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(How The 2014 Budget May Impact On Business Owners' Exit Strategies)

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Although to most of the world the 2014 federal budget ("Budget") may have seemed to be of limited consequence, there are a lot of taxpayers who will be significantly impacted by its content. For example, business owner's exit strategies may become much less tax effective if the proposed changes to the taxation of eligible capital property ("ECP") are enacted. In this regard, while at first glance, a move from the current ECP regime ("Current Regime") to co-ordinate it with the existing capital cost allowance regime seems completely logical and relatively innocuous, it is the change to how ECP is taxed upon its disposition that should cause owner-managers who may be considering selling their businesses to start thinking about selling a lot more seriously.

The reason for this is that for many clients, ECP and, in particular, goodwill, will be the single biggest asset that they will have to sell, and the shift from the Current Regime of taxing such income at 50% of the active business rate to the traditional capital gains regime applicable to other depreciable property ("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 tax changes assume that an individual named Ely has been carrying on a hat business through a corporation named Ely's Caps Limited ("Ely Cap" for short). Ely wants to sell his interest in Ely Cap but he can't find a purchaser who will buy his shares. However, he has received an offer to buy all of Ely Cap's goodwill for $10,000,000.

Under the Current Regime, if Ely Cap agrees to accept the offer, the sale would give rise to $10,000,000 of taxable income. Assuming this income will all be subject to the general corporate tax rates in Ontario about $1,325,000 of tax will be payable by Ely Cap. In addition, after the end of Ely Cap's current taxation year, the sale will give rise to a $5,000,000 addition to Ely Cap's capital dividend account ("CDA"), which will allow Ely to remove $5,000,000 of cash from Ely Cap for his *personal use* with no additional taxation.

Under the New Regime, the full $10,000,000 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 $2,300,000. As was the case under the Current Regime, this sale would immediately generate a CDA in Ely Cap of $5,000,000, which could be distributed to Ely tax free.

Assuming Ely is happy living off the $5,000,000 of CDA and is willing to leave any remaining after-tax proceeds in Ely Cap, then the result of the change from the Current Regime to the New Regime is that Ely Cap would lose its ability to “defer” $1,000,000 of 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 CDA balance out of Ely Cap for a very long time *if ever*. So, in many cases the loss of the corporate deferral under the New Regime will really amount to an effective 10% tax on Ely Cap, which is nearly 45% more tax than Ely Cap 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 and previously unannounced 10% tax will likely be a significant revenue generator for the Canada Revenue Agency.

Of course the New Regime is not yet law and some practitioners might take comfort that the proposal to create the New Regime in the Budget has been put forward as a “consultation” process. However, based on the results of prior “consultation” processes and the streamlined approach to legislation generally taken by the current government, it seems that business owners should view the Budget announcement as fair notice that the New Regime will more than likely be enacted in the manner proposed - without grandfathering. As a result, 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.

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A prior and more detailed version of this article was published in Tax Notes No. 614, March, 2014 as well as in the Estate Planner No. 230, March, 2014, both published by Wolters Kluwer (CCH) Limited.

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