LIFETIME CAPITAL GAINS TAX EXEMPTION

CANADIAN FEDERATION OF INDEPENDENT BUSINESS

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The importance of the capital gains exemption for owner-managers

MAKE SURE YOU DON'T MISS OUT!

By Danielle Sideris

Since 1985, the capital gains exemption has been available to Canadian business owners. The concept is simple—if you sell shares of a qualifying corporation for a gain, you may not be taxed on some or all of that gain. The amount of the gain that is exempt has been increasing in recent years. On January 1, 2014, the exemption was increased from $750,000 to $800,000. For 2015 and subsequent years, the exemption is indexed to inflation. For residents of Quebec, the provincial exemption limit follows the federal amount.

It is very important to understand when the exemption is and isn't available. **The rules are complicated and it is quite possible that your shares may not qualify by not meeting one of the detailed conditions that apply.** While shares of some corporations may never qualify for the exemption (for example, shares of many investment companies won't qualify), other share investments that are currently offside can be put back on track with advance planning. Since the conditions are detailed, very simple steps can often make the difference between qualifying and not qualifying for the exemption when you dispose of your shares.

It should be noted that your exemption can also be used to offset gains from certain types of qualifying farm/fishing property (which also includes shares of farm/fishing corporations and interests in farm/fishing partnerships). We won't address these rules in this article, but again advance planning is crucial for these properties as well. Note that the federal government increased the exemption limit on qualified farm/fishing property such that the indexed limit previously discussed is topped up to $1 million for dispositions after April 20, 2015 for this type of property.

For over 45 years, CFIB has paved the way for small business fairness in Canada.

The Canadian Federation of Independent Business (CFIB) leads the fight for exemptions from capital gains tax for small business owners. For over 45 years, CFIB has paved the way for small business fairness in Canada. Thanks to over 30,000 Action Alert responses from our members, CFIB was able to successfully lobby the federal government to raise the Lifetime Capital Gains Exemption (LCGE).

The LCGE is a big benefit to our members since most Canadian entrepreneurs see the sale of their businesses as a significant source of retirement income. It is also an incentive to help raise the level of investment in small businesses. CFIB members have raised questions on how the LCGE works. The following information by Danielle Sideris, who has long-time expertise dealing with tax planning for small- and medium-sized businesses, and their owners, answers the most frequently-asked questions.

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WHAT IS THE LIFETIME CAPITAL GAINS EXEMPTION LIMIT?

As mentioned above, an $800,000 capital gains exemption is available for capital gains arising from the disposition (i.e. sale) of qualified small business corporation shares in 2014.

Remember that the new limit that came into effect on January 1, 2014 and was subsequently indexed to inflation. This subsequent indexation of that limit applies to all individuals (even those who have previously fully used the Lifetime Capital Gains Exemption).

KNOW THE CONDITIONS

Their details will clarify which shares qualify and which do not.

HOW DO I QUALIFY FOR THE CAPITAL GAINS EXEMPTION?

If you sell shares of a small business corporation (SBC), and meet the conditions for the exemption, then the gain from the sale of your business will qualify for the capital gains exemption. To qualify for the exemption, the first condition is that your corporation must be an SBC at the time of sale. That means that it must be a Canadian-Controlled Private Corporation (or CCPC) and all or substantially all of its assets must be used in an active business carried on primarily in Canada. The Canada Revenue Agency interprets “all or substantially all” to mean that assets representing at least 90% of the fair market value of all corporate assets must be used for business purposes.

ADVANCED PLANNING

Will allow you to stay on track.

If you hold shares of an SBC, there is a second set of conditions which you must meet to qualify for the exemption:

1. More than 50% of the corporation’s assets (again on the basis of fair market value) must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale; and
2. The shares must not have been owned by anyone other than you or someone related to you during the 24-month period immediately before the sale.

To find out what the current LCGE limit is, visit **cfib.ca/LCGE**.

I HAVE AN UNINCORPORATED BUSINESS AND I INTEND TO SELL—CAN I USE THE EXEMPTION?

The capital gains exemption only applies to shares of an SBC and not to the sale of assets of an active, unincorporated business (assuming the business is not farming or fishing). However, it is possible to “roll” your business assets into a corporation without triggering tax, and then sell the shares of this new corporation. In fact, if the incorporation process is done correctly, you won’t have to wait 24 months before selling your shares to use the exemption.

HOW DO I CLAIM THE EXEMPTION?

If you meet the conditions above, the exemption can simply be claimed on your tax return when you sell the shares of your corporation for a gain. Please keep in mind however that the SBC test will apply at the time of sale, and the other tests apply during the 24 months leading up to the sale date. So, for those companies on the borderline of meeting the conditions, it is possible that the shares may not qualify if they are sold at the wrong time. The 90% test in the SBC definition is usually the most difficult test to meet, and many corporations will meet this test at certain times, and fail the test at other times. A similar problem can occur for businesses that mature—the level of business investment required can decrease, resulting in the accumulation of investment assets.

When it isn't clear that your corporation will meet the exemption rules continuously in the future, it may make sense to take steps now to make sure you will benefit from the exemption. Therefore, in the right circumstances we often recommend to clients that they "crystallize" their exemption at a time when the corporation does qualify, perhaps by purifying the corporation first (purifying involves removing excess non-business assets e.g. by paying dividends).

CAN I USE THE EXEMPTION TO REMOVE CASH FROM MY COMPANY?

You should keep in mind that while you can step up the tax cost of your shares, you can't take back cash or other non-share consideration when triggering the gain, as this could produce unfavourable tax consequences under specific anti-avoidance rules. In addition, these anti-avoidance rules can apply if you subsequently try to use the stepped-up cost of your shares to obtain cash. For example, if you attempt to obtain cash by selling the shares for cash to a corporation controlled by another family member, you'll be subject to the rules.

I INTEND TO PASS THE CORPORATION ON TO MY CHILDREN. IS THE EXEMPTION BENEFICIAL FOR ME?

Definitely. Although you can transfer shares of your corporation to your spouse without incurring tax, a transfer to your children on death will result in a deemed sale of your shares at their fair market value at that time. So, the exemption will help reduce the amount of tax that your family will have to pay on your death.

The discussion earlier on crystallizing your exemption is equally relevant in succession situations. Your shares must qualify for the exemption at the time of death (or under a special rule for deceased taxpayers, during any time in the 12-month period preceding death). A crystallization can again ensure that your family will enjoy the benefits of the exemption.

WHAT IS A CRYSTALLIZATION?

A crystallization allows you to trigger a capital gain at a time when the shares of the corporation will qualify. This removes the need to monitor whether the corporation meets the rules described earlier, and also locks in the exemption in the event that it is eliminated by the government before your actual sale. However, with the exemption limit increasing annually after 2014 due to indexing, this will impact the decision of whether crystallizing makes sense.

There are a number of ways to crystallize your capital gains exemption. Under one common method, you can transfer your shares back to your corporation or to a holding company and elect to realize a gain on the transfer. The shares taken back will have a stepped-up cost, thereby reducing any future capital gain when you sell the shares to a third party. If your corporation does not currently qualify, perhaps due to holding excess non-business assets, it may still be possible to extract these assets so that the corporation meets the capital gains exemption conditions long enough to crystallize the exemption. The rules around a purification of your corporation also highlight why acting in advance of a sale is important—some tax-deferred purification techniques can't be used in contemplation of a specific sale.

The capital gains exemption rules are complicated, and it is crucial that you seek professional advice before attempting to crystallize your exemption. For example, a crystallization can cause a minimum tax liability for some individuals. Or, it may not be possible to crystallize if your investment expenses have exceeded your investment income over the years.

The comment above in respect to using the exemption to remove cash from the corporation will apply to your children as well—the anti-avoidance rules contain provisions designed to also prevent your children from cashing in the share cost base that relates to your exemption. For residents of Quebec, an exemption may be available to claim for Quebec tax purposes on a transfer of a family business to a non-arm's length corporation provided that certain conditions are met.

You should note that there may be additional income tax implications where shares of your corporation are held by a minor child directly or through a trust. As a bit of a background: a tax on split income applies to prevent the use of certain income splitting arrangements. As a consequence of these rules, minor children are subject to tax at the highest marginal rate on income they receive under an income splitting arrangement. When initially introduced, taxable capital gains earned by a minor child were not subject to the rules. However, the 2011 federal budget extended the rules to apply to capital gains from a disposition of shares of a corporation to a non-arm's length person, if taxable dividends on those shares would have been subject to the tax on split income. Under the rules, capital gains realized by a minor (directly or through a trust) will be deemed to be dividends where the disposition is to a non-arm's length person, and therefore, the Lifetime Capital Gains Exemption will not be available. This change applies to capital gains realized on or after March 22, 2011.

Under proposed changes released in 2017, the tax on split income will be extended to apply to adult family members in certain situations, effective January 1, 2018. However, under the proposals, capital gains realized by adults on the disposition of property eligible for the Lifetime Capital Gains Exemption will not be subject to the tax on split income.

Whether you're planning to sell the business to third-parties or pass on the business to your family members through succession, the capital gains exemption is an important tool to help minimize the tax cost of your exit from the business. Make sure you don't miss out!

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There have been several attempts over the years to eliminate the Lifetime Capital Gains Exemption. CFIB and its members managed to protect this necessary small-business investment incentive and will continue to do so moving forward.

There are other important measures for the investment community (such as the capital gains inclusion rate), but these in no way lessen the importance of the LCGE for small- or medium-sized firms. In fact, after strong, continued lobbying by CFIB, the federal government not only increased the threshold to $800,000 for 2014, but also announced that the threshold would be indexed to inflation, as of the 2015 taxation year. This was a major victory that helps all small businesses, and it would not have happened without CFIB!

We are also pushing for assets (such as business property) to be included in the calculation of the LCGE, and for the overall process to be greatly simplified. Succession planning will only become more important over the coming decade and this article is part of our campaign to increase awareness about the most effective ways to deal with the transition of businesses from one generation to the next.

We're here to help.

Any questions? Call our business counsellors today.

1-888-234-2232.

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