Sell Now!

(How the 2016 Budget *Will* Impact Business Owners' Exit Strategies)

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Back in 2014 I wrote an article reviewing the significant impact on business owners of potential changes to the taxation of Eligible Capital Property ("ECP")[1] that had been floated in the 2014 Federal Budget ("2014 Budget").[2] The 2014 Budget papers were somewhat light on details and included a promise to hold consultations about the proposed changes.

Although the consultations never took place and the status quo continued for the past two years under the former Conservative government, this has all changed as part of the new Liberal government's ambitious 2016 Federal Budget. In particular, the 2016 Budget includes in its Notice of Ways and Means Motions ("NWMM") detailed legislative proposals to eliminate the current ECP regime ("Current Regime") by causing ECP to be taxed in essentially the same manner as ordinary depreciable capital property ("New Regime") effective January 1, 2017.

Since my 2014 concerns will likely now become a reality in 2017, I thought it would be worth bringing some items to your attention.

Assuming legislation released with the 2016 Budget to implement the New Regime is enacted substantially as proposed, then beginning in 2017, business owners' exit strategies will become

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[1] ECP encompasses a broad range of property that can include: goodwill, customer lists, milk quotas, marketing quotas and farm quotas, licences of an unlimited duration, taxi and other government licenses, perpetual or indefinite franchises, certain trademarks which do not give rise to deductible expenses, other intellectual property such as from copyrights and trade secrets and property resulting from incorporation and certain other qualifying corporate reorganization expenses. A good summary of the broad class of property that can comprise ECP is found in Brent Kerr, "Eligible Capital Property: Update on the Rules," *2006 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 2006), 17:1-29 at 13.

[2] See *Tax Notes* No. 614, March, 2014 as well as the *Estate Planner* No. 230, March, 2014, both published by Wolters Kluwer (CCH) Limited.

much less tax effective. While at first glance, a move from the Current Regime seems completely logical and relatively innocuous,[3] it is the change to how ECP is taxed upon its disposition that should cause owner-managers who are considering selling their businesses to start thinking about selling a lot more seriously.

For many clients, ECP and, in particular, goodwill will be the single biggest asset that they will have to sell. The shift from the Current Regime to the traditional capital gains regime applicable to other depreciable property under the New Regime will result in a significant loss of tax deferral in situations where the owner-manager has no personal need for the full amount of the proceeds of sale.

To better understand the impact of these proposed tax changes assume that an individual named Ely has been carrying on a hat business through a corporation named Ely's Caps Limited. Ely wants to sell his interest in Ely's Caps but he can't find a purchaser who will buy his shares. However, he has received an offer to buy all of Ely's Caps' goodwill for $10 million.

Under the Current Regime, if Ely's Caps agrees to accept the offer, the sale would give rise to $10 million of taxable income. Assuming this income will all be subject to the general corporate tax rates in Ontario, about $1.325 million in tax will be payable by Ely's Caps.[4] In addition, after the end of Ely's Caps' current taxation year, the sale will give rise to a $5 million addition to Ely's Caps' capital dividend account, which will allow Ely to remove $5 million of cash from Ely's Caps for his *personal use* with no additional taxation.

Under the New Regime, the full $10 million of proceeds would be taxed at corporate capital gains tax rates, which would give rise to a total corporate tax liability in Ontario of slightly more than $2.5 million. As was the case under the Current Regime, this sale would immediately generate an addition to Ely's Caps' capital dividend account of $5 million, which could be distributed to Ely tax free.

Assuming Ely is happy living off the $5 million from the capital dividend account and is willing to leave any remaining after-tax proceeds in Ely's Caps, then the result of the change from the Current Regime to the New Regime is that Ely's Caps would lose its ability to "defer" nearly $1.2 million in taxes.

The "cost" of the loss of this deferral should not be understated since, as a practical matter, most owners in Ely's situation and in situations involving more modest sales than Ely's would likely not draw more than the capital dividend account balance out of Ely's Caps for a very long time, *if ever*.

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[3] In some cases the impact of the changes may even be positive. For example, vendors with capital losses will now be able to offset capital gains on a sale of ECP against their capital losses, which would not have been the case under the Current Regime.

[4] To the extent that Ely's Caps has not used up its full small business deduction limit the first $1 million of proceeds could have been taxed at rates as low as 7.5% in 2016.

So, in many cases the loss of the corporate deferral under the New Regime will really amount to an effective 12% tax on Ely's Caps, which is almost double the corporate tax that Ely's Caps would have paid under the Current Regime.

Assuming the New Regime becomes law, then it would certainly appear that given the massive transition of wealth that is set to occur over the next number of years this new 12% tax will likely be a significant revenue generator for the Canada Revenue Agency, though for reasons that I still can't understand, the Department of Finance still hasn't touted the change in this manner.[5]

Although the New Regime is not yet law, business owners who were already thinking about selling would be advised to carefully reconsider the timing of their exit because now may be a very good time to sell. At the very least, consideration should be given to implementing strategies[6] that may allow business owners to enjoy the benefits of the Current Regime while they still can.[7]

About Michael Goldberg

Michael Goldberg is a senior tax partner at Minden Gross LLP and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real life tax situations for professional advisors who serve high net worth clients.

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[5] The 2016 Budget papers do show an increasing positive fiscal impact from these changes (2016-17 $30 million and 2017-2018 $190 million of new revenue). Query if even these numbers are too modest.

[6] A discussion of such transactions, which are often referred to as goodwill (ECP) bump or "crystallization" strategies is beyond the scope of this article.

[7] Assuming the New Regime is legislated, expect a return to the old status quo of vendors having a very strong preference to sell shares (it appears that the CCA rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly more favourable variations for existing ECP, so that the New Regime should be relatively tax neutral for purchasers). Due to the low tax rates applicable to ECP sales, this may not have always been the case in the more recent past, even for vendors whose shares would otherwise have qualified for capital gains exemption treatment. In some situations it has been possible for both vendors and purchasers to achieve the best of both worlds from a tax perspective by employing so-called "hybrid" sale structures, whereby transactions are structured to allow vendors to sell their shares and also sell assets of the corporation. For more on hybrid sale structures see, for example, Charles P. Marquette, "Hybrid Sale of Shares and Assets of a Business" in *Canadian Tax Journal* (2014), vol. 62, no. 3, 857-879.

Please note that once the New Regime is in place much of the deferral benefit that was enjoyed by vendors through the use of hybrid structures will be lost. Still purchasers will still want to purchase assets and vendors will want to purchase shares so perhaps these structures will continue to be viable.