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CROSS-BORDER WEALTH MANAGEMENT

Lifetime Capital Gains Exemption & Qualified Small Business Corporation

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Overview

The Lifetime Capital Gains Exemption ("LCGE") is a once-in-a-lifetime tax deduction that is available for every Canadian resident individual on up to $913,630 CAD (2022, and indexed to inflation on an annual basis) of capital gains realized on the sale of Qualified Small Business Corporation ("QSBC") shares and certain other capital properties. In order to claim the LCGE, the capital gain must be realized by an individual, trust, or partnership (with the gain allocated to an individual) with an available LCGE balance.

Qualifying Criteria

There are three tests that must be met to ensure the shares meet the definition of QSBC shares and therefore qualify for the LCGE:

1. Small Business Corporation Test

At the time of sale, the shares must be shares of a Small Business Corporation ("SBC"). Generally, an SBC is defined as a Canadian-Controlled Private Corporation ("CCPC") where all or substantially all (at least 90%) of the fair market value of the corporation's assets is attributable to assets that are:

1. Used principally (more than 50%) in an active business carried on primarily (more than 50%) in Canada;
2. Capital stock or indebtedness of one or more SBCs that are connected to the corporation; or
3. A combination of (a) & (b).

Note that:

- Active business assets exclude the following: excess cash, investments, investments in real estate, and other assets not essential to the operation of the business.
- A corporation is connected to a particular corporation if it controls the particular corporation or owns more than 10% of the issued capital of the particular corporation in terms of both the fair market value and voting rights.
- A CCPC is a private corporation resident in Canada that is not controlled directly or indirectly by non-residents or public corporations.
- It is common planning to "purify" a company in order for it to qualify as an SBC at the determination time. As an example, excess cash can be paid out to the shareholders of the corporation or used to pay down outstanding debts. Alternatively, investments with accrued gains can be donated without triggering taxes payable and even providing a corporate tax deduction. Non-qualifying assets of the corporation can even be moved to another corporation.

2. Holding Period Test

The shares must not have been owned by anyone other than the individual or a person related to the individual throughout the 24 months preceding the disposition. Usually, newly issued shares must be held for at least 24 months in order for the shares to be QSBC shares. However, there are exceptions to this rule in a number of circumstances, including where the shares are issued as payment for other shares, as payment of a stock dividend, or in connection with an incorporation of the business.

3. Fair Market Value Asset Test

Throughout the 24 months immediately preceding the sale of the shares, the shares were those of a CCPC where more than 50% of the fair market value of its assets was attributable to assets used principally (more than 50%) in an active business carried on primarily (more than 50%) in Canada by the corporation or a corporation related to it.

Using the LCGE

As mentioned above, the LCGE is a once-in-a-lifetime tax deduction that is available for every Canadian resident individual on up to $913,630 CAD (2022, and indexed to inflation on an annual basis) of capital gains realized on the sale of QSBC shares and certain other capital properties. If only a portion of the exemption is used, the remainder is available for future use. Furthermore, as the exemption is indexed to inflation, every year the available LCGE grows larger. In other words, a "new" amount of LCGE will accrue even if an individual has previously used their total available exemption. It is important to note that the $913,630 CAD is on a gross basis. The amount of total "taxable capital gains" that may be sheltered is $456,815 CAD, since only 50% of capital gains are taxable in Canada. Other balances that need to be analyzed when deciding to leverage the LCGE, as they could potentially decrease the amount of LCGE available, include your:

- Cumulative Net Investment Loss ("CNIL"); and
- Allowable Business Investment Losses ("ABIL").

Planning Opportunities

There are three tests that must be met to ensure the shares meet the definition of QSBC shares and therefore qualify for the LCGE:

Estate Freeze – Crystallization Using the LCGE

An individual can use the LCGE not only on a disposition of their shares, but also in succession planning when passing on their shares. The LCGE is not currently scheduled to disappear, but crystallization of the LCGE is a viable option should it be repealed in the future. By crystallizing the LCGE, an individual triggers a capital gain at a time when the shares qualify for the exemption without actually disposing of the shares. The crystallization transaction can occur during the shareholder's lifetime or upon their passing, increasing the cost basis of the shares transferred to the deceased individual's beneficiaries.

Multiplying the LCGE

It is possible, through the use of a family trust, for each beneficiary to use their available LCGE to reduce or eliminate tax payable on a sale of QSBC shares. This multiplication can also be used in conjunction with the crystallization planning above. As an example, if there is a family trust with mom, dad, and their three children as capital beneficiaries, it is possible to utilize the LCGE and pay no Canadian tax on up to $4,568,150 CAD of capital gains on the shares disposed of or crystallized during 2022.

Implications for U.S. Citizens

If you are a U.S. citizen resident in Canada, you are still entitled to utilize the LCGE on your Canadian tax return. However, the U.S. will not realize the LCGE, so you will not receive a corresponding tax deduction on your U.S. tax return. This can lead to U.S. tax payable with no offsetting foreign tax credit from Canada, which is why it is important to allow adequate planning time and model out the use of the LCGE.

Developing a tax efficient strategy to leverage the LCGE is critical. Whether you are a Canadian tax resident or a dual tax resident of Canada and the U.S., it is important to garner professional advice.

Contact Cardinal Point for more information