WHO WINS & WHO LOSES

SHARE SALES & PROPOSED CHANGES TO CAPITAL GAINS

When selling one's business, the transaction will usually be conducted as either a sale of the shares in the corporation (a "Share Sale") or as a sale of the business' asset (an "Asset Sale"). Historically, a Share Sale has been the more beneficial choice for vendors as the proceeds of the transaction are considered as capital gains, which have been more leniently taxed than other income. Further, a sale of shares in an eligible small business could allow additional benefits to the vendor by way of the lifetime capital gains exemption ("LCGE").

At the time of writing, the LCGE is set at $1,016,836, which means that a selling shareholder who has never used their LCGE could avoid paying up to $272,156.16 in additional tax (assuming such individual is in Ontario's highest tax bracket), thus making a Share Sale even more profitable to the vendor. However, proposed changes to the Income Tax Act ("ITA"), if enacted, will change the benefits of Share Sales and make them less lucrative to high-earning vendors, while possibly making them more advantageous to shareholders with smaller sales.

Among the notable initiatives proposed in the 2024 federal budget, the Liberal government plans to amend the ITA and raise the taxable portion of capital gains above $250,000 from 50% to 66.6%. Additionally, the proposal intends to increase the LCGE from $1,016,836 to $1,250,000, with LCGE continuing to increase every year thereafter on pace with inflation. If the 2024 federal budget is approved, the above changes are expected to come into effect on June 25th, 2024.

In light of the proposed amendments to the ITA and LCGE, it is expected that the market may see a momentary spike in M&A transactions as business owners assess the financial and tax implications of selling their businesses before or after the enactment of these changes.

With that being said, the Liberal government's proposed budget suggests that these changes will only impact the top 0.13% of Canadians, and that individuals selling shares in their business for $2,250,000 or less could actually see themselves paying less tax under the new ITA regime. To an extent, this assertion could be supported, as illustrated by the Examples 1 and 2.

1. $2.25M SHARE SALE IN 2025

Shareholder A sells the shares of their small business for $2,250,000 in 2025. Now, assuming that inflation will increase by 2% in 2025, the LCGE will see a proportionate rise growing from $1,250,000 to $1,275,000.

Deducting the assumed 2025 LCGE from the total paid to Shareholder A, the capital gains from the transaction amount to $1,225,000.

Tax will be attributed to 50% of the first $250,000 of Shareholder A's capital gains for a total of $125,000 being subject to tax. Thereafter, the taxable portion of the remaining $725,000 will be 66.67% or $483,357.50, for a combined total of $608,357.50 of Shareholder A's Share Sale being subject to tax.

If Shareholder A is already in Ontario's highest tax bracket, Shareholder A will pay 53.53% tax on the $608,357.50 portion of the capital gains calculated above. This will result in Shareholder A paying $325,653.77 in tax on their $2,250,000 Share Sale, or in other words a 14.47% marginal tax rate on the transaction.

2. $2.25M SHARE SALE 05.31.2024

Shareholder A sells the shares of their small business for $2,250,000 on May 31st, 2024. The LCGE stands at $1,016,836, meaning Shareholder A has taxable capital gains of $1,233,164 from the Share Sale. Currently only 50% of capital gains are taxed which means the amount subject to tax is equal to $616,582.00.

If Shareholder A is already in Ontario's highest tax bracket, Shareholder A will pay a total of $330,056.34 in tax on their $2,250,000 Share Sale (a marginal tax rate of 14.67%), or $4,402.57 more than if the Share Sale closes in 2025.

It should be noted that there are several variables that will have a material effect on the above examples, including, the total purchase price, 2025 inflation data, whether Shareholder A has previously applied any LCGE, and the vendor's tax bracket status will sway these results.

However, Examples 1 and 2 do demonstrate that the proposed 2024 budget changes may in some cases benefit selling shareholder, especially as LCGE steadily increases with inflation.

That being said, if the purchase price exceeds $2,250,000, the vendor will likely see a vast increase in their tax liabilities, as demonstrated in Example 3.

3. $5M SHARE SALE 2025 VS 05.31.2024

Shareholder B sells the shares of their small business for $5,000,000 in 2025. Assuming the 2025 LCGE is $1,275,000 (consistent with Example 1), Shareholder B's capital gains will amount to $3,725,000. The taxable portion of the capital gains will be calculated as $2,441,782.50, being $125,000 on the first $250,000 (50%), plus $2,316,782.50 on the remaining amount (66.67%). If Shareholder B falls under Ontario's highest tax bracket, then this means Shareholder B will owe $1,307,086.17 in tax on their $5,000,000 sale (a 26.14% marginal tax rate).

However, if Shareholder B had sold their shares prior to the proposed changes, then the taxable portion of the capital gains after the LCGE would have been only $1,991,582, and thus amounting to $1,066,093.84 in tax (a 21.32% marginal tax rate), or $240,992.33 less than in 2025.

As illustrated by the above examples, individuals considering a sale of their business may wish to accelerate these transactions ahead of the proposed budget changes. Hopeful vendors should seek the advice of qualified financial and tax professionals to weigh the costs and benefits of Asset Sales and Share Sales before and after the June 25th, 2024, as well as other tax deferring techniques, such as a gradual disposition of shares to maximize the annual benefit of 50% taxable capital gains on the first $250,000.

RJS LAW has experience with M&A files of all shapes and sizes and regularly assist clients in tax reorganizations and pre-purchase due diligence. We would be happy to provide you and your business with tailor-made solutions and advice to help you smoothly navigate any challenges you may face.
The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

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