MONTHLY NEWSLETTER

Fracking Your Goodwill

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Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

On December 7, 2015, the new federal government announced a number of income tax changes which took effect January 1, 2016. The changes include provisions to create a new top federal personal income tax rate of 33% for individual taxable income in excess of $200,000. This represents a 4% increase. Coupled with the Ontario "super tax" rate applicable to taxable income in excess of $220,000, the recent federal changes will see the highest tax rate on ordinary income in Ontario jump to 53.53% in 2016. The highest income tax rate applicable to other than eligible dividends, eligible dividends and capital gains are now 45.30%, 39.34% and 26.76%, respectively.

IMPLICATIONS FOR REMUNERATION PLANNING

The new rates represent a significant cost to entrepreneurs running profitable small businesses. For owner-managers with private corporations, this will further emphasize the importance of traditional tax planning to smooth or split income. For example, income can be retained at the corporate level to defer the personal tax cost associated with either salary or dividends and smooth personal income across a number of years. If income is maintained below $200,000 annually, the top income tax rates outlined above will not apply. Alternatively, by introducing low income family members such as a spouse or age of majority children as shareholders, dividends can be paid to spread income across a family unit to take advantage of lower marginal tax rates. So long as each family member owns a distinct class of shares, the dividends paid can vary as desired amongst each shareholder.

In some cases, such traditional planning is not available due to personal cash flow needs or the absence of low income family members. As noted above, the tax savings related to receiving a capital gain rather than a dividend can exceed 18% (45.30% - 26.76%). Clearly, from a tax perspective, capital gains are preferable to dividends. When investing in public company shares, funds in unregistered accounts can be invested in growth shares instead of dividend-paying shares as a simple way of improving the tax efficiency of a taxpayer's portfolio. Unfortunately in a private company setting, converting dividends into capital gains is not as straightforward.

GOODWILL FRACKING

One opportunity of interest to take advantage of capital gains rates is commonly referred to as "goodwill fracking" and is the subject of the remainder of this newsletter.

Many small businesses have inherent value which has accumulated over a number of years. This value, which represents goodwill, often does not appear on a tax return or financial statements. Goodwill represents value over and above the net assets of the corporation that a potential buyer would be willing to pay in a sale scenario.

For illustrative purposes, assume a dental practice with goodwill of $1,000,000 is operated in a professional corporation ("Old PC"). This type of goodwill valuation is not uncommon for single-owner dental practices with high revenues and a strong client list. To access the tax benefits associated with this goodwill, the dentist could incorporate a new professional corporation ("New PC"). New PC would purchase the operating assets and goodwill from Old PC for fair market value. For simplicity, we will ignore the tax implications for the other operating assets and assume that the goodwill is sold for $1,000,000. New PC would issue Old PC a promissory note and would fund the payments as income is earned by the practice in the future.

It is important to note that if the Canada Revenue Agency ("CRA") were to audit the transaction they would likely review the valuation. As New PC and Old PC are related corporations for income tax purposes, the $1,000,000 must be an appropriate estimate of fair market value. It is important that the basis for this value be well documented. We recommend that the opinion of an independent certified business valuator be obtained for this purpose. It is also worth mentioning that all of the business operations would transfer to New PC. New bank accounts would be opened, new accounts opened with the CRA, and so on. This transition process increases the administrative burden for our dentist in this example, but as we will see, the headaches associated with this process may be warranted if the conditions are right.

When goodwill is sold by a corporation such as Old PC, only 50% of its value is taxable. The other 50% is non-taxable and can be distributed to the shareholder as a tax-free capital dividend. In our simple example, this would mean that $500,000 would be subject to corporate income tax. Assuming that the general corporate tax rate in Ontario of 26.5% applies, this would equate to approximately $132,500 in corporate income tax for Old PC. This will add $360,000 to Old PC's general-rate income pool (GRIP). Eligible dividends can be paid from GRIP. The significance to our dentist is that eligible dividends provide a 6% personal tax savings relative to other than eligible dividends. On $360,000, this will result in approximately $21,500 of personal tax savings. The other non-taxable $500,000 could be distributed to the dentist tax-free as a capital dividend.

The tax benefits do not stop there. As New PC purchased the goodwill for fair market value, it is entitled to deduct 7% per year of 75% of the taxable portion of the goodwill ($500,000) annually on a declining balance basis. Recall that in the absence of fracking the goodwill in this manner, the goodwill did not appear on the Old PC balance sheet or tax return as it had not been acquired.

When you run through all of the numbers, once the $1,000,000 is distributed to the shareholder, the applicable rate is only slightly higher than the 26.76% capital gains rate. Goodwill fracking effectively allows our dentist to convert what would otherwise be dividends into capital gains. The following chart summarizes the various income tax results associated with fracking goodwill in the example of our dentist.

Personal tax savings by receiving $500,000 of tax-free dividends compared to other than eligible dividends	$226,500
Personal tax savings by receiving $360,000 of eligible dividends	$21,500
Estimated corporate tax savings of depreciating the cost of the goodwill over time	$58,000
Corporate tax cost of sale of goodwill	-$132,500
Total estimated savings	$173,500

In total, the shareholder of a corporation with goodwill of $1,000,000 will save approximately $173,500 by fracking their goodwill assuming distributions would otherwise occur at the highest marginal tax rate. At this level of goodwill, it is clear that this type of planning is warranted. For lesser goodwill amounts, the results will be less attractive once professional fees, business disruption, etc. are factored into the analysis but may still warrant consideration for this type of planning.

SUBSEQUENT PLANNING

The tax-free capital dividend of $500,000 could be distributed all in one year. Alternatively, by mixing a portion of tax free dividends and taxable dividends each year, cash flow needs of the shareholder can be met while maintaining income levels below $200,000 for a number of years to avoid the application of the new highest tax bracket.

It is worth noting that New PC would now operate the business formerly operated by Old PC. Old PC could be retained by the shareholder and used as a holding company for investment purposes. Having a separate corporation is usually advisable for asset protection reasons and for the purposes of meeting the requirements for the capital gains exemption (90% or more of the assets of New PC must be "active" business assets). Alternatively, Old PC and New PC could be amalgamated at some point in the future to revert to a single corporation again.

CONCLUSION

The potential benefits offered by goodwill fracking can be significant as this type of planning allows owners of private company shares to access capital gains rates. As capital gains rates continue to diverge from dividend and ordinary income rates, it will be interesting to see if the federal government will make adjustments to either the capital gains inclusion rate or their effective tax rate. For now however, there is no indication that such changes are forthcoming, and so goodwill fracking continues to be an attractive planning technique in the right circumstances.

Our example focused on a dental practice, but this type of planning is available to any type of corporation with goodwill. Each specific situation must be reviewed on a case by case basis as the planning may vary. If you think that goodwill fracking could benefit you or your corporation, please do not hesitate to contact us.