THE NAVIGATOR

CAPITAL GAINS EXEMPTION ON PRIVATE SHARES

How you may be able to save approximately $200,000 of tax on the sale of your business

If you're thinking about selling Qualified Small Business Corporation (QSBC) shares, you may be able to save a significant amount tax by claiming the lifetime capital gains exemption (LCGE).

This article describes how you can qualify for the LCGE and some of the considerations you should keep in mind when claiming the LCGE. The LCGE allows you to exempt $800,000 (2014 – indexed annually starting 2015) of capital gains from the disposition of your QSBC shares. If your marginal tax rate is 50%, the LCGE could translate into a potential tax savings of $200,000.

The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

WHEN CAN YOU USE THE CAPITAL GAINS EXEMPTION?

Aside from a simple sale of shares, there are a number of other circumstances where you can use the LCGE. Some of the situations where you can use the LCGE are:

- An estate freeze of a family business. An estate freeze may allow you to transfer the future growth of a company to other shareholders. During the freeze, you may also crystallize the capital gains exemption to increase the ACB of your shares. Ask your RBC advisor for the article titled "Estate Freeze" for additional details;
- A direct transfer of family business shares to other family members;
- A private Canadian company being taken over (by way of share purchase) or merging with another Canadian or foreign company;
- A deemed disposition of private shares on death; or
- On the sale of other types of properties, such as farming property. Ask your RBC advisor for a copy of the article "Selling the Farm and the Capital Gain Exemption" if you would like more information.

QUALIFYING FOR THE EXEMPTION

In order to be able to claim the LCGE, you must sell qualifying property.

Qualifying property includes QSBC shares, qualified farming property and qualified fishing property. Although the definition of QSBC shares is quite complex, the general criteria for private company share to qualify as QSBC shares are as follows:

- The shares must be of a Canadian-controlled private corporation;
- During the 24 months prior to the sale, the shares were not held by anyone other than the taxpayer or anyone related to the taxpayer;
- All or substantially all, which generally means at least 90%, of the assets have been used principally to carry on an active business carried

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on primarily in Canada at the time of disposition; **and**

- During the 24 months prior to the sale and while the corporation was owned by the taxpayer, more than 50% of the assets have been used principally in an active business carried on primarily in Canada.

Please note that shares you hold in a registered retirement savings plan (RRSP) do not qualify for the LCGE.

The criteria above have been greatly simplified. You should speak with your qualified tax advisor to determine whether your private company shares qualify as QSBC shares.

Purifying Your Corporation

If more than 10% of the assets in your corporation are passive investment assets, your private company shares will not qualify as QSBC shares. You may need to restructure or "purify" your business assets prior to the sale to ensure that you can claim the LCGE. Speak with your qualified tax advisor to determine which assets you should remove from your corporation and how to do so. Some of the common methods of purifying a company are:

Non-taxable methods (if there is excess cash in the business)

- Reduce liabilities including loans you or shareholders have made to the business
- Pay out capital dividends if there is a positive Capital Dividend Account balance in the corporation
- Pay a return of capital dividend
- Purchase more active business assets

Taxable methods

- Pay salaries
- Pay taxable dividends (payments can be made as cash or in-kind)
- Sell passive assets and pay down debt or invest in active assets

Tax-deferred method

- Transfer the passive assets to another corporation

What if You're Not Incorporated?

If you are a sole proprietor and you plan to sell your business, you may still be able to benefit from the LCGE. In order to claim the LCGE, you will need to create a corporation and sell the shares of that corporation. If you transfer all or substantially all of your business assets into a corporation and immediately sell the shares of the newly formed corporation, you may be able to claim the LCGE. Speak to your qualified tax advisor if you are a sole proprietor and are planning to sell your business.

Past Exemptions May Impact Your Current Situation

There were a number of different capital gains exemptions available prior to 1995. One of these exemptions was the $100,000 general capital gains exemption. This general exemption was available to all taxpayers on gains relating to any kind of capital property, including public company shares, bonds, mutual funds, real estate, etc. This general exemption was abolished in the 1994 federal budget. If you had any unused general capital gains exemption at that time, you could have made a special election on your 1994 income tax return to exempt up to $100,000 of capital gains accrued on any of your capital property. You can no longer make this election.

A special $500,000 capital gains exemption continued to exist after February 22, 1994, which you could use under certain circumstances. One situation where this exemption can apply is if you realize a capital gain

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on the disposition of QSBC shares. This is the LCGE today. The LCGE was increased to $750,000 in 2007, $800,000 in 2014 and will be indexed annually beginning 2015.

Please note that if you used any of the capital gains exemptions in the past, you must reduce your available LCGE by the amount of past exemptions you claimed. In addition, there may be further reductions to the LCGE, as a result of claims for an allowable business investment loss (ABIL) or certain other deductions. Speak with your tax advisor to determine if you qualify for this exemption; and if so, the amount for which you qualify.

Kiddie Tax and Non-Arm's Length Dispositions

A common tax planning strategy is multiplying the use of the LCGE on the sale of a single business. One way to achieve this is by placing private company shares in a family trust and naming various family members as beneficiaries of the family trust. Upon the disposition of the QSBC shares, any capital gains the trust realizes on the sale can be allocated to the beneficiaries of the family trust. The beneficiaries can use their LCGE to reduce or eliminate tax on the capital gains allocated to them.

Prior to March 21, 2011, minor children could use their LCGE on capital gains they realize on any disposition of QSBC shares. However, following the 2011 federal budget, capital gains realized by minor children on the sale of private company shares to **non-arm's length persons** are re-characterized as dividends and are subject to the kiddie tax rules. In these circumstances, the minor would not be able to use their LCGE since, under these rules, the capital gains is dividend income. This dividend income will be taxable to the minor at the highest marginal tax rate for non-eligible dividends.

Alternative Minimum Tax (AMT)

Another issue to consider is the impact that AMT can have for the tax year in which you will claim the LCGE. AMT aims to ensure that every individual Canadian taxpayer pays a minimum amount of tax. The calculation of AMT is based on an "adjusted taxable income" which seeks to remove the advantages of certain tax-preferential items such as capital gains. The difference between the AMT that you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability if your taxes payable exceed AMT. You should contact your tax advisor to verify if AMT will be a factor when you claim the LCGE. You can also ask your RBC advisor about the article titled "Alternative Minimum Tax (AMT)" for more information.

Plan in Advance

It is important that you plan well in advance of the sale or transfer of your business. As noted above, there are a number of criteria that must be met in order for you to be able to claim the LCGE. You may need to take certain steps to qualify. For example, if your corporation holds a significant amount of passive investment assets, you may need to take steps to ensure that you can qualify for the LCGE. Speak to your qualified tax advisor to determine if you can benefit from claiming the LCGE.

Please contact us for more information about the topics discussed in this article.

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