Michael Carabash
BA LLB MBA

Michael Roseman
CPA CA

Lifetime Capital Gains Exemption: What Dentists Need to Know

The Lifetime Capital Gains Exemption **(LCGE)** allows dentists to reduce or eliminate capital gains tax when they sell shares of their corporations

How the Lifetime Capital Gains Exemption Works

A dentist sells growth shares in a professional corporation and receives more money than the shares cost. For simplicity, let's assume the difference is a gain of $800,000[1]. Under the *Income Tax Act*, half of that gain ($400,000) is taxable at the dentist's marginal tax rate. To simplify matters, we'll assume that this dentist's average tax rate on that entire gain is 45 percent. Without the LCGE, that dentist would end up paying $180,000 in capital gains tax when the shares are sold (45% x $400,000). This tax bill could have been significantly reduced or eliminated, however, if the dentist qualified for and used the LCGE.

The Correct Shares

Only certain share qualify for the LCGE: so-called "growth", "equity" or "common shares" qualify because their value can increase over time resulting in a gain when they are sold. Non-growth shares (typically called "income splitting", "special" or "preferred shares") do not qualify because they are redeemable by the professional corporation for a specific (and often nominal) amount, thereby precluding any gain when they are sold.

Multiplying the LCGE

If a dentist and their spouse, parents and children own growth shares in the professional corporation, the LCGE can be used by each such family member to save even more capital gains tax. Fair warning: if you are planning to give family members growth shares, consider having a shareholders' agreement in place to ensure that you maintain ultimate control of those shares. Such an agreement can be used, for example, to require reluctant family members to sell their shares when you want them to.

When it comes to family members receiving shares, timing is also crucial: if the professional corporation has been operating for some time and a dentist wants his or her children to receive new growth shares, but not have to pay much for them (e.g. $1 per share), the existing shareholders of those growth shares need to perform a legal manoeuver called an estate freeze. This freezes the present value of the professional corporation among existing shareholders while transferring future growth to the family members coming on board (who can receive those shares for a nominal amount).

Qualifying for the LCGE

To qualify for the LCGE, the shareholders (i.e. the dentist and immediate family members) must satisfy several tests:

- The shareholder must be resident in Canada throughout the year.
- The shares must be for a qualifying small business corporation.
- The shares must have been owned for 24 months by the shareholder or related persons.

• The corporation must satisfy an asset test during the previous 24-month period and on the day of the sale as well.

Some of these requirements are somewhat complex and will be examined briefly in turn.

The 24-Month Ownership Rule

To qualify for the LCGE, throughout the 24 months immediately before the sale of shares, the only persons who can own the shares are shareholders and persons related to them.

It is important to have a complete and up-to-date minute book to prove (among other things) who the shareholders are, that they own growth shares, and that they meet the 24-month ownership rule. Failing to do so could expose a shareholder to a Canada Revenue Agency (CRA) challenge and a denial of the LCGE.

In ***Twomey v. The Queen***, 2012 DTC 1255, the CRA challenged a shareholder's eligibility to use the LCGE because he had not technically owned 77 shares (of the 78 he was selling) for 24 months before selling them in 2005. When the corporation was incorporated years prior, the shareholder only received one share. This was a clerical mistake; he should have received 100 shares. When this error was discovered in 2005, the minute book was updated (i.e. documents were backdated). The CRA claimed that 99 shares had been issued in 2005, and not upon incorporation. The Tax Court of Canada, however, sided with the taxpayer on the basis that he had always acted throughout as though he had received 100 shares and had corrected the mistake when it was discovered. This was in keeping with the corporation's requirement to maintain true, complete, and accurate records. As such, the shareholder qualified for the LCGE.

Exception to the 24-Month Ownership Rule

The 24-month ownership rule may cause a dentist hardship and force a delay in selling the practice at the desired time; this is particularly true for an established dentist who has yet to incorporate and who may not want or be able to wait 24 months before selling. Thankfully, there is an exception: this rule will not apply if shares were issued to a shareholder as part of a transaction or series of transactions in which the shareholder disposed of all or substantially all personal assets used in an active business that they operated. In other words, if a dentist transfers all or substantially all of the assets he or she owned and used in their dental practice to their professional corporation and received shares in exchange, he or she can then turn around and sell those shares shortly thereafter to a purchasing dentist and still qualify for the LCGE.

Asset Tests

To qualify for the LCGE, a shareholder must show that, for the 24-month period immediately prior to the sale of the shares, more than 50 percent of the fair market value of the professional corporation's assets were used principally in an active business carried on primarily in Canada. Worth mentioning is that this test does not require a dentistry professional corporation to exist and have assets for at least 24 months prior to the sale: dentists who rely on the exception to the general 24-month share ownership rule (as previously discussed) can still qualify for the LCGE as long as they satisfy this asset test during the time they owned their shares.[2]

To qualify for the LCGE, a shareholder must also show that, on the day of the share sale, all or substantially all of the fair market value of the professional corporation's assets were used principally in an active business carried on primarily in Canada. Here, the phrase "all or substantially all" is generally considered by the CRA to mean more than 90 percent. That said, a number of tax court decisions[3] interpreting similar language in other tax contexts has cast some doubt on that interpretation, leaving open the argument that something less than 90 percent (e.g. 80 percent) could satisfy the "all or substantially all" threshold.[4]

For both asset tests, "fair market value" actually means "gross fair market value," which ignores liabilities; thus if a dentist shareholder loans money to a dentistry professional corporation to allow it to pay off its liabilities leading up to a sale, the loan amount will be viewed as an asset and the corresponding liability to the dentist shareholder will be ignored.[5]

Also for both asset tests, "active business" generally means any business carried on by a corporation that generates income from business activity as opposed to deriving so-called "passive" income from property (e.g. collecting rent or royalties, etc.).[6] The difficulty here is that a professional corporation may own certain assets – such as excess cash, real estate, investments and life insurance – that are not principally used in an active business (i.e. the dental practice) and which comprise more than 50 percent (for the previous 24 months) or arguably more than 10 percent (on the day of the sale) of the gross fair market value of all of the corporation's assets. If that's the case, then the shareholder won't be eligible to use the LCGE.

Whether a particular asset is "used principally" in an active business is determined on a case-by-case basis. The courts have held that if an asset was an integral aspect of business operations, the withdrawal of which would have a destabilizing effect, then it would be considered an asset used in an active business.[7]

It is a question of fact whether real estate owned by a professional corporation and used to house a dental practice is used principally in an active business. The CRA has stated that "the fact that 50 percent of the space of a building is used… is generally a strong indication that the building is used principally in an active business. In the ***Canada Trust Company***[8] case, the Tax Court of Canada accepted the square footage use of a building as a factor to be given significant weight in the determination of the particular use to which a building is put".[9] The CRA has also stated that qualitative factors such as the original intent for purchasing the building, the actual use to which the building is put in the course of the business, the nature of the business involved, and the practice in the particular industry are all relevant as well.[10] In the ***Boulanger v. The Queen***[11] case, a corporation's only assets since 1992 were a vacant property and a sum owing for the sale of one-half of another property that originally had been intended for the operation of a business. The Federal Court of Appeal held that the asset tests had not been satisfied when the shareholders sold their shares in 1996 and denied them the LCGE.

If the professional corporation does not satisfy these assets tests during the prescribed timelines, then it will need to be "purified" by transferring non-qualifying assets out before the shareholders sell their shares.

AD TK

Conclusion

The LCGE is quite complex, and qualifying for it requires careful planning – sometimes years in advance. Even if a shareholder qualifies, the extent of the LCGE may be limited by other tax considerations – such as cumulative net investment loss rules, prior allowable business investment loss deductions and alternative minimum tax. If you are thinking about selling your practice and want to take advantage of the LCGE, speak with a dental lawyer and dental accountant as soon as possible.

1 The 2015 LCGE limit, indexed by a factor of 1.017, is currently $813,600.
2 The *Income Tax Act* says that the 50% test must be met throughout the period while the shares of the dentistry professional corporation were owned by the shareholder.
3 See for example: ***Wood v. M.N.R.*** [1987] 1 C.T.C. 2391; ***Balz (F.) Estate v. Minister of National Revenue***, [1992] 1 C.T.C. 2332, ***Fournier c. R.***, [2004 T.C.C. 786, ***Imapro Corp. v. Canada***, [1992] 2 C.T.C. 298, and ***Ilott v. R.***, [2002] ***T.C.J. No. 675; Keefe v. R.*** [2004] 1 C.T.C. 3028; ***Ruhl v. R.***, [1997] T.C.J. No. 1365; ***McDonald v. R.***, [1998] 4 C.T.C. 2569; ***Watts v. R.***, [2004] T.C.C. 535; ***Seto v. R.***, 2007 T.C.C. 489 [Informal Procedure], ***Thibault c. R.***, [2008 T.C.C. 16], and ***Reluxicorp inc. c. R.*** [2011] T.C.C. 336.
4 Keep in mind that the courts, and not the CRA, have the final say on how the *Income Tax Act* is interpreted.
5 CRA technical interpretation 2003-0030045 dated October 10, 2003.
6 See ***Ollenberger v. Canada***, [2013] F.C.J. No. 286 (varied for other reasons in [2013] F.C.J. No. 463).
7 See ***Ensite Limited v. The Queen***, [1986] 2 S.C.R. 509; ***Skidmore v. Canada***, [2000] F.C. No. 276; and ***Reilly Estate v. Canada*** [2007] T.C.J. No. 271; and Technical Interpretation No. 9606355.
8 85 DTC 3122 (T.C.C.)
9 Technical Interpretation No. 9808635, July 22, 1998.
10 Document No. 2009-0307931E5, November 5, 2009.
[2003] F.C.J. No. 1336.

Michael Carabash is a dental lawyer and holds a Certificate in Dental Practice Management. His websites are www.DentistLawyers.ca, www.DentistLegalForms.com and www.DentalPlace.ca. Michael is raising money to establish a free public dental clinic in Jamaica which can accommodate Ontario dentists (among others) wishing to volunteer. He can be contacted at 647-680-9530 or michael@dentistlawyers.ca.

Michael Roseman CPA, CA is a chartered accountant dealing primarily with dentists and doctors. He can be reached at 416-894-4963 or mtr@michaelroseman.ca.