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New rules for eligible capital property

April 2016

The 2014 federal budget announced a public consultation on a proposal to repeal the existing eligible capital property (ECP) regime and replace it with a new capital cost allowance (CCA) class for depreciable capital property. The 2016 federal budget has finally introduced draft legislation to implement this change. This new tax treatment for ECP could potentially have significant tax consequences for sale transactions that close after 2016.

What is ECP?

Some of the more common examples of ECP include goodwill, customer lists, trademarks, franchise rights, farm quotas and some patents (generally, intangible assets of a business). Certain expenses of incorporation, reorganization or amalgamation also qualify as eligible capital expenditures.

A business can incur costs to acquire ECP; however, in many cases, no costs are incurred to acquire the property and it does not become relevant for tax purposes until the property is sold—one key example being the sale of internally-generated goodwill.

What are the current rules?

Under the existing rules, 75% of all expenditures on ECP are included in the cumulative eligible capital (CEC) pool and deducted at a 7% declining balance basis each taxation year. Upon a sale of ECP, 75% of the sale proceeds reduce the CEC pool. Any negative balance will first recapture previously claimed CEC deductions and be taxable as a full income inclusion, and two-thirds of any remaining amount is then included in income as active business income. To the extent the proceeds exceed the cost of the property, 50% will get added to a corporation's capital dividend account (CDA).[1] Amounts can be paid out of a corporation's CDA on a tax-free basis.

To illustrate by means of a simple example, assume a corporation sells goodwill for $1 million. No costs were incurred to acquire the goodwill. The CEC pool will have a negative balance of $750,000

[1] Where a private corporation is the vendor

($1,000,000 x 75%). $500,000[2] is reported as active business income and $500,000[3] is added to the company's CDA.

What are the proposed rules?

Under the proposals, the cost of property acquired on or after January 1, 2017 that would previously have been added to CEC at a 75% inclusion rate will be added to new Class 14.1 (for depreciable capital property) at a 100% inclusion rate. The CCA depreciation rate for this new class will be 5% on a declining balance basis (instead of at the current rate of 7%). Class 14.1 will follow all of the rules generally applicable to other CCA classes—for example, recapture, capital gains and depreciation (e.g., the "half-year rule").

When the property is sold, amounts previously claimed as depreciation (CCA) will be reported as income to the extent the proceeds exceed the undepreciated capital cost (UCC) of the class (up to the original cost of the property). To the extent the proceeds exceed the cost of the property, 50% will be reported as a taxable capital gain (investment income). The other 50% will be added to the corporation's CDA.

Using the same example noted above,[4] the company will report a $500,000 taxable capital gain (subject to refundable tax[5]) and $500,000 will get added to the corporation's CDA.

The new rules will apply as of January 1, 2017.

What if my business has ECP on December 31, 2016?

There are transitional rules to provide for the transfer of existing CEC balances to the new CCA class as of January 1, 2017. This will include taxpayers whose taxation year straddles January 1, 2017. In general, the opening balance of Class 14.1 will be equal to the balance in the existing CEC pool on December 31, 2016. For the first 10 years, the depreciation rate for Class 14.1 will be 7% in respect of expenditures incurred before January 1, 2017.

Capital gains treatment for dispositions of ECP is effective January 1, 2017—subject to one transitional rule. Where the taxation year straddles January 1, 2017 and there is a disposition of ECP prior to January 1, 2017, the disposition is either treated as a disposition of capital property or the taxpayer can elect (prior to the filing due date for the particular year) to have the amount included in computing the taxpayer's income from the business for the year.[6] This means the taxpayer is effectively able to choose to have the amount reported as either business income or as a taxable capital gain.[7] A disposition of property after 2016 that was originally recorded as ECP will be subject to special rules. The rules are intended to ensure that receipts related to expenditures incurred before January 1, 2017 do not result in excessive recapture when applied to reduce the balance of the new CCA class.

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[2] $750,000 x 2/3
[3] $1,000,000 x 50%
[4] Sale of goodwill for $1 million with no cost base
[5] For a Canadian-controlled private corporation
[6] Proposed paragraph 13(37)(d)
[7] In certain circumstances, the taxpayer will be able to elect to defer this taxable capital gain or income inclusion.

Other new rules

Special rules will apply to expenditures that do not relate to a specific property of a business but would have been treated as ECP. Every business will be considered to have goodwill associated to it (even if no expenditures on goodwill have been made). An expenditure that does not relate to a particular property will result in an increase in the capital cost of the goodwill of the business and a consequential increase in the undepreciated capital cost (UCC) of Class 14.1. A receipt that does not relate to a specific property will reduce the capital cost of the goodwill of the business, and therefore the balance of the Class 14.1 pool, by the lesser of the cost of the goodwill (which may be nil) and the amount of the receipt. Any excess will be treated as a capital gain. The rules relating to recapture and capital gains will also apply to goodwill.

The budget proposals also include special measures intended to simplify the transition to the new CCA regime. First, for expenditures incurred before 2017, the CCA deduction per year[8] will be the greater of $500 and the amount otherwise deductible for the year. Second, the first $3,000 of incorporation expenses will be allowed to be claimed as a current expense rather than included in Class 14.1 and depreciated over time.

Planning

Under the current rules, there is a significant tax deferral benefit where a Canadian-controlled private company disposes of ECP. This is due to the fact that half the amount is taxed as active business income and the other half is added to the CDA. Under the proposals, half the amount is taxed as investment income, which is subject to an additional refundable tax (which is not refunded to the corporation until taxable dividends are paid out to the shareholders). Currently, corporate vendors of ECP are able to distribute a significant portion of the cash proceeds to the shareholder(s) tax-free (as a payment out of the CDA) and the balance of the proceeds can remain tax deferred in a holding company until it is needed. This has been a common planning strategy.

The proposed changes to the ECP rules will have a significant impact on transaction based sales. A key consideration in almost every sale of a private company is whether the sale should be structured as an asset or a share sale. Generally, purchasers prefer to buy assets and sellers prefer to sell shares. In many cases, sales transactions have been structured as a hybrid sale, which combines aspects of both asset and share sales to achieve a beneficial result for both parties. Once these new rules become law, hybrid sale transactions where the main asset being sold is goodwill (or any other ECP) will become less attractive.

Conclusion

If your business has significant internally-generated goodwill, or accrued gains on other ECP, consider if any planning needs to be put in place before 2017 to benefit from the current regime. One option would be to realize the accrued gain through a corporate reorganization prior to the effective date for the new rules.

If you would like to learn more about these changes or any of the other measures announced in the 2016 federal budget, please consult with your tax advisor.

[8] Up to tax years that end prior to 2027

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