# Selling Your Business: Capital Gains Stripping

SUMMARY




This strategy effectively converts otherwise taxable capital gains into tax-free dividends.


## What is it?

When shares of a Canadian corporation are sold, the seller is generally subject to tax on the capital gain based on the increase in value of the shares (which includes the business assets and any cash it may have). In order to reduce the capital gain as much as possible, corporations will utilize tax-free intercompany dividends to remove as much cash as possible. This strategy effectively converts otherwise taxable capital gains into tax-free dividends.

## Anti-avoidance rules

It applies where a corporation receives dividends from another Canadian Corporation for one of the three purposes listed below:

1) A significant reduction in a pending capital gain
2) A significant reduction in the FMV of any share
3) A significant increase in the cost of property

If this provision applies it will recharacterize the tax-free dividends as proceeds of disposition resulting in a taxable capital gain.

## Safe income on hand exemption

For income that has already been subject to corporate tax, the "capital-gains stripping" strategy described above is not a problem. This after-tax income retained by a corporation is referred to as "Safe Income". For dividends in excess of the safe income, the anti-capital gains stripping provisions described above may apply. As such, safe income of a corporation needs to be tracked and should be calculated well before a share sale.

## Advantages

- A common tax planning strategy on the sale of shares to avoid significant taxes.
- Converts taxable capital gains into tax-free inter-company dividends

## Disadvantages

- Accounting/Legal Fees for the safe income calculation & tax planning
- The safe income calculation can be quite complicated and requires professional tax advice.
- If the shareholder needs the funds personally for short-term reasons, it may be more beneficial to trigger a capital gain, since only 50% of the income is taxed.

**A common tax planning strategy on the sale of share to avoid significant taxes.**

I&A
PROFESSIONAL CORPORATION
chartered professional accountants