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Marmer Penner Newsletter

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CONTINGENT INCOME TAX COST OF DISPOSITION – CAPITAL GAINS VS DIVIDEND

Income taxes which reviewed as a negative most times transform into a positive at marital breakdown. To a shareholder embroiled in a matrimonial dispute, the income tax costs of disposition are the silver lining in a cloud which requires the value of a business to be included in net family property.

Contingent income taxes on shares are calculated in two different ways – either as a tax on capital gains from the sale of the shares or as a dividend of the expected windup of the corporation. While the personal income tax rate on capital gains and dividends have tended to move in lock step over the last 30 years, the spread between the two rates is widening. Our review of where each approach is more appropriate may be warranted.

From a vendor's point of view, the advantages of a share sale include:

a) the ability to utilize the $500,000 lifetime capital gains exemption on the sale of shares of a qualified small business corporation;

b) no internal income taxes in the corporation; and

c) the ability to sell the value of unused non-capital losses.

A sale of shares may be simpler than a sale of assets from an income tax standpoint. The income tax on a share sale is determined by calculating the accrued capital gain, which is the difference between the value of the shares, or the deemed proceeds and the adjusted cost base of the shares. The adjusted cost base of the shares may be the original cost to the shareholder or a higher amount if a capital gains election or a corporate reorganization has occurred in the past. The taxable capital gain may be further reduced by the availability of a lifetime capital gains exemption. Once the

capital gain is determined, a portion is included in taxable income. This portion changed from 75% for dispositions before February 28, 2000 to 66⅔% for dispositions after February 27, 2000 and before October 18, 2000 to the current 50% rate for dispositions after October 17, 2000. For dispositions in 2001, the effective tax rate for taxpayers in the highest marginal tax bracket is 23.21%, which is the 50% inclusion rate multiplied by the 46.42% tax rate.

From a purchaser's point of view, an asset purchase offers the following advantages:

a) no risk of assumption of the vendor's liabilities; and

b) a higher cost base on assets which may have appreciated in value, e.g. fixed assets and goodwill.

In some cases, such as the sale of an operating company which meets the definition of a qualified small business corporation and has valuable non-capital losses, both the vendor and purchaser will prefer a share sale. However, in many other circumstances, the vendor and purchaser will have divergent goals. As a result, the income tax on eventual transfer of the business may occur either by sale of shares or assets.

A typical situation where share sale is inappropriate relates to an investment holding company. Whether the investment is in publicly-traded securities or real estate, a buyer will generally be disinterested in a share purchase due to a combination of low cost base on the investments, risk of assuming the vendor's liabilities and the absence of a desire to assume that exact mix of portfolio investments. Where this occurs, the vendor will cause the corporation to liquidate its assets instead. The sale of individual assets to the purchaser triggers income taxes inside the corporation including certain refundable taxes which are recoverable on the windup of the corporation when taxable dividends are deemed to be paid to the shareholder. The combination of corporate and personal taxes combined with refundable taxes and tax-free dividends complicate the calculation of taxes on the windup of a corporation. The taxable portion of the dividend is subject to a lower rate of income tax due to the corporate tax already incurred on the assets sold.

In 2001, the highest marginal effective tax rate on dividends is 31.35%. This exceeds the effective tax rate on capital gains of 23.21% by 8.14%.

The following chart summarizes the effective tax rate on dividends in capital gains from the inception of capital gains taxes in Canada:

While the contingent taxes appear lower based on a capital gain, a share sale may not be appropriate. Where contingent income taxes are calculated, your valuator should be able to advise you which disposition cost is most tax efficient and which one is more likely based on the business in question.