The Tax Informant

"Father, forgive them, for they do not know what they are doing"

The Department of Finance Canada and its civil servants in complete disarray (Part 2) – Section E

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E. Since 2001, nearly 13,000 children between the ages of 0 and 19 have realized almost $3 billion in tax-free capital gains by selling shares of SMEs. Who is guilty of this momentous gaffe? Take a wild guess…

As every tax expert knows, since 1985 there has been a lifetime capital gains tax exemption on the sale of SME shares (there is also an exemption on the sale of qualified farm or fishing property). For small business shares in 2018, every eligible individual may accumulate up to $848,252 in tax-exempt capital gains (the limit is $1 million for farm or fishing property).

According to the Department of Finance Canada, this measure was adopted in 1985 to stimulate risk-taking and investment in small companies and to help business owners become financially secure for retirement. It was also designed to promote the growth of farm and fishing companies. But how do you explain that **nearly 13,000 children between 0 and 19 years of age** have benefited from this exemption since 2001 (we would have **gone as far back as** 1985 if tax statistics were easily available for years prior to 2001)? How is it possible that between $2.5 billion and $3 billion in capital gains have slipped through the hands of tax authorities (both at federal and provincial levels) since 2001? How is it that the federal and provincial governments have lost between $500 million and $600 million in tax revenue since 2001? Have these young people helped SMEs take risks? Was it the government's plan to make sure they are financially secure for retirement? Ridiculous, right? Here is the proof that shows that this simply does not make any sense. And of course, you, the taxpayer, are footing the bill…

Tax statistics from the CRA

The figures we use have all been published by the Canada Revenue Agency (CRA) since 2001. For 2017 and 2018, we extrapolated using statistics from previous years because the data for this period is not yet available. Usually, statistics deal with five-year age groups but young taxpayers are grouped into one single category (under 20 years of age). Even if that includes individuals who are 18 and 19 (adults), keep in mind that the tests associated with capital gains exemption generally require that the small business shares be kept for at least two years (directly or via a trust). That means that for someone who is 18 or 19, a significant part of the increase in value occurred when they were a minor.

We are aware that the proportion of individuals aged between 0 and 19 who claim this exemption is very low compared to the adult population. However, the **average capital gains exemption** claimed by each of these young individuals over the past few years was a staggering **$280,000**! Surprising, right? And it's all lost tax revenue. In our opinion, this figure should have been zero! And if you want to go check the CRA's tax statistics for yourself, don't forget to multiply by two, because the statistics only list the amount of the "taxable capital gains deduction" which is 50% of the gain realized.

Recently, this author was made aware of a situation where five members of the same family (both parents and three minor children) claimed an exemption for $4 million in capital gains out of a little more than $8 million, or five times the applicable exemption limit at the time of $800,000. And that is far from being the only outlandish case. Apart from a handful of hardliner tax experts for whom such a situation may seem reasonable, most tax experts will tell you that this generosity to minors makes absolutely no sense. Why provide an aid of this magnitude to families who clearly do not need this kind of assistance?

Tax nonsense and analogy with the principal residence exemption

We can make a very simple analogy with the exemption from tax on the capital gains realized on the sale of a principal residence. Since 1981, this exemption has been limited to one single "family", which here essentially means tax spouses and … **minor children**! That means that if this "family" has more than one residence (cottage, city home, condo in Florida, etc.), only one property is eligible for a capital gains exemption for every given year they owned multiple residences (whether directly or via a trust).

It is therefore impossible to claim a principal residence exemption for more than one building by using minor children. This is simple, clear, and fair.

So how is this possible with small business shares? Tax legislation has long existed to create "presumptions" when minor children are involved. Here is one example (among many): paragraph 256(1.3) of the ITA clearly states that capital stock of a corporation owned by a child under 18 years of age (directly or via a discretionary family trust) is deemed to be owned by the parent of the child … but only in order to determine whether corporations are "associated" (for the purpose of sharing the amount eligible for the reduced tax rate for SMEs). Why does this presumption not make the capital gains realized on small business shares owned by a child under 18 years of age deemed realized by their parent? Would it be hard to enforce? Not at all … and everyone, except in extremely rare cases, would obviously agree with such a legislation. But the civil servants at the Department of Finance Canada who are responsible for tax policies prefer to squander away our collective wealth by continuing to ignore the problem. With the stunning incompetence (which is putting it politely) of the Morneau tax reform carried out in the second half of 2017, this multiplication of the exemption had initially been opposed (ineptly) before the Department of Finance Canada backpedalled in October 2017 without having issued a simple rule like the one we are proposing here. The result: since 2001, federal and provincial governments have missed out on between $500 million and $600 million in tax revenue. We can only shake our heads in disbelief and utter "*Father, forgive them, for they do not know what they are doing*."