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Marmer Penner Newsletter

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TAX SAVINGS ON MARITAL BREAKDOWN

On marital breakdown, where a family business is involved, it is not uncommon to see shares of a small business corporation held by each spouse. Generally, only one spouse will wish to remain involved in the business and as a result, a transfer of shares will be required in the process of settling equalization.

In order to avoid income tax on the transfer of assets arising from the breakdown of marriage, most asset transfers occur on the basis that the *Income Tax Act* permits such asset transfers between spouses and former spouses to occur at cost. However, the same subsection of the *Income Tax Act* which permits the transfer at cost also permits the transferor to elect out of this provision and transfer the shares at fair market value.

The obvious question arises "why would anybody wish to trigger taxable income by transferring at a higher value?" The answer is that if the transferor has the ability to utilize the lifetime capital gains exemption on the shares of a qualified small business corporation, the transfer at fair market value still may be relatively tax free but also allow the transferee to receive the shares with a higher adjusted cost base. That higher cost base may have significant value to the transferee depending on when the transferee expects to eventually sell the shares.

Let's look at an example. Lucy and Ricky each own 50% of the shares of Copacabana Corporation, which is a qualified small business corporation, whose value is $1,000,000. Lucy agrees to transfer her shares to Ricky and elects to make this transfer at fair market value and utilize all of her $500,000 lifetime capital gains exemption to shelter her capital gain on disposition. Ricky expects to retire in ten years and sell Copacabana Corporation to a third party. By transferring the shares at fair market value, Ricky's adjusted cost base is now $500,000 higher saving him over $116,000 in expected future tax. Adjusting for the ten year present value factor, the present value of these tax savings is over $80,000 to Ricky. This amount can be shared with Lucy by adjusting the equalization amount.

There is one other tax issue that relates to Lucy. Depending on Lucy's other income, she may incur alternative minimum tax ("AMT") in the year she utilizes all or most of her lifetime capital gains exemption. Any AMT paid is generally recoverable in future years as it may be applied to reduce future income taxes. As a result, Lucy would overpay tax in the year of transfer and then recover this income tax in future years. The time value of Lucy's prepayment of income tax should be considered in the equalization adjustment. Conversely, Ricky could lend Lucy the money to finance her AMT liability unless the future tax recovery reverses the cost to her.