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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.

Pursuant to the 2007 Federal Budget, capital gains arising on dispositions of qualifying shares of small business corporations, as well as dispositions of qualified farm property occurring after March 18, 2007, are eligible for a lifetime capital gain exemption of $750,000.00. If a portion of the former general lifetime capital gains exemption of $500,000.00 has already been used, then the balance of the small business capital gain exemption will still be available in the future for shares of a small business corporation and qualified farm property.

The use of these exemptions achieves actual tax savings since the cost base of the shares to the transferee is increased to their current fair market value for future dispositions. It may be possible to double up on the use of this exemption if both spouses acquired capital assets with their own funds.

The term "small business corporation" is defined in section 248(1) of the *Income Tax Act* (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 (a) used in an active business carried on primarily in Canada by the corporation or a related corporation, or (b) shares or debt of one or more other small business corporations that were at that time connected with the corporation, or (c) a combination of the assets described in (a) and (b) above.

According to the Canada Revenue Agency (the "CRA"), the term "all or substantially all" is interpreted to mean 90% or more. This definition was clarified so that "all or substantially all" refers to the fair market value of the assets in question. Prior to this legislative change, there was some uncertainty as to whether this phrase referred to the cost of assets or to their fair market value.

The CRA has generally interpreted the term "primarily", as used in "an active business carried on *primarily* in Canada", to mean more than 50%. The facts of each particular case must be looked at for this test, with relevant factors including gross assets, employees and sales.

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 $750,000.00 capital gains exemption. Only "qualified small business corporation shares" are eligible for this exemption.

Generally, in order to be a qualified small business corporation share, such share (a) must be a share of the capital stock of a small business corporation at the time of disposition, (b) must not have been owned by anyone other than the individual or persons related to the individual throughout the 24 months immediately preceding the time of disposition, and (c) throughout the 24-month holding period, must be a share of the capital stock of a Canadian-controlled private corporation that used more than 50% of the fair market value of the assets of such corporation in an active business carried on primarily in Canada by the corporation or a related corporation.

The 24-month holding period referred to above specifies that no unrelated person may hold the shares in question during that period. However, the individual is not required to own the shares for the entire 24-month period. Shares held by an individual for less than the 24-month holding period, including newly issued shares acquired by an individual as part of a tax-free rollover of a sole proprietorship business to a new corporation pursuant to Subsection 85(1) of the Act, may still be qualified small business corporation shares assuming all other requirements are met.

The transfer of shares in a small business corporation to a spouse or spousal trust on the death of an individual now has more significance as a result of the $750,000.00 capital gains exemption. Shares of an individual who died prior to the end of the 24-month holding period do not qualify for this exemption when a deemed capital gain occurs automatically on the death of the individual. A transfer of such shares on the death of the individual to the individual's spouse or a spousal trust has the advantage of tax savings as a result of the use of the $750,000.00 capital gains exemption, as well as the advantage of further tax deferral.

The conditions to be met in order to be a qualified small business corporation share are similar where shares of a small business corporation are held indirectly through the use of a holding company. Where a holding company is used, 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% test during the holding period, (b) assets

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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 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 intended to prevent the stacking of corporations.

In order to be a connected corporation under the Act, the holding corporation must control the other corporation or 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.

Proceeds of disposition arising from shares in a corporation that is considered a "specified investment business" are not eligible for the lifetime capital gains exemption. A specified investment business is defined in subsection 125(7) of the Act as a corporation whose principle 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.

The provisions of the Act dealing with the $750,000.00 capital gains exemption are extremely complicated. For this reason, individuals should not wait until they wish to dispose of their shares in a small business corporation to do their tax planning. Consideration must be given to purification of the assets of the corporation by removing tainted assets in excess of the prescribed percentages prior to realization of the capital gains exemptions. In addition, individuals who own qualified small business corporation shares should consider transferring such shares to a holding company or a related party in order to trigger a $750,000.00 capital gain and take advantage of the present exemption.

The various estate planning methods referred to in this issue of the Legal Business Report may be used in combination in order to maximize tax deferral and savings. Therefore, in certain cases it may be possible to utilize the benefits of both an estate freeze and the $750,000 lifetime capital gains exemption.

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RECENT CASE LAW

1. THE MEANING OF "ACTIVE BUSINESS"

***Harquail et al v. M.N.R*. [2001] F.C.J. No. 1616**

In a Federal Court of Appeal decision, Gulf Pulp and Paper Inc. ("Gulf") operated a pulp mill and owned forest concessions and rights to develop a hydroelectric project. In 1969, Gulf transferred assets consisting of land and buildings to Arnaud Properties. For legal reasons Gulf transferred its hydroelectric assets and hydroelectric development rights to Hall River which was a wholly owned subsidiary of Arnaud Properties.

The hydroelectric assets owned by Hall River represented 100% of that company's assets and 90% or more of the overall assets of Arnaud Properties. Arnaud Properties only activity was selling lots but it believed that it could dispose of the lots more easily if electricity could be supplied to the residents at a lower cost. This required the profitable development of the hydroelectric project. Therefore, numerous efforts were made by both Arnaud Properties and Hall River to promote such development. Eventually, in the fall of 1988, another corporation became interested in developing the hydroelectric project. As a result, on February 24, 1989, all the shareholders of Arnaud Properties sold their shares to the other corporation.

In assessing the taxpayers for 1989, the Minister denied them the capital gains deduction for a qualified small business corporation ("QSBC") shares in respect of their disposition of their shares of Arnaud Properties.

In dismissing the taxpayers' appeals, the Tax Court of Canada concluded, *inter alia* (a) that Arnaud Properties had not carried on business after 1975, since there had been no sale of lots after that date; (b) that Hall River had not been capable of concluding an agreement with Hydro-Quebec regarding the hydroelectric project and as a result had never carried on business; and (c) that, as a result of these findings, neither Arnaud Properties nor Hall River were a qualified small business corporation during the twenty-four month period immediately preceding February 24, 1989, so that the taxpayers were not entitled to the QSBC capital gains deduction which they had claimed.

The taxpayers appealed to the Federal Court of Appeal which allowed their appeals. The issue was whether Arnaud Properties or Hall River was an "active business" throughout the twenty-four month preceding the date of the sale by the

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taxpayers of their shares of Arnaud Properties. Although the Federal Court of Appeal decision in ***M.N.R. v. M.P. Drilling Limited*** (76 D.T.C. 6028) was not directly on point, it did contain an important *obiter dictum* concerning when a corporation begins to carry on business. In that case, the Federal Court of Appeal rejected the argument that because the taxpayer had not generated any revenue, let alone profit, it was not engaged in the process of operating a profit-making entity.

In the present case, from 1978 until February 24, 1989, Hall River never detracted from its objectives of developing a hydroelectric project. The key impediment was Hydro-Quebec's policy that any electricity produced by an independent producer had to be used by the producer for its own purposes and could not be resold to third parties. There was no agreement on price such as to make the hydroelectric project profitable in the eyes of Hall River. As a result, the shareholders of Arnaud Properties finally sold their shares.

The Federal Court of Appeal held that to find that Hall River never carried on business during the time it spent money and energy to make real the objects of its incorporation (i.e. "to produce…and dispose of electricity…") would be too restrictive an approach to both the interpretation of the law and the appreciation of the facts. To require the existence of an agreement on the sale of electricity before Hall River could be considered to be "carrying on business" would be to add an element not found in the legislation.

In conclusion, Hall River was carrying on business without interruption since 1978. It was constantly looking for a market to develop its hydroelectric potential. Hence, it met the requirements of being a QSBC both in terms of "active business" and in terms of the relevant 24-month period. The Minister, therefore, was ordered to reassess on the basis that the taxpayers were entitled to the QSBC capital gains deduction claimed.

Skidmore v. M.N.R. **[2000] F.C.J. No. 276**

In this decision of the Federal Court of Appeal, on May 27, 1982, Birchill Nurseries Inc. ("Birchill") entered into an agreement with the Ontario Government to erect greenhouses and to grow seedlings. The Ontario Government gave Birchill a startup grant, extending the agreement on July 7, 1983, and agreeing to acquire Birchill's entire crop of seedlings up to a target number. If Birchill defaulted the Ontario Government was entitled to demand partial repayment of the startup grant. Birchill maintained sizeable term deposits.

The Minister was of the view that, as a result of these term deposits, Birchill was not using all or substantially all of its assets in an active business, and therefore was not a QSBC. As a result, the Minister denied the taxpayers claim for the QSBC capital gains deduction following their sale of their shares of Birchill in 1989.

The Tax Court of Canada dismissed the taxpayer's appeals for an amount set aside as a reserve to be considered a backup asset used in a business, a rational relationship is required between such amount, and a reasonably determined reserve. The taxpayers were unable to show why Birchill's term deposits had increased while its risk of having to repay the Ontario Government grant was decreased. The taxpayers were also unable to demonstrate that the term deposits were needed as a form of self-insurance in the event of a crop failure. The taxpayers were unable to prove that Birchill was relying on its term deposits as an integral aspect of its business operations. As a result, Birchill was not a QSBC, and the taxpayers were not entitled to the capital gains deduction claimed by them.

The taxpayer's appeals to the Federal Court of Appeal were dismissed. Since the taxpayer had failed to demonstrate that Birchill's cash reserves were reasonably required as backup assets, there was no palpable or overriding error made by the Tax Court of Canada judge. Based on the principle in ***McCutcheon Farm v. M.N.R.*** (91 D.T.C. 5047) a taxpayer is required to show clearly that its reserves are reasonable, and that a rational relationship exists between the principal sums accumulated and the reserves required. As a result, the Minister's assessments were affirmed.

2. MEANING OF "SPECIFIED INVESTMENT BUSINESS"

Lloyd Rogers v. M.N.R. **97 D.T.C. 890**

The taxpayer owned shares of a corporation which owned a shopping centre and was involved in the business of leasing to tenants and overseeing the operations of the shopping centre. In the late 1980s, the taxpayer disposed of his shares of this corporation and claimed the QSBC capital gains deduction. The Minister denied the deduction stating that the corporation was not a QSBC as it is was a 'specified investment business' .

The taxpayer appealed the assessment arguing that the shares he disposed of were in fact QSBC shares as the corporation was an active business being involved in a wide variety of administrative activities in addition to leasing, such as supervising the repair of a great number of construction deficiencies on the premises and dealing with complaints from the public about the shopping centre and its activities. The taxpayer submitted almost one thousand documents attesting to the numerous administrative functions the corporation took on.

The Minister argued that the corporation was not a QSBC, as it was a 'specified investment business' as per its definition in subsection 125(7) of the Act. The Minister asserted that the corporation was a 'specified investment business' in that its primary purpose was to passively receive income (i.e. rent) from property owned. The Minister provided financial statements of the corporation which indicated that the majority of income derived from the business was rental income. The Minister also indicated that the administrative activities of the corporation were not extensive enough to meet the statutory five full-time employee standard in subsection 125(7) and validate an exception.

The Court stated that in order for the shares of a corporation to qualify as QSBC shares, the corporation must *not* be engaged in a 'specified investment business'. The Court found that the corporation was a 'specified investment business' as, while the corporation did engage in administrative functions, it was clear after cross-examination of the taxpayer that almost all or the corporation's income was rental income. As such the Court dismissed the taxpayer's appeal.

The Court's finding underscored that even if a portion of a corporation's income is obtained through managerial or other services it offers, it does not lead to the conclusion that the corporation is a 'specified investment business' as the test for being a 'specified investment business' is based on the *primary purpose* of the business.

Lee et al v. M.N.R. **99 D.T.C. 925**

In this Tax Court of Canada case the taxpayers were the owners of a corporation named Cassidy Mobile Home Park Ltd ("Cassidy"). Cassidy's business was the operation of a mobile home park on land which it owned. In the mid-1990's, the taxpayers claimed the QSBC capital gains deduction following the sale of their shares of Cassidy. The Minister denied such a deduction stating that Cassidy was not a QSBC. The taxpayer appealed the Minister's assessment.

The Minister argued that Cassidy was not a QSBC, as it did not *actively* carry on a business, but rather that Cassidy was a 'specified investment business' instead. A 'specified investment' business' is defined in subsection 125(7) of the Act as a being an investment carried on by a corporation whose principle 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.

The Minister argued that Cassidy was a 'specified investment business' as its primary purpose was to passively receive income in the form of rent from tenants who occupied mobile home lots it owned. A number of leases and documentary evidence to attested to this. The Minister further claimed that Cassidy did not fit into either of the above exceptions as (i) it did not employ five full time employees or (ii) would not have reasonably needed to employ five full-time employees if other services had not been provided to them by another corporation.

The taxpayers, on the other hand, argued that Cassidy was a QSBC. They claimed that while Cassidy did obtain income from property, it actively carried on the business of maintaining the park and providing other services to the park's tenants which was a sufficient enough activity in the corporation's business to justify the employment of over five full-time employees.

The Court found that Cassidy was not a QSBC, but rather a 'specified investment business'. The Court came to this conclusion on the basis that (i) the principal purpose of Cassidy's business was clearly to derive income from property in the form of rent; and (ii) the maintenance activities of Cassidy were not extensive enough to meet the statutory five full-time employee standard in subsection 125(7). As such the appeal was dismissed and the taxpayers could not claim a QSBC capital gains deduction following the sale of their shares of Cassidy. In coming to its conclusion, the Court stated that the concept of 'specified investment businesses' was introduced for the purpose of ensuing that 'active' component of a QSBC truly meant active and that the word not be, in effect, judicially written out of the Act.

***M.N.R. v. Hughes & Co. Holdings Ltd.* 94 D.T.C. 6511**

In this Federal Court case, the taxpayer corporation was engaged in property management and employed several full-time and part-time employees. It had claimed the small business deduction for certain years on the basis that although it derived income from property it was not a specified investment business because it employed several part-time employees in addition to 5 full-time employees and therefore met the

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statutory exemption. The Minister disallowed the deduction on the basis that the corporate taxpayer was a specified investment business because "more than 5 full-time employees" meant 6 or more full-time employees, and the taxpayer did not meet this criterion.

The Federal Court dismissed the appeal and held that the phrase "more than 5 full-time employees" had to be interpreted to mean at least 6 full-time employees. The statutory language did not contemplate part-time employees and therefore the word "more" was in reference to full-time employees specifically, not employees generally. The Court stated that even if the taxpayer had 5 full-time employees and several part-time ones, this did not to meet the requirement contained in the Act*.*

Baker v. M.N.R. **[2005] F.C.J. No. 901**

In an appeal to the Federal Court of Appeal from the Tax Court of Canada (i) the individual taxpayers appealed a decision which disallowed their claims for the capital gains exemption and (ii) the corporate taxpayer appealed a decision which disallowed its claim for the small business deduction. The central issue was whether the taxpayer corporation was carrying on "active business" as required by the Act*.*

The taxpayer corporation earned rental income from a commercial office building and employed at least 6 custodians who each provided cleaning services for four hours a day from Monday to Friday. The position of the Minister was that the corporation was not carrying on active business as required by the *Act* because its employees worked only 20 hours per week, which did not constitute full-time employment. The position of the taxpayer corporation and its shareholders was that 20 hours per week of employment was standard for the industry and should be accepted as full-time employment in that industry.

The Federal Court of Appeal dismissed the taxpayers' appeal. It held that the statutory requirement for a business to employ more than 5 full-time employees in order to be considered an active business should be analyzed in light of the definition's object and purpose. The reason behind the requirement is to ensure that a minimum level of activity exists in a business before allowing it a small business deduction. Further, the taxpayers' argument that "full-time" could be interpreted differently in different industries would lead to a subjectivity that would violate the principle that similarly situated taxpayers should be taxed equally.

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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.