

# The Navigator



Wealth  
Management

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## Tax Savings if business sold in 2016

Tax increase on sale of goodwill creates 2016 deadline

The March 22, 2016 federal budget proposed major changes to the taxation of eligible capital property (ECP). The tax changes will take effect for purchases and sales of ECP that occur after 2016. If you are contemplating selling the assets in your business, the changes may significantly increase your tax liability. Please note that the budget proposal discussed in this article has been referred to the Standing Committee on Finance on May 10, 2016 but has not received the Royal Assent.

Please contact us for more information about the topics discussed in this article.

While business decisions should not be entirely dictated by tax motivations, the tax impact of the changes to the taxation of ECP could change your decision on the timing of the sale.

The most common types of ECP include goodwill, customer lists, quotas, patents and trademarks. For many business owners, a significant portion of their business value is attributed to goodwill. This means a sale of your business assets may consist of the sale of goodwill. Under the current tax rules, only 50 per cent of the gain on the sale of goodwill is taxable in the corporation at active business income tax rates. The other 50 per cent is non-taxable and is added to your corporation's capital dividend account (CDA) after the end of the corporation's taxation year. A positive CDA balance can be paid out to you, the shareholder, tax-free as a capital dividend.

The 2016 federal budget proposed

that a sale of goodwill be treated the same way as a sale of a tangible depreciable asset such as a building or equipment used in your business. When your corporation purchases buildings, equipment, computers and other tangible property, it cannot deduct the full cost of property from its taxable income. Instead, these assets are grouped into different "classes" and subject to different write off rates to reflect the wear out and obsolescence over time. The systematic deduction/amortization is called capital cost allowance (CCA). When the corporation sells the property for more than its original cost, there is a capital gain and recapture of any CCA that was claimed. Recapture of CCA allows the government to recover the tax benefits the corporation has enjoyed. Recapture is included in the corporation's income and is taxed at active business income tax rates. Starting January 1, 2017 goodwill that is purchased will have its own CCA

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class and will be subject to a 5% CCA rate for any new purchases.

If your corporation sells its goodwill after 2016, proceeds in excess of the original cost of the goodwill will be a capital gain and there may be recapture of any CCA. In the case of internally generated goodwill, the original cost would be NIL and there would be no recapture. 50 per cent of the capital gain is added to

the corporation's CDA and can be paid out tax-free (similar to current tax rules on the sale of goodwill mentioned above) but after 2016 the taxable portion of the gain will be taxed as passive investment income at higher corporate tax rates and not the lower active business tax rates.

The following table compares the corporate tax liability for the sale of goodwill in 2016 and 2017.

2016		2017	
Sale price	\$10,000,000	Sale price	\$10,000,000
Cost	—	Cost	—
Active business income	10,000,000	Capital gains	\$10,000,000
– income inclusion rate	50%	– income inclusion rate	50%
Taxable income	5,000,000	Taxable income	5,000,000
Corporate active business tax rate	27%	Corporate investment income tax rate	51%
Corporate tax payable	\$1,350,000 (B)	Corporate tax payable	\$2,550,000 (A)
Funds available to invest in the corporation	\$3,650,000	Funds available to invest in the corporation	\$2,450,000
Funds available for personal use/ investment (note 1)	\$5,000,000	Funds available for personal use/ investment (note 1)	\$5,000,000
Total funds available for investment	\$8,650,000	Total funds available for investment	\$7,450,000
Corporate tax savings if goodwill sold in 2016 (A) – (B)		\$1,200,000 (note2)	

#### Assumptions:

- Corporation is a CCPC, using an average tax rate of 27% for active business income and 51% for investment income
- Small business deduction has been fully utilized
- Selling price: CAN\$10 million
- Cost of goodwill: \$0 (goodwill is internally generated, not purchased)

Note 1: 50% of the sales proceeds is non-taxable and added to the corporation's CDA and can be paid out tax-free to shareholders

Note 2: The tax deferral benefit for 2016 goodwill sales is lost if the shareholder(s) withdraws all or part of the after-tax proceeds from the corporation (\$3,650,000 in our example)



Due to the difference in tax rates, many business owners with goodwill may be motivated to sell their business before the end of 2016 in order to take advantage of the current tax treatment.

A sale of goodwill under the current rules would be taxed in the corporation at tax rates ranging from approximately 13-16 per cent, depending on the province. After 2016 the sale of goodwill will be subject to a capital gains tax rate which ranges from approximately 25-27 per cent, depending on the province. The after-tax proceeds may continue to be invested in the corporation and may provide funding for your retirement. However, after the proposed changes in the tax rules take effect, the benefit of the tax deferral is significantly reduced and may negatively impact your retirement planning.

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What about those businesses with goodwill that are not planning to sell or those that are but have no imminent offers? You may be able to trigger the gains related to ECP before the end of the year through a reorganization. It will allow you to crystalize the gain today to reduce the impact of higher taxes after the end of 2016.

A sale of goodwill involves an asset sale. As such, you may not be able to enjoy the capital gain exemption (CGE) which is only available on a share sale. If you sell shares of a qualified small business corporation (QSBC) in 2016 you can claim the

CGE, which allows you to exclude up to \$824,176 of capital gains from taxation. However, it may be possible to structure the sale of your business as a hybrid transaction that involves both a sale of shares and assets. This type of transaction may allow you to access the CGE but also have some of the proceeds allocated to the sale of goodwill in the corporation and subject to the lower active business tax rates. A detailed discussion of the crystallization of the gain on ECP and hybrid sales strategies is beyond the scope of this article. You should consult with a qualified tax advisor to learn more about these strategies and determine if any of them are available to you.

The proposed tax changes to the ECP regime may result in a larger tax liability for business owners with significant ECP. Whether you are thinking of selling your business today, or passing it to the next generation, it may be a good time to look at any opportunity to benefit from the existing tax treatment of ECP before the end of 2016. Any opportunity to minimize your tax will provide you with greater retirement funding and enhance your overall wealth.

The sale of a business is a complex process and it is highly recommended that you engage various specialists to advise you throughout the transaction. If you would like to speak to an RBC specialist regarding the sale of your business, speak to your RBC advisor for a referral.

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