

# Tax Notes

March 2014  
Number 614

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## SELL NOW! (HOW THE 2014 BUDGET MAY IMPACT ON SMALL BUSINESS OWNERS' EXIT STRATEGIES)

— Michael Goldberg, tax partner, Minden Gross LLP, MERITAS law firms worldwide

Although to most of the world the federal Budget tabled on February 11, 2014 (the "Budget") may have seemed to be of limited consequence, there are many tax practitioners and clients who will be significantly impacted by its content. From painful changes to the taxation of estates, to the elimination of immigrant trust planning, severe restrictions on both the offshore regulated "bank" exception and captive insurance programs, as well as a host of pending tightening measures that will impact multinational enterprises and the use of treaties, tax planners will definitely have their hands full.

However, for my clients, I see the biggest impact coming from the proposed consultation process to make changes to the taxation of eligible capital property ("ECP"). While at first glance, a move to coordinate the current ECP regime (the "Current Regime") with the existing capital cost allowance regime seems completely logical and relatively innocuous,<sup>1</sup> it is the change to how ECP is taxed upon its disposition that may cause owner-managers who are considering selling their businesses to start thinking about selling more seriously.

In this regard, for most owner-managers whose ECP has been internally generated and has been the subject of little, 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 that they will have to sell, and a 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 (the "New Regime") may 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 is the sole shareholder of a Canadian-controlled private corporation, Ely's Caps Limited ("Ely Cap"), carrying on a hat business, 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 described in the Budget papers?

Under the Current Regime, if Ely Cap sold all its business assets (assuming 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 an addition to Ely Cap's "cumulative eligible capital" account of \$15 million under paragraph (e) of the definition in subsection 14(5). Two-thirds of this amount, an amount of \$10 million, would be included in Ely Cap's income and would be taxable at ordinary corporate rates pursuant to paragraph 14(1)(b). As a result, assuming that Ely Cap has otherwise used its

\$500,000 small business deduction in the year, in Ontario the \$10 million of taxable income would be subject to corporate taxes at a rate of 26.5% for a total of \$2.65 million of tax.

In addition, the sale would give rise to a \$10 million addition to Ely Cap's capital dividend account ("CDA") (after the end of Ely Cap's current taxation year), which would 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 33.82%,<sup>2</sup> being approximately \$2.485 million. If Ely were to do this, the total tax payable on a \$20 million sale of goodwill would be approximately \$5.135 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 23.08%; this would give rise to tax of slightly more than \$4.615 million in the corporation. As was the case under the Current Regime, this sale would generate a CDA in Ely Cap of \$10 million, which could be distributed to Ely tax-free. However, due to recent tax rate changes that have increased the tax rate for ineligible dividends to 40.13%, the integrated tax rate to remove the remaining goodwill proceeds of \$5.385 million (\$10 million less \$4.615 million 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 \$5.18 million.<sup>3</sup>

As the Ely Cap example makes clear, there will be a small absolute tax cost of making a personal distribution of the corporate after-tax ECP proceeds under the New Regime of about \$45,000 (\$5.18 million - \$5.135 million).<sup>4</sup> On the other hand, by leaving the ECP proceeds in excess of CDA amounts in a vendor corporation such as Ely Cap, it will be possible to enjoy some personal deferral of tax in both these cases. In particular, under the Current Regime, this deferral would be about \$2.485 million (\$5.135 million - \$2.65 million)<sup>5</sup> and under the New Regime it will be reduced to about \$565,000 (\$5.18 million - \$4.615 million).<sup>6</sup>

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 million (\$4.615 million - \$2.65 million)<sup>7</sup> by forcing it to pay those additional corporate taxes in the year of the sale.

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 prior experience with the current government's consultation process (for example, in respect of the taxation of estates), the cynical side of me believes that practitioners should view the Budget announcement as fair notice that the New Regime will likely be enacted in the manner proposed — without grandfathering. As a result, given the potential cost to clients, I think this may be the time to ask them about their exit-planning decisions and to consider whether now may be the time to sell.<sup>8</sup>

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#### Notes:

<sup>1</sup> In some cases, it may even be positive. For example, vendors with capital 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.

<sup>2</sup> For simplicity, I have assumed that Ely pays tax at the top marginal tax rates in Ontario.

<sup>3</sup> It is assumed that Ely Cap does not have a general rate income pool balance.

<sup>4</sup> Determined by calculating the difference between the total integrated tax under the New Regime and under the Current Regime.

<sup>5</sup> Determined by calculating the difference between the total integrated tax under the Current Regime and the corporate tax under the Current Regime.

<sup>6</sup> Determined by calculating the difference between the total integrated tax under the New Regime and the corporate tax under the New Regime.

<sup>7</sup> Determined by calculating the difference between the corporate tax under the New Regime and the corporate tax under the Current Regime.

<sup>8</sup> 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 capital cost allowance rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly less 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.