

Buying and Selling a Business: Assets or Shares - Reviewing Your Options

As a business person contemplating the purchase or sale of a business you will need to consider the structure of the transaction. Generally speaking, there are two methods: 1) the purchase or sale of the assets used to operate the business and 2) the purchase or sale of the shares of the corporation that owns the assets and operates the business.

One of the major advantages of the asset transaction to the purchaser is the ability to choose only those specific assets desired. After having completed all of the appropriate due diligence searches, there is very little risk of unknown liabilities arising after the transaction is completed. The purchaser of shares, however, acquires all of the assets and liabilities of the target corporation. While due diligence is conducted in respect of the corporation, unknown liabilities may indeed arise after the close of the transaction. For this reason, a purchaser may favour an asset transaction.

The issue of employees can be very complex. If the business is a unionized workplace then the Labour Relations Act, 1995 will apply and the purchaser will likely be considered to be a successor employer regardless of the structure of the transaction. This means that the purchaser will inherit the collective agreement with the union. With regard to non-unionized workplaces, while the employer-employee relationship is unaffected by a share transaction, an asset transaction gives rise to many factors for consideration. In an asset purchase, a purchaser may or may not continue to employ the vendor's employees. Under the Employment Standards Act, 2000 of Ontario, if the purchaser continues to employ the vendor's employees, the employment is not terminated by the sale but rather the purchaser is considered to be a successor employer and inherits the history of every employee, including years of service. The result can be severe to the purchaser who shortly after the closing determines that a long term employee is unfit for the job and must give such employee an unduly long, but nonetheless statutory, notice of termination. On the other hand, if the purchaser does not continue the employment of some or all of the employees, the vendor must terminate such employees prior to the completion of the transaction having provided each employee with the statutory notice of termination or pay in lieu thereof. This can be costly to the vendor. There are also very complicated common law issues associated with the termination of an employee and these should be given very careful consideration.

One way for the vendor and the purchaser to mitigate the risks associated with employees in an asset transaction is to provide the purchaser with a certain period of time post-closing to assess the employees. If the purchaser terminates any employee for cause during the stipulated time frame, then the parties may further agree that the vendor will indemnify the purchaser for the costs associated with the termination. While this does not remove the obligation for payment from the purchaser as employer, the purchaser is able to seek reimbursement from the vendor.

The sale of assets will usually attract the application of the Bulk Sales Act, 1999 of Ontario which prevents a vendor from selling its assets out of the ordinary course of business without first making adequate provision for the payment of its trade creditors. If the purchaser fails to require the vendor to comply with the legislation, the transaction may be set aside and in some cases the purchaser may be held personally liable to account to the trade creditors. It is imperative that there be compliance with the Bulk Sales Act.

In an asset transaction, some assets may require the consent of a third party in order to be transferred to the purchaser. An example of this could be an equipment lease. In a share transaction, however, a purchaser automatically acquires title to assets as no formal transfer of

title is necessary. It is important to carefully review the terms of all existing contracts when contemplating the transaction. Even in a share transaction some assets may give rise to certain events where there is a change in control or ownership of the target corporation. For example, a lease for the business premises may state that a change in control or ownership of the tenant requires the landlord's consent or results in a forfeiture of the lease.

Tax consequences may very well be among the most important considerations when choosing the method of the transaction. Generally speaking, a purchaser prefers to buy assets while a vendor prefers to sell shares.

The purchaser is generally concerned about long term tax consequences. In an asset purchase, the purchase price is allocated to the hard cost of the assets, including depreciable assets, regardless of the historical cost base of same. The increased cost base provides for greater depreciation of depreciable assets by the purchaser in the following years. On the other hand, if shares are acquired, the purchase price is allocated to the cost base of the shares with no immediate benefit to the purchaser. Additionally, the purchaser inherits the underlying tax characteristics of the assets of the target corporation which generally results in less depreciation expense in the future and a larger annual tax bill.

The vendor is generally concerned about immediate tax consequences. Where the vendor's sale of shares results in a capital gain, only 50% of the gain is taxable in the hands of the vendor. Further, some or all of the capital gain may be either exempt from taxation or deferred in special circumstances. Some of these special circumstances include the availability of the vendor's \$750,000 lifetime capital gains exemption if the shares are qualifying small business corporation shares, capital gains rollovers and capital gains reserves. In an asset sale, the tax consequences to the vendor depend upon the underlying tax characteristics of each asset. The sale typically gives rise to some component of ordinary income which is taxed at full rates. For example, depreciable capital property will give rise to recapture of the capital cost allowance to original cost and inventory gives rise to income gains. The vendor must further consider how it will distribute the proceeds arising from the sale of assets. This is usually in the form of a dividend to its shareholders resulting in a second level of taxation. As less income tax is typically paid by the vendor in a share sale, the vendor prefers to sell shares. From a purchaser's perspective, this may allow a lower purchase price to be negotiated for the shares.

While a purchaser may generally favour an asset sale and a vendor may generally favour a share sale, these preferences may change for various reasons. For example, the purchaser may prefer a share purchase if the target corporation has significant non-capital loss carry forwards which can be used to reduce the future income of the business and the taxes payable. It is therefore very important for each party to thoroughly review the tax consequences of each method.

The method of transaction - assets or shares - will be based on a number of business, legal and tax considerations, only a few of which have been addressed in this article. For a more thorough review of your options, you should consult with your lawyer prior to committing yourself.