APRIL 1, 2016

Repeal of the Eligible Capital Property Regime: A Final Window of Opportunity for Canadian Business Owners

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As part of Canada's Federal Budget that was presented on March 22, 2016, Finance Minister Bill Morneau announced the repeal, effective January 1, 2017, of the existing eligible capital property (**ECP**) tax regime and its merger into the existing depreciable capital property rules. While the new rules will provide similar deductions in computing income to those under the existing ECP regime and will offer a degree of simplification in this area, the change will have a significant impact on Canadian business owners in the context of a sale of their business. This is particularly true for those operating through Canadian-controlled private corporations (**CCPCs**) – essentially private Canadian corporations that are not controlled by non-residents and/or public companies.

ECP includes goodwill as well as other intangibles not otherwise included in a separate class of depreciable property, such as trademarks, customer lists and certain licenses.

Briefly, under the current ECP regime, 75% of eligible capital expenditures are included in a cumulative eligible capital property (CEC) pool. A deduction can be claimed at the rate of 7% per year on a declining balance basis. Under the proposed rules, 100% of expenditures incurred on or after January 1, 2017 that would have previously been included in the CEC pool will be included in a new class of depreciable property (class 14.1). The rate of depreciation for expenditures incurred on or after January 1, 2017 will be 5% on a declining balance basis. CEC balances will be transferred to the new class 14.1 pool as of January 1, 2017. The CCA depreciation rate for property included in the class 14.1 pool related to expenditures incurred before January 1, 2017 will be 7% until 2027.

The most significant consequence of these amendments however is that a gain on the sale of ECP will now be taxed as a capital gain and subject to the refundable tax anti-deferral mechanism applicable to investment income when realized by a CCPC.

Under current tax rules, half of the gain resulting from a disposition of ECP is taxable at the low corporate business tax rate, while the remaining 50% of the gain is included in the CCPC's capital dividend account and can be distributed tax-free to individual shareholders. Thus, the sale of a business by a CCPC with an establishment in Québec would result in an effective tax rate on the goodwill gains of 13.45%, while the equivalent rate in Ontario would be 13.25%. This very low effective tax rate affords a significant tax-deferral opportunity in respect of the taxable portion of the gain if it is retained in corporate solution.

Under the new regime, gains on the sale of ECP will be taxed as regular capital gains and, as a result, subject to the higher tax rate applicable to investment income realized by CCPCs (as opposed to business income). Hence, 50% of the gain would be taxed at a rate of 50.6%, in Québec, and 50.1%, in Ontario, resulting in an effective corporate tax rate of approximately 25% (i.e., almost double the corporate tax payable under the current ECP regime). A portion of this tax is refundable upon the payment of taxable dividends to individuals. Thus, the significant deferral opportunity that exists under the current regime will be eliminated under the new regime.

Since the proposed change is effective as of January 1, 2017, the remainder of 2016 is the last window of opportunity for Canadian business owners to sell their businesses out of a CCPC in an asset deal, or a transaction that involves both an asset sale and a share sale (often called a hybrid transaction) where the lifetime capital gains exemption is available to shareholders of the CCPC, and benefit from the deferral opportunities provided by the current ECP regime. In certain circumstances, it may be worthwhile for owners of CCPCs holding ECP (whether business goodwill or an individual item such as a trademark) with significant accrued gains to consider crystallizing those gains before year-end in the context of a corporate reorganisation. Where it is unclear whether incurring the tax cost for a crystallization is worthwhile, with proper planning the transaction can defer that decision for a number of years, until it is clearer whether there really is a benefit from crystallizing the ECP gains.

For more information on this topic, read our previous communication on Budget 2016.

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