Sell Now! (How the 2014 Budget May Impact on Business Owners' Exit Strategies)

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The federal government's 2014 Budget contained a host of changes, including "proposals" to change the taxation of eligible capital property (i.e., goodwill, patents, trademarks, intellectual property, etc.) so that it will be taxed in the same way that gains on other depreciable capital property (e.g. equipment, commercial vehicles, etc.) are taxed. While changes to the eligible capital property ("ECP") regime seem logical and innocuous at first glance, if implemented these changes will lead to approximately a 10% increase in the corporate tax payable on such gains, or in other words a roughly 45% increase over the current corporate tax payable on such sales. These changes should cause owner-managers who may be considering selling their businesses, to start thinking about selling a lot more seriously.

To better understand the impact of the 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 was considering getting out of the business in the next few years but when he was made aware of the proposed changes to the ECP rules, he immediately began to explore his options. While Ely was primarily interested in selling his shares in Ely Cap, he was unsuccessful in finding a purchaser who would buy them. He has, however, received an offer to buy all of Ely Cap's goodwill for $10,000,000.

Under the current ECP regime, if Ely Cap accepts the offer, the sale would give rise to $5,000,000 of taxable income. Assuming this income will all be subject to the general corporate tax rates on active business income in Ontario, about $1,325,000 of tax will be payable by the corporation. 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 with no additional tax.

Under the proposed new ECP regime, we understand that the full $10,000,000 of proceeds would be taxed at corporate capital gains tax rates, which would give rise to a
corporate tax liability in Ontario of slightly more than $2,300,000. As was the case under the current ECP regime, this sale will still generate a CDA in Ely Cap of $5,000,000, which could be distributed to Ely tax free.

Assuming Ely is happy/able to live off the $5,000,000 of CDA, and is willing to leave the other remaining after-tax proceeds in Ely Cap, the result of the change from the current ECP regime to the new one is that Ely Cap will have $1,000,000 less in after-corporate-tax dollars.

The “cost” of the additional tax 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 may not draw more than the CDA balance out of Ely Cap for a very long time if ever. So, in many cases the higher tax cost under the new ECP regime will really amount to an effective additional 10% tax on Ely Cap, which, as mentioned above, is nearly 45% more tax than Ely Cap would have paid under the current ECP regime.

Ely ultimately decided to sell Ely Cap’s goodwill. Being the philanthropic person he is, Ely decided to cause Ely Cap to create an endowment by donating all of the tax “savings”. As it turns out, even with the $1,000,000 corporate donation, Ely Cap would be left with more after-corporate-tax dollars then if the sale of goodwill had been completed after the new ECP regime became law, and no donation was made. (The Jewish Foundation would be happy to assist in implementing a charitable plan similar to Ely’s.)

Assuming the new ECP regime becomes law, it would certainly appear that this new and previously unannounced 10% tax will likely be a significant revenue generator for the Canada Revenue Agency given the massive transition of wealth that is set to occur over the next number of years. Of course the proposals are not yet law and some practitioners might take comfort that the proposals have been put forward as a “consultation” process. That process may mean the new regime may not be law for some time, but 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 2014 Budget announcement as fair notice that the new ECP regime will more than likely be enacted in the manner proposed - without grandfathering. 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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