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LIFETIME CAPITAL GAINS EXEMPTION

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on estate planning techniques for small businesses and their shareholders. Alpert Law Firm is experienced in providing legal services to its clients relating to estate planning, including the preparation of wills, deeds of gift, trust documents and all documentation required in connection with estate freezes and other tax, corporate and estate planning matters.

A. GENERAL CONSIDERATIONS

Section 110.6 of the Income Tax Act (the "Act") provides every individual resident in Canada with a lifetime exemption from tax on a certain amount of eligible capital gains, also commonly referred to as the "lifetime capital gains exemption".

The lifetime capital gains exemption (LCGE) in the Act provides individuals resident in Canada with a lifetime exemption from tax on a certain amount of eligible capital gains arising on dispositions of qualifying small business corporation (QSBC) shares, and farming and fishing property (defined in subsection 110.6(1)). As of January 1, 2021, the limit on dispositions of QSBC shares is $892,218 and is indexed annually to match the rate of inflation. For dispositions of qualified farming or fishing property, the limit is $1,000,000.

(i) Definition of "Small Business Corporations"

The term "small business corporation" is defined in section 248(1) of the Act as a Canadian-controlled private corporation of which all or substantially all of the fair market value of the assets were at the particular time: (i) used principally in an active business carried on primarily in Canada by the corporation or a related corporation; or (ii) shares or debt of one or more other small business corporations that were at that time connected with the corporation; or (iii) a combination of the assets described in (i) and (ii) above.

(a) "All or Substantially All"

According to the Canada Revenue Agency's (the "CRA") administrative policy, the phrase "all or substantially all" is generally interpreted to mean 90% or more. However, the Tax Court of Canada has interpreted the phrase differently. In *Wood v.*

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Minister of National Revenue, [1987] 1 CTC 2391, the Tax Court of Canada interpreted “all or substantially all” in the context of a non-resident’s entitlement to non-refundable tax credits. The Tax Court in *Wood* held that there could be no simple mathematical formula for the phrase “all or substantially all” and commented that the Court will generally determine the meaning of such a phrase on the basis of the particular facts and circumstances. In *547931 Alberta Ltd. v. R.,* 2003 TCC 170, Justice Bowie similarly stated that if Parliament had intended that 90%, or any other fixed percentage, should govern, then it would have expressed that in the statute, rather than using what is obviously an expression of some elasticity.

Subsequent to the above-mentioned decisions, CRA published Technical Interpretation 2013-0495631C6 regarding its position on the interpretation of “all or substantially all” in the context of the lifetime capital gains exemption rules. The CRA acknowledged that "all or substantially all" could, depending on the circumstances, be satisfied even if the 90% level is not reached and stated that where the 90% level is not attained, the CRA must consider each case in its particular context to determine if a threshold lower than 90% could satisfy the "all or substantially all" test.

Although “all or substantially all” is not necessarily a bright line test, it is generally preferable for a corporation to ensure it is on side for the 90% test rather than having to convince a CRA auditor to apply a more flexible analysis. Nevertheless, if CRA denies a shareholder’s claim to the lifetime capital gains exemption on the basis that the corporation failed to meet the 90% test, the shareholder may be able to successfully challenge such assessment in the Tax Court of Canada by relying on *Wood* and other similar decisions.

(b) Definition of “Active Business”

The term “active business” is defined in subsection 248(1) of the Act as any business other than a “specified investment business” or a “personal services business”.

A specified investment business is defined in subsection 125(7) of the Act as a corporation whose principal purpose is to derive income from property, unless: (i) the business employs more than five full-time employees; or (ii) in the course of carrying on the active business, any other corporation associated with it provides managerial, administrative, financial, maintenance or other similar services to the corporation and the corporation could reasonably be expected to require more than five full-time employees if those services had not been provided.

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A personal services business is defined in subsection 125(7) of the Act as a corporation which meets the following conditions:

(i) The corporation's principal business activity is to derive income from services rendered by an individual on behalf of the corporation, referred to as an "incorporated employee";

(ii) The incorporated employee, together with related persons, own at least 10% or more of the issued shares of any class of the corporation or of any related corporation;

(iii) But for the existence of the corporation, the incorporated employee might reasonably be regarded as an officer or employee of the corporation or partnership to whom the services are provided;

(iv) The services of the corporation are not being provided to an associated corporation; and

(v) The corporation does not employ more than 5 full-time employees in the business.

(ii) Definition of "Qualified Small Business Corporation Shares"

A corporation that meets the above-mentioned criteria is a small business corporation pursuant to the Act. However, not all shares held by an individual in a small business corporation qualify for the capital gains exemption. Only "qualified small business corporation shares" are eligible for this exemption.

Pursuant to subsection 110.6(1) of the Act, in order to be a qualified small business corporation share, such share: (i) must be a share of the capital stock of a small business corporation at the time of disposition; (ii) must not have been owned by anyone other than the individual or a person or partnership related to the individual throughout the 24 months immediately preceding the time of disposition; and (iii) throughout the 24-month holding period, must be a share of the capital stock of a Canadian-controlled private corporation and more than 50% of the fair market value of the assets of the corporation were used principally in an active business carried on primarily in Canada by the corporation or a related corporation.

Shares of an individual who died prior to the end of the 24-month holding period do not qualify for the lifetime capital gains exemption when a deemed capital gain is

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realized on the death of the individual. However, the shares may be transferred on the death of the individual to the individual's spouse or a spousal trust, in which case the tax on the accrued capital gain will be deferred until the earlier of the sale of the shares or the death of the spouse, and such shares will remain eligible for the $800,000 capital gains exemption.

(iii) Holding Company Considerations

Where the shares of a small business corporation are held indirectly through the use of a holding company, in order for shares of the holding company to meet the definition of a "qualified small business corporation share", all or substantially all of the fair market value of the assets of the holding company must, throughout the 24-month holding period, be attributable to: (a) shares or debt of connected corporations that meet the 50% active business asset test during the holding period; (b) assets used directly in an active business carried on primarily in Canada; or (c) any combination of such shares, debt and assets.

In the event that the holding company does not meet the "all or substantially all" test throughout the 24-month holding period, its shares will be qualified small business corporation shares only if the connected corporation in which it holds shares meets the "all or substantially all" test throughout the 24-month period rather than the 50% test as otherwise provided. This substitution of a 90% test for the 50% test is an anti-stacking rule intended to prevent individuals from circumventing the 50% test by using layers of corporations.

Connected corporations are defined under subsection 186(4) of the Act. In order for two corporations to be connected, the holding corporation must (i) control the other corporation; or (ii) own shares having at least 10% of the voting rights of such corporation and having a fair market value of more than 10% of the fair market value of all the issued shares of the corporation.

(iv) Purification

In order for a corporation to meet the above-mentioned 50% and 90% active business asset tests, the corporation must be "purified" by removing non-qualifying assets of the corporation in excess of the prescribed percentages prior to realization of the capital gains exemptions. Common types of non-qualifying assets that may prevent the 50% and 90% tests from being met include excessive holdings of cash, passive investments, shareholder advances or loan receivables.

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Purification may involve straightforward techniques such as buying new active business assets to tip the balance, using non-qualifying assets to pay down the corporation's debt obligations, or paying out capital dividends. Alternatively, purification may be accomplished by incorporating a new holding corporation, and transferring the non-qualifying assets of the operating corporation on a tax-free basis to the newly formed holding corporation.

Owners of small business corporations should regularly ensure that the corporation is on side for both the 50% and 90% tests. Otherwise, the taxpayer may lose his or her entitlement to the lifetime capital gains exemption in the event that something unexpected happens that triggers a deemed disposition of shares – such as the death of the shareholder. For this reason, shareholders should consult their tax professionals well ahead of time to discuss purification strategies and it is not advisable to wait until they wish to dispose of their shares to do their tax planning.

(v) Crystallizing the Lifetime Capital Gains Exemption

Due to the various strict requirements for the lifetime capital gains exemption as set out above, an individual may not be able to ensure that he will be entitled to claim the lifetime capital gains exemption when he eventually decides to sell his shares. For example, the corporation may change its primary business activities and may cease to have an active business, or the corporation's shareholdings may change such that the corporation is no longer a Canadian-controlled private corporation. In addition, although unlikely, it is possible that access to the lifetime capital gain exemption may be further restricted or repealed by the federal government in the future. In order to avoid such uncertainties, a shareholder may wish to crystallize his lifetime capital gains exemption when the necessary requirements are satisfied, so that there is no need to worry about his or her future eligibility to claim the exemption.

A shareholder who owns qualified small business corporation shares may crystallize the lifetime capital gains exemption by undertaking transactions which trigger a disposition of the shares. A common method of crystallization is to transfer the shares to a new holding corporation pursuant to subsection 85(1) of the Act and to elect an amount that triggers the desired gain for the lifetime capital gains exemption.

Alternatively, the shareholder may wish to transfer the shares to a related individual or trust. If the shares are transferred to a spouse or a common-law partner, the individual would need to elect out of the automatic rollover provisions contained in subsection 73(1) of the Act in order to trigger a gain. If the shareholder received less

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than fair market value consideration in exchange for the shares, the application of the attribution rules must be considered.

If a shareholder wishes to crystallize his lifetime capital gains exemption and at the same time (i) maintain control of the corporation; and (ii) allow all the future growth of the corporation to pass to his family members, an estate freeze may be appropriate. An estate freeze will also potentially allow the family members who receive freeze shares to utilize their lifetime capital gain exemptions in the future in connection with any future growth in the value of the freeze shares, subject to considerations of the tax on split income ("TOSI") rules.

Effective January 1, 2018, the TOSI rules contained in section 120.4 of the Act were significantly amended to reduce or eliminate the ability of taxpayers to engage in income sprinkling. In general, family members who receive shares but have not contributed to the business will be subject to tax at the highest marginal personal income tax rate on any dividend income received from the corporation. However, the amended TOSI rules will generally not limit the family members' access to the lifetime capital gain exemption, with one exception for minors.

For adult individuals, the definition of split income under the amended TOSI rules specifically exclude capital gains realized from the disposition of (i) qualified small business corporation shares; and (ii) qualified farming or fishing property. However, for individuals under the age of 18, the capital gains will only be exempt from the TOSI rules if the qualifying shares or property is transferred by the minor to an arm's length person. In the event that a minor disposes shares to a non-arm's length person, the capital gains realized from the disposition will be subject to tax at the highest marginal personal income tax rate and will not be eligible for the lifetime capital gains exemption unless another exception to the TOSI rules is applicable.

(vi) New Intergenerational Transfer Rules

Bill C-208 (the "Bill") amends the Act to address the punitive tax effects on intergenerational transfers that arises from the anti-avoidance rule in section 84.1 of the Act, and also serves to modify the application of paragraph 55(5)(e) to increase flexibility in respect of tax-deferred corporate reorganisations involving businesses owned by siblings. The Bill received royal assent on June 29, 2021. On June 30, 2021, the Department of Finance announced that the federal government proposes to introduce legislation clarifying that the amendments contained in the Bill will be applicable beginning January 1, 2022. However, on July 19, 2021, the government re-clarified that Bill C-208 applies in law, although forthcoming amendments will be

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intended to ensure that the changes facilitate genuine intergenerational transfers and are not used for artificial tax planning purposes.

(a) Amendment to Section 84.1

Section 84.1 of the Act contains an anti-avoidance provision that limits "surplus stripping" whereby shareholders may otherwise realize a tax-free return of capital instead of a taxable dividend. A criticism of section 84.1 was that it prevented a LCGE from being claimed where the sale of QSBC shares was made to a corporation controlled by family members. Thus, section 84.1 made it more advantageous to make the sale of QSBC shares to *bona fide*, arm's length parties rather than to a related party.

Bill C-208 limits the anti-avoidance rule in section 84.1 through the additions of paragraph 84.1(2)(e) and subsection 84.1(2.3). Paragraph 84.1(2)(e) deems a taxpayer and a purchaser corporation to be dealing at arm's length where the following conditions are met: (a) the transaction involves QSBC shares or family farm or fishing corporation shares; (b) one or more children or grandchildren 18 years of age or older of the vending taxpayer controls the purchaser corporation; and (c) the exchanged shares were not disposed of by the purchaser within 60 months of the purchase. The result of these additions is that taxpayers will be able to sell QSBC shares to their children 18 years of age or older and be able to claim the LCGE on the sale of those shares.

Subsection 84.1(2.3) sets out the consequences if the shares are disposed of by the purchaser within 60 months of the purchase (for reason other than death). These consequences include: (i) a reduction of the LCGE claimable where the corporation has taxable capital employed in Canada in excess of $10 million; (ii) requiring an independent assessment of the fair market value (FMV) of the subject shares; and (iii) an affidavit signed by the taxpayer and a third party attesting to the disposal be provided to the CRA.

(b) Amendment to Paragraph 55(5)(e)

Subsection 55(2) of the Act contains an anti-avoidance rule that prevents the conversion of a taxable capital gain into a tax-free intercorporate dividend. An exception to subsection 55(2) is contained in paragraph 55(3)(a) (the "related party exception") However, paragraph 55(5)€ deems siblings to be unrelated rending them unable to rely on the exception in paragraph 55(3)(a).

Bill C-208 provides an exemption to the deeming rule in paragraph 55(5)(e) such that it would not apply where the dividend was received or paid as part of a transaction,

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event, or a series of transactions or events by a corporation whose share of the capital stock is a (i) QSBC share; or (ii) a share of the capital stock of a family farm or fishing corporation. Therefore, Bill C-208 creates the potential for intergenerational transfers involving siblings to qualify for the related party exception under paragraph 55(3)(a).

(c) Concerns with the Amendment

Bill C-208 has caused some concern that the new amendments to section 84.1 are open to abuse. For example, taxpayer B, who owns a qualifying private corporation, B Ltd., could access B Ltd.'s cash without either: (i) selling, and subsequently losing control of, the corporation; or (ii) distributing the cash to himself as a taxable dividend. To accomplish this, taxpayer B would:

(i) incorporate a Newco where B purchases 50 common shares at the price of $500 and B's daughter, C, purchases 1000 voting shares at the price of $500;

(ii) sell the shares of B Ltd. to Newco in exchange for a promissory note for the amount of cash in B Ltd.;

(iii) distribute the cash in B Ltd. to Newco as a tax-free intercorporate dividend; and

(iv) discharge the promissory note by paying the cash received as a tax-free intercorporate dividend by Newco to B.

The result of these transactions is that B will have received the cash in B Ltd. on a tax-free basis as long as C controls Newco, which, in this example, she does.

The federal government made an announcement on July 19, 2021 indicating an intention to make further amendments in order to "honour the spirit of Bill C-208" and ensure that any unintended loopholes will be addressed. These amendments will address, in part:

i) The requirement to transfer legal and factual control of the corporation carrying on the business from the parent intergenerationally;

ii) The level of ownership that the parent can retain post-transfer;

iii) The requirements and timeline for the parent (or grandparent) to transition their involvement in the business; and

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iv) The subsequent generation's requisite level of involvement after the transfer.

These changes are still undergoing review and will be introduced in a parliamentary bill at the later of: (a) the date of publication of the final draft legislation; or (b) November 1, 2021, after final legislative proposals are published. The Bill will remain in effect at least until this target date.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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