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Multiplication of the lifetime capital gains exemption: proposed rules

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In its Consultation Paper and draft legislation released July 18, 2017, the Department of Finance proposes to restrict the lifetime capital gains exemption (LCGE). The Department of Finance indicates that the current tax rules do not properly prevent the multiplication of the LCGE. In many cases, the exemption of each individual family member is used to shelter gains on a family business.

This *Tax Alert* will focus on the rules that are designed to restrict access to the LCGE by several family members, whether individually or through a family trust, where tax-planning strategies are used to reduce capital gains when the individuals have not contributed to the family business.

The transitional rules and proposed relief from the above changes will be discussed in detail, as well as future planning considerations.

Lifetime capital gains exemption: new restrictions

The proposed legislation in subsections 110.6 (12) and (12.1) of the Income Tax Act (ITA) on restricting the multiplication of the LCGE is split into three general measures:

1. No LCGE is available for individuals under the age of 18 years, or on any gains accrued before the beginning of the year the individual turned 18. This does not affect the individual's ability to claim the LCGE on any gains accruing after age 18.

2. No LCGE is available on taxable capital gains that arise from the disposition of a property that was included in an individual's split income. The proposed mechanism to restrict this is to reduce the amount an individual can deduct under the LCGE by twice the amount of the taxable capital gain that was subject to split income tax.

   Furthermore, a reasonableness test will determine whether the LCGE applies with respect to a capital gain described above. This is the same reasonableness test that is proposed as part of the measures to extend the "tax on split income" (TOSI) rules released in conjunction with the capital gains measures. The current TOSI rules are not applicable to adult specified individuals (age 18 or older), but the proposed measures extend the application of the TOSI rules to adult specified individuals who receive income derived from a business of a related individual. Different tests exist for individuals aged 18-24.

   In general, the proposed reasonableness test will assess the adult child's contributions to the business, from both a labour and capital perspective, to determine whether the child should be taxed at their normal rate or at the highest tax rate. This reasonableness test is highly subjective and the Department of Finance has given no indication as to who will administer the test.

3. No LCGE is available on gains accruing prior to the rollout from a trust. In other words, individuals will no longer be able to claim the LCGE in respect of capital gains that accrued during a period in which the trust held the property. Furthermore, these measures will apply whether the trust realizes the gain and allocates it to the beneficiary or the property is distributed at cost to the beneficiary (by way of a tax-free rollover) who later realizes the gain. In both instances, the LCGE will not apply.

   An exception to this measure does exist if the property is held by a spousal or common-law partner trust or an alter ego trust of which the individual claiming the LCGE is the principal beneficiary.

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Certain employee-share ownership trusts, in which the beneficiary entitled to the capital gain is an arms-length employee, of the employer sponsoring the arrangement will also be exempt from the above treatment.

These exceptions recognize that the current tax rules already constrain the aforementioned trusts in a way that prevents income sprinkling and that continues to promote investment by employees in the businesses that employ them. The Department of Finance suggests that this will continue to help businesses grow, create jobs and innovate.

Age	Proposed LCGE measures
Minor	Not eligible to claim the LCGE in respect of dispositions after 2017, subject to the transitional rule for dispositions in 2018.
Adult	No LCGE in respect of capital gains from a disposition after 2017, subject to the transitional rule for elective dispositions in 2018: ▪ to the extent the capital gain accrued before the year in which the individual attained age 18; ▪ to the extent the capital gain accrued during a period in which a trust held the property (with an exception for certain capital gains that accrue on property held by an eligible LCGE trust); and ▪ to the extent the taxable portion of the capital gain from the disposition of property is included in an individual's split income under the TOSI.

These measures will apply to dispositions that take place after 2017, but certain special transitional rules are proposed for the 2018 year.

Election: deemed disposition in 2018

The proposed transitional rules will allow affected individuals to elect and realize a capital gain on any day in 2018 in respect of eligible property by way of a deemed disposition up to the fair market value of the property. The proposed legislation found in subsections 110.6(18) and (18.1) will allow eligible taxpayers to recognize capital gains accrued to any particular day in 2018 on certain eligible property in order to shelter the gains using the LCGE.

An eligible taxpayer for a taxation year can be either an individual or a trust that is a personal trust or an employee share ownership trust. Additionally, more specific conditions apply for eligibility.

To qualify as eligible property, the property must be owned continuously by the eligible taxpayer from the end of 2017 until the end of the taxpayer's disposition day, which may be any day in 2018. At the time of disposition, this property must be capital property of the taxpayer and must be either a qualified small business corporation share or a qualified farm or fishing property. For individuals under the age of 18, the property must not be a share of a corporation.

All of the current tax rules will apply to the capital gains realized under the election (e.g. CCPC, asset tests), however the 24-month holding period tests need only be satisfied for a period of 12 months before the disposition time. This modification to the holding period tests is intended to give the taxpayer enough time to use the LCGE under the existing rules, by way of the election.

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An election must be made by an eligible taxpayer in the form and manner prescribed by the Minister of National Revenue; it must be filed on or before the balance-due date of the taxpayer's election year, and it must contain the disposition date and a description of the property. Late, amended or revoked elections will be possible until the year 2021, but subsection 110.6(28) prohibits revocation or amendment where the amount designated is greater than 11/10ths of its fair market value at the time of disposition. Furthermore, a penalty will apply for all qualifying amendments, revocations and late filings.

The proposed amount of the penalty is one-third of one per cent of the taxable capital gain on the eligible property resulting from the election, multiplied by the number of months after the balance-due date (in most cases, May 2019, since the individual filing deadline is April 30). Similar rules will apply for trusts.

Planning considerations: where do we go from here?

The Department of Finance has asked stakeholders for submissions regarding the proposed changes for private corporations and their shareholders, including the changes to the LCGE. Thus, the final version of the amendments may have a lesser impact than described above. Nonetheless, we are entering an uncertain and likely negative tax world for private corporations and their owners. If the proposed amendments are enacted in their current form, business owners should use the aforementioned election where the value of eligible property is significantly greater than its cost, in order to benefit from the LCGE before it is no longer available for family members not involved in the business. The election will increase the adjusted cost base of the shares and will reduce taxation on a future sale.

In order to qualify for the transitional rule (12 months active business asset test) as of December 31, 2017, companies may need to purify in order to remove any assets tainting the QSBC status in the 12-month period before the deemed disposition. Consider triggering a gain by way of an actual disposition (crystallization) in 2017 to fall within the existing rules. This can be done without an actual sale to a third party.

Several issues, including valuation, U.S. tax implications, and alternative minimum tax, must be considered as part of the tax plans described above.

A Collins Barrow tax advisor can help you assess the impact these proposed changes in tax law will have on your private corporation and its shareholders, and can help you take the necessary steps to minimize the implications.

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