Hybrid Sale of Goodwill: Benefit Ending

One accepted form of planning for the sale of goodwill (as part of the sale of a business operated by a CCPC) has been a hybrid sale, which involves both a sale of assets and a sale of shares (*Geransky v. The Queen*, **2001 CanLII 480 (TCC)**). A hybrid sale achieves the objectives of both the vendor and the purchaser: the vendor can use his or her capital gains exemption (CGE), and a purchaser achieves a step-up in the tax cost of the business assets. However, the benefits of hybrid sales for goodwill will no longer be realized starting January 1, 2017, because a sale of eligible capital property at a gain will now result in a capital gain rather than in active business income to the corporation; as a result, the vendor will find this tax-planning option unattractive.

Consider Opco, a CCPC whose shares are owned by Mr. X. Mr. X has not used his lifetime CGE, and his shares are qualified small business corporation (QSBC) shares. An arm's-length purchaser (Purchaseco) has offered to purchase the assets of Opco for $5 million, which (for the purposes of illustration) consist exclusively of goodwill having zero cost. The shares have a nominal ACB.

To effect a hybrid sale, Mr. X exchanges his shares of Opco for preferred shares and one new common share by way of a subsection 85(1) rollover, with an elected amount of $800,000. Mr. X shelters the corresponding gain by using his lifetime CGE. Mr. X then sells the preferred shares of Opco to Purchaseco for $800,000 in cash. Opco subsequently redeems the preferred shares for an $800,000 promissory note. Finally, Opco sells its assets (100 percent goodwill) to Purchaseco for gross proceeds of $5 million, consisting of $4.2 million in cash and the cancellation of the $800,000 promissory note. Mr. X is a top-bracket (53.53 percent) taxpayer living in Ontario, and the transactions take place in 2017. The accompanying table illustrates a vendor's problems with a hybrid sale. Note in particular the corporate tax on the gain at more than 50 percent (19.50 percent and 30.67 percent).

Hybrid Sale Under Proposed Capital Gain Regime

	$ millions
Proceeds from sale of shares	0.8
ACB	(0.0)
Gain	0.8
Taxable capital gain (50%)	0.4
Lifetime CGE	(0.4)
Personal taxes at 53.53%	0.0

Proceeds from sale of goodwill	5.0
Cost of goodwill	(0.0)
Capital gain	5.0
Taxable capital gain (50%)	2.5
Corporate taxes at 19.50% (non-refundable)	0.5
Corporate taxes at 30.67% (refundable)	0.8
Dividend refund at 38.33%	(0.3)
Cash distributed to shareholders[a]	3.2
Dividend from CDA	2.5
Non-eligible dividends	0.7
Personal taxes at 45.3%	0.3
Combined corporate and personal taxes	1.3
Total after-tax cash proceeds received by Mr. X	3.7
Tax deferral if proceeds retained by Opco	0.0
RDTOH not recoverable by non-eligible dividends[b]	0.5

[a] $4.2 − $0.5 − $0.8 + $0.3.
[b] $0.8 − $0.3.

Relative to the pre-2017 eligible capital property regime (calculations not shown), the tax results are much less attractive: the after-tax cash proceeds received by Mr. X are substantially less (due to the higher corporate tax), and he has no potential for tax deferral by retaining the proceeds in the corporation. Further, because only a portion of the sales consideration is received in cash by Opco, there are insufficient funds to pay the amount of dividends required to recover the full RDTOH balance.

If a hybrid sale is used in spite of the above complications, care must be taken in designing the rights of the preferred shares to avoid part IV and part VI.1 tax. Also, Opco should ensure that it does not have an RDTOH balance prior to the redemption of the preferred shares.

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