



NO.: **IT-426R**

DATE: September 28, 2004

SUBJECT: **INCOME TAX ACT**
Shares Sold Subject to an Earnout Agreement

REFERENCE: Subsection 39(1) (also paragraph 12(1)(g), subparagraph 40(1)(a)(iii), subsections 110.6(2) and 110.6(2.1) of the *Income Tax Act* (the "Act"))

At the Canada Revenue Agency (CRA), we issue income tax interpretation bulletins (ITs) in order to provide technical interpretations and positions regarding certain provisions contained in income tax law. Due to their technical nature, ITs are used primarily by our staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, we offer other publications, such as tax guides and pamphlets.

While the comments in a particular paragraph in an IT may relate to provisions of the law in force at the time they were made, such comments are not a substitute for the law. The reader should, therefore, consider such comments in light of the relevant provisions of the law in force for the particular taxation year being considered, taking into account the effect of any relevant amendments to those provisions or relevant court decisions occurring after the date on which the comments were made.

Subject to the above, an interpretation or position contained in an IT generally applies as of the date on which it was published, unless otherwise specified. If there is a subsequent change in that interpretation or position and the change is beneficial to taxpayers, it is usually effective for future assessments and reassessments. If, on the other hand, the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date on which the change is published.

Most of our publications are available on our Web site at: www.cra.gc.ca

If you have any comments regarding matters discussed in an IT, please send them to:

**Income Tax Rulings Directorate
Policy and Planning Branch
Canada Revenue Agency
Ottawa ON K1A 0L5**

or by email at the following address: bulletins@cra.gc.ca

This version is only available electronically.

Contents

Application

Summary

Discussion and Interpretation

Introduction (¶ 1)

Conditions for the Application of the Cost Recovery Method (¶ 2)

Description of the Cost Recovery Method (¶s 3-7)

Other Comments (¶s 8-9)

Explanation of Changes

Application

This bulletin cancels and replaces Interpretation Bulletin IT-426 dated February 19, 1979. Unless otherwise stated, all statutory references throughout the bulletin are to the Act.

Summary

This bulletin describes the cost recovery method of reporting capital gain or capital losses on the sale of shares subject to an earnout agreement. Taxpayers may use the cost recovery method where certain conditions are satisfied.

Discussion and Interpretation

Introduction

¶ 1. Where shares of a corporation are sold under an agreement whereby the proceeds of disposition are at least partially determined pursuant to an earnout clause in an agreement i.e., the quantum of proceeds is determined by reference to future earnings generated by the underlying assets of the corporation, it is usually impossible to determine accurately, within a reasonable time after the sale, the amount of the gain or loss realized on the sale. From a legal point of view, it is possible that paragraph 12(1)(g) would apply to all payments made under the earnout clause, or that the total proceeds of disposition as at the date of the sale must include the value of the earnout rights. These approaches can produce unsatisfactory results for both the taxpayer and the CRA. Consequently, the CRA will accept the use of the cost recovery method of reporting the gain or

loss on the sale of shares under an earnout agreement where the conditions described in ¶ 2 are met.

Conditions for the Application of the Cost Recovery Method

¶ 2. Taxpayers may use the cost recovery method if 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.

Description of the Cost Recovery Method

¶ 3. Under the cost recovery method, the vendor reduces his adjusted cost base of the shares as amounts on account of the sale price become determinable. Once such an amount on account of the sale price exceeds the adjusted cost base of the shares (as reduced by any previous such amounts), the excess is considered to be a capital gain that is realized at the time that that amount became determinable, and the adjusted cost base becomes nil. All such amounts that subsequently become determinable are treated as capital gains at the subsequent time.

¶ 4. If subsection 26(3) of the *Income Tax Application Rules, 1971* is relevant in determining the adjusted cost base of shares sold to which the cost recovery method is applicable, the vendor does not report any gain thereon until the aggregate of determinable amounts therefore exceeds the greater of the historic cost and the fair market value on valuation day of such shares.

¶ 5. For the purposes of this bulletin, an amount becomes determinable once it is capable of being calculated with certainty and the taxpayer has an absolute but not necessarily immediate right to be paid. Where the sale agreement stipulates a minimum amount payable by the purchaser in any event, that amount is considered to become determinable by the vendor at the time of the sale.

¶ 6. A capital loss is recognized only at the time the maximum that may be received is irrevocably established to be less than the vendor's adjusted cost base. For example, if the earnout clause sets a maximum that could become payable under the contract and that amount is less than the vendor's adjusted cost base of the shares sold, a capital loss equal to the deficiency is recognized at the time of the sale. If the sale price is comprised of a series of maximum amounts and the actual amounts thereof are to be determined upon the realization of events subsequent to the date of sale, additional capital losses are recognized, when each such amount becomes determinable, to the extent that the maximum sale price is further reduced. If there is no maximum set, a capital loss is not recognized until the time when it can be established that the total of the amounts to be paid cannot exceed the vendor's adjusted cost base of the shares sold.

¶ 7. Where in a taxation year the aggregate of amounts established to have become determinable is in excess of the adjusted cost base of the shares, a reserve under subparagraph 40(1)(a)(iii) may be claimed for that year in respect of that part of such aggregate that is payable after the end of the year. It is the CRA's position that a reasonable reserve under such circumstances is equal to the lesser of:

- (a) the aggregate of determined capital gains at the end of the taxation year × the aggregate of amounts payable after the end of the taxation year
- and
- (b) the amount, if any, by which 4 exceeds the number of preceding taxation years ending after the disposition of the property × aggregate of determined capital gains at the end of the taxation year

A "determined capital gain" in the formula above means a capital gain (before the reserve) calculated pursuant to the rules in ¶s 3 to 5 under the cost recovery method. Thus, no part of the capital gain may be deferred beyond 5 years pursuant to subparagraph 40(1)(a)(iii) regardless of the fact that proceeds may not all be payable within a 5-year period.

Other Comments

¶ 8. For the purposes of this bulletin, an agreement that merely determines when amounts are to be paid, as opposed to determining the quantum of proceeds, is not considered to be an earnout agreement.

¶ 9. Where a taxpayer uses the cost recovery method to report a capital gain as the proceeds become determinable after the disposition of a share that was at the time of disposition a “qualified farm property” or a “qualified small business corporation share” as defined in subsection 110.6(1), the taxpayer is entitled to claim the capital gains deduction to the extent permitted by subsections 110.6(2) or 110.6(2.1) respectively.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised interpretations of the CRA.

Reasons for the Revision

This bulletin updates the former IT-426 that allows the taxpayers to use the cost recovery method of reporting capital gains or capital losses on disposition of shares subject to an earnout agreement where certain conditions are met. This bulletin has been revised mainly in order to clarify the application of the cost recovery method.

Legislative and Other Changes

¶ 1 has been modified to clarify the possible tax treatments of earnouts.

New ¶ 2 was previously included in former ¶ 1.

In new ¶ 2, the fourth condition has been modified in order to clarify the meaning of the 5-year period.

In new ¶ 2, a sixth condition has been added, which provides that IT-426R applies only to persons resident in Canada.

In ¶ 5, the meaning of the term “determinable” has been modified to specify that an amount be brought into account when the taxpayer has an absolute but not necessarily immediate right to be paid.

¶ 7 has been modified to clarify the application of the reserve for capital gains provided in subparagraph 40(1)(a)(iii) where the cost recovery method is applied by a taxpayer.

¶ 8 was former ¶ 2.

New ¶ 9 has been added to provide comments with respect to the application of the capital gains deduction when a capital gain is reported by a taxpayer after the disposition of a share under the cost recovery method.