# Tax Planning for Business Owners
## The Capital Gains Deduction

April 2023

For 2023, business owners can use the Capital Gains Deduction to shelter up to $971,190 of capital gains on the sale of shares of a qualifying small business corporation. Due to the potential tax savings from accessing this deduction, it represents one of the most compelling tax planning opportunities for Canadian business owners. As the rules are complex, only a general discussion is provided here. As with all tax planning, professional advice is critical to understanding the specific implications in your situation.

### Lifetime individual deduction

The Capital Gains Deduction is available only to Canadian resident individuals, and can only be claimed on an actual transfer of shares or upon a deemed sale of shares; such as the deemed disposition that takes place upon death. As it is only available to an individual on the sale or transfer of shares, a business divestiture undertaken as a sale by the corporation of its business assets will not qualify for the deduction.[1] In addition, where an individual owns shares of a holding corporation, and in turn the holding corporation owns shares of another (operating) corporation, it is only the sale of shares by the individual that potentially qualifies for the deduction.

As of 2023, the cumulative limit of qualifying capital gains that can be sheltered during the lifetime of each individual is $971,190 (which represents the 2014 amount of $800,000 indexed for inflation). This limit will be further indexed to inflation in subsequent years. Given that the lifetime deduction amount was only $500,000 until 2007, it may be worthwhile for individuals who have previously claimed a portion of their lifetime deduction to consider planning that would enable them to access any remaining unused lifetime amount.

Certain amounts claimed by an individual, such as allowable business investment losses, capital losses, interest expenses or other investment expenses (i.e., cumulative net investment losses), may reduce, disentitle or defer the timing of an individual's claim for the deduction. In addition, other personal tax considerations such as the application of "Alternative Minimum Tax" may result from the use of the Capital Gains Deduction, thereby reducing its benefit.

### Qualifying shares of a small business corporation

There are three main tests that must all be satisfied in order to be considered "qualifying small business corporation shares."

**1. Small business corporation ("SBC") test**
This test examines the use of the corporation's assets at the time the shares are sold. In particular, the corporation must be a "Canadian-controlled private corporation" which carries on an active business primarily in Canada, in order for the shares to qualify for the deduction. Where there is a layered corporate structure with one or more levels of subsidiary corporations, the shares held directly by the individual may qualify if the active business is carried on by one or more of the subsidiary companies. For the purpose of the Capital Gains Deduction, earning income from property, such as rental income from real property, or earning investment income from a portfolio does not qualify as an active business unless the activity is conducted as a business. As such, the shares of an "investment holding corporation" will generally not qualify for the deduction.

**2. Holding period asset use test**
This test examines the extent of use of the corporation's assets in an active business in the period preceding the share sale. For example, generally at the time of a sale at least 90% of the value of the assets must be used in the active business. There is also a 50% asset test throughout the 24-month period prior to the sale. In the event of death, if the 90% asset test is not met upon the deemed disposition, the shares may still qualify if the 90% asset test was met at any time in the year preceding death. Given this limited relief, it is critical to monitor the corporation's qualifying

status and to consider "purification" strategies to remove inactive (passive) assets from the corporation, when appropriate, in order to meet these threshold tests. Some simpler purification strategies involve using excess cash to pay corporate liabilities or purchase business assets, and the tax-efficient withdrawal of funds as a capital dividend or return of capital. If the passive investment assets are liquidated or distributed "in-kind" as part of the purification strategy, it will be important to consider the possible corporate tax on any accrued gains, as well as the personal tax on any distributions to the shareholder.

**3. Holding period ownership test**

This test examines the continuity of ownership of the shares in the period prior to the sale, since generally a shareholder must have owned his or her shares in the corporation throughout the 24 months immediately preceding the disposition. However, there are possible exceptions where the shares were acquired from a family member (or other related person or corporation), or if the shares were acquired in the course of incorporating an existing business.

## Family business considerations[2]

Many tax planning strategies are available to obtain optimal benefit from the Capital Gains Deduction. It may be possible to re-organize share ownership of a qualifying corporation to multiply access to the deduction by making it available in the future to other family members. It may also be possible to immediately trigger the use of the deduction without any change in beneficial ownership in a transaction called a "crystallization," for example, in the context of a share re-organization or an initial public offering of shares of an otherwise qualifying corporation. This would have the benefit of creating an increased tax cost base in the shares, thereby reducing the capital gain on the shares on the future sale or transfer (e.g., at death).

Tax planning for the deduction is often combined with a succession plan involving an "estate freeze" which transfers future growth to other family members (typically on a tax-deferred basis) and can limit the tax liability upon the transferor's death to be based on the accrued gain at the time of the freeze. Sound tax planning advice by professionals who have specific expertise is recommended to explore opportunities to utilize the deduction during your lifetime, or as part of a tax-efficient estate plan.

## Seek advice

Tax and estate planning requires consultation with professional advisors as the rules are extremely technical and complex. In addition, each individual's situation will be unique in many respects, requiring the expertise of a professional to customize the appropriate plan or solution to fit your particular circumstances and personal objectives. You may require a tax advisor, estate planning lawyer and a professional appraisal.

For more information, please speak with one of our team members.

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[1] It is also worth noting that recent tax changes have reduced the tax benefits of an asset sale involving the sale of goodwill, thereby further enhancing the benefit of a share sale, particularly when the Capital Gains Deduction is available to the shareholder(s).

[2] Anti-avoidance tax measures aimed at preventing corporate "surplus stripping" can apply on the transfer of a business to a family member (versus a sale to a third-party purchaser) to convert a capital gain otherwise realized on the transfer into a taxable dividend (which is subject to a higher tax rate than a capital gain, and is ineligible for the Capital Gains Deduction). Recent tax legislative developments have sought to address this inconsistency in the tax law, and facilitate other complex tax-efficient corporate restructurings involving family businesses. For more information, please ask your BMO Financial Professional for a copy of our publication *Tax Relief Proposed for Intergenerational Transfers of Family Businesses*, and consult with your external tax advisor for direction in your particular situation.



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