On 22 March 2016, Federal Finance Minister Bill Morneau tabled his first budget. The following is the executive summary highlights of Budget 2016 that are relevant to the purchase and sale of private companies.

Eligible capital property (ECP)

Sellers and potential sellers of businesses carried on by private corporations should be aware that changes proposed in Budget 2016 will potentially have significant negative tax consequences for transactions that close in 2017 and later.

A fundamental consideration in virtually all Canadian private company sale transactions is whether the parties wish to structure the deal as either:

- A sale of net-tangible and intangible assets used in a business
- The sale of shares of the corporation carrying on the target business
- The sale of the shares of one or more personal holding companies that, directly or indirectly, own shares of a company carrying on the target business

While traditional views have generally held that purchasers will always prefer to buy the assets of the target business while sellers favor a sale of shares, it is possible in some circumstances to combine certain aspects of both asset and share sales to achieve a desirable result for both parties.
A purchaser’s bias to an asset transaction is based on an ability to amortize intangible and depreciable assets based on their fair market value purchase price and the reduced risks associated with inheriting the unknown liabilities of the corporation acquired.

A seller’s bias to a share deal is generally rooted in a lower tax rate for capital gains, flexibility in tax planning and the availability to shelter a portion of the sale proceeds from tax by the use of the shareholders’ lifetime capital gains exemption (CGE) on the sale of certain qualified small business corporation shares.

Under current rules, where the resulting gain on the asset sale involves a significant goodwill component and/or where there are significant corporate tax attributes (e.g., operating losses), the effective tax rate on the sale of the net assets of the target business by a Canadian corporation is often more advantageous than a share sale.

• The sale of goodwill results in 50% of the proceeds being subject to tax, with the other 50% being available for tax-free distribution to shareholders as a capital dividend.
• The taxable portion of the proceeds on the sale of goodwill is taxed as active business income, while a share sale by a private corporation results in a capital gain that is taxed as investment income.
• Investment income is subject to an additional refundable tax in a Canadian-controlled private corporation (CCPC) that is refunded only when taxable dividends are paid to shareholders.

Consequently in an asset transaction, if not all of the proceeds of the sale are distributed to individual shareholders, but are in part retained in a personal holding company, a significant tax deferral will result.

This deferral opportunity has become a common tax planning technique which provides sellers with a significant portion of the cash proceeds available for their personal use and enjoyment while the balance of the after-tax proceeds can be invested in a holding company. The after-tax investment income earned on those funds is available for distribution to individual shareholders on a relatively tax-neutral basis and available to finance the business owner’s retirement.

Consequently, structuring a transaction as an asset deal often provides the sellers with greater after-tax proceeds (at least on a partially distributed basis) while at the same time providing the aforementioned tax and commercial benefits to the purchaser.

Legislative changes
Budget 2014 announced a consultation process to change the ECP regime which determines the taxation of goodwill and other intangibles on the sale of business assets. The Department of Finance has stated that the new proposals were intended to “simplify” the Income Tax Act by merging intangible assets into the same system as depreciable property.

Budget 2016 includes a portion of the long-expected draft legislation to repeal the ECP regime (which treats the taxable 50% portion of the goodwill gain as business income) effective 1 January 2017. Under these proposals, purchasers will continue to enjoy the tax benefits of acquiring assets with the purchased goodwill being amortized at similar rates under the capital cost allowance (CCA) system that currently exists for depreciable property.

However, for sellers the proceeds related to the sale of goodwill will first recapture any amortization of previously purchased intangible assets, with the excess taxed as a capital gain subject to the additional refundable tax for CCPCs.

Accordingly, dispositions of goodwill on or after 1 January 2017 will no longer benefit from the deferral opportunities as described above and consequently significantly reduce the capital to invest in new or existing businesses.

In addition, it should be noted that CCPCs and their entrepreneurial shareholders will be the only group to see a reduction in the after-tax proceeds available from a sale of business assets as a result of these proposed changes. Entrepreneurs generally do not have funded pension arrangements and rely entirely on the sale of their business to provide income throughout their retirement.

What are the likely consequences of these proposed changes?
• Sellers will likely wish to pursue a sale of shares which traditionally provides use of the CGE and other tax planning opportunities, and also avoids the commercial complexities that may arise on a sale of business assets.
• Sellers will look to purchasers to increase the price on asset transactions to share a portion of the tax benefit that a purchaser will enjoy from an asset structure compared to a share deal.
• If an asset sale is the preferred alternative, consideration should be given to closing the transaction (or realizing the gain on goodwill through a corporate reorganization) prior to the effective date for the new rules.
Conversion of tax-deductible inter-corporate dividends into capital gains (section 55)

Budget 2015 included proposals to deal with perceived abuses of the rules contained in section 55 of the *Income Tax Act*. These proposals are intended to expand the circumstances where a tax-deductible inter-corporate dividend is recharacterized as a capital gain. These rules are an important consideration for most corporate distributions and a common technique for effectively managing the tax consequences on a sale of shares or the distribution of the after-tax proceeds on a sale of assets.

The original proposed amendments and subsequent modifications to the proposed legislation contain numerous technical anomalies that arguably could result in inappropriate tax consequences for many transactions. Interested parties continue to provide comments to the Department of Finance to suggest changes that would provide a more equitable result for taxpayers.

Budget 2016 makes reference to the fact that the Government intends to introduce the previously announced measures, as modified to take into account consultations and deliberations since their release.

Transfers of life insurance policies

Often the sale of shares of a private company requires a pre-closing distribution of certain assets that are not to be acquired by the purchaser. This may include certain investment assets which often will include various life insurance policies on the lives of the existing shareholders.

Under existing legislation, a sale or distribution of a life insurance policy to a non-arm's-length corporation or partnership is deemed to occur at the policy's cash surrender value, notwithstanding that the corporation or partnership may pay the full value of the policy. Budget 2016 proposes to limit the tax benefits of such transfers, as well as retroactively adjust certain benefits associated with policies transferred before 22 March 2016.

Budget 2016 proposes for dispositions of life insurance policies that occur after 21 March 2016 to include the fair market value of any consideration given in the policyholder's proceeds of disposition and the acquirer's cost. In addition, if there is a contribution of capital to a corporation or partnership, any increase in paid-up capital of a corporation or adjusted cost base in a partnership interest will be limited to the amount of the policyholder’s proceeds of disposition.

Budget 2016 also proposes to reduce the inclusion to the capital dividend account for private corporations and adjusted cost base for partnerships on an insurance policy death benefit payout for the excess consideration (the value of the policy in excess of the cash surrender value at the time of transfer) for policies transferred before the budget date, and in respect of a death occurring on or after the budget date. As well, any increase in paid-up capital of a corporation's shares or adjusted cost base of a partnership interest issued in satisfaction of the policy transfer will be limited to the proceeds of disposition.

Other observations

- **Corporate tax rates**: No changes are proposed to the general corporate income tax rate. Budget 2016 proposes that the small-business tax rate remain at 10.5% after 2016. The small-business tax rate had been scheduled to be reduced to 9% by 2019.

- **Personal income tax rates**: Budget 2016 does not propose any further changes to personal income tax rates or income tax brackets. The changes to tax brackets and the increase in the highest federal marginal personal income tax rate from 29% to 33% in December 2015 remain in effect.

- **Capital gains inclusion rates**: It was speculated prior to Budget 2016 that the capital gains inclusion rate, currently 50%, was to be increased. Budget 2016 does not propose any amendments to the capital gains inclusion rate.

- **Stock option benefits**: It was speculated prior to Budget 2016 that there would be changes to the stock option benefit rules. Budget 2016 does not propose any amendments to the stock option rules. The issuance of shares or options to acquire shares to employees continues to be an effective tool to enable employees to benefit on a private company sale on a tax-effective basis.
Repeal of previously announced personal tax measures

- Previously announced measures and draft legislation relating to the exemption of capital gains on donations of proceeds arising from the sale of real estate and certain private company shares has been eliminated. These measures were scheduled to come into force on 1 January 2017 and would have provided a very tax-efficient method for donating private company sale proceeds for philanthropic purposes.

Endnote

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