Manulife

TAX, RETIREMENT & ESTATE PLANNING SERVICES

TAX TOPICS

The Lifetime Capital Gains Exemption

Introduction
This Tax Topic briefly reviews the rules contained in section 110.6 of the Income Tax Act (the "Act") concerning the lifetime capital gains exemption and discusses some planning techniques that may be utilized to take advantage of these rules. Further discussion of planning techniques available to maximize the use of the lifetime capital gains exemption can be found in the Tax Topic entitled, "Capital Gains Exemption - Planning Techniques".

Legislative History
Many changes to this provision have been enacted and proposed since it was introduced. Outlined below is a brief legislative history.

As part of his May 23, 1985 Federal Budget, Finance Minister Michael Wilson announced the creation of a new lifetime exemption of up to $500,000 for capital gains realized by individuals resident in Canada. The capital gains exemption was enacted by Bill C-84 and received Royal Assent on February 13, 1986.

Shortly after, Federal "Tax Reform" was implemented through Bill C-139 which received Royal Assent on September 13, 1988. Bill C-139 introduced several substantial changes to the capital gains exemption rules. As a result, the inclusion rate for capital gains was changed from 1/2 (for years prior to 1988) to 2/3 (for 1988 and 1989) and 3/4 (for 1990 and subsequent taxation years). The capital gains exemption was capped at $100,000 for most types of property. On February 22, 1994, the $100,000 general capital gains exemption was repealed, leaving in place a $500,000 "enhanced" capital gains exemption for certain types of property including shares of a qualified small business corporation and qualified farm property[1].

In 2000, the inclusion rate was reduced to 2/3 for dispositions of property occurring after February 27, 2000, and before October 18, 2000. The inclusion rate of 1/2 is effective for dispositions of property after October 17, 2000.

The $500,000 lifetime capital gains exemption became available in 2006 for capital gains arising from dispositions of qualified fishing property after May 1, 2006 by an individual (or in certain circumstances, a personal trust).

[1] If the $100,000 general capital gains exemption was used in the past, it will reduce the enhanced capital gains exemption that is available for future use.

The 2007 Federal Budget increased the lifetime capital gains exemption from $500,000 to $750,000 for eligible dispositions on, or after, March 19, 2007. The capital gains exemption increase was enacted by Bill C-28 and received Royal Assent on December 14, 2007.

Effective for the 2014 taxation year, Budget 2013 proposes to increase the Lifetime Capital Gains Exemption (LCGE) by $50,000 to $800,000. This exemption applies to the disposition of qualified small business corporation shares and qualified farm and fishing property. Under the 2013 budget this LCGE was also indexed to inflation for taxation years after 2014, such that for the 2016 taxation year, for example, the LCGE is $824,176.

For dispositions of qualified farm and fishing property after April 20, 2015[2], the 2015 federal budget introduced an additional deduction which essentially increases the LCGE to $1,000,000. This LCGE is not indexed and remains at $1,000,000 for taxation years after 2015. This measure has received Royal Assent.

Also, each time that the LCGE is mentioned in this bulletin, this refers to the ceiling of $824,176 established for 2016 for qualified small business corporation shares (indexed annually) and/or the ceiling of $1,000,000 for 2016 regarding qualified farm and fishing property.

Qualification for the Exemption
This LCGE in the amount of $824,176 (for 2016) applies to capital gains from tax on dispositions of Qualified Small Business Corporation ("QSBC") shares; another exemption of $1,000,000 (for 2016) applies to capital gains realized following the disposition of qualified farm property and qualified fishing property. The exemption also applies to capital gains that are flowed to individuals through partnerships, trusts and certain other types of investment vehicles. The exemption is available to individual taxpayers while resident in Canada.

The exemption is not available to offset capital gains realized by a corporation. Nor is it available to offset capital gains retained by a trust, i.e., capital gains that are not paid or payable in the year to a beneficiary.

Finally, the capital gains exemption is not available to non-resident individuals throughout the year (subsections 110.6(2) and (13) of the Act). However, a part-time resident may qualify for the exemption if the individual was resident in Canada throughout the particular year and the immediately preceding or immediately following taxation year (subsection 110.6(5) of the Act).

Qualified Small Business Corporation Shares
In order to qualify for the LCGE, shares of a corporation must be QSBC shares. To qualify as QSBC shares there are several complex tests that must be met with respect to the type of assets owned by the corporation and the length of the period during which the shares are held.

The first test to qualify as QSBC shares is at the time of disposition the shares must be shares of a Small Business Corporation (“SBC”). A SBC is a Canadian Controlled Private Corporation (“CCPC”) of which all or substantially all (i.e., 90% or more) of the assets, on a fair market value basis, are used principally in an active business, carried on primarily (i.e., 50% or more) in Canada by the corporation or a related corporation. The assets meeting the "all or substantially all" test may be shares or debt in another SBC which is controlled by the CCPC or of which the CCPC owns at least 10% of the voting shares and value.

The second test is a holding period test. To meet this test, no one other than the shareholder (or a related person or partnership) must own the shares for two years. During this period, at least 50% of the fair market value of the corporation's assets must have been used in an active business. The tests become very complicated where holding companies are involved.

Qualified Farm Property
The LCGE can also be used to offset capital gains on qualified farm property. Qualified farm property is defined as real property, shares of a family farm corporation, an interest in a family farm partnership, an eligible capital property owned by an individual or spouse or an interest of the individual or spouse in a family

[2] After December 31, 2014, for the purposes of Quebec income tax.

farm partnership. To qualify, the property must have been "used in the course of carrying on the business of farming in Canada" by the individual, his spouse, any of his children or parents, by a family farm corporation or partnership in which he, his spouse or any of his children or parents has a share or interest or a personal trust of which any of them is a beneficiary.

There are two tests to determine whether the property is considered to be "used in the course of carrying on the business of farming in Canada." The first test is a holding period test. To meet this test, the property must have been held for two years prior to the disposition by one of the permitted users described previously. The second test is a revenue test. In at least two years of ownership by a family member or personal trust who is a permitted user described previously, the gross revenue of the person from the farming business in which the property was principally used must have exceeded income from all other sources. Where the user is a family farm corporation or partnership, the individual must have been actively engaged on a regular and continuous basis in the farming business in which the property was used for at least two years. A more detailed discussion can be found in the Tax Topic entitled, "Tax Issues Relating to the Transfer of the Family Farm".

Qualified Fishing Property
The LCGE for capital gains arising on a disposition of qualified fishing property used in a family fishing business applies to dispositions after May 1, 2006 by an individual or in certain circumstances, a personal trust. Qualified fishing property includes real property, fishing vessels and eligible capital property used in a fishing business carried on in Canada. It also includes shares of family fishing corporations and interests in family fishing partnerships.

Planning Considerations Regarding Availability of the Exemption
If a corporation holds non-active assets, transferring those assets to separate holding companies may be considered. The anti-avoidance rules provided in sections 55 and 84.1 and subsections 85(2.1), 110.6(7), (8), and (9) of the Act should be reviewed prior to entering into any transactions that attempt to extract assets from a corporation on a tax-deferred basis. In addition, all planning considerations in respect of qualifying for the exemption should include a review of the general anti-avoidance rule ("GAAR") contained in section 245 of the Act.

Planning Considerations Relating to Timing of Use of Exemption
There are planning techniques available to accelerate the realization of capital gains in order to use the capital gains exemption. One of the more common reasons to realize a gain is to lock in the capital gains exemption while the QSBC shares qualify; for example, before the corporation accumulates investment assets.

A taxpayer could realize a gain on QSBC shares, qualified farming property and/or qualified fishing property by transferring the qualifying property to a spouse or child or by implementing an estate freeze. For more information on this type of planning see the Tax Topic, "Capital Gains Exemption – Planning Techniques."

Prior to undertaking any transactions meant to accelerate the realization of capital gains, the business and tax costs should be analyzed. For example, the transfer of farm property to a trust or family member on a non-rollover basis may result in the recapture of capital cost allowance, land transfer tax, attribution of future income or gains and diminished control of the asset. Capital gains sheltered by the exemption can result in an alternative minimum tax ("AMT") liability unless there is other income taxed at full rates sufficient to offset any AMT liability (sections 127.5 to 127.55 of the Act). Although the capital gains exemption is deductible in computing income for AMT purposes, AMT may still arise. The exemption is expressed as a deduction at the capital gains inclusion rate (currently 50%) but 80% of the total capital gain is included in computing income for AMT purposes. As a result, 30% of the gain, in most cases, will be subject to AMT.

As well, taxable capital gains will be included in the calculation of "net income". However, the capital gains exemption is not deducted in the calculation. Many tax credits and the entitlement to other items are calculated based on net income. For example, a taxpayer's net income can have a significant impact on the old age security clawback, the age credit and unemployment insurance repayments. All these "costs" may potentially exceed the tax savings resulting from using the capital gains exemption to step up the cost base of the asset.

Maximum Entitlement in Any Given Year
Where an individual has cumulative net investment losses ("CNIL"), his or her cumulative gains limit will be reduced by such amounts. This limitation ensures that individuals cannot incur deductible expenses (e.g., interest) in connection with the purchase of low income producing assets and then utilize the capital gains exemption when the assets are sold at a gain.

An individual's CNIL is the amount by which post-1987 investment expenses exceed post-1987 investment income. Investment expenses generally include the following:

- net losses from property including interest and carrying charges relating to the property;
- business losses from rental property;
- share of current losses (other than allowable capital losses) incurred as a limited partner or as a member of a partnership in which he or she is not actively involved;
- limited partnership losses (other than allowable capital losses) carried forward from previous years and claimed in the current year; and
- 50% of flow-through resource expenditures.

Investment income generally includes the following:

- income from property such as interest and dividends, including the dividend gross-up for dividends from taxable Canadian corporations, rents and royalties;
- limited partnership income (other than capital gains) received by a limited partner or by a member of a partnership in which he or she was not actively involved;
- amounts received in a year by an individual in respect of an annuity (other than an income-averaging annuity contract or an annuity purchased pursuant to deferred profit sharing plan); and
- 50% of recoveries of resource expenditures.

It should be noted that the entire lifetime capital gains exemption can be taken, even though a CNIL exists, provided that taxable capital gains exceed the individual's CNIL account balance by a sufficient amount.

Capital gains realized in the period from 1985 to 1987 in excess of an individual's capital gains exemption claimed for those years are included in the calculation of that individual's cumulative gains limit. This addition effectively reduces the individual's CNIL from 1988 onwards.

Planning Considerations Relating to the CNIL Account
The CNIL account introduces another facet to tax planning. The calculation of an individual's CNIL is done on a cumulative aggregate basis. It is therefore necessary to calculate investment income and investment expenses for all years after 1987 on an ongoing basis, aggregating the income and expenses from all investments.

A person's CNIL is not calculated on an investment-by-investment basis; rather, all investments are pooled. The result is that an individual's capital gains exemption entitlement may be reduced for a particular year by an investment expense generated from a different investment than that being disposed of in a particular year. As a result, the timing of dispositions may become very important (i.e., making dispositions in years in which there is no or a negative CNIL account balance). As a practical result, taxpayers will be required to keep records in respect of investment income realized or investment expenses incurred even in years where there is no tax payable.

Since dividends are included in investment income and reduce the CNIL account balance, there is an incentive in owner-manager situations to pay dividends to shareholders as opposed to salaries. Shareholders may also consider charging interest on shareholder loans to a corporation; such interest is similarly included in investment income and reduces the CNIL account balance.

Allowable Business Investment Loss Restriction
Allowable Business Investment Losses (“ABILs”) are a special class of capital losses that a taxpayer incurs on small business corporations. ABILs are available to reduce other income, not just capital gains. Note

however, that taxpayers who have claimed ABILs against other income must incur taxable capital gains of an equal amount prior to accessing their capital gains exemption.

Impact of Corporate owned Life Insurance

Holding a cash value life insurance policy in a corporation may affect whether shares of a corporation qualify as QSBC shares. Whether the corporate-owned life insurance policy held while the life insured is alive is considered an active business asset and whether the death benefit proceeds from a life insurance policy are used in an active business must be determined. Further, the "value" of the policy must be determined for purposes of the asset tests (for both the prior two years and at the time of disposition).

In Question 32 at the 1988 Canadian Tax Foundation Annual Roundtable, the CRA indicated that a life insurance policy is normally considered a passive asset, i.e., an asset not used in carrying on an active business by the corporation. This position was clarified in an answer to Question 12 posed at the 1993 Annual CALU Conference (Technical Interpretations 9310100 and 9310105 dated May 17, 1993). CRA indicated that a life insurance policy with a cash surrender value is a form of long-term investment and therefore, would not qualify as an asset used in an active business prior to the death of the life insured. In an answer to a further question posed at the same conference, CRA indicated that where a term insurance policy without cash value is held by a corporation in a situation where the policy is considered to have value prior to the death of the life insured, it would be a question of fact as to whether the policy would be considered an asset used in an active business.

With respect to the death benefit proceeds from a life insurance policy, this issue was also discussed in the questions posed at the 1993 Annual CALU Conference. CRA indicated that the proceeds from a life insurance policy would not normally be considered an asset used in an active business where the life insurance proceeds are to be distributed by the corporation as a dividend or used to fund a buy-sell agreement. However, the insurance proceeds would likely constitute an active business asset where the proceeds are used to recruit, hire and train new management personnel or used to overcome short term financial difficulties arising on the death of a key person. The determination would be a question of fact in each case.

Once the type of asset (passive or active) is determined, the measurement of the fair market value of the life insurance policy must also be determined. Paragraph 110.6(15)(a) of the Act provides a special rule applicable for the purpose of the definition of QSBC share. This rule applies where a shareholder of the corporation (or a corporation connected with the particular corporation) is the life insured under the corporate-owned life insurance policy. Subparagraph 110.6(15)(a)(i) provides that the fair market value of the life insurance policy at any time before the death of the life insured will be equal to its cash surrender value (as defined in subsection 148(9)). The definition of cash surrender value in subsection 148(9) of the Act is computed without reference to any policy loans made under the policy.

If a person other than a shareholder (for example, an employee) is the life insured, the fair market value of the policy would be determined in accordance with normal valuation practices. The policy would be valued in accordance with the position in Information Circular 89-3, taking into account several factors such as: cash surrender value, face value, state of health of the insured and the insured's life expectancy, conversion privileges, other policy terms such as term riders, and replacement value.

Subparagraph 110.6(15)(a)(ii) of the Act provides that the cash surrender value (as defined in subsection 148(9)) immediately prior to death will be considered to be the fair market value of the death benefit proceeds if the proceeds are used within 24 months after death to redeem, acquire or cancel shares owned by the life insured immediately before death. This rule applies to the death benefit proceeds from the life insurance policy and any assets attributable to those proceeds. A written application can be made to CRA for an extension of the 24-month period.

If the death benefit proceeds are not used directly or indirectly to redeem, acquire or cancel shares owned by the life insured or if a shareholder is not the life insured (for example, an employee being the life insured), the fair market value would be determined in accordance with normal valuation practices, taking into consideration all relevant factors. Generally the fair market value of the death benefit proceeds would be

equal to the amount received or receivable. CRA confirmed these positions in Technical Interpretation #2000-0014265, dated April 5, 2000.

It is important to note that any type of passive investment asset may cause the corporation to be offside for purposes of the QSBC test. Generally, funds not required in the active business operations are used to purchase the insurance policy. Therefore, the corporation would likely have failed the QSBC tests regardless of whether the insurance policy was purchased, since the funds would likely have been invested in a different passive asset.

Refer to Appendix I for examples of the impact of a cash value life insurance policy on an individual's ability to claim the capital gains exemption.

Conclusion

The capital gains exemption creates additional opportunities (and complexities) in tax planning. Taxpayers should consult their tax advisors when they are attempting to utilize their exemption.

Last updated: January 2016

Tax, Retirement & Estate Planning Services at Manulife writes various publications on an ongoing basis. This team of accountants, lawyers and insurance professionals provides specialized information about legal issues, accounting and life insurance and their link to complex tax and estate planning solutions.

These publications are distributed on the understanding that Manulife is not engaged in rendering legal, accounting or other professional advice. If legal or other expert assistance is required, the service of a competent professional should be sought.

This information is for Advisor use only. It is not intended for clients. This document is protected by copyright. Reproduction is prohibited without Manulife's written permission.

Manulife, the Block Design, the Four Cubes Design, and strong reliable trustworthy forward-thinking are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license.

Appendix I

Impact of Cash Value Life Insurance on the LCGE

ABC Co. is a CCPC and carries on an active business in Ontario. ABC Co. owns both the building and the equipment it uses in its operations. ABC Co. also owns a cash value life insurance policy on the life of the sole shareholder.

If ABC Co. reported the following financial statement information:

Example A – Cash value life insurance policy owned since 1995

ABC Co.
Balance Sheet
As at December 31, 20XX

Assets	
Cash	$ 200,000
Accounts receivable	1,300,000
Cash surrender value of policy	500,000
Inventory	1,000,000
Equipment	3,000,000
Building	4,000,000
	10,000,000
Liabilities and Shareholder's Equity	
Accounts Payable	$ 200,000
Bank loan	1,800,000
Mortgage	4,000,000
	6,000,000
100 Common Shares	100
Retained Earnings	3,999,900
	10,000,000

The assets used in carrying on an active business in Canada include cash, accounts receivable, inventory, equipment and building with a fair market value of $9,500,000 (assuming the balance sheet reflects the fair market value). The cash surrender value of the life insurance policy is not considered an asset used by ABC Co. in carrying on its active business in Canada.

Since the active business assets are valued at $9,500,000 and the total value of ABC Co.'s assets is $10,000,000, 95% of the fair market value of the corporation's assets is being used in carrying on an active business in Canada. As all or substantially all of the assets of ABC Co. (i.e., 90% test) are being used in carrying on an active business and assuming the holding period tests have been met, the common shares of ABC Co. qualify as shares of a small business corporation. An individual owning common shares of ABC Co. could claim the lifetime capital gains exemption on any gain realized on a disposition of these shares (assuming the other conditions for the holding period tests are met).

If ABC Co. reported the following financial statement information:

Example B – Cash value life insurance policy owned since 1985

ABC Co.
Balance Sheet
As at December 31, 20XX

Assets	
Cash	$ 200,000
Accounts receivable	200,000
Cash surrender value of policy	1,600,000
Inventory	1,000,000
Equipment	3,000,000
Building	4,000,000
	10,000,000
Liabilities and Shareholder's Equity	
Accounts Payable	$ 200,000
Bank loan	1,800,000
Mortgage	4,000,000
	6,000,000
100 Common Shares	100
Retained Earnings	3,999,900
	10,000,000

The assets used by ABC Co. in carrying on an active business in Canada include cash, accounts receivable, inventory, equipment and building with a fair market value of $8,400,000 (assuming the balance sheet represents the fair market value). The cash surrender value of the life insurance policy is not considered an asset used by ABC Co. in carrying on its active business in Canada.

Since only 84% of the fair market value of the corporation's assets are being used in carrying on an active business in Canada, the common shares of ABC Co. do not satisfy the "all or substantially all" test described earlier. Accordingly, an individual could not claim the lifetime capital gains exemption on any gain realized on a disposition of ABC Co. shares, as of the balance sheet date.

However, ABC Co. may be purified. Transferring sufficient assets to another corporation may allow the common shares of ABC Co. to qualify as QSBC shares at the time the common shares are sold. Careful planning must be undertaken to ensure that tax is not triggered on transferring the assets.