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Consider selling your business before 2017 – changes to eligible capital property rules

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Entrepreneurs work hard at building their enterprise – but most of them want to eventually reap the rewards by selling all or part of their business. Entrepreneurs may focus on maximizing the purchase price through negotiation with a prospective purchaser, which is important. But they may be missing out on some important tax planning steps that can also have a significant impact on how much after-tax proceeds they can retain subsequent to the sale.

Recent changes to Canadian tax legislation underline the need to pay attention to tax planning.

Business owners planning to sell all or a portion of their business in the near future might want to make that sale happen sooner rather than later, to avoid a tax bite that is scheduled to get a lot bigger on January 1, 2017. Even if you aren't planning on selling, you might do well to reorganize your business in a way that triggers your gains before January 1, 2017 rather than after that time, depending on the circumstances.

Owners of CCPCs may be subject to higher tax on the sale of their business

The upcoming change affects Canadian-Controlled Private Corporations (CCPCs), which are private Canadian corporations that are not controlled by non-residents and/or public companies.

Under the new rules, the existing Eligible Capital Property (ECP) tax regime will be merged into the current depreciable capital property rules. ECP includes intangibles not otherwise included in a separate class of depreciable property, such as trademarks, customer lists and certain licences.

However, for many businesses, the most important aspect of this change is the fact that ECP also includes goodwill, which is the entire value of the business that cannot be attributed to other tangible business assets (net of liabilities) or other intangible assets that are not separately identifiable. In most instances, goodwill represents a material amount of the purchase value (i.e. generally the purchase price in excess of the value of net identifiable assets). This goodwill may not have a significant tax cost where it was "internally generated" by the business (i.e. where the existing goodwill of the business was not purchased from another business by the entrepreneur). What this can mean is that all or substantially all of the realized gain from the sale of goodwill may be subject to income tax on the sale.

These proposed changes are part of Canada's Federal Budget presented on March 22, 2016.

Currently, only 50% of ECP gains are taxed, and, assuming the top combined Federal and Ontario corporate income tax rate of 26.5%, results in an effective corporate tax rate on ECP gains of 13.25%. However, as of January 1, 2017, gains on the sale of ECP will be taxed as ordinary capital gains, so that 50% of the gain will be subject to a much higher upfront tax rate of 50.17%, which results in an overall upfront effective corporate tax rate of about 25%, nearly double the current rate.

Steps to consider to avoid higher taxation

So if you're an owner of a CCPC, what are your choices and what do you need to consider?

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How much of your company's value is attributable to ECP? Consider how much of your company's value is considered goodwill and other eligible intangibles, and therefore subject to the higher tax rate after the end of 2016. If not much of the business value is attributable to ECP, it could be that no immediate action is necessary.

Sell early? If you are planning to sell the assets of your business in the near term, think about whether it is practical to seek out a good offer and complete the purchase before the end of 2016, to minimize the effects of the changes to the ECP rules.

Crystallize gains now? If you are not planning to sell your business soon, there may be steps you can take to crystallize your gains related to ECP. Such steps would be intended to have those gains taxed at the current rates, reducing the impact of potential taxes on a sale of the business in the future at the much higher rates in place after the end of 2016.

Shares versus assets? Since selling the shares of your company and selling the business assets are treated differently under Canadian tax legislation, you should consider whether changes to your corporate structure will help you shelter more of your capital gains from taxation.

Hybrid transactions – where are we now? Some transactions, which involve both a sale of shares (to access capital gains exemptions) and assets, may now be less attractive to entrepreneurs selling their business. The circumstances of each case will dictate whether or not this particular type of transaction continues to have merits going forward.

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