HENDRY WARREN LLP
MONTHLY NEWSLETTER

Goodwill Fracking Revisited

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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.

Our January 2016 newsletter focused on "Fracking Your Goodwill" and the potentially significant income tax benefits which could result under such a strategy. In this newsletter, we revisit the merits of this tax planning strategy in light of the 2016 federal budget and the changes to the cumulative eligible capital rules.

SUMMARY OF GOODWILL FRACKING

The highest income tax rates in Ontario applicable to ordinary income, other than eligible dividends, eligible dividends, and capital gains are now 53.53%, 45.30%, 39.34% and 26.76%, respectively. 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.

One opportunity of interest to take advantage of capital gains rates is goodwill fracking. 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. Very simply, goodwill fracking involves uncovering this inherent goodwill and the tax advantages that result from doing so.

To access this value, a new corporation would be incorporated to purchase all of the operating assets of the existing business, including goodwill, for their fair market value. All of the business operations would transfer to the new corporation. This transition process increases the administrative burden during the year of transition of the business, and so the headaches associated with this process must be weighed against the potential benefits.

When goodwill is sold in this manner only 50% of its value is taxable. The other 50% is not taxable. Our January newsletter reviewed the various other tax consequences related to the sale of goodwill in detail using goodwill valued at $1,000,000 for illustrative purposes. When you run through all of the numbers, once the $1,000,000 sale proceeds of the goodwill is distributed to the shareholder, the applicable tax rate is only slightly higher than the 26.76% capital gains rate. Goodwill fracking effectively allows distributions from a corporation which would otherwise be in the form of dividends to be converted into capital gains.

In total, based on current rates, a taxpayer in Ontario 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 applicable to dividends. 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. For a full version of our January newsletter, please visit our website at hwllp.ca.

CHANGES TO TREATMENT OF ELIGIBLE CAPITAL PROPERTY

One important change in the 2016 federal budget was the proposal to repeal the current tax treatment of eligible capital property (including goodwill) and replace it with a new capital cost allowance class. These proposals were recently enacted into law and will take effect January 1, 2017. One of the reasons outlined for this change is to help simplify reporting for taxpayers. The rules were previously quite convoluted, and so there is some merit to this rationale for trying to simplify these rules.

The proposal will also make an important change to how the sale of eligible capital property is taxed moving forward, and is likely part of the motivation for the recent amendments. Currently, only one half of the proceeds on the sale of goodwill are taxed and the applicable tax rate is at ordinary business income rates. In a corporate setting, the effective tax rate is 15% to the extent that income in the year is $500,000 or less, or 26.5% for any income thereafter.

Starting in 2017, one half of the proceeds will continue to be taxed. The key difference however is that the taxable portion will be treated as passive income and will be taxed at a rate of approximately 50%. A portion of the tax is ultimately refundable to the corporation upon payment of a sufficient taxable dividend to its shareholder. As a result of these changes, the income tax deferral benefits previously obtained by leaving the goodwill proceeds in the corporation will be lost. Further, the merits of the goodwill fracking strategy will be significantly hindered as, in order to recover a portion of the corporate tax, a taxable dividend will now be required (recall that goodwill fracking is meant to try to convert a dividend into a capital gain).

CHANGES TO THE CHILD BENEFIT SYSTEM

Another significant change announced by the 2016 federal budget was the reform to the child care benefit system. Previously, a set amount was paid for each child based on their age, regardless of the income level of the parents. The new system provides higher amounts for low income families and gradually reduces the benefit as family incomes rise. The child benefit is $0 when family income hits $200,000 in a given year. The annual benefit for a child under 6 can now reach a maximum of $6,400 or $5,400 for children between the ages of 6 and 17; this benefit is not taxable. Clearly there is now an incentive, to the extent possible, to manage income levels in order to maximize the child benefits a family is eligible to receive.

The non-taxable portion of goodwill proceeds can be distributed to the shareholder of the corporation on a tax-free basis in the form of a capital dividend. There is no requirement to draw all of the tax-free money out of the corporation in a given year. The changes to the child benefit system therefore offer an interesting advantage by fracking goodwill for families with young

children. By mixing a portion of tax-free capital dividends and taxable dividends each year, cash flow needs of the family can be met while maintaining income levels at a desired level to maximize the child benefits and avoid higher income tax brackets.

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. Given the pending changes to the eligible capital property rules and the recent changes to the child benefit system, goodwill fracking prior to January 1, 2017 under current rules could make a lot of sense. In 2017, the merits of this strategy will be greatly diminished. So while fracking in the oil fields has been slowed by low oil prices, the time for goodwill fracking is now.

The rules and strategies discussed in this newsletter are quite complicated and will not be beneficial to everyone. If you would like to discuss the merits of goodwill fracking in greater detail, please do not hesitate to contact our office.