

# Lifetime Capital Gains Tax Exemption

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Ever since CFIB's inception in the early 1970s, the Federation has championed exemptions from capital gains tax. In the view of our members, the \$750,000 lifetime capital gains exemption is needed since most Canadian entrepreneurs see the sale of their businesses as their retirement income. It is also an incentive to help raise the level of investment in small businesses. Recently several CFIB members have raised questions on how the lifetime capital gains exemption works. The following information by Bruce Ball, a recognized authority on capital gains, succession and retirement planning, answers the most frequently-asked questions.

## The Importance of the Capital Gains Exemption for Owner-Managers

**Make sure you don't miss out!**

*By Bruce Ball*

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 profit, the first \$750,000 of your gain on a lifetime basis can be received on a tax-free basis. But 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 \$750,000 exemption can also be used to offset gains from certain types of qualifying farm property, farm corporations and farm partnerships. We won't address these rules in this article, but again advance planning is crucial for these properties as well.

### 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 per cent of their fair market value of all corporate assets must be used for business purposes.

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 per cent 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.

## **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. 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.

## **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 per cent 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, 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).

## **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.

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.

## **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). So a crystallization can again ensure that your family will enjoy the benefits of the exemption.

The comment earlier about using the exemption to receive cash from the corporation will apply to your children as well—the anti-avoidance rules contain provisions designed to prevent your children from cashing in the share cost base that relates to your exemption.

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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Over the years there have been several attempts to eliminate the Lifetime Capital Gains Tax Exemption. CFIB, with the help of its members, has managed to protect this necessary small-business investment incentive. The inclusion rate (the amount of the increased value of any eligible investment that is taxed) was reduced from 75 per cent to 50 per cent. This is an important measure for the investment community but in no way eliminates the necessity of the lifetime exemption for small- or medium-sized firms. We will continue to push for improved treatment of capital gains taxes. In fact, for a considerable period we have attempted to have governments raise the lifetime exemption threshold to \$1 million. 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.

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