Tax Notes
Eligible Capital - Some Big Changes
Part II

By: David Louis, J.D., C.A., Tax Partner.
Minden Gross LLP

Special thanks to Joan Jung, also of Minden Gross LLP, for her comments and giving me the idea for the article.

*(*This release is based on an article published in Tax Notes, March 2005, Number 506, CCH Canadian Limited)*

In last month's article, I talked about the taxation of eligible capital, and the significant reduction in corporate-level tax when contrasted even with capital gains status - once the preferred way to go for the vendor of a business. Where capital gains status is desired (e.g., to generate refundable tax), an election is potentially available pursuant to subsection 14(1.01) of the Act, for eligible capital other than goodwill (see, however, "Addendum" at the end of this article).

Little has been written as to the distinction between goodwill and other eligible capital - there is no definition of "goodwill" in the Act. However, a few years ago, the CICA Handbook distinguishes between goodwill and other intangible assets. Accordingly, section 1581 provides guidance on the distinction under GAAP**[i]**. The latter must arise either from a legal right, or be separable (capable of being sold):

.48 An intangible asset should be recognized apart from goodwill when:

> *(a) the asset results from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations); or*
>
> *(b) the asset is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).*

Otherwise it should be included in the amount recognized as goodwill. [JULY 2001]

.49 An intangible asset that cannot be sold, transferred, licensed, rented or exchanged individually meets criterion (b) when it can be sold, transferred, licensed, rented or exchanged in combination with a related contract, asset or liability. An assembled workforce is not recognized as an intangible asset apart from goodwill. Appendix A provides additional guidance relating to the recognition of acquired intangible assets apart from goodwill, including examples of intangible assets that meet the recognition criteria in paragraph 1581.48.**[ii]**

> **Note**: The reason for the distinction is that the old "40 year amortization" rule for goodwill was dropped. In the case of intangible assets other than goodwill, Handbook section 3062.10 requires that a recognized intangible asset (other than goodwill) should be amortized over its useful life to an enterprise, *unless the life is determined to be indefinite****[iii]*** (note the word "indefinite" – not "infinite"). In all cases, the carrying value must be written down if the value is impaired. While the purchaser may therefore have definite views about allocations to goodwill and other intangibles, the subsection 14(1.01) election provides the vendor with considerable leeway; however, if intangibles constitute Class 14 property, there will be a mandatory allocation to capital property (rather than eligible capital), thus forcing recapture/capital gains. Happily, Class 14 property - which must be a patent, franchise or concession for a limited period - may not be a preferred item for a purchaser. However, the concepts of "limited period" per Class 14, and indefinite life are not necessarily mutually exclusive.**[iv]**

Bonuses restricted

As I mentioned in last month's article, because the sale of goodwill does not generate refundable tax, the distribution of the taxable portion of goodwill as a dividend will result in a material degree of under-integration. Of course, this advantage can be remedied if the taxable portion can be bonused out. Needless to say, however, absent the CRA's usual policy in respect of owner-manager bonuses,[v] an issue arises as to whether the bonus is reasonable.

In the 90's, the CRA had been increasingly reassuring that its bonus policy would extend to the taxable portion of eligible capital. Unhappily, in the new millennium, this trend came to an abrupt halt. At the 2003 annual Canadian Tax Foundation conference (subsequently documented in *Technical News No. 30*), the CRA indicated that the policy would not apply to remuneration paid out of the proceeds generated from a major sale of business assets, including the sale of the entire business or those of a large division.[vi] The CRA has suggested that such bonuses are not necessarily unreasonable; however, it reserves the right to review the issue. The CRA has indicated that it will issue advance rulings in these situations, and several of these have been published.

So what else is new?

Here are some other recent developments in the taxation of eligible capital:

- **Non-arm's length "grinds".** For non-arm's length transfers of depreciable property of a prescribed class, paragraph 13(7)(e) "grinds" the depreciation base to the extent of the non-taxable portion of the capital gain of the vendor. Similar provisions in respect of eligible capital are contained in the December 20th 2002 technical amendments.[vii]

  Even with these amendments, it may often make sense to purposely trigger a taxable disposition of eligible capital. Consider, for example, a professional who wishes to incorporate, but needs distributions on an ongoing basis to defray personal needs. Suppose that goodwill of, say, $100,000 is to be transferred into his or her corporation. If this is done on a rollover basis, funds subsequently distributed in the form of dividends would attract top-bracket Ontario tax of about 31.4%. Suppose a rollover is not claimed. The disposition of goodwill on a taxable basis would attract a rate of 23.2% (i.e., the same as a capital gain)[viii] but would provide a credit balance of $100,000, thus saving $31,400. In addition, there would be eligible capital of $50,000, 75% of which would be added to cumulative eligible capital, subject to a 7% "amortization". This generates a tax shield with a present value of about $8,500 at a 4% discount rate. All told, this strategy generates considerable tax savings:

Tax on dividend of $100,000	$31,400
Less - tax on disposition of goodwill	-23,200
Add - present value of tax shield (approx.)	8,500
Tax saving from taxable disposition of goodwill	$16,700

- **Non-competes.**[ix] As most readers are aware, payments in respect of non-competition and other restrictive covenants are now potentially fully taxable (exceptions may apply for the dispositions of a partnership interest or shares). However, where the amount is required to be included in "cumulative eligible capital"[x], the taxpayer may escape full taxation if the taxpayer and purchaser elect in prescribed form to apply the exception. In keeping with the draconian nature of the restrictive covenant proposals, proposed paragraph 56.4(3)(e) requires both the vendor and purchaser to include a copy of the form in the income tax return for the year in which the covenant was agreed to, and both must file the return on or before the filing due date for that year.[xi] If this is desired, it is important to ensure that the purchaser agrees to these terms.[xii]

  As I mentioned earlier, recent changes to the CICA Handbook eliminate the amortization for true goodwill and other intangible assets with an indefinite life. As a result, a purchaser, especially if a listed corporation, may want to minimize the allocation to non-competes, assuming that amortization is required.

Addendum – Subsection 14(1.01)

Based on a discussion I had with a Department of Finance official after Part I of this article was published, subsection 14(1.01) was not intended to apply to internally developed eligible capital.**[xiii]** Further, there is no intention to change the wording of the provision in this respect (i.e., to clarify that it does not apply to internally developed eligible capital)**[xiv]**.

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[i] Of course, some intangible assets are depreciable property: Class 14 potentially includes property that is a patent, franchise, concession or licence for a limited period.

[ii] Appendix A includes examples of various types of intangibles other than goodwill. For example, contract-based intangible assets include:

(a) licensing, royalty, standstill agreements;

(b) advertising, construction, management, service or supply contracts;

(c) lease agreements;

(d) construction permits;

(e) franchise agreements;

(f) operating and broadcast rights;

(g) certain use rights;

(h) servicing contracts such as mortgage servicing contracts; and

(i) employment contracts.

[iii] Per section 3062.10, when an intangible asset is determined to have an indefinite useful life, it should not be amortized until its life is determined to be no longer indefinite.

Considering the improvement on income resultant from non-amortization, my personal feeling is that the Handbook itself does not offer a great deal of guidance in determining when an asset has indefinite life. Appendix A includes nine sample fact situations as examples of the determination of useful/indefinite life, indicating that: “The facts and circumstances unique to each acquired intangible need to be considered in making similar determinations”.

[iv] The CRA’s general position in respect of Class 14 is that renewals or extensions following the original term are relevant in determining the life of the property only where such renewals or extensions are “automatic or within the control of the taxpayer, that is they do not require any further negotiation with or the concurrence or consent of the grantor”. In Doc. No. 9514235, August 23, 1995, the CRA indicates a CRTC broadcast license is a Class 14 asset, presumably because renewal efforts exceed this threshold. However, Appendix A to Handbook section 3062 includes an example of a broadcast license which is expected to be renewed indefinitely – where, historically, there has been “no compelling challenge” to renewal. Such a broadcast license is “deemed to have an indefinite useful life because cash flows are expected to continue indefinitely.”

A trademark would normally be eligible capital because it does not have a limited period (thus qualifying for both eligible capital treatment and, potentially, the subsection 14(1.01) election). However, Appendix A to Handbook section 3062 indicates that, depending on the circumstances, a trademark may or may not be subject to amortization, showing an example of an automobile trade mark which, though not previously subject to amortization, would now be amortized over the next four years, because management decided to phase out production of that automobile line over that period.

Per paragraph 11 of Interpretation Bulletin IT-477, Class 14 status does not extend to not extend to a service contract – i.e., contract under which a person is entitled to remuneration for the performance of specified services, so that cost of such a contract would normally be eligible capital; thus, eligible capital or deemed capital gains treatment per subsection 14(1.01) may apply. (See also *Capital Management Ltd. v. M.N.R.* (68 DTC 5041, SCC); *Investors Group v. M.N.R.* (65 DTC 5120, Exch. Ct).) Per Paragraph A23 of Appendix A to Handbook section 1581, such a service contract would be a customer-related intangible; based on a file in which I was recently involved, such contracts may not be subject to amortization if expected to be renewed indefinitely.

[v] Historically, the policy emanated from Question 42 of the 1981 Revenue Canada Round Table. However, a more up-to-date statement is found in "The Impact of Recent Cases", 2001 CR p.39:13 (as confirmed in Technical News No. 22, (January 11th, 2002)). It was indicated that: "We will not question the reasonableness of the payments as long as the salaries and bonuses are paid to managers who are (1) shareholders of the CCPC either directly or through a holding company, (2) Canadian residents, and (3) actively involved in the day-to-day operations of the company. The key is that the Canadian-resident recipients must be active in the operating business and contribute to the income-producing activities from which the remuneration is paid."

[vi] The CRA indicates, further, that this would encompass all sources of income triggered by the proceeds including capital gains, recapture of capital cost allowance, and income arising from the disposition of eligible capital properties (unless such sale of assets is incidental to the normal business operations).

[vii] Variable A of the definition of "cumulative eligible capital in subsection 14(5), subject to grandfathering relief.

[viii] It should be noted that the disposition by an individual does not suffer from the "under-integration issue" that is inherent in a corporate-level disposition, which makes a disposition of capital property more "distribution efficient" at this level by virtue of the RDTOH generated. For a similar example, see L. Branham, *op. cit*., 2003 BCC p.14:28.

[ix] To round out my survey of recent changes, I note that the "replacement property" provisions in subsection 14(6) are to be amended to address short taxation years. Also, Doc. No. 2005-011128117, January 24, 2005, confirms that AMT does not apply to the non-taxable portion of eligible capital – another reason for not making a subsection 14(1.01) election.

[x] By virtue of Variable E in that definition contained in subsection 14(5).

[xi] Although there are many elections that must be filed with tax returns, relatively few impose absolute time deadlines on filing.

[xii] A number of issues arise from this election. What if the value of a non-compete is attributable to the owner-manager rather than the corporate vendor? Can/would the CRA reallocate to the owner-manager under section 68 as proposed? If so, does this mean that the election doesn't apply (because the owner-manager does not carry on the business, as was determined in the case law)? If no amount is allocated to the non-compete, can an election be filed (i.e., as a protective mechanism) to begin with, or is it necessary to allocate a nominal amount? And finally, the most nagging question of all: will the filing of the election itself precipitate CRA consideration of the foregoing?

[xiii] This is not surprising since the Joint Committee raised the issue of "acquisition" in its submission in respect of the December 20th, 2002 proposals, but there was no change in the February 27th, 2004 draft legislation.

[xiv] The official acknowledged that, in some circumstances, particularly where expenditures should be capitalized, counterarguments could be made. I do not intend to explore the underlying issues; at best, the subsection is fraught with ambiguity in respect of this issue.