

The Lifetime Capital Gains Exemption for your Private Company Shares

The lifetime capital gains exemption is a valuable tax incentive that is available to business owners selling their "qualified small business corporation (QSBC) shares" or "qualified farm or fishing property". This article focuses on the capital gains exemption as it applies to QSBC shares.

The lifetime capital gains exemption limit on the sale of QSBC shares for 2019 is \$866,912¹. This means that if an individual sells QSBC shares for a gain in 2019, the first \$866,912 of the capital gain can generally be received tax-free².

The lifetime capital gains exemption limit on the sale of Qualified Small Business Corporation (QSBC) shares for 2019 is \$866,912

There are specific conditions that must be met for the shares of a corporation to qualify as QSBC shares. Therefore, it is important to undertake some advance planning to ensure your eligibility for the exemption.

Qualifying for the capital gains exemption in respect of QSBC shares

To qualify for the exemption, you must meet three separate tests.

- 1. Small business corporation test:** The first test involves determining if the corporation is a small business corporation at the time of the sale. In order to be a small business corporation, the corporation must be a Canadian-Controlled Private Corporation (CCPC), as defined in the *Income Tax Act* (Canada) and all or substantially all of its assets must be used in an active business carried on primarily in Canada. The Canada Revenue Agency (CRA) interprets "all or substantially all" to mean that at least 90% of the fair market value (FMV) of all corporate assets must be used for active business purposes.
- 2. Holding period ownership test:** The second test involves determining who held the shares prior to their sale, and requires that the shares were owned by you, a partnership of which you were a member, or a person related to you throughout the 24-month period immediately before the sale.

¹ This amount is indexed annually for inflation. The lifetime capital gains exemption applicable to capital gains realized on the disposition of qualified farm or fishing property is the greater of (1) \$1 million; and (2) the indexed lifetime capital gains exemption applicable to capital gains realized on the disposition of QSBC shares.

² The deduction that may be claimed is subject to (a) the annual gains limit, (b) the cumulative gains limit, and (c) the amount of unused lifetime exemption available.

- 3. Holding period asset test:** The final test deals with the value of the corporation's active business assets during the holding period. The rule requires that more than 50% of the FMV of the corporation's assets must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale

If these tests are satisfied, you may be able to claim the exemption on your tax return in the year of the sale. Since it is sometimes difficult to predict when you will sell the shares of your corporation (e.g., an unsolicited offer from a competitor, or a health problem), you may face a situation where the exemption is lost because the qualifying criteria have not been met at the time of the sale. Advance planning is advised to ensure that you can make full use of the exemption.

Crystallizing the capital gains exemption

The term "crystallization" refers to the process of triggering a capital gain at a time when the shares of the corporation qualify for the exemption. Crystallizing your capital gains exemption has the following potential benefits:

- It removes the need to continuously monitor that the tests to qualify for the exemption are met; and
- It ensures that you will have benefited from the exemption in case it is eliminated in the future by the government before your actual sale.

The capital gains exemption may be crystallized through a corporate reorganization in which an individual would exchange their shares in the corporation for a new class of shares of the existing or a newly incorporated corporation, and elect a proceeds of sale amount that results in a gain being realized on the exchange. The adjusted cost base of the new shares will be higher, and therefore any future sale or transfer will result in a smaller capital gain and less tax owing.

It is important to note that if you have cumulative net investment losses (CNIL)³, your capital gains exemption will generally be reduced. As a result, the timing of your disposition of QSBC shares may be important. You may wish to consider selling shares eligible for the capital gains exemption in years where there is no (or a negative) CNIL balance.

Alternative minimum tax and the capital gains exemption

It is important to note that capital gains sheltered by the use of the capital gains exemption may result in an alternative minimum tax (AMT). AMT limits the tax advantage a taxpayer can receive in a year from certain incentives, including the lifetime capital gains exemption. A taxpayer must pay the higher of AMT and ordinary/regular income tax.

In years following the use of the capital gains exemption where AMT was applied, you may want to attempt recovering the AMT by having adequate taxable income as the AMT you pay acts as a credit against future regular tax. You can carry forward the amount by which your AMT exceeds your regular tax over a seven year period.

Multiplying the capital gains exemption

You can potentially multiply access to the lifetime capital gains exemption if other family members own shares of the QSBC.

³ CNIL is the cumulative excess of your investment expenses over your investment income for all tax years after 1987.

If it is expected that there will be a significant appreciation in the value of the business between now and the time of transition, consideration should be given to the share structure of the corporation (multiple family members or the use of a family trust).

A trust is commonly used to make the exemption available to multiple family members. Incorporating a trust into the new ownership structure may allow the trustees of the trust to attribute to each of the beneficiaries a portion of the capital gain realized upon the disposition of such shares and thus allow each beneficiary to potentially receive up to \$866,912 in capital gains tax free.

Keep in mind that the tax on split income (TOSI) rules enacted in 2018 may impact the ability to multiply the capital gains exemption where minor children are involved and the disposition of the shares was to a non-arm's length party. While beyond the scope of this article, TOSI can impact taxpayers that receive directly or indirectly dividends, interest, and certain types of capital gains from a related business, partnership or trust. If caught under these new rules, the amounts will be deemed to be split income and will be taxed in the hands of the individual at top marginal tax rates.

Considerations:

Due to the complex nature of the attribution rules briefly discussed in this article, consider speaking to your TD advisor and tax specialist prior to implementing any of these tax-planning strategies.



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