BUDGET 2014: CONSULTATION ON ELIGIBLE CAPITAL PROPERTY

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Budget 2014 announced a public consultation on a proposal to (i) repeal the eligible capital property ("**ECP**") regime, (ii) replace it with a new capital cost allowance ("**CCA**") class available to businesses, and (iii) transfer taxpayers' existing cumulative eligible capital ("**CEC**") pools to the new CCA class.

Background

Under the current rules, capital expenditures are generally not deductible in computing a taxpayer's income from a business, unless specifically permitted under certain provisions of the *Income Tax Act* (Canada) (the "**Tax Act**"). One such provision permits discretionary deductions, in the form of CCA, in respect of the cost of depreciable capital property based on prescribed maximum rates of deductible depreciation applied on a declining balance basis to the undepreciated capital cost of the property. Different types of depreciable property are assigned to various classes, or pools, of assets, each having its own prescribed maximum rates of depreciation. Upon the disposition of depreciable capital property, amounts received by a taxpayer in respect of such property could give rise to income in the form of recaptured depreciation (or, in certain circumstances, a loss on income account) and/or a capital gain or capital loss.

Capital expenditures incurred in respect of intangible property, such as a customer list or goodwill of an acquired business, would not generally result in the acquisition of an asset that would fall within one of the classes of depreciable property in respect of which a CCA deduction is available. Under current rules, such an expenditure could qualify as an eligible capital expenditure ("**ECE**") where it is of a capital nature and was incurred to acquire a right or benefit of an intangible nature for the purpose of earning income from a business, other than an expenditure that is deductible as a current expense or that is incurred to acquire an intangible property that is treated as depreciable property for CCA purposes. An eligible capital receipt is generally an amount that is received in respect of a business, on capital account, and with respect to rights or benefits of an intangible nature, other than an amount that is otherwise required to be included in income or an amount that is on account of proceeds of disposition of a capital property.

Under the current ECP regime, three-quarters (or 75%) of the amount of an ECE incurred by a taxpayer is

added to the taxpayer's CEC pool in respect of the business to which it relates and is amortized at a rate of 7% per year on a declining-balance basis. Similarly, three-quarters (or 75%) of an eligible capital amount received by a taxpayer is deducted from the relevant CEC pool. Where, as a result of a deduction from the CEC pool, the balance of the CEC pool in question becomes negative, the amount of such negative balance would be required to be fully included in the taxpayer's income, as recaptured CEC, to the extent of any previously deducted amounts on account of CEC. Once all of the previously deducted amounts have been recaptured, one-half (or 50%) of any remaining excess amount (an "**ECP Gain**") would essentially be included in the taxpayer's income from the business, thus resulting in a tax treatment that is similar to that which applies to capital gains realized from the disposition of capital property, at least in terms of the quantum of the income inclusion.

Proposed Rules

Under the proposed rules, a new class of depreciable property for CCA purposes would be introduced. Expenditures that are currently added to taxpayer's CEC pools at a 75% inclusion rate would instead be fully included in the new CCA class. However, instead of being deductible at a 7% rate as is currently the case with amounts in taxpayers' CEC pools, the new CCA class would have a maximum annual prescribed rate of depreciation of 5%. The existing rules governing the CCA regime would also generally apply to the new CCA class, including the rules related to recaptured CCA, capital gains and depreciation, as well as the "half-year rule" which generally applies to reduce in half the amount of CCA that can otherwise be claimed by a taxpayer with respect to expenditures made for the acquisition of depreciable capital property in respect of the year of acquisition.

The proposed rules would also include special rules for goodwill and expenditures and receipts that do not relate to a specific property. The definition of what constitutes "property" for income tax purposes is broad and includes, among other things, a right of any kind whatever. As a result, most eligible capital expenditures and eligible capital receipts would be considered to relate to acquisitions or dispositions of specific property, and consequently would result in an adjustment to the balance of the new CCA class upon an acquisition or disposition of that specific property. However, this would not be the case for all eligible capital expenditures or receipts. As a result, it is proposed that every business of a taxpayer will be considered to have goodwill associated with it, even in the absence of any purchased goodwill. In this regard, any eligible capital expenditure or receipt that does not relate to the acquisition or disposition of any specific property would be accounted for by adjusting the capital cost of the goodwill of the business, and consequently the balance of the new CCA class. Expenditures would increase the capital cost of goodwill, and therefore the balance of the new CCA class, whereas receipts would reduce the capital cost of the goodwill, and consequently the balance of the new CCA class, by the lesser of the capital cost of the goodwill and the amount of the receipt. Any

previously deducted CCA would be required to be included in the taxpayer's income to the extent that the amount of the receipt exceeds the balance of the new CCA class to the taxpayer. If the amount of the receipt exceeds the original capital cost of the goodwill, the amount of such excess would be treated as a capital gain.

Finally, the proposed rules will also include certain transitional provisions for the transfer of existing CEC pool balances to the new CCA class. Upon the implementation of the new rules, the opening balance of the new CCA class for a particular business of a taxpayer would be equal to the balance of the existing CEC pool for that business as at the time of implementation. For the following 10 years, the depreciation rate for the new CCA class would be 7% for expenditures incurred before the implementation of the new rules. Furthermore, qualifying receipts from the disposition of property the cost of which was previously included in the taxpayer's CEC pool and receipts that do not represent the proceeds of disposition of property, would reduce the balance of the new CCA class at a 75% rate (i.e., 3/4 of the amount of such receipts would be deducted from the remaining undepreciated capital cost balance of the new CCA class). However, the total amount of such qualifying receipts that may be deducted at a 75% rate would be limited to the total amount that could have been received by a taxpayer prior to triggering an ECP Gain under the previous ECP regime. This transitional rule is intended to ensure that intangible capital property receipts do not result in excess recapture when applied to reduce the balance of the new CCA class.

Observations on the Proposed Rules

The following are a few observations on the new proposed rules. First, under the current ECP regime, 50% of the portion of any eligible capital receipts in excess of a taxpayer's CEC pool balance and the total of deductions previously taken on account of CEC (i.e., the ECP Gain) would be included in the taxpayer's business income. In this regard, even though the excess amount giving rise to an ECP Gain is essentially taxed in a manner similar to a capital gain, the amount of the ECP Gain is nevertheless considered business income for purposes of the Tax Act. Under the proposed rules, the amount corresponding to what would have been an ECP Gain under the ECP regime would now be treated as a capital gain. For a business sold by a taxpayer that is a Canadian-controlled private corporation carrying on an active business, an ECP Gain under the ECP regime could have been potentially eligible for the small business deduction, and therefore taxed at a significantly lower corporate tax rate than a capital gain, which would be subject to the rate applicable to investment income.[1] However, one advantage to having what was formerly business income treated as capital gain would be that a taxpayer with available capital loss carry forwards could potentially use such losses to offset all or a portion of any capital gain realized, where under the current ECP regime, only non-capital business losses could be used to shelter an ECP Gain.

Second, the stated purpose of the replacement of the ECP regime with a new CCA class is to simplify the tax system as it pertains to the treatment ECEs since the ECP regime had become increasingly complicated over

the years. While a reduction in the complexity of the rules dealing with the tax treatment of ECEs is commendable and may be achieved in the long term through the replacement of the ECP regime with a new CCA class, it remains to be seen whether such goal of simplification may be somewhat undermined in the short to medium term given the potential added complexities of tracking pre- and post- implementation expenditures within the new CCA class in the 10-year transition period. From a practical perspective, depending on how the transitional rules are structured and applied, this could effectively lead to two separate ECE pools for certain taxpayers for a number of years following the implementation of the new rules. It was announced that special rules to simplify the transition for small businesses would be considered as part of the consultation process. Perhaps the Minister of Finance (Canada) should also consider extending the application of these special rules to simplify the transition to all businesses, or possibly allowing larger businesses to elect into a form of simplified transitional regime.

Finally, the amount that can be claimed in respect of ECEs, while only slightly lower on an annual basis under the new CCA class regime as compared to that which was available under the ECP regime, will be significantly reduced in the year such expenditures are incurred due to the application of the half-year rule to the new CCA class, particularly in the context of business acquisitions with large goodwill components.

Detailed draft legislative proposals will be released for comment and the timing of the implementation will be determined after the consultation process has been completed.

by Michel Ranger

[1] For 2014, the applicable combined federal and provincial corporate tax rates to income of a Canadian-controlled private corporation that is eligible for the small business deduction is 15.5% and 19% in Ontario and Québec, respectively, whereas the rates applicable to investment income are 46.4% and 46.6%, respectively.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.