The $750,000 Lifetime Capital Gains Exemption

One particular tax planning technique available to business owners selling their private companies is the lifetime capital gains exemption on the sale of Qualified Small Business Corporation (QSBC) shares.

The lifetime capital gains exemption is an economic incentive to help raise the level of investment in small businesses. If an individual sells Qualified Small Business Corporation shares for a profit, the first $750,000 of the capital gain can be received tax-free.

This is a lifetime exemption, meaning an individual can only shelter up to a maximum of $750,000.

There are specific conditions that must be met for shares of a corporation to be classified as QSBC shares. It is important to undertake some advance planning to ensure eligibility for the exemption.

Qualifying for the capital gains exemption in respect of QSBC shares

To qualify for the exemption, you must meet two tests.

The first test is that your corporation must be a "small business corporation" at the time of sale. That means that it must be a Canadian-Controlled Private Corporation (CCPC) 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 assets representing at least 90% of the fair market value of all corporate assets must be used for active business purposes.

The other test you must meet to qualify for the exemption is that more than 50% of the fair market value 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, and the shares must not have been owned by anyone other than you or someone related to you during the 24-month period immediately before the sale.

If both 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 QSBC 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 the QSBC capital gains exemption now has the following potential benefits:

1. It removes the need to continuously monitor if the tests for exemption are met; and

2. 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 QSBC capital gains exemption may be crystallized through a corporate reorganization in which an individual would exchange the shares in his/her company for a new class of shares of the existing or newly incorporated company. 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.

Multiplying the QSBC capital gains exemption

If other members in the family own shares in a QSBC you can multiply access to the $750,000 capital gain exemption.

When a family business is sold it is not uncommon for multiple family members to each enjoy the QSBC exemption. 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 company (multiple family members or 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 $750,000 in capital gains tax free.

QSBC capital gains exemption and inter-generational family business transfers

The exemption can also be useful in an intergenerational family business transfer.

When an individual business owner dies, his or her shares can be transferred to a spouse without any tax implication. However, a transfer to children will result in a deemed disposition of shares at their fair market value and tax will be payable on the capital gains. The tax owing can be reduced by utilizing the exemption on the individual's death assuming the shares qualify for the exemption at the time of the individual's death or during the 12-month period preceding death.

Another option would be to crystallize the gains during the individual's lifetime, thus ensuring that family members will receive the benefits of the exemption.

Whether an individual is planning to sell his or her business to a third party or pass it on to other family members through succession, the capital gains exemption will help minimize the tax cost of exiting the business.

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