The Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Wealth Management

Capital gains exemption on private shares

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

The federal government has proposed changes which target private corporations. Generally, effective for 2018 and later taxation years, the government has proposed to limit income splitting to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults.

The government also intends to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. Details of this proposed measure will be released in draft legislation as part of the 2018 federal budget. If enacted, this measure may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures. If you are an owner of a private corporation, you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

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

If you are thinking about selling your business, you may be able to save a significant amount of tax by claiming the lifetime capital gains exemption (LCGE) on the sale if your business is incorporated and the shares are Qualified Small Business Corporation (QSBC) shares.

This article describes how you may qualify for the LCGE and some of the factors you may consider when claiming the LCGE. Each individual resident in Canada can claim a LCGE on the disposition of QSBC shares. The LCGE was increased effective for 2014 to $800,000 for dispositions of QSBC shares and is indexed for years after 2014. The exemption is $835,716 for 2017 (you can find the current year LCGE on the Canada Revenue Agency's (CRA) website). If your marginal tax rate is 50%, the LCGE could result in a potential tax savings of over $200,000.

To claim the LCGE, you must sell qualifying property. Qualifying property includes QSBC shares, qualified farming or fishing properties.

When can you use the LCGE?

Aside from a simple sale of shares of your corporation, below are some of the situations where you may use the LCGE:

- You implement an estate freeze of a family business. An estate freeze may allow you to transfer the future growth of a company to other shareholders, usually family members. During the freeze, you may be able to crystallize the LCGE and increase the ACB of your shares on a tax-deferred basis. Ask your RBC advisor for the article titled "Estate Freeze" for details;
- You transfer family business shares to other family members;
- Your private Canadian corporation is taken over by way of share purchase or merging with another Canadian or foreign corporation;
- On your death, capital gains are realized on the deemed disposition of your private company shares; or
- You sell certain 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" for details.

Qualifying for the LCGE

To claim the LCGE, you must sell qualifying property. Qualifying property includes QSBC shares, qualified farming or fishing properties. Although the definition of QSBC shares is quite complex, the general criteria for private company shares to qualify as QSBC shares are as follows:

- At the time of disposition, the shares must be of a Canadian-controlled private corporation;
- At the time of disposition, all or substantially all, which generally means 90% or more, of the fair market value of the assets are used principally in an active business carried on primarily in Canada;
- During the 24 months prior to the disposition, the shares must not be owned by anyone other than the individual or a person or partnership related to the individual; **and**
- During the 24 months prior to the disposition while the shares were owned by the individual or a person or partnership related to the individual, more than 50% of the fair market value of the assets must have been used in an active business carried on primarily in Canada.

Please note that shares you hold in a registered savings plan, such as 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 fair market value of the assets in your corporation are not used in active business, for example, the corporation holds a substantial amount of portfolio investments, your private company shares will not qualify as QSBC shares. You may need to remove the assets that are not used in your active business, or "purify" your corporation, prior to the disposition 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

- Reduce liabilities, including loans you or other shareholders have made to the business
- Pay out capital dividends if there is a positive Capital Dividend Account balance in the corporation
- Make return of capital payments to shareholders

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.

– Purchase more active business assets

Taxable methods

– Pay salaries

– Pay taxable dividends (payments may 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 (this generally means 90% or more) 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 the disposition of 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 is available is if you realize a capital gain on the disposition of QSBC shares. This is the LCGE today. The LCGE was increased to $750,000 in 2007 and to $800,000 in 2014 and is 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 same amount. In addition, there may be further reductions to the LCGE, as a result of claims for allowable business investment losses (ABILs) or certain other deductions, such as net investment losses. 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 may potentially be allocated to the beneficiaries of the 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, Please contact us for more information about the topics discussed in this article.

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)

AMT may impact your tax liability for the tax year in which you 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 when your taxes payable exceed AMT. You should contact your tax advisor to determine 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 implement certain planning strategies to qualify. For example, if your corporation holds a significant amount of passive investment assets, you may need to take steps to ensure that the shares of your corporation qualify as QSBC shares. Speak to your qualified tax advisor to determine if you can benefit from claiming the LCGE.

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.

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