STEVENSON HOOD THORNTON BEAUBIER LLP
BARRISTERS AND SOLICITORS

BUSINESS SALES AND CHANGES TO THE TAX LAWS
By Beaty F. Beaubier, Q.C., TEP & Stephanie Gleisberg

The sale of a business can proceed either by way of a sale of shares by the shareholders of a corporation that carries on a business, or alternatively, a sale by a corporation of its underlying business assets. The seller often prefers to sell shares as this is subject to capital gains tax rates (i.e. only one-half of the gain is taxable and the other half is tax free). When individuals sell shares of a corporation carrying on a business, often a significant portion of their capital gain ends up being tax free. Those individuals can usually make use of the lifetime capital gains exemption (currently $824,176.00). The purchaser, on the other hand, often prefers to acquire business assets. From an income tax perspective, this typically allows the purchaser to obtain a "step up" in the tax cost of the business assets that it can depreciate, amortize or otherwise write-off for income tax purposes either in the year of acquisition or in the future.

The Federal Budget delivered on March 22, 2016, introduces a number of income tax changes. Among those changes, the Budget proposes to repeal the existing eligible capital property ("ECP") rules and replace them with a new capital cost allowance class starting January 1, 2017. This will have a significant impact on business sales where goodwill is involved.

Tax Rates

Before getting into the detailed rules, an overview of personal and corporate income tax rates will be helpful:

Saskatchewan Resident Individuals – Top Marginal Income Tax Rates (on income > $200,000)

Type of Income	Tax Rate
Business income, salary, interest, and rental	48.00%
Capital Gains	24.00 % (22.00% on sales of qualified farm property and qualified small business corporation shares not otherwise sheltered by the capital gains exemption)
Dividends – not eligible	40.06%
Dividends – eligible	30.33%

Canadian Controlled Private Corporations – Tax Rates

Type of Income	**Tax Rate**
Active business income <= $500,000	12.50%
Active business income > $500,000	27.00%
Interest, real estate rentals	50.67% (30.67% refundable, giving rise to a net 20.00% tax rate after refundable taxes; capital gains rates are ½ of these rates)
Canadian public company (eligible dividends)	38.33% (all of which is refundable, giving rise to a 0% tax rate after refundable taxes)

<u>Goodwill Sales - 2016</u>

Goodwill is an intangible asset, usually made up of things such as business processes, business procedures, market share and the customer base. Under the 2016 tax rules, goodwill is characterized as ECP. When a business is sold, a portion of the selling price will be allocated to goodwill. Sometimes, the amount allocated can be several hundred thousand or even several million dollars. From the seller's perspective, the income tax results arising from a sale of ECP can often be very attractive, including:

1. One-half of the gain on the sale of ECP (or goodwill) is completely tax free.

2. Where the seller is a Canadian-controlled private corporation ("**CCPC**"), this tax free portion is added to its capital dividend account. In due course, that corporation can pay a tax free capital dividend out of its capital dividend account to its Canadian resident shareholders.

3. The other half of the gain on the sale of ECP is taxable as business income. In the hands of a CCPC carrying on an active business in Canada, this business income is taxed at 27% (assuming the corporation has already earned at least $500,000 of business income from its general operations in the year, which was eligible for the small business deduction rate of 12.5%).

4. With respect to the corporation's business income that is taxed at the 27% tax rate, the after-tax portion falls into the general rate income pool ("**GRIP**"). Dividends paid by the corporation out of GRIP (known as eligible dividends) to its individual shareholders resident in Saskatchewan are subject to a maximum tax rate of 30.33%.

<u>Goodwill Sales - 2017</u>

Under the new rules, which will take effect for disposition of goodwill (i.e. eligible capital property) starting in 2017, significant changes are going to take place. The good news is that one-half of the gain will still be non-taxable. Where a CCPC is the seller, it will continue to be able to add this tax free portion to its capital dividend account and pay it out as a tax free capital dividend to its shareholders. The bad news is that the other half of the gain which is taxable will no longer be characterized as business income. Rather it will be a taxable capital gain, which is considered "Canadian investment income" for the purposes of the Act. This results in the following:

1. In the hands of a CCPC, a taxable capital gain is subject to a tax rate of 50.67%. While 30.67% is refundable, this refund (or reduction) of tax only arises when the CCPC pays taxable dividends to its shareholders.

2. Canadian investment income, due to the fact that it is not "business income", is ignored in the calculation of a CCPC's GRIP. As such, the after-tax portion of this income will not be paid out as an eligible dividend (unless the corporation in question has significant GRIP from other business activities). That being the case, taxable dividends paid by the corporation to its individual shareholders resident in Saskatchewan will be subject to a maximum tax rate of 40.06%.

An Example

Assume a business sale (i.e. an asset sale) takes place. As part of that sale, goodwill having a fair market value of $1,000,000 (no tax cost) is sold. The differences between a sale taking place in 2016 vs. 2017 can be illustrated as follows:

	2016 Sale	**2017 Sale**
Corporation		
Goodwill – Proceeds of Sale	1,000,000.00	1,000,000.00
Tax Free Portion (50%)	$500,000.00	$500,000.00
Taxable Portion (50%)	$500,000.00	$500,000.00
Corporate Tax Rate 2016: Active Business (27%) 2017: Taxable Capital Gain (50.67%)	$135,000.00	$253,350.00
Net After-Tax Proceeds to Corporation (before any refundable income taxes have been recovered) – a difference of $118,350.00	$865,000.00	$746,650.00
Less Capital Dividend Paid to Canadian resident shareholders on a tax free basis	($500,000.00)	($500,000.00)
Net Monies Remaining in Corporation At this point: 1. Shareholder has received $500,000.00 (tax free); and 2. Corporation has $118,350 more after-tax money if the business sale takes place in 2016 than would be the case if the sale occurs in 2017.	$365,000.00	$246,500.00

	2016 Sale	**2017 Sale**
Refundable Tax Recovered if taxable dividend paid (which results in a "net" corporate tax rate of 20% with respect to the taxable capital gain of $500,000)	$0.00	$153,350.00
Taxable dividend paid by corporation 2016 sale: Eligible dividend paid 2017 sale: Other than eligible dividend paid	($365,000.00)	($400,000.00)
Individual Shareholder		
Personal Income Tax Eligible Dividend (if 2016 sale: 30.33%) - $365,000.00 dividend Other than Eligible Dividend (if 2017 sale: 40.06%) - $400,000.00 dividend[1]	$110,704.50	$160,240.00
Total Corporate and Personal Tax **[The difference is $14,535.50 on a total gain (or proceeds) of $1,000,000.00.]**	$245,704.50 ($135,000.00 corporate tax + $110,704.50 personal tax)	$260,240.00 ($253,350 less $153,350, being the corporate tax, + $160,240 personal tax
Total Tax Rate on Taxable Portion ($500,000 from the sale of goodwill was taxable) **The net "tax cost", once monies are taken out of the corporation, is a little over 2.9% of the "taxable income", or 1.45% of the proceeds of sale of the goodwill (keeping in mind that only ½ of the gain is taxable).**	49.14% (The "cost" compared to perfect integration is 1.14%)	52.048% (The "cost" compared to perfect integration is 4.048%)

As is readily apparent, in the event of a business sale where a significant portion of the sale price is allocated to ECP (goodwill), the 2016 corporate rates will be far lower than what will be faced in 2017. Corporate income taxes rise around 23% in 2017 in respect of the taxable portion of the gain. While some of this increased corporate tax is recoverable if taxable dividends are paid out to its individual shareholders, the problem is that those shareholders will now have to pay taxes on dividends just to get the corporate taxes down. **Often, corporations would prefer to leave the after-tax sale proceeds in the corporation for reinvestment (other than the "capital dividends" that can be paid out tax free).** Given the very significant corporate tax cost that applies to business sales in 2017 and later years, corporations will often be forced to pay out huge taxable dividends in order to reduce their corporate tax burdens, which in turn will increase personal taxes.

---

[1] The amount paid out as a taxable dividend is the (i) corporation's taxable income amount less (ii) the corporation's income tax on that amount, net of refundable tax recoveries.

Some 2016 Planning Considerations

For those businesses already contemplating a sale in 2016, there is new urgency to ensure that the sale is completed by the end of this year. For those who are thinking about selling their business in the next few years, the impact of these new tax rules should be taken into account in deciding whether those plans should be accelerated. In some circumstances, if the sale to arm's length purchaser cannot be completed in 2016, it may be appropriate to consider implementing a plan of reorganization to give rise to a sale or disposition of the business (including its ECP) this year, even though that sale may end up being to a related company. While certain other tax considerations arise in this type of reorganization, the advantages of proceeding may outweigh any disadvantages.

One key thing to keep in mind if an "internal" sale is completed in 2016 (between 2 related corporations) is the impact to the purchaser on the addition to the ECE pool:

1. If there is a sale of eligible capital (e.g. goodwill) to a related party, the addition to the ECE pool is 50% of the purchase price thereof.

2. On the other hand, if there is a sale of goodwill to an arm's length person, the addition to the ECE pool is 75% of the purchase price thereof.[2]

This is not necessarily an impediment to the planning. If there is a later sale of the business to an arm's length 3rd party, the ECE pool (or depreciable pool) amounts are adjusted in the hands of the "end purchaser".

[2] Act, ss. 14(5), definition of "cumulative eligible capital" in part "A" of the formula.