Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Capital gains exemption on private shares

How you may be able to save approximately $400,000 of taxes on the sale of your business

If you're thinking about selling your business, you may be able to save a significant amount of tax by claiming the lifetime capital gains exemption (LCGE) on the sale if you're selling the shares of an incorporated business that are qualified small business corporation (QSBC) shares. This article describes how you may qualify for the LCGE and some of the factors you may need to consider when claiming the LCGE.

What is the LCGE?

The LCGE reduces or eliminates the taxable capital gains realized on the disposition of certain eligible property. Individuals who are resident in Canada may qualify for the LCGE on the disposition of QSBC shares. The 2024 budget increased the LCGE from $1,016,836 to $1,250,000 for dispositions that occur on or after June 25, 2024. The LCGE will resume indexation in 2026.

To provide you with an idea of what the tax savings could be when you claim the LCGE, assume you sell the shares of your incorporated business on or after June 25, 2024, and can use an LCGE amount of $1.25 million against the capital gains realized. If your marginal tax rate is 50%, you can potentially save about $400,000 in taxes by using the LCGE.

You may also be able to claim the LCGE when you dispose of a qualified farm or fishing property. For more information on the LCGE when selling a farm, please ask an RBC advisor for the article on this topic.

When can you use the LCGE?

Aside from a simple sale of the shares of your corporation, below are some of the situations where you may use the LCGE:

- You implement an estate freeze of your business. An estate freeze may allow you to transfer the future growth of the company to other shareholders, usually family members. During the freeze, you may be able to crystallize the LCGE and increase the ACB of your shares on a tax-deferred basis. Ask an RBC advisor for the article on estate freezes for more details;

- You transfer the shares of your business to other family members;
- Your corporation is taken over by way of a share purchase or a merger with another Canadian or foreign corporation;
- On your death, capital gains are realized on the deemed disposition of the shares of your business; or
- You sell certain other types of property, such as a farming or fishing property.

Qualifying for the LCGE

To claim the LCGE, you must sell qualifying property. Qualifying property includes QSBC shares, qualified farming or fishing property. Although the definition of QSBC shares is quite complex, the general criteria for private company shares to qualify as QSBC shares are as follows:

- At the time of disposition, the shares must be those of a Canadian-controlled private corporation;
- At the time of disposition, all or substantially all of the fair market value of the assets in the corporation are used principally in an active business carried on primarily in Canada. The Canada Revenue Agency (CRA) generally takes the position that all or substantially all means 90% or more;
- During the 24 months prior to the disposition, the shares were not owned by anyone other than you or a person or partnership related to you; and
- During the 24 months prior to the disposition, while the shares were owned by you or a person or partnership related to you, more than 50% of the fair market value of the assets must have been used in an active business carried on primarily in Canada.

Please note that shares you hold in a registered savings plan, such as a registered retirement savings plan (RRSP), don't qualify for the LCGE.

The criteria above have been greatly simplified. You should speak with a qualified tax advisor to determine whether your private company shares qualify or could qualify as QSBC shares.

Purifying your corporation

If more than 10% of the fair market value of the assets in your corporation are not used in active business, for example, your corporation holds a substantial amount of portfolio investments, your private company shares will not qualify as QSBC shares. You may need to remove the assets that are not used in your active business, or "purify" your corporation, prior to the disposition to ensure that you can claim the LCGE. Speak with a qualified tax advisor to determine which assets you should remove from your corporation and how best to do so. Some of the common methods of purifying a company are:

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Non-taxable methods

- Reduce liabilities, for example repay shareholder loans or reimburse shareholders for business expenses paid by them;
- Pay out capital dividends if there is a positive capital dividend account balance in the corporation;
- Make return of capital payments to shareholders; and
- Use surplus cash to purchase active business assets.

Taxable methods

- Pay salaries or bonuses;
- Pay taxable dividends; and
- Sell passive assets and pay down debt or invest in active assets.

Tax-deferred method

- Transfer passive assets to another corporation.

What if you're not incorporated?

If you're a sole proprietor and you plan on selling your business, you may still be able to benefit from the LCGE. In order to claim the LCGE, you will need to create a corporation and sell the shares of that corporation. If you transfer all or substantially all of your business assets into a corporation and immediately sell the shares of the newly formed corporation, you may be able to claim the LCGE. Speak to a qualified tax advisor if you're a sole proprietor and are planning to sell your business.

Past exemptions may impact your current situation

There were a number of different capital gains exemptions available prior to 1995. One of these exemptions was the $100,000 general capital gains exemption. This general exemption was available to all taxpayers on gains relating to the disposition of any kind of capital property, including public company shares, bonds, mutual funds, real estate, etc. This general exemption was eliminated in the 1994 federal budget. If you had any unused general capital gains exemption at that time, you could have made a special election on your 1994 income tax return to exempt up to $100,000 of capital gains accrued on any of your capital property. You can no longer make this election.

A $500,000 capital gains exemption continued to exist after February 22, 1994, which could only be used under certain circumstances, for example on the disposition of QSBC shares. This is the same LCGE that exists today. The $500,000 LCGE was increased to $750,000 in 2007 and to $800,000 in 2014. It was indexed annually after 2014 until June 25, 2024. As mentioned earlier, for dispositions on or after June 25, 2024, the LCGE was raised to $1.25 million and indexation will resume in 2026.

If you used any of the capital gains exemptions in the past, you must reduce your available LCGE by that same amount. In addition, there may be further reductions to the LCGE, as a result of claims for allowable business investment losses (ABILs) or certain other deductions, such as net investment losses. If you believe you qualify for the LCGE, speak with a tax advisor to determine the amount for which you qualify.

Multiplying the LCGE and the TOSI rules

It may be possible to multiply the LCGE on the sale of a single business. One way to achieve this is by placing private company shares in a family trust and naming various family members as beneficiaries of the family trust. Upon the disposition of the QSBC shares, any capital gains the trust realizes on the sale may potentially be allocated to the beneficiaries of the trust. The beneficiaries can use their LCGE to reduce or eliminate tax on the capital gains allocated to them.

Capital gains realized by a minor child on the sale of private company shares to a non-arm's length person may be subject to the tax on split income (TOSI) rules, also known as the kiddie tax rules. Under these rules, the capital gain realized by a minor on the disposition to a non-arm's length person will be re-characterized as a dividend, subject to tax at the highest marginal rate for non-eligible dividends. As a result, the minor will not be able to use their LCGE since the income is considered a dividend, not a capital gain. It is important to distinguish that a minor can still use their LCGE against capital gains realized on a disposition of QSBC shares to an arm's length person, whether the shares are held directly, or indirectly through a trust.

TOSI may also apply to certain types of income from a private corporation that is paid to an adult family member. However, TOSI does not apply to taxable capital gains realized from the disposition of QSBC shares. This is regardless of whether the shares are sold to an arm's length or a non-arm's length person. The TOSI rules therefore don't limit access to the LCGE for adult individuals.

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Alternative minimum tax (AMT)

AMT may impact your tax liability for the tax year in which you claim the LCGE. AMT aims to ensure that every Canadian individual pays a minimum amount of tax. The calculation of AMT is based on an "adjusted taxable income" which seeks to remove the advantages of certain tax-preferential items such as capital gains. If the AMT calculated is greater than your regular tax liability, the AMT becomes your tax liability for the year. The difference between the AMT that you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability when your taxes payable exceed your AMT. You should contact a tax advisor to determine if AMT will be a factor when you claim the LCGE. You can also ask an RBC advisor for our article on AMT for more information.

Canadian Entrepreneurs' Incentive

Starting in 2025, if you are selling shares of your business, you may also qualify for the Canadian Entrepreneurs' Incentive. This incentive reduces the capital gains inclusion rate to 33.33% on a lifetime maximum of $2 million in eligible capital gains realized on the disposition of qualifying shares. The lifetime limit would be phased in by increments of $200,000 per year, beginning on January 1, 2025, before ultimately reaching a value of $2 million by January 1, 2034.

Plan in advance

It's important that you plan well in advance of the sale or transfer of your business. As previously mentioned, there are a number of criteria that must be met in order for you to be able to claim the LCGE and you may need to implement certain planning strategies to qualify. Speak to a qualified tax advisor to determine if you can benefit from claiming the LCGE.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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