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The Lifetime Capital Gains Exemption

The sale of your business might be the most significant transaction of your lifetime, especially from a tax perspective. If you are selling the shares of your corporation, you may realize a capital gain that must be included in your income. With proper planning, you may be able to enhance your family's wealth and mitigate the resulting tax liability.

CAPITAL GAINS EXEMPTION

The lifetime capital gains exemption ("LCGE") is a provision in the Income Tax Act ("the Act") that allows an individual to shelter, during their lifetime, a cumulative amount of $883,384 of capital gains realized on the disposition of Qualified Small Business Corporation ("QSBC") shares. Assuming the highest marginal tax rate for individuals is 50%, claiming the maximum exemption would provide a tax savings of approximately $221,000 for the shareholder.

The LCGE amount is indexed to inflation and adjusts annually. Since it is a lifetime exemption and the amount continues to increase annually, even if an individual has previously claimed the LCGE in prior years they may still be able to claim additional exemption amounts on future qualifying transactions.

For qualified farming or fishing corporations, the capital gains exemption amount is $1,000,000.

REQUIREMENTS

The exemption can only be claimed by an individual selling qualified shares; it cannot be claimed by a corporation. There are a number of conditions that must be met for the shares of a corporation to qualify as QSBC shares.

1. Holding Period Test - the shares must be held by an individual, or persons related to that individual, either directly (e.g., shares are owned personally) or indirectly (e.g., shares are held by a trust of which the individual is a beneficiary) throughout the 24-month period preceding the disposition.
2. Small Business Corporation Test - the shares that are disposed of by the individual must be "small business corporation" (“SBC”) shares at the time of the disposition. A SBC is generally defined as a Canadian Controlled Private Corporation where all or substantially all (90 percent or more) of the fair market value of the assets at that time are attributable to assets that are:
    a. used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it;
    b. shares of the capital stock or indebtedness of one or more small business corporations that are at that time connected with the particular corporation;

or,

    c. a combination of assets described above in paragraphs (a) and (b).

3. Asset Test – using the same principles as above, for each and every of the previous 24 months, the company must have been a Canadian Controlled Private Corporation and more than 50 percent of the fair market value of the assets of the corporation must have been used in an active business carried on primarily in Canada.

Examples of assets that generally are considered to be used in an active business are:

a. Cash or equivalents that, if withdrawn, would destabilize your business;

b. Inventory;

c. Manufacturing equipment and machinery;

d. Trade accounts receivable; and

e. Goodwill.

SBC AND ASSET TEST EXAMPLES

Consider the following example:

Business Owner

Common Shares

Operating Company

Goodwill	$2,000,000
Capital Assets	$1,000,000
CSV Life Insurance	$400,000
Investments	$3,100,000

CAPITAL GAINS EXEMPTION ANALYSIS:

ACTIVE ASSETS (46.15%)

Goodwill	$2,000,000
Capital Assets	$1,000,000
Total	**$3,000,000**

PASSIVE ASSETS (53.85%)

Investments	$3,100,000
CSV Insurance	$400,000
Total	**$3,500,000**

*** The 90% and 50% tests are not satisfied and thus the CGE is not available**

If over 10% of the fair market value of your corporation consists of assets not used in an active business (i.e. surplus cash and marketable securities) at the time of sale, or over 50% during any one of the previous 24 months, the above-noted tests may not be satisfied.

In this example, the value of the marketable security investments and the cash surrender value of the life insurance policy, which are both considered passive assets, exceed 10% and 50% of the value of the corporation. As a result, the company is not considered a QSBC.

In such situations, purification strategies could be implemented to enable the shareholders to potentially claim their exemptions on a future the sale of the shares.

Such strategies could include:

- Extracting surplus cash and marketable securities to the shareholder or to a holding company; or,
- Use surplus funds to acquire active business assets or settle outstanding debts.

Purifying your company at the time of sale to meet the 90% test and claim your exemption is possible, although it may come with a tax cost. However, it is not possible to retroactively purify your company during the previous twenty-four months to meet the 50% test. Therefore, you should be monitoring your corporation on a regular basis with your professional tax advisors to ensure that the company satisfies all of the required conditions for the capital gains exemption to apply within the relevant time periods.

MULTIPLYING THE EXEMPTION

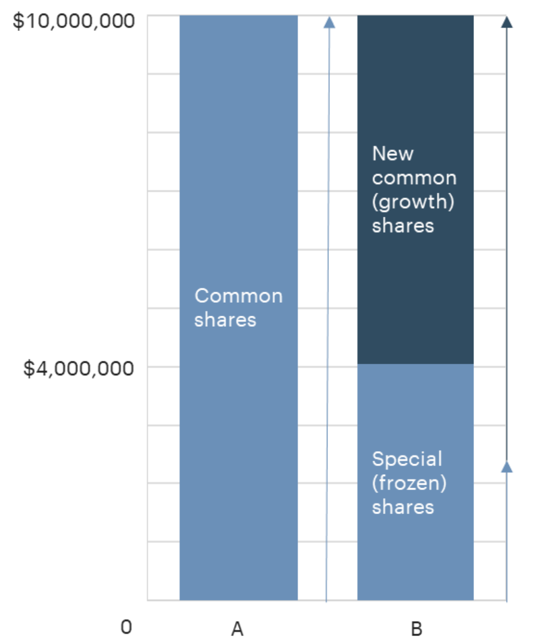
As mentioned previously, the tax savings associated with claiming the LCGE are significant. However, if you are the only shareholder of the company, only you would be able to claim the exemption on a sale. In some cases, you may want to consider a corporate reorganization transaction, referred to as an Estate Freeze, which would allow your family members to become shareholders in order to utilize their capital gains exemptions on a future sale of the company. You can multiply the use of the exemption and reduce the family's overall tax burden by having members of your family hold shares in the corporation, either personally or as discretionary beneficiaries of a family trust.

SCENARIO A – SALE OF BUSINESS WITHOUT FREEZE:

	Common shares
Proceeds	$10,000,000
Cost Base	Nil
	$10,000,000
Owner's LCGE	(883,384)
Capital Gain	$9,116,616
Tax on Gain (@25%)	**$2,279,154**

SCENARIO B – SALE OF BUSINESS WITH FREEZE:

	Frozen Shares	**Growth Shares**
Proceeds	$4,000,000	$6,000,000
Cost Base	Nil	Nil
	$4,000,000	**$6,000,000**
LCGE (assume 4 individual trust beneficiaries)	($883,384)	($3,533,536)
Capital Gain	**$3,116,616**	**$2,466,464**
Tax on Gain (@25%)	**$779,154**	**$616,616**
Total Tax Paid	**$1,395,770**	



HOLDING COMPANY STRUCTURES

The article thus far has focused on the traditional ownership structure where the business owner holds all the common shares of the operating company directly. However, you may be in a situation where your operating company shares are held through a holding company.

As discussed above, the LGCE can only be claimed by an individual, not a corporation. Therefore, in this indirect ownership structure, the exemption would only be available if the individual disposes of their shares of the holding company and not in situations where the holding company sells shares of the operating company.

Sometimes a holding company is used to accumulate the retained earnings of an operating company over time. The surplus cash transferred to the holding company may have been used to acquire passive investment assets. In such situations, the holding company may not meet the conditions for the capital gains exemption to apply.

When determining whether the holding company meets the QSBC share tests, all of the assets of the holding company must be considered, including the shares of any "connected" private corporations (i.e., two companies are considered connected for tax purposes if one company controls the other company or if one company owns shares representing more than 10% of the voting rights and fair market value of the other company).

In order for a holding company, which in turn owns the shares of an operating company, to meet the requirements of the LGCE it must either have:

a. If 90% or more of the holding company's assets are either active assets and/or investments in connected CCPCs, then the connected company or companies need only meet the 50% test; or,

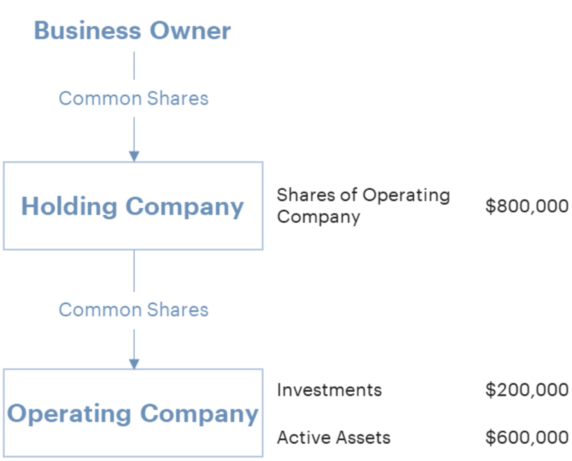
b. If the holding company does not meet the 90% test, then the connected company or companies must meet the 90% test throughout the 24-month period and the holding company must meet the 50% test.

Essentially, it will be necessary for either the holding corporation or its connected subsidiary or subsidiaries to meet the 90% threshold throughout the 24-month period preceding the disposition of the share

Consider the following examples of how the SBC and Asset Tests would be applied in various holding company structures:

UNINCORPORATED BUSINESS

Example 1



CAPITAL GAINS EXEMPTION ANALYSIS:

HOLDING COMPANY

Since more than 90% of the Holding Company's assets relate to the value of the Operating Company and the Operating Company meets the 50% test, the shares of Holding Company would meet the active business asset test.

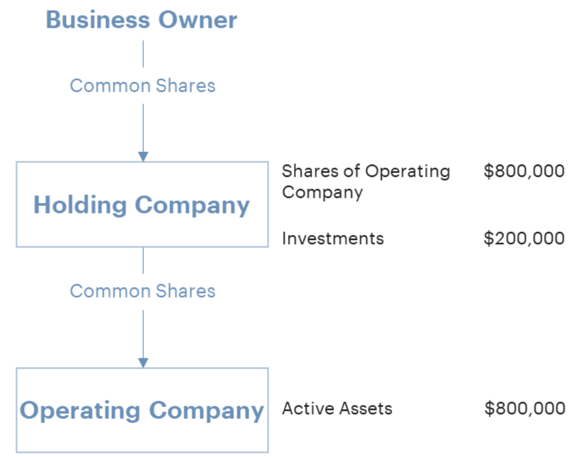
Percentage of Active Assets	100%

OPERATING COMPANY

Operating Company meets the 50% test but not the 90% test.

Percentage of Active Assets	75%

Example 2



CAPITAL GAINS EXEMPTION ANALYSIS:

HOLDING COMPANY

Less than 90%, but more than 50%, of Holding Company's assets relate to the Operating Company. Therefore, Operating Company would have to meet the 90% test throughout the preceding 24-month period in order for LGCE to apply.

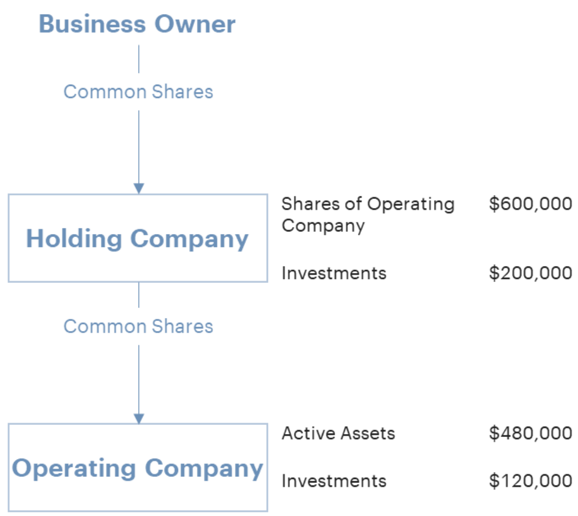
Percentage of Active Assets	80%

OPERATING COMPANY

Operating Company meets the "all or substantially all" active business asset test.

Percentage of Active Assets	100%

Example 3



CAPITAL GAINS EXEMPTION ANALYSIS:

HOLDING COMPANY

Less than 90%, but more than 50%, of Holding Company's assets relate to the Operating Company. Therefore, Operating Company would have to meet the 90% test throughout the previous 24 month period in order for Holding Company to qualify for the LCGE.

Percentage of Active Assets	75%

OPERATING COMPANY

Operating Company does not meet the 90% test. Purification strategies would be required and the 90% test would have to be achieved for the next 24 consecutive months.

Percentage of Active Assets	80%

The capital gains exemption only applies to the sale of shares of a qualifying corporation; it does not apply on an asset sale or on the sale of an unincorporated business.

If you are currently operating as a sole proprietor and would like to take advantage of the exemption, there are provisions in the Act that allow for a tax-deferred transfer of all or substantially of your business assets into a corporation and the subsequent sale of the shares of the new corporation to benefit from the exemption without having to meet the two-year holding period test for the shares.

OTHER PITFALLS

In addition to the various tests discussed above, there may be other issues that could reduce or eliminate your ability to claim the exemption.

The balance of your cumulative net investment loss ("CNIL") may reduce the balance of your LGCE that is eligible to be claimed in a particular tax year. The CNIL essentially tracks the excess of your accumulated investment expenses over accumulated investment income that have been included in your historical tax personal tax returns. To the extent that your claimed investment expenses are greater than your reported investment income, you will not have access to the full amount of the exemption. This can be rectified by realizing additional investment income or limiting your expenses claimed prior to utilizing the LCGE.

In a similar vein, any current or prior year allowable business investment losses will reduce the amount of the capital gains exemption may be claimed.

Prior to 1995, a general capital gains exemption of $100,000 was available to all taxpayers with respect to the disposition of any capital property. You must reduce your LCGE claim by the amount of your general exemption claimed prior to 1995.

SUMMARY

The LCGE is a valuable tool that can facilitate the transfer of your business to the next generation on a tax-efficient basis and also reduce the taxes owing at death. If you wish to discuss how you may take advantage of this exemption, please speak to a member of the Client Wealth Management or Wealth Planning teams.