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SELL NOW! (HOW THE 2016 BUDGET WILL IMPACT BUSINESS OWNERS' EXIT STRATEGIES)

— *Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide 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.*

The second instalment of "NRT Tax Traps and the Non-Specialist Advisor" will appear in the next issue of Tax Notes.

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"), as that term is defined in section 54 of the *Income Tax Act* (Canada) (the "Act"),[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 had 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 ("2016 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 dusting off that old article and updating it a bit.

Assuming legislation released with the 2016 Budget to implement the New Regime is enacted substantially as proposed in the NWMM, then beginning in 2017 business owners' exit strategies will become much less tax effective. While at first glance a move from the Current Regime to co-ordinate it with the existing capital cost allowance regime applicable to other depreciable capital property seems completely logical and relatively innocuous,[3] it is the change to how ECP is taxed upon its disposition that

[1] Unless otherwise noted, all statutory references are to the Act. 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 and includes 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.

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

[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.

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should cause owner-managers who may be considering selling their businesses to start thinking about selling a lot more seriously.

In this regard, for most owner-managers whose ECP has been internally generated and subject to few, if any, eligible capital expenditure claims, the recapture element associated with the sale of ECP is usually not a big deal. However, for many clients, ECP and, in particular, goodwill will be the single biggest asset 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 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.

For example, assume that your client Ely has been carrying on a hat business under the name Ely's Caps Limited ("Ely Cap" for short), and the goodwill of Ely Cap has recently been valued at $20 million. What would be the impact to Ely and Ely Cap under the Current Regime, and under the New Regime, assuming that it is implemented as suggested in the 2016 NWMM?

Under the Current Regime, if Ely Cap sold all of its business assets (I'll assume that the remainder of its assets, inventory, etc. would be sold at cost), the $20 million of proceeds receivable for the goodwill would give rise to a $15 million income inclusion under paragraph E of the cumulative eligible capital definition in subsection 14(5). Two thirds (⅔) of this income inclusion, an amount of $10 million, would be taxable at ordinary corporate rates pursuant to paragraph 14(1)(*b*). As a result, assuming that Ely Cap would otherwise have used up its $500,000 small business deduction in the year, in Ontario the $10 million of taxable income will be subject to corporate taxes at a rate of 26.5% for a total of $2.65 million of tax.

In addition, the sale will give rise to a $10 million addition to Ely Cap's capital dividend account (after the end of Ely Cap's current taxation year), which will allow Ely to remove $10 million of cash from Ely Cap for his personal use with no additional taxation.

If Ely wanted to remove the remaining $7.35 million of goodwill proceeds ($10 million net of the $2.65 million of corporate tax) for his personal use, Ely would likely do so by way of Ely Cap declaring eligible dividends on his shares of Ely Cap, which would result in him paying additional tax of 39.34%,[4] being another $2.89 million and change. If Ely were to do this, the total tax payable on a $20 million sale of goodwill would be approximately $5.54 million.

Under the New Regime, the full $20 million of proceeds would be subject to corporate capital gains tax rates, which in Ontario are currently about 25.08% and which would give rise to tax of slightly more than $5,015,000 in the corporation. As was the case under the Current Regime, this sale would generate a capital dividend account in Ely Cap of $10 million, which could be distributed to Ely tax free. However, due to ongoing and continuing tax rate changes that have increased the tax rate for ordinary taxable dividends to 45.89% in 2017 when the New Regime comes into force,[5] the integrated tax rate to remove the remaining goodwill proceeds of $4,985,000 ($10 million less $5,015,000 of corporate tax) from Ely Cap would increase the total tax payable on the sale of its goodwill (net of refundable taxes receivable by Ely Cap) to approximately $5,640,000.

As the Ely Cap example makes clear, there will be a cost of making a personal distribution of the corporate after-tax ECP proceeds under the New Regime of about $100,000 ($5,640,000 - $5,540,000[6]). On the other hand, by leaving the ECP proceeds in excess of capital dividend account amounts in a vendor corporation such as Ely Cap, it will be possible to enjoy some personal deferral of tax in both of these cases. In particular, under the Current Regime, this deferral would be about $2,890,000 ($5,540,000 - $2,650,000[7]), and under the New Regime it will be reduced to about $625,000 ($5,640,000 - $5,015,000[8]).

[4] For simplicity I have assumed that Ely pays tax at the top marginal tax rates in Ontario. It should be noted that on death and possibly in other situations the use of "pipeline"- type structures could allow for a reduction in the additional taxes otherwise payable. Such structures have their own tax risks associated with them and are beyond the scope of this article.

[5] The ordinary dividend tax rate, which is 45.30% in 2016, is anticipated to increase to 46.34% in 2018 and to 46.75% in 2019.

[6] Determined by calculating the difference between the total integrated tax under the New Regime and under the Current Regime.

[7] Determined by calculating the difference between the total integrated tax under the Current Regime and the corporate tax under the Current Regime.

[8] Determined by calculating the difference between the total integrated tax under the New Regime and the corporate tax under the New Regime.

The "cost" of the loss of this deferral should not be understated since as a practical matter, most clients in Ely's situation and in situations involving far 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*. As a result, in many cases the corporate deferrals under both regimes will really amount to effective personal tax "savings" and the change from the Current Regime to the New Regime on a $20 million sale of Ely Cap's goodwill will "cost" Ely Cap nearly $2,365,000 ($5,015,000 - $2,650,000[9]) by forcing it to pay those additional corporate taxes in the year of the sale.

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.[10]

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[11] that may allow business owners to enjoy the benefits of the Current Regime while they still can.[12]

Special thanks to Ryan Chua of Minden Gross LLP for his comments on earlier drafts of this article. All errors and omissions are the author's.

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[9] Determined by calculating the difference between the corporate tax under the New Regime and the corporate tax under the Current Regime.

[10] 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.

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

[12] 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. Though, 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 Charles P. Marquette, "Hybrid Sale of Shares and Assets of a Business" in "Personal Tax Planning" (2014), vol. 62, no. 3 Canadian Tax Journal, 857-879.

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