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Marmer Penner Newsletter

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Effect of Incorporation on Business Valuation

Amidst all the talk of tax cuts in the most recent Ontario Budget, the proposal to permit professionals to incorporate their practices may have been missed by some. According to the Budget documents, Ontario proposes to extend the right to operate a business through a corporation to all regulated professionals. While professionals will be able to enjoy many of the tax and non-tax advantages of incorporation, their professional liability will not be limited in any way by practicing within a professional corporation. In addition, non-members of professional associations will not be allowed to own shares in a professional corporation. What this latter restriction means is that unlike other incorporated businesses, incorporated professional practices will not be able to income split by way of dividends to family members who are not themselves members of the same professional association.

When determining the purchase price for a business, different considerations are made when the transfer comprises a sale of assets as opposed to a sale of shares. For professional practices that were never allowed to incorporate in Ontario in the past, the share sale was never contemplated. Two advantages of a share sale which will effect the future valuation of professional practices are as follows:

(a) The deferral of taxation on the transfer of goodwill; and

(b) The ability to utilize the lifetime capital gains exemption of a qualified small business corporation (QSBC).

Let's consider the sale of a sole practitioner's dental practice. In our example, the retiring dentist and the purchasing dentist have agreed that the value of a dental practice, which has gross billings of $600,000, is $400,000. This consists of $100,000 for equipment and receivables, which closely approximates its net book value and $300,000 for goodwill. In this example, goodwill was determined to be 50% of one year's gross billings. The rule of thumb in the sale of dental practices is to determine goodwill as a percentage of one year's revenue.

In a sale of assets, the transfer of the equipment and receivables will attract little or no income tax as it is likely transferred at or near its tax cost. The disposition of goodwill is taxed at income tax rates similar to a capital gain. For a taxpayer with income tax at the highest marginal rate in 2000, the tax on a disposition of goodwill of $300,000 is about $96,000. The present value of the future tax savings to the purchaser from the ability to depreciate this purchased goodwill is about $38,000. As a result, the taxation of the sale of the goodwill "costs" the vendor and the purchaser about $58,000 between the two of them in incremental income taxes.

Where a share sale is contemplated, the goodwill will not be sold as it will be owned by the dental corporation, rather, it will be the shares of the dental corporation which will be sold. As a result, neither the $96,000 liability by the vendor, nor the $38,000 tax savings by the purchaser will be realized. Furthermore, where the corporation qualifies, the gain on any share sale may be sheltered by the lifetime capital gains exemption.

Let's re-examine what the retiring dentist would have received on a sale of assets. The selling price was $400,000, which after tax of $96,000 left the dentist with net proceeds of $304,000. The cost to the purchaser was $400,000; however, after considering the present value of future tax savings of $38,000 from depreciating the goodwill, the net cost was $362,000.

Under a share sale where the corporation meets the definition of a QSBC, there would be no tax on the sale. Presumably, the vendor and the purchaser would agree on a price somewhere between $304,000 and $362,000 after tax. If we assume they would agree on the midpoint, a price of $333,000 would be negotiated.

What impact does this have on valuation? Under the current asset sale structure, the $400,000 price less $100,000 for tangible assets resulted in goodwill of $300,000 or 50% of one year's gross billings. Under a share sale, the purchase price was $333,000, implying goodwill of $233,000 after adjusting for tangible assets of $100,000. As a result, the implied rule of thumb for goodwill decreases from 50% in this example, to 38.8% ($233,000 / $600,000) when a share sale is contemplated.

The surprising result of this analysis indicates that, notwithstanding the income tax advantages created by the ability to incorporate, the value of professional practices with significant goodwill may decrease. The reason for this decrease in value is that the related tax liability on sale will also decrease resulting in a similar net value after tax.