profit calculations if the new business or expansion can be identified separately from the business acquired. If not, the parties should consider restricting expansion.

(7) *Taxes:* The parties should consider how the business will account for taxes during the earn-out period. For example, if taxes are payable as a result of the acquisition, the parties should consider if they should be charged against the earnings. Also, if there are losses, thus creating loss carry-forwards before or after acquisition, the parties should consider who will receive the tax benefit.

(8) *Other:* Consider the treatment of accounts receivable, bad debts, overhead administrative charges, management fees, and other related-party charges.

V. ACCELERATION AND PRE-PAY OPTIONS IN EARN-OUTS [§8.5]

As discussed in "The Concept of an Earn-out in Business Acquisitions" in this chapter, an earn-out is a financial tool that can be used to bridge the valuation of the business by the purchaser and vendor, respectively. An earn-out, from the vendor's perspective, has similar elements to a loan and therefore should not be an obligation that the purchaser may assign, particularly in the context of a further sale of the acquired company or business. Ultimately, the specific commercial context of an earn-out will determine whether a purchaser or vendor may wish to pre-pay or accelerate the earn-out obligation, and the specific terms will be a matter of negotiation; there is no "market standard" in this respect.

There are a variety of situations where an earn-out can be deployed. The inherent flexibility offered by earn-out provisions means that either vendors or purchasers may choose to pre-pay or accelerate for different reasons. For example, from the purchaser's perspective, it may wish to make significant changes to the target company or business. This may raise the possibility of dispute where the vendor does not agree with the nature of the change or the direction of the business on a go-forward basis. In the context of an earn-out where the vendor remains a direct or indirect shareholder of the target, the purchaser may have to respect certain consent rights under a shareholders agreement. Pre-payment can therefore be useful where the purchaser wishes to avoid a dispute (or having to comply with

vendor consent rights) by simply making a payment—perhaps on a discounted basis—prior to expiration of the earn-out period.

In contrast, the vendor may wish to accelerate the earn-out obligation (at the full value of the earn-out) upon the occurrence of certain events, such as the further sale of the acquired company or business, bankruptcy, termination of key employees (particularly where a vendor principal is engaged in a management contract), or certain breaches of representations and covenants. From the vendor's perspective, acceleration clauses offer protection against the purchaser's ability to make adverse changes to the acquired company or business.

The "Sample Earn-out Clauses" in this chapter contemplate acceleration of the earn-out, at the vendor's election, where certain purchaser defaults occur. They do not contemplate a purchaser acceleration or pre-pay option.

VI. INCOME TAX CONSIDERATIONS WHEN USING EARN-OUTS IN BUSINESS ACQUISITIONS [§8.6]

A. INCOME TAX ON EARN-OUTS IN ASSET SALES [§8.7]

Before structuring an asset sale as an earn-out, the parties to the sale should consider the possible application of s. 12(1)(g) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). Usually, the sale of capital assets is characterized as a capital receipt. However, s. 12(1)(g) provides that any amount received by the vendor that is dependent on the use of or production from property—whether or not that amount was an instalment of the sale price of the property—is income of the vendor. Note that this provision does not apply to agricultural land.

Further, although the vendor is required to include the amount received from the sale of the assets as income, usually the purchaser cannot deduct the payments in computing its income. Rather, the purchaser's payments will be capitalized and become its cost of the property.

Where a sale of assets is structured so that part of the purchase price is fixed and part depends on production from or use of the property sold, Canada Revenue Agency's administrative position respecting the application of s. 12(1)(g), is outlined in Interpretation Bulletin IT-462 Archived, "Payments based on production or use" (October 27, 1980)

(an archived bulletin remains accurate statement of Canada Revenue Agency's administrative position), at para. 5 as follows:

> (c) Where the agreement for sale provides for a fixed sum plus payments based on production or use, the payments based on production or use are brought into income under s. 12(1)(g) and the fixed sum is treated as proceeds of disposition; and
>
> (d) Where the agreement for sale provides for payments based on production or use but also stipulates that there is to be a minimum sale price (or minimum annual payments), the payments based on production or use are brought into income under s. 12(1)(g) regardless of whether they are less than, or in excess of, the minimum. However, any other payments which must be made to meet the minimum requirements are treated as proceeds of disposition.

It is important to note that the application of s. 12(1)(g) is not limited to the production or use of tangible assets and includes intangibles, such as customer lists and contracts. A typical example of when s. 12(1)(g) will apply is when a client list of a business is sold and the purchase price is payable in instalments based on commissions or profits earned over a certain period by the purchaser from that list. See, for example, *Smith v. R.*, 2011 TCC 461.

In some situations that can be characterized as one-time sales, s. 12(1)(g) will not apply. See, for example, *R. v. Mel-Bar Ranches Ltd.,* 89 DTC 5189 (F.C.T.D.), in which the court held that the sale of timber located on ranch land at a price per tonne was not based on production, but was a sale of a specified block of logs at a fixed price.

If the vendor of the property is a non-resident of Canada and the property in question is "taxable Canadian property", the sale will be subject to s. 116 of the *Income Tax Act*. Generally, the non-resident vendor must apply for a clearance certificate either before or within 10 days after the disposition of such property occurs and pay 25% of its gain from the sale of that property (or furnish acceptable security). If the vendor does not obtain such a clearance certificate, the purchaser may be liable to pay 25% of the purchase price (and not 25% of the capital gain) as tax within a specified time. If the property is depreciable property, the relevant percentage is 50%.

Section 12(1)(g) may create additional problems for the parties to a sale when an earn-out clause is used because it may be difficult to determine