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Using the Capital Gains Exception

The Exemption

For the years 1985 and following, the Government introduced the capital gains exemption. The purpose of the exemption was to allow taxpayers $500,000 of tax-free capital gains. Unfortunately, the generosity of the Government in allowing such great amounts of capital gains to go untaxed gave rises to a political uproar. As a result, the government was forced to retreat from its original position and limit the amount of capital gains eligible for the exemption to $100,000 where, for the most part, it remains today.

The notable exceptions to this $100,000 rule are gains on qualified farm property and qualified small business corporation shares. Owners of such property can enjoy $500,000 worth of untaxed capital gains on its disposal. Qualified farm property can be real property used in the course of carrying on the business of farming in Canada, a share of the capital stock of the family farm corporation, an interest in a family farm partnership, and certain other intangible properties used in farming. A qualified small business corporation share is, simply put, a share of the capital stock of a Canadian-controlled private corporation which actively carries on business in Canada or which owns shares of the stock of other such corporations. It must either control the corporations in which it holds the shares or it must own more than 10% of the votes and fair market value of all the issued shares of the subsidiary.

At the time of the sale of the shares, the corporation must use all or substantially all (generally over 90%) of its assets in the active business. For up to 24 months prior to the sale, the legislation requires that more than 50% of the fair market value of the assets of the corporation be used in an active business or be shares of corporations which use all or substantially all of their assets in an active business.

Using the Exemption

Although the capital gains exemption exists for the time being, each new budget date seems to bring rumours of its demise, and there is always some concern that the Government will do away with it at some future date.

Therefore, to the extent your capital gains exemption has not been used, you might consider triggering any gains which exist on assets that you own to use it up. The easiest way to trigger a gain is by the disposal of the property. Where you have assets that you no longer need, these can be sold at their fair market value to an arm's length purchaser, making any resulting gain eligible for the capital gains exemption. This of course, would be convenient if you still need the property. If you need to continue to use the property, you might consider selling to a family member at its fair market value. If you sell the property to your spouse, you must elect in your tax return that the property was sold at its fair market value. Otherwise, the tax legislation deems that the property was sold at its cost, resulting in no gain. Furthermore, you should be sure that your spouse pays you fair market value consideration for the property, otherwise any future gain on the property or any income earned from the property will be attributed to you.

You should also make sure that you charge a fair market value rate of interest on any loan you make to your spouse or other related individual to help them buy the property, or else the attribution rules could apply.

It may be possible for you to sell your property to a corporation you own. Watch out, though. Where you transfer shares of a corporation to another company you own and take back money or other assets in return, the law could deem you to have received dividends from your company as a result. To avoid the deemed dividend rule, the value of the non-share assets you take back from your company cannot exceed the paid up capital of the transferred shares. The remainder of the consideration taken back must be in new shares of the company. In this case, although you will not have received much cash or debt in return for your assets, you will receive new shares with a higher tax cost base than your old shares. You can use your capital gains exemption to exempt the gain you earn from the disposition of your old shares from capital gains tax. When you eventually come to sell your new shares, you will not have to pay tax on that portion of the gain that you recognized when you transferred your old shares for new shares.

Although these suggestions may help you trigger your capital gains exemption, you must be wary of other problems the taxman can throw in your path such as the minimum tax rules.

The implementation of any tax saving strategy is based on your personal financial situation. Professional advice should be obtained before implementing any of the suggestions contained herein.

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