Lifetime Capital Gains Exemption

Karen Blanchard

The lifetime Capital Gains Exemption (CGE) provides small business owners with an opportunity to save income tax on up to $375,000 of taxable gains recognized on the disposition of qualified shares of their small business. With an increasing number of professionals incorporating their businesses due to legislative changes and baby boomers thinking about retirement and succession planning for their small businesses, there are now an increased number of people who may qualify for a reduction in tax payable on the disposition of their businesses. The CGE can help small business owners achieve their planning goals in a tax-efficient manner.

The exemption is available to shareholders who have taxable capital gains from the disposition of qualified small business corporation shares (QSBC), qualified farm property, qualified fishing property or a reserve brought into income from any of these sources. Because only one-half of these capital gains are included in taxable income, the cumulative capital gains deduction is $375,000 (one-half of $750,000). This could mean a tax savings of up to $172,500 assuming a combined federal and provincial tax rate of 46% in Ontario.

The CGE allows business owners to shelter up to $750,000 of the growth in value of their business over time from income tax upon disposing of shares of the business. For the purposes of this article, only the disposition of QSBC will be covered.

How do business owners qualify for the capital gains exemption?

As with any tax matter, there are rules to consider in determining whether a disposition qualifies for this exemption. These rules are discussed in general terms below.

Residency

The CGE is only available to individuals who were resident in Canada throughout the year in question. In a case where residency is not obvious or may be deemed, an individual will need to refer to the specific rules in determining their residency. It may be helpful to note that a person will be considered to be a resident during the year in question for the purposes of CGE if they were resident for a part of the year as well as the full year prior to or after the year in question.

Qualified Small Business Corporation

The rules associated with determining whether a share of a corporation is considered to be a QSBC share are complex but there are essentially three tests which must be met. These tests are as follows:

- The share must be a share of a small business corporation (SBC) at the time of disposition and it must be owned by an individual, their spouse or common-law partner, or a partnership of which the individual was a member (the 90% test);
- The share must meet the 24-month holding period test; and
- The share must meet the asset-use test for the 24 months prior to disposition.

The 90% test

A SBC is a Canadian-controlled private corporation (CCPC) of which, at the time of disposition, all or substantially all of the assets (90% or more) on a fair market value basis:

- are used principally in an active business carried on primarily in Canada by the corporation or a related corporation;
- are shares or debt of connected corporations that were small business corporations; or
- are a combination of both of the items above.

The holding period test

Throughout the 24 months immediately preceding the disposition of the share, no one owned the share other than the individual, a partnership of which the individual was a member or a person related to the individual.

The asset-use test

Throughout the 24 months immediately before the share was disposed of, it was a share of a CCPC of which more than 50% of the fair market value of the assets of the cor-

poration were:

- used mainly in an active business carried on primarily in Canada by the CCPC or by a related corporation;
- certain shares or debts of connected corporations; or
- a combination of the items above.

Note that although this test appears similar to the 90% test, there are more complex rules to be considered.

What does this mean?

In order to ensure that the disposition of a share of a business will qualify for the CGE, advance planning is necessary. If there are extraneous assets in the business which will cause it to be offside on the asset-use test, those assets should be transferred out of the corporation at least two years in advance of a disposition. Quite often there will be investments made from excess cash accumulated over the years which will be considered inactive assets. In order to transfer these assets out of the corporation in a tax-efficient manner, professional advice should be sought.

Prior to a sale, any assets which would cause the shares to fail the 90% test should also be removed from the corporation. In some cases, there are assets which, although they do not create a problem regarding the asset-use test, they will cause the shares to be offside on the 90% test.

The process of removing the non-active business assets is referred to as purifying the corporation.

In family situations there is often an opportunity to multiply the CGE by having two or more family members own shares of the corporation. Where there has been significant growth in the value of a corporation, existing shareholders may wish to undertake a value freeze and crystallize the CGE. At such time, additional family members may be introduced as shareholders allowing them to use the CGE on future gains in value. Making changes to share structures involving family members can result in unintended tax consequences if not carried out properly and so should only be undertaken with the advice of a tax specialist.

Summary

The capital gains exemption provides an opportunity for significant tax savings on the disposition of a business. Business owners should consider putting in place a detailed plan of action in order to take full advantage of these savings.

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Estate Planning Mistakes

Reflect the Life Stages of Your Children

Jean Blacklock and Sarah Kruger

Every book on estate planning reminds us that the impending arrival of a new baby is a very important life event requiring a first or updated will. While that advice is sure true, the mistake we will discuss in this chapter is letting that flush of "estate planning enthusiasm" fade over the years.

It does seem that people are most eager about will planning when the child is on the way (oh yes, and on the eve of the skydiving adventure bought at a silent auction!). Maybe it is the excitement of being first-time parents that explains this burst of enthusiasm, but every estate lawyer is familiar with the panicked calls received shortly before the due date: "We need a will!"

Just as we all have hundreds of photos of our first child and then merely dozens of those that follow, parents' enthusiasm for updating wills to accommodate changes in the family seems to wane over the years.

We were reminded of this when reviewing the comments from one of the lawyers who shared her thoughts for the book. She noted that she'd recently worked on an estate where the last will had been prepared when the deceased woman was married with several children. She later divorced and then had children in two other relationships but never remarried. When she died, her one and only will from her