

Goodwill-

Individual Incorporation Issue

By I. H. Asper

Submitted by R. J. Emo, O.L.S., and reprinted with the permission of The Globe and Mail and of the author.

Just as personal tax rates have risen for above average income earners in Canada, so has interest among professionals in the question of whether or not to carry on business as an individual, in partnership or as a corporation.

As a result, there are thousands of corporations operating professional practices of one kind or another because the tax advantages can be substantial. Not only professionals, such as architects, town planners, insurance brokers, engineers and fiscal consultants are moving more and more toward operating through a corporation, but many corporate executives are also incorporating themselves as management consultants.

One reason is straightforward. The corporate rate of tax on the first \$100,000 of earnings is only 25 per cent, flat, while it is much higher on the individual rate chart.

It is well established now that individual incorporation can in most cases be achieved under the income tax law, but a second problem still requires delicate handling if tax penalties are to be avoided and advantages gained from incorporation.

This is the aspect of the goodwill of a professional practice when it is transferred from the individual to his professional corporation.

The first question that arises is whether or not any goodwill exists and if so, how to value it. The reason it is important is that when one transfers business to a company, it should be done at fair market value. Also, if one's company buys goodwill from the individual, the company, over a period of time, can claim deductions of the amount of purchased goodwill while the seller may not be required to pay tax on all the money he collects from the sale of the goodwill of his practice, because of the transitional provisions enacted to smooth out the switch from the pre-1972 tax system to the 1972 reform plan.

For one tax reason or another, the debate over goodwill has raged, over the past 20 years and, judging by a recent tax case, is nowhere near resolved yet.

The case, involving a professional engineer, is fairly instructive about where the courts are heading on this subject.

The professional in question was an engineer who had acted as a consultant

in the Maritime Provinces since 1951. By 1960, he had built up a team of respected reputation of the engineer, plus his team, plus his own continuity of service. As well, the court agreed with the principle that where business is making engineers and in 1961 he incorporated the practice.

When he incorporated, his professional advisers took the position that the company should pay him more than \$50,000 (as a tax free capital gain, in those days) for transferring his professional goodwill to the company that bore his name.

The department of National Revenue looked at the transaction and claimed there was no goodwill when a professional transferred his practice to a company controlled by him. But, it said, if indeed goodwill could be sold in such a case, it would be valued at much less than \$50,000 and closer to \$9,000.

The fact that there could be such a variation indicates the great uncertainty over this area of the law.

The Tax Review Board chairman, Judge K. A. Flanigan, heard the case and gave a carefully reasoned judgment that might serve as a modern guide through the maze.

In effect, he concluded that the question on whether or not any goodwill existed was one which could only be determined from the facts of each case. Thus it is not black and white, as the tax authorities maintained.

In this case, he said, there was goodwill because what was being transferred to the new company was the name and enough to pay its owner a reasonable salary, gets a reasonable return on capital invested and still has profits left over, those are not normal but super profits.

If a business shows super profits over a reasonable period of time, after rewarding the services and capital of its sponsors, those super profits must be attributed to the existence of a special, unique characteristic of the business — goodwill.

Having so found, Judge Flanigan considered the independent evidence and testimony from experts on how to put a vehicle on the goodwill of a particular business.

The taxpayer's witnesses said the capital value of goodwill was, according to commercial custom, 10 times the annual amount of post-tax super profits. The court agreed and although it reduced the amount of annual super profits to which the 10 times factor would be applied to about \$3,300, it accepted the 10 times super earnings concept and allowed \$33,000 for goodwill.

The 10 times earnings multiplier might seem somewhat high for a personalized professional practice. The Revenue Department appeared willing to accept five times earnings as the appropriate means of calculating goodwill.

Nevertheless, the court accepted the higher figure, and in so doing, gave hopes to the many thousands of professional and executive taxpayers who might one day find themselves in similar circumstances.

THIS OFFICE GETS THE STRANGEST LETTERS

Mar. 4, 1976

Mr.
c/o Andrew Gibson
84 John Street
ARNPRIOR, Ontario

My Dear Mr.

We wish to thank you for your letter and nude pictures which we recently received. However, we will not be able to use your body in our next centerfold.

On a scale from 0 to 10, your body was rated minus 2. The rating was done by a panel of women ranging in age from 65 to 75 years. We tried to have our panel of women in the 25 to 35 year old age bracket rate, but we could not get them to stop laughing long enough.

Should the tastes of the American women ever change so drastically that they would want you in the centerfold, you will be notified by this office. In the meantime, however, don't call us, we'll call you.

Sympathetically,

Ruth Hytone

Ruth Hytone, Editor
Playgirl Magazine

RH:di