

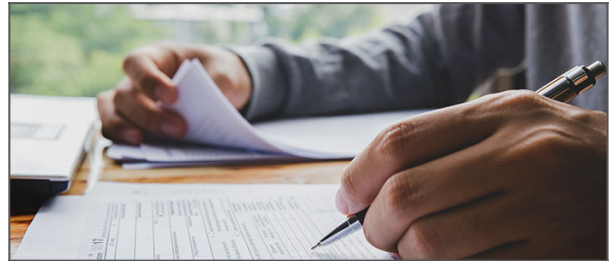
The Lifetime Capital Gains Exemption: Crystal Clear or Pure Confusion?

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What is the “lifetime capital gains exemption” and how can you take advantage of it?

The Lifetime Capital Gains Exemption (“LCGE”) allows every eligible individual to claim a deduction to their taxable income for capital gains realized on the disposition (or deemed disposition) of qualified small business corporation shares (“QSBCS”). In 2023, the exemption limit per individual on the disposal of QSBCS is \$971,190, **which, with proper planning, may result in a tax-free sale.**



While the focus of this article will be on the disposition of QSBCS, the LCGE can also be utilized for the disposition of qualified farm or fishing property (“QFFP”). In 2023, the exemption limit per individual on the disposal of QFFP is \$1,000,000.

In both situations, prior planning is crucial to take advantage of the LCGE.

Are your shares “qualified small business corporation shares”?

When determining if shares are QSBCS, three tests must be satisfied:

1. At the determination time, the shares must be shares of a “small business corporation” owned by the individual, the individual’s spouse or common-law partner, or a partnership related to the individual. A “small business corporation” generally means a Canadian-Controlled Private Corporation where at least 90% of the fair market value of all corporate assets are used in an active business carried on primarily in Canada;
2. Throughout the 24 months immediately before the determination time, the shares were not owned by anyone other than the individual or a person or partnership related to the individual; and
3. Throughout the 24 months immediately before the determination time, the shares must be shares of a Canadian-Controlled Private Corporation where at least 50% of the fair market value of the corporate assets are used in an active business carried on primarily in Canada.

Since #2 and #3 require compliance for 24 months immediately before the determination time, several strategies can be utilized to ensure the LCGE can be taken advantage of when

the opportunity for disposition arises.

Should you crystallize your “lifetime capital gains exemption”?

When the QSBCS meet the three tests above, an individual may want to consider “crystallizing” and triggering the capital gain through a corporate reorganization. Like the adage *“a bird in the hand is worth two in the bush”*, the main advantage of crystallizing is that the individual benefits from the LCGE rather than risk future changes that eliminate their ability to take advantage of it (including the risk of the elimination of the LCGE altogether).

Should you use purification strategies to take advantage of the “lifetime capital gains exemption”?

When the QSBCS do not meet the three tests above, an individual may want to consider “purifying” (which, colloquially means to move redundant cash and investments out of the corporation in order to make sure the shares remain QSBCS through tax planning). Simple strategies include disposing of non-qualifying assets or distributing non-qualifying assets as “dividends-in-kind”; however, the tax cost of these strategies should be weighed against the tax benefit of the LCGE.

More complex, but potential tax-deferred purification strategies, include:

1. **Inter-Corporate Dividend Payments or Redemption of Shares:** After-tax retained earnings or “safe income” can be paid through inter-corporate dividends, which typically flow tax-free between taxable Canadian corporations. In certain situations, income in excess of these amounts can also be paid through inter-corporate dividends. However, this transaction must be approached with caution, given the potential application of the anti-avoidance rule in subsection 55(2) of the *Income Tax Act*.
 - a. How would this work? The individual would implement a section 86 freeze of their shares in the operating corporation and exchange their common shares for (i) preference shares and (ii) a new class of common shares. The individual would then incorporate a holding corporation and transfer the new class of common shares to said holding corporation on a tax-deferred basis in exchange for common shares of the holding corporation. The operating corporation could then pay a dividend to the holding corporation equal to the amount in excess of after-tax retained earnings.
 - b. From a tax perspective, an inter-corporate dividend and a redemption of shares held by a corporation result in similar tax treatment. Therefore, a similar strategy can be employed by redeeming corporately-held shares over time. In some circumstances, redemptions of shares may get around section 55(2) issues.
2. **Introduction of a Trust with a Corporate Beneficiary:** The benefit of tax-free inter-corporate dividends and the benefit of a family trust can also be combined. As with the above transactions, this transaction must be approached with caution, given the potential application of the anti-avoidance rule in subsection 55(2), as well as subsection 75(2), of the *Income Tax Act*.
 - a. How would this work? The individual would form a family trust, which would hold shares in the operating corporation. The family trust would have beneficiaries, including the holding corporation. The operating corporation would pay a dividend to the trust, which would then distribute the dividend to the corporate beneficiary without losing the benefit of the tax-free flow

of inter-corporate dividends.

3. **Butterfly Transaction:** The last resort (because of costs, complexity and risks) would be to employ a butterfly transaction, which is a colloquial term given to transactions where assets are transferred to another corporation under section 55(3) of the *Income Tax Act* on a tax-deferred basis. This is typically done when there are section 55(2) anti-avoidance rule concerns that are preventing the above two options. To minimize risks, this must be done well in advance of any potential sale.

There are various other criteria and consequences to consider when determining whether the lifetime capital gains exemption is right for you. It is recommended that you **contact one of our TDS Tax Lawyers** to advise how you can take advantage of the lifetime capital gains exemption and associated crystallization or purification strategies.

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