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DONE DEAL

What it's like buying and selling a book of business during a pandemic

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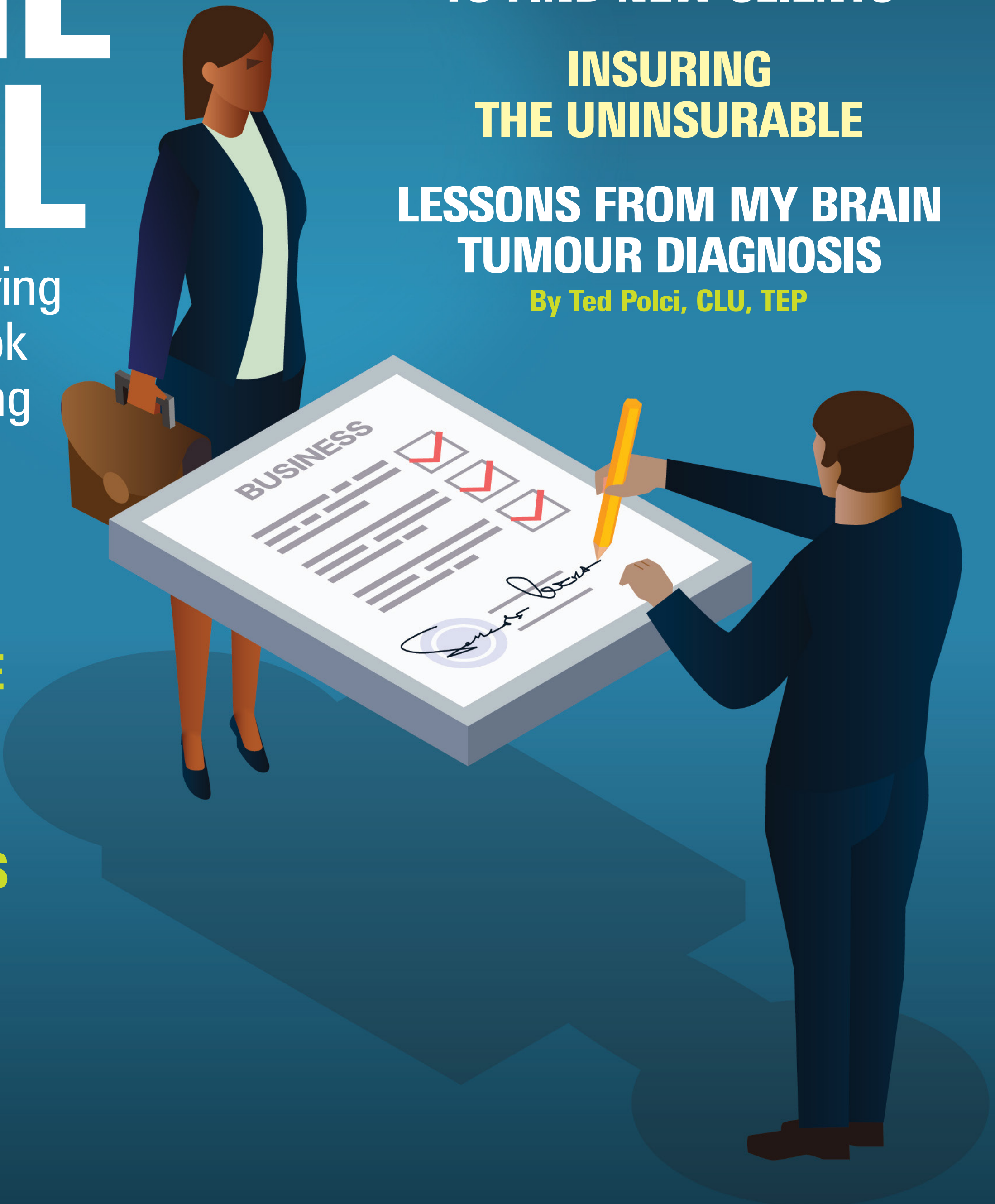
By Ted Polci, CLU, TEP



Advocis

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Knowing the Fine Print

Many tax implications affect the purchase and sale of a financial planning practice. **Jamie Golombek** and **Debbie Pearl-Weinberg** provide the details

If you're an advisor buying or selling a practice, it is important to recognize that the structure of the arrangement may have tax consequences for you. In addition, as goodwill is now treated as depreciable property, this can also affect the tax results.

The starting point to determine the appropriate tax treatment to be applied to the purchase or sale of an advisory practice is to ascertain whether the purchase or sale occurs in your capacity as an employee, or if you are self-employed and either running your practice as a sole proprietorship or you have incorporated your practice.[1] Secondly, consider whether the proceeds you are paying or receiving for the "book" are payable/ receivable up front, or paid out over a multi-year period.

EMPLOYEE OR SELF-EMPLOYED?

Employees

In 2004, the Supreme Court of Canada (SCC) ruled in a case involving the purchase of a client list by an employee. In this case,[2] the taxpayer was a financial advisor employed by a brokerage firm who decided to purchase the client list of a departing financial advisor. The SCC held that both the payment to buy a "client list" and the interest paid on money borrowed to finance the purchase of the client list were not tax deductible.

This decision has had a significant impact on advisors who are considered employees, the result being that any amounts paid to purchase a client list are simply not deductible. Instead, what often happens is that the sale is conducted via the brokerage firm, whereby the departing advisor continues to be paid by the employer off of the revenue stream generated from the book of business "sold" to the purchasing advisor. The purchasing advisor receives a reduction in their ongoing compensation from the brokerage firm, essentially making the payments tax deductible to the purchaser and taxable to the vendor.

If the vendor is an employee, what is actually being sold? Some insight may be gleaned from the analysis in the *Gifford* case. According to the SCC's decision, what was being sold was a combination of goodwill, developed over years of the departing advisor's dealing with his clients, and an agreement not to compete with the purchaser. In fact, in *Gifford*, the purchase and sale agreement required the vendor to provide written endorsements of Mr. Gifford to select clients and not to compete for them for 30 months.

Assuming that the facts in *Gifford* do not significantly differ

[1] *Note that the ability for non-insurance commissions (i.e., mutual fund and securities commissions) to be paid or earned by a corporation (which is not itself registered as a dealer) is questionable and beyond the scope of this article. For more information, see CRA Technical Interpretations 2006-0176531I7 and 2017-0693761E5 and two decisions of the Tax Court of Canada:* Boutilier v. The Queen, *2007 TCC 96 and* Wallsten et al v. The Queen, *2001 DTC 215.*

[2] *See Gifford v. The Queen (2004 SCC 15).*

ILLUSTRATION: ISTOCKPHOTO

from a typical sale by an employee, the proceeds received by the vendor who is an employee would likely be fully taxable, either as employment income or as payment received in respect of an agreement not to compete, which will effectively be treated as employment income. Note that this need not be a separate, stand-alone agreement but rather could take the form of a provision or covenant in the sale agreement.

Self-employed proprietorship or carrying on business through a corporation

If the advisor is self-employed, including carrying on the advisory business through a corporation, the tax treatment will depend on whether the advisor is selling the business of an unincorporated practice, selling shares of the corporation that carries on the business, or is selling the business assets of the corporation.

Sale of an unincorporated practice

Vendor

The unincorporated advisor who is selling his or her financial planning practice must allocate the proceeds received between the sale of goodwill and any other assets that form part of the sale.[3] The disposition of intangible assets related to the business, such as goodwill, is treated as the disposition of a depreciable capital property. If the goodwill was not previously purchased from another party, then it will result in a capital gain, 50% of which will be taxable. If the goodwill was previously purchased from another party, and capital cost allowance (CCA) has been claimed, then there may also be recapture of previously claimed depreciation. Recapture is fully included in income for the year of sale.[4]

Purchaser

The purchase of the goodwill will be treated for tax purposes as the purchase of depreciable capital property. CCA or tax depreciation may be claimed annually at a 5% declining balance rate on the goodwill. Just as with other depreciable capital property, in the year the goodwill is purchased from an arm's length person, only one half of the CCA otherwise available may be claimed.

ILLUSTRATION: ISTOCKPHOTO

Sale of shares

Setting aside the much larger issue of whether or not an advisor is permitted to incorporate a non-insurance (i.e., securities) financial advisory practice,[5] the sale of shares should result in a capital gain. One half of the capital gain will be included in income, and will potentially be eligible for tax-free treatment if the gain can be sheltered by any remaining lifetime capital gains exemption on the sale of qualified small business corporation shares [6] (assuming the shares qualify for such treatment).[7]

Sale of business assets by corporate entity

Similar to the sale of an unincorporated practice, where a practice is sold by a corporation, the purchase price must be allocated between the goodwill, and any other assets that form part of the sale.[8] The sale of the goodwill will result in a capital gain to the extent that the proceeds exceeds the original cost of such property, 50% of which will be treated as investment income within the corporation and taxed at a combined federal/provincial rate exceeding 50% (in most provinces) assuming the corporation is a Canadian-controlled private corporation. Note that although some of this tax will be refunded when the after-tax investment income is paid out to a shareholder as a taxable dividend, it is initially a high rate of tax that is originally paid by the corporation on the taxable portion of the capital gain.

The 50% non-taxable portion of the capital gain will be added to the corporation's capital dividend account (CDA). When there is a positive balance in the CDA account, it can be generally be paid out as a tax-free capital dividend to Canadian resident shareholders.

[3] *The vendor will likely also provide a covenant not to compete with the purchaser. In most cases, no proceeds are allocated to this covenant. A discussion of non-compete agreements is beyond the scope of this article.*

[4] *Transitional rules apply if the goodwill sold was former eligible capital property (ECP). A discussion of these transitional rules is beyond the scope of this article.*

[5] *Supra. note 1*

[6] *The lifetime capital gains exemption (the "LCGE") is available for gains realized on the disposition of shares that are qualified small business corporation ("QSBC") shares. The LCGE is $892,218 for 2021 and is indexed annually for inflation.*

[7] *Similar to the case with the sale of an unincorporated practice, there will likely be a covenant not to compete. In most cases, no proceeds are allocated to this covenant.*

[8] *Ibid.*

[9] *See CRA archived Interpretation Bulletin IT-462 - Payments Based on Production or Use, which sets out the CRA's position on the tax treatment of any amount received that is dependent on the production from or use of property.*

[10] *Technical Interpretation 2004-0098121E5.*

[11] *289018 Ontario Limited v. M.N.R (87 DTC 38).*

[12] The Estate of Jean-Paul Rouleau v. M.N.R. *(91 DTC 120).*

[13] *CRA Technical Interpretation 9522420 and paragraph 12(1)(g) of the Act.*

[14] Smith v. The Queen, *2011 TCC 461.*

[15] *If the full reverse earn out is not collected, a capital loss may arise in the hands of the vendor. The purchaser could also be subject to tax consequences under the debt forgiveness rules.*

When the taxable portion of the capital gain is eventually paid out as a dividend to an individual shareholder, it will be taxable in the hands of the shareholder as a non-eligible dividend. At that time, the corporation should receive a refund of some of the refundable tax paid at the time the corporation realized the capital gain.

PROCEEDS PAYABLE OVER SEVERAL YEARS

In some transactions, the purchase price for goodwill is paid out over a number of years. The mechanics of the sale determine its tax treatment.

Reserves

When the amount allocated to goodwill or any capital property is determined in advance but is payable over a number of years, the entire amount must be included in proceeds of disposition in the year of the sale. The question then arises whether a reserve can then be claimed for the proceeds not yet received. The I*ncome Tax Act* (the Act) provides a reserve in certain situations where property is sold in the course of business. Since goodwill is now treated as a capital property, a capital gains reserve should be available. This capital gains reserve was typically claimed when a capital property (e.g., shares of a corporation) was sold. The Act permits a capital gain to be included in income over a period of up to five years if a portion of the proceeds are payable to the taxpayer after the end of the year where no less than 20% of the capital gain is to be included in income each year.

Earnout

If the payments for the goodwill associated with the sale of a practice are all or are in part based on future commissions, the outcome may be different. This is where the details of the actual agreement are key.

The CRA's position is that if the payments for the goodwill associated with the sale of a practice are all based on future commissions, all amounts received by the vendor will be taxable in the year received as ordinary income.[9] This applies even if an amount is "an instalment of the sale price of property." If, on the other hand, the agreement of sale provides for a fixed lump sum payment plus a percentage of future commissions, the lump sum payment is proceeds of disposition of the property sold (e.g., goodwill), giving rise to capital gains treatment as discussed above, and the future commissions are fully taxable as ordinary income when received.

The CRA's view is that if the consideration received for the disposition of goodwill is dependent upon the use or production from that property, and no amount can be quantified at the time of sale, such consideration is not proceeds of disposition of goodwill and is instead taxable as income when received.[10]

As support for this seemingly harsh result, the CRA referred to a Tax Court decision[11] in which the court held that the profit from the sale of a business, which included goodwill and know-how, where the payment was received as a percentage of sales, was taxable as ordinary income as it fell within the terms of the above-noted tax provision. The taxpayer had unsuccessfully argued that since what was being sold was simply "know-how," the proceeds should be taxable as a disposition of ECP.

Curiously, the CRA seemed to have ignored another tax case a few years later with the opposite result. In that case,[12] the judge found that payments on the sale by an accountant of his goodwill, paid over five years based on gross billings, were not subject to the payments-based-on-production rule and were, in fact, to be treated as proceeds of disposition of ECP. The CRA acknowledged that this different treatment could occur, as in their view the case law does not impact their administrative position.[13]

A more recent case involved the sale of a client list, where the total purchase price was set, but the payments were to be adjusted each year based on actual commission revenue for the prior year.[14] This case involved the 2002 sale of a client list by a Quebec insurance broker. The agreement specified that the purchase price, subject to adjustment, would be paid 40% in 2002 ($143,000) with 20% ($69,500) payable in each of 2003, 2004, and 2005. The payments due beyond 2002 were subject to interest. If the annual commission revenue at any payment date was greater or less than the amount originally contemplated, the annual payments contemplated above would be adjusted upwards or downwards accordingly.

The taxpayer included in his income for the 2002 to 2005 taxation years the total consideration received for the sale of the clientele — including the interest — as the disposition of ECP, and thus claimed the capital gains–type treatment. The CRA reassessed the taxpayer, including the subsequent adjusted payments received in 2003, 2004, and 2005 as income from the sale of a business whose payments were based on production and thus 100% taxable. The CRA also taxed the interest received annually in full.

The judge agreed with the CRA, upholding the reassessment. As he wrote, "it cannot be said that the purchase price was fixed and determined in advance since the annual payments to the appellant were calculated each year based on commissions received for the previous year. The initial price of $351,000 was only an estimate and the purchase price was not fixed… [It] could fluctuate depending upon the annualized commissions received on any anniversary payment date."

Reverse earn-out

A reverse earn-out occurs when the purchase price of property is set as a maximum amount at the outset, but may be adjusted downwards in the future if certain projections regarding future performance do not materialize. Where this occurs, the Act will not require an ordinary income inclusion to the original sale of the goodwill. Rather, a capital gain will have been realized, with a capital gains reserve possibly claimed.[15]

Based on the above analysis, careful tax planning is needed to ensure optimal tax treatment. Expert valuation advice may also be needed to determine the appropriate allocation of proceeds received to any non-compete agreement. Finally, consideration should be given to whether the purchase price should be fixed in advance and payable at once. If the purchaser cannot pay all at once, perhaps the price could be fixed in advance to ensure capital gains treatment, along with a possible capital gains reserve. F

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