Aries Advisory Group Ltd.

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The Acquisition of Shares or Assets When Buying a Company

One of the issues that surfaces when buying a business is whether shares or assets will be purchased. Both parties to the deal are motivated to minimize tax and exposure to contingent liabilities. Depending on what is purchased, one party may benefit to the detriment of the other. This newsletter discusses the implications of buying shares vs. assets and how a buyer to an acquisition can mitigate his exposure.

Taxation

A seller would normally prefer to sell shares since in most jurisdictions, the tax rates on the sale of shares are usually lower than when assets are sold. In Canada, the first $750,000 of any gain on sale of shares is tax free for Canadian Controlled Private Corporations and only 50% of any gain over $750,000 is taxable. If assets are sold however, a seller may be subject to double taxation. This is because the company would pay tax on the asset sales before the remaining proceeds are distributed to shareholders who would then be liable for personal taxes on any amounts received.

A buyer would generally prefer to purchase assets since this would increase the tax base of the assets purchased to fair market value from the lower value contained in the seller's books. This additional asset base would be used to reduce future taxes through increased tax depreciation. In addition, if goodwill arises on the acquisition (being the excess of the purchase price over the fair market value of the assets purchased), it too is deductible for tax by the buyer.

Liabilities

A seller would rather sell shares so that he is not liable for the payment of any liabilities within the company. In some jurisdictions (e.g. Ontario) bulk sales acts exist whereby the seller is compelled to pay all creditors as a condition of the sale of the majority of the company's assets.

A buyer would prefer to purchase assets to avoid assuming any liabilities. In particular, unknown or contingent liabilities would be the biggest concern since these items would not have been factored into the offer price for the company.

Continuity

In this instance, a buyer may prefer to purchase shares if the company has entered into key leases or agreements that are crucial to the ongoing business' success and are not assignable to a buyer or its new company.

Employees

In a share sale, employees (along with their seniority and years of service) would be assumed by the buyer. Should a buyer wish to terminate any employees after the sale, he would be liable for any severance payments. However if a buyer purchases assets, he can make employment offers to the employees he wants. And in some jurisdictions, the buyer would have no severance liability for any employees left behind.

Closing Costs

These costs are usually higher on an asset sale. For example, legal and notary fees to transfer the ownership of the assets are higher in an asset sale. If land is being sold, a commission may be payable to a real estate broker. Most of these costs would be avoided on a share sale.

If a seller refuses to sell assets, here are some ways that a buyer can mitigate his risk in a share acquisition transaction:

1. Include in the purchase and sale agreement representations and warranties from the seller that it will indemnify the buyer for any material, undisclosed or contingent liabilities.
2. Holdback a portion of the purchase price on closing in order to offset undisclosed or contingent liabilities that arise after the closing date.
3. Key agreements or leases entered into by the target may require approvals from the counter party for an assignment of the contract as a result of a change of control. The buyer should include in the purchase agreement a condition precedent to closing that all key agreements are assigned.
4. If a buyer plans to eliminate employees after the acquisition, it should either factor any severance payments into its offer price or holdback an amount for severance after closing.

Aries Advisory Group can assist either party to a merger or acquisition in regards to its strategy. We will discuss the transfer of shares or assets and set out the pros and cons of each. We will then recommend the best alternative given our client's negotiating position. If you require assistance in the acquisition or sale of a business, please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.