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Investing not Business

Capital gains exemption at risk for active businesses

COURT REPORT

BY JAMIE GOLOMBEK

Small business owners must be vigilant to ensure investment through their small business corporations does not inadvertently disqualify heirs from ultimately claiming the lifetime capital gains exemption upon sale or death.

The exemption, which is currently set at $500,000 of capital gains but is scheduled to be increased to $750,000, is available to shareholders who sell "qualified small business corporation" (QSBC) shares.

A recent case (*The Estate of Edward Reilly v. The Queen*) exemplifies how the QSBC exemption can be forfeited by having too many investments inside an otherwise active business corporation.

Under the *Income Tax Act*, to qualify for the exemption, you must have sold QSBC shares, that, at the time of sale (or death) use substantially all (generally assumed to be 90%) of their assets to carry on an active business in Canada.

Edward Reilly died on March 13, 2000. At the time of his death, he owned a holding company which in turn owned an operating company, Reilly Ventures Limited ("Reilly"). Reilly owned and operated four family businesses: a Home Hardware franchised store, a plumbing business, a carwash and a laundromat.

When the executrix filed Reilly's terminal income tax return for the year of death, she claimed the QSBC exemption for $273,200, representing the capital gain arising from the deemed disposition, at fair market value, of his shares.

The CRA reassessed and denied the exemption claim, arguing that the shares deemed disposed of upon death did not meet the definition of QSBC shares since Reilly corporation could not satisfy the 90% "all or substantially all test."

The CRA produced Reilly's balance sheet for the year ended May 31, 2000, just shortly after Reilly's death. The CRA concluded that since only 62% of Reilly's assets at the time of Reilly's death were actively used in the business, the corporation did not meet the test and therefore did not qualify for the QSBC exemption.

REILLY 'S BALANCE SHEET

Assets per Balance Sheet	Balance Sheet Value	%
Cash and Marketable Securities	$272, 821	38.0
Accounts receivable, inventory, taxes recoverable, prepaid expenses, and goodwill	256, 240	35.5
Capital properties (land, bldg., equipment, etc.)	90,022	12.5
Investment in Home Hardware Franchise	95,509	14.0
Total Assets	$718,592	100

The estate argued that the cash and marketable securities were necessary "to permit a smooth transfer of the operating businesses from Mr. Reilly to the next generation."

The judge disagreed, finding that "there is no evidence that the cash and marketable securities held by [Reilly] were necessary or even important for the carrying on of its small active businesses."

The judge also reviewed the prior four years' balance sheets and determined the value of Reilly's cash and marketable securities, as a percentage of the book value of all the corporation's assets, was never less than 27%. As a result, the judge could not find that "all or substantially all of the fair market value of the assets of Ventures was attributable to assets used principally in an active business."

The lesson for advisors is obvious: ensure that our small business corporate clients understand the need for keeping their operating company "pure." The most common way is to continuously pay a tax-free inter-corporate dividend from the operating company (the active business) to a holding company, thus continuously purifying the operating company. The investing activities are then conducted through the holding company, which wouldn't qualify for the QSBC exemption anyway, thereby preserving the exemption for the operating company. AER

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