

MONTHLY NEWSLETTER

Qualified Small Business Corporation Shares and the Capital Gains Exemption



JACOB MILOSEK, CPA, CA
JENNIFER DAWE, CPA, CA

AUGUST 2015

Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

CAPITAL GAINS EXEMPTION (“CGE”)

On 21 April 2015, federal Finance Minister Joe Oliver tabled his first budget. Included in the budget was an announcement that the 2015 CGE for capital gains realized on the disposition of qualifying shares is \$813,600. This amount will be indexed for inflation for future years. This is a welcome change for taxpayers as in recent years the exemption was limited to \$750,000. The CGE is a tax concept applicable to Canadian resident individuals (other than trusts). During their lifetime, each individual taxpayer can shelter from tax, capital gains on the disposition of qualifying shares up to the amount of their total CGE. The purpose of the CGE is to encourage Canadian taxpayers to invest in small business and expand the domestic economy. The highest marginal tax rate in Ontario is currently 49.53%. Only one half of capital gains are taxable, thus the maximum potential tax savings from the CGE is approximately \$201,400 for each shareholder.

There are other tax attributes that may affect a taxpayer’s ability to claim the full capital gains exemption. When planning to use the capital gains exemption, it is important to complete an extensive review of prior investment transaction to ensure that the taxpayer is eligible to use the CGE.

QUALIFIED SMALL BUSINESS CORPORATION (“QSBC”)

In order to qualify for the CGE, the investment must be in shares of a QSBC. A QSBC share is defined as capital stock of a corporation that, at the time of sale, was as a Canadian controlled private corporation (CCPC) where all or substantially all (administratively considered to be greater than 90% by the Canada Revenue Agency) of the fair market value of the assets are;

-
- i. Used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it,
 - ii. Shares or indebtedness of connected small business corporations, or
 - iii. Assets described in i) and ii);

There is also a timing component to the qualification of the shares. Throughout the 24 months immediately preceding the date of sale, the shares cannot be owned by the person or a person unrelated to the shareholder. Additionally, throughout the 24 months immediately preceding the date of sale, corporation must have been a CCPC with more than 50% of the fair market value of the assets of which was attributable to:

- i. Assets used principally in an active business carried on primarily in Canada by the corporation, or
- ii. Shares or indebtedness of connected corporation who meet the above test.

Applying the rules to a corporation can require extensive historical and current knowledge of the corporation. There may be grey area regarding the active versus passive classification of assets. For example, cash accumulated in a corporation is generally considered passive, unless it is required for the operating of the business. Further, assets must be monitored to ensure that the aforementioned tests are met consistently for the 24 month period preceding the disposition. If any time the 50% test is not met during this period, the clock will restart on the 24 months.

PLANNING OPPORTUNITIES

As illustrated, there can be a significant tax benefit to claiming the CGE. Business owners and shareholders of small businesses should consider whether they are eligible to claim the CGE on the disposition of their shares. Whether a disposition is imminent or forecasted in the future, there is tax planning that can be completed to provide shareholders the opportunity to take advantage of the CGE.

The simplest strategy for accessing the CGE would be to incorporate a sole proprietorship that operates an active business. The CGE only applies to the disposition of QSBC shares. A sole proprietor may sell their business, but will pay tax on the capital gains resulting from the disposition of assets. There is no exemption available in this scenario. By incorporating, the proprietor becomes a shareholder, and may be able to access the CGE on disposition. With the appropriate planning and compliance, it is possible to transfer the assets of an existing business on a tax deferred basis. There are a number of other factors to consider when evaluating incorporation.

In some cases, it may be possible to multiply the CGE, effectively sheltering a larger portion of the gain by sprinkling the gain amongst multiple shareholders. Having family members own shares of the corporation directly, or through a family trust, would allow future growth in the corporation to attribute to those shares. These shares would participate in the capital gains on disposition and each shareholder would evaluate their individual access to their personal CGE upon disposition.

In order to claim the CGE, we know that there are a number of asset tests. In order to keep the corporation “pure” for purposes of the QSBC rules, or “purify” an existing corporation, excessive cash reserves should be withdrawn regularly. In some cases, it may be beneficial to incorporate a second corporation to hold passive investments. These corporations are generally referred to as “holding companies”. Although there are a number of restrictions on how the funds can be transferred to a holding company on a tax efficient basis, there are opportunities to orchestrate such a reorganization. It is important to keep the 24 month tests in mind when considering when you implement these strategies.

There are number of planning opportunities related to the CGE that can save small business owners a significant amount of tax. Upon incorporation, the share structure should be reviewed to consider these benefits. After incorporation, there may be opportunities to reorganize the share capital to take advantage or expand these benefits. Please do not hesitate to contact our office to determine the most efficient structure to meet your current and future needs.