage for the individual seller, i.e. a fiscal exemption of up to \$500,000. However, this solution exposes the buyer to the risk of hidden obligations or debts arising after the transaction; to prevent such occurrences, the buyer shall demand personal guaranties from the seller. The sale of assets eliminates the risks to the seller of assuming hidden liabilities, but it takes away an important fiscal advantage from the seller.

The decision to proceed via either of these transactional vehicles shall be the object of a serious negotiation between the parties, as a result of the legal and fiscal impacts. However, this question presupposes that: 1) the business is owned by a corporation; 2) the shares of that corporation are held by an individual; and 3) the sale shall result in a capital gain for the seller. Otherwise, there is no reason to resolve this dilemma.

On the whole, numerous rules govern the fiscal aspect of the sale of a business. It is thus highly advised not to improvise by entering a transaction of which many legal ins and outs are ill-known. The services of an accounting expert, well versed in fiscal matters, are recommended and shall be revealed essential to duly completing the projected transaction.

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