

# NOTE ON CAPITAL GAIN DEDUCTION

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Lifetime capital gains exemption / deduction (LCGE/CGD) is an important tax advantages for individuals with shares in

- Qualified Small Business Corporation shares (QSBC) or
- Qualified farm or fishing property (QFFP).

## Amount of Capital Gain Exemption / Deduction (CGE/CGD)

<i>Period</i>	QSBC Qualified Small Business Corporation shares		QFFP Qualified Farm or fishing property	
	<u>Exemption</u>	<u>* Deduction (½)</u>	<u>Exemption</u>	<u>* Deduction (½)</u>
since 1985	\$500,000	\$250,000	\$500,000	\$250,000
after March 19, 2007	\$750,000	\$375,000	\$750,000	\$375,000
in 2014	\$800,000	\$400,000	\$800,000	\$400,000
in 2015	\$813,600	\$406,800	\$1,000,000	\$500,000
in 2016-2022	(see Appendix A for history of amounts)			
in 2023	\$971,190	\$485,595	\$1,000,000	\$500,000
in 2024 until June 24	\$1,016,836	\$508,418	\$1,016,836	\$508,418
in 2024 from June 25	\$1,250,000	\$625,000	\$1,250,000	\$625,000
in 2025	\$1,250,000	\$625,000	\$1,250,000	\$625,000
in 2026	\$1,275,000	\$637,500	\$1,275,000	\$637,500

\* Lifetime cumulative deduction limit

Deduction represent application of the (actual) inclusion rate on the exemption amount

## Qualified Small Business Corporation Shares (QSBC)

- concept used for CGD (ITA 110.6(2.1)), capital gains deferral (ITA 44.1), allowable business investment loss (ABIL) (ITA 39(1)(c)) and attribution rules through a corporation (ITA 74.4; 74.5)

### Definition of Small Business Corporation (SBC) (ITA 248(1))

- at any particular time
- a particular corporation that is a CCPC
- all of substantially all of the FMV of the assets of which at that time is attributable to asset that are
  - a) used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it,
  - b) shares of the capital stock or indebtedness of one or more small business corporations that are that time connected with the particular corporation
  - c) assets described in (a) and (b)

### Interpretation

- 'All of substantially all' = at least 90%  
(CRA position; Wood, 87 DTC 312 (TCC) (for some flexibility?))
- 'Primarily' = more than 50%  
(CRA position)

### Qualified Small Business Corporation shares (ITA 110.6(1))

#### share of the capital stock

- owned by an individual (or more than one, if applicable) (other than a personal trust)
- at determination date = SBC test
- throughout the 24 months = Holding period test
- throughout the 24 months = Basic asset test or Modified asset test

## Qualified Farm or Fishing Property (QFFP)

### Definition of Qualified farm or fishing property (QFFP) (ITA 110.6(1))

#### share of the capital stock

- of an individual (other than a personal trust) at any time
- owned by an individual, spouse or common-law partner or partnership with them
- real or immovable property or a fishing vessel that was used in the course of carrying on a farming or fishing business in Canada
- a share of the capital stock of a family farm or fishing corporation
- an interest in a family farm or fishing partnership
- an eligible capital property acquired in the course of carrying on a farming or fishing business in Canada

## Timing and Criterias for Capital Gain Deduction for QSBC

	Determination Date
1) SBC test	
2) Holding period test	┌────────────────── 24 months ───────────────────┐
3A) Basic asset test 3B) Modified asset test	┌────────────────── 24 months ───────────────────┐

### 1) SBC Test

(at determination date)

<i>Ownership</i>	individual, individual's spouse or partnership related to individual (ITA 110.6(14)d))
<i>Corporation status</i>	CCPC
<i>All or substantially all (interpreted as 90%) of the FMV of assets (including unrecorded assets but excluding liabilities)</i>	<ul style="list-style-type: none"> <li>a) used principally in an active business earned on primarily (&gt;50%) in Canada by               <ul style="list-style-type: none"> <li>- the particular corporation</li> <li>- a corporation related to the particular corporation</li> </ul> </li> <li>b) shares or debt (of a SBC that was connected the particular corporation)</li> <li>c) a combination of (a) and (b)</li> </ul>

### 2) Holding Period Test

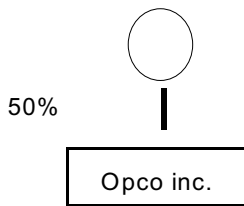
(24 months\*\* preceding the determination date)

owned by no one other than

- the individual
- a person or partnership related to the individual (ITA 110.6(14)c, d, e, f))

### 3A) Basic Asset Test

(24 months\*\* preceding the determination date)

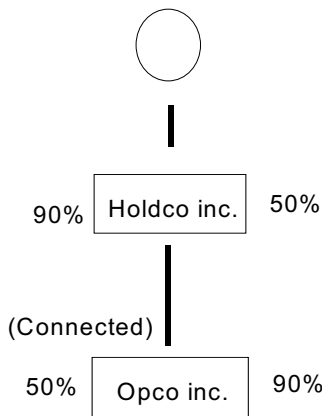


share of a CCPC for which more than 50% of the FMV of its assets were used principally in an active business carried on primarily (>50%) in Canada by

- the corporation
- a related corporation

### 3B) Modified Asset Test (Stacking Rule)

(24 months\*\* preceding the determination date)



a) both the parent and the connected corporation must each meet the 50% test

- own active business assets and
- shares or debt of a connected corporation

b) one (either the parent or the connected corporation) must meet the 90% test

- own active business assets and
- shares or debt of a connected corporation

more than 50% / 90% of the FMV of its assets were used principally in an active business carried on primarily on Canada

\*\* For deceased taxpayer:

Tests (12 months (instead of 24 months) preceding the determination date) (ITA 110.6(14)(g)) (immediately before the death of an individual)

### Eligible Taxpayer able to Claim the Capital Gain Deduction

- Individual resident in Canada throughout the year (ITA 110.6)
- Individual non-resident in Canada (deemed resident for CGD - ITA 110.6(5))
  - if resident in Canada part of the year in the taxation year
  - and resident in Canada throughout
    - the immediately preceding taxation year, or
    - the immediately following taxation year

## Calculation of Capital Gain Deduction

a) **Unused lifetime deduction in 20X1** (ITA 110.8(2.1(a)))

Lifetime cumulative deduction limit (*)			xxx
less: Prior years' deductions			
Capital gains deduction claimed		xxx	
less: Adjustment to 20X1 inclusion rate		(xxx)	(xxx)
Unused lifetime deduction in 20X1			<u>xxx</u>

b) **Annual gains limit for 20X1** (ITA 110.6(1))

Net TCG for 20X1 (adjusted for ABIL)			xxx
less: Net Capital Losses deducted in 20X1		(xxx)	
ABIL realized in 20X1		(xxx)	(xxx)
Annual gains limit for 20X1			<u>xxx</u>

c) **Cumulative gains limit for 20X1** (ITA 110.6(1))

Cumulative Net TCG			xxx
less: Cumulative Net Capital Losses deducted		(xxx)	
Cumulative ABIL realized		(xxx)	
Cumulative CG deductions		(xxx)	
Cumulative net investment loss (CNIL)			
Investment expenses			
Cumulative interest expenses	(xxx)		
Cumulative net rental losses	(xxx)		
Investment income			
Cumulative interest income	xxx	(xxx)	(xxx)
Cumulative gains limit for 20X1			<u>xxx</u>

d) **Capital gains deduction claimed in 20X1** (Lesser of (a), (b), (c))

xxx

## Planning - Crystallization of CGD

- Problem
  - possibility of losing the CG deduction
    - change in laws
    - corporation may not qualify in the future
- Solution
  - create a capital gain
    - selling some shares
    - transfer of shares to another corporation (regular transfer or rollover ITA 85)
    - transfer of shares in an estate freeze context
  - use the Capital gain deduction (CGD)
  - increase the ACB of the shares (in preparation of future disposition)

## Planning - Purification of a Corporation for CGD

- Problem = test of 50% not meet or test of 90% not meet  
= capital gain deduction not available
- Solution = transfer some assets to meet the tests
  - paying liabilities
  - distribution of cash (dividend, salary)
  - selling non-qualifying assets
  - reduction of PUC
  - transfer of assets to another corporation
  - purchase active business assets
  - giving charitable donations to registered charities
  - paying retiring allowance

## Other elements

- Possibility of application of Alternative minimum tax (AMT) with CGD
- Anti-avoidance rule QSBC (ITA 85(2.1))
- Capital gain deferral re small business investments (ITA 44.1)
  - for individual (not trust)
  - for qualifying disposition (eligible SBC share)
    - common share of an active business corporation
    - owned throughout the 185-day period that end immediately before disposition
  - if acquisition of replacement share (eligible SBC share)
    - within 120 days after the end of the year
    - designated to be replacement share
- Consider election ITA 48.1 when small business corporation (SBC) becomes public regarding deemed disposition and reacquisition for capital gain deduction purpose

## Cumulative Net Investment Loss (CNIL)

- Definition of “Cumulative net investment loss” (CNIL) (ITA 110.6(1))  
CNIL of an individual at the end of a taxation year means the amount, if any, by which
  - (a) the total of all amounts after 1987 of “investment expense” exceeds
  - (b) the total of all amounts after 1987 of “investment income”
- Definition of “Investment expense” (ITA 110.6(1))
  - all property expenses, including interest expenses (incurred or deemed)
  - certain specific expenses, including interest and some charges, deducted from the income of a partnership as a specified member (limited partner or not actively engaged)
  - losses incurred from a partnership as a specified member
  - limited partnership loss carryover deducted in the year (ITA 111(1)(e))
  - losses from all property, including net rental losses
  - net capital loss carryover deducted in the year on net taxable capital gains not eligible for capital gains deduction
- Definition of “Investment income” (ITA 110.6(1))
  - income from all property, including CCA recapture if on property
  - income from a partnership as a specified member
  - income from rental property, including CCA recapture
  - net taxable capital gains on certain property not eligible for capital gains deduction

## Intergenerational Business Transfer Framework

- Context  
“A genuine intergenerational share transfer would be a transfer of shares of a corporation (the Transferred Corporation) by a natural person (the Transferor) to another corporation (the Purchaser Corporation) where a number of conditions are satisfied.” (Federal Budget March 28, 2023, p.16)
- Issue  
unfortunate limitations of capital gains deduction for business transfer within a family
- Bill C-208 - June 29, 2021
  - facilitate intergenerational business transfers where ITA 84.1 inappropriately applied
- Budget March 28, 2023 (starting on January 1, 2024)
  - change to facilitate only where a genuine intergenerational business takes place
- Conditions of a genuine intergenerational share transfer (Budget March 28, 2023, p.17)
  - “each share of the Transferred Corporation must be a ‘qualified small business corporation share’ or a ‘share of the capital stock of a family farm or fishing corporation’, at the time of the transfer”
  - “The Purchaser Corporation must be controlled by one or more persons each of whom is an adult child of the Transferor (including grandchildren, step-children, children-in-law, nieces / nephews, grandnieces / grandnephews)
  - additional conditions (see Table A) Choice of one of two transfer options:
    - immediate intergenerational business transfer (three-year-test)
    - gradual intergenerational business transfer (five-to-ten-year-test) (estate freeze)

Table A - Additional conditions of a genuine intergenerational share transfer

Proposed conditions	Immediate Business Transfer (three-year test)	Gradual Business Transfer (five-to-ten-year test)
1) Transfer of Control of the Business	<p>Parents immediately and permanently transfer <b>both legal and factual*</b> control, including an immediate transfer of a majority of voting shares, and a transfer of the balance of voting shares within 36 months</p> <p>* Factual control means economic and other influence that allows for effective control of a corporation</p>	<p>Parents immediately and permanently transfer <b>only legal**</b> control, including an immediate transfer of a majority of voting shares (no transfer of factual control), and a transfer of the balance of voting shares within 36 months</p> <p>** Legal control generally means the right to elect a majority of the directors of a corporation</p>
2) Transfer of Economic Interests in the Business	<p>Parents immediately transfer a majority of the common growth shares, and transfer the balance of common growth shares within 36 months</p> <p>(It is expected that the transfers of legal and factual control as well as future growth of the business are sufficient to ensure the parents have transferred a substantial economic interest in the business to their child(ren).)</p>	<p>Parents immediately transfer a majority of the common growth shares, and transfer the balance of common growth shares within 36 months</p> <p>In addition, within 0 years of the initial sale, parents reduce the economic value of their debt and equity interests in the business to:</p> <p>(a) 50% of the value of their interest in a farm or fishing corporation at the initial sale time, or</p> <p>(b) 30% of the value of their interest in a small business corporation at the initial sale time</p>
3) Transfer of Management of the Business	<p>Parents transfer management of the business to their child within a reasonable time based on the particular circumstances (with a 36-month safe harbour)</p>	<p>Parents transfer management of the business to their children within a reasonable time based on the particular circumstances (with a 36-month safe harbour)</p>
4) Child Retains Control of the Business	<p>Child(ren) retains legal (not factual) control for a 36-month period following the share transfer</p>	<p>Child(ren) retains legal (not factual) control for the greater of 60 months or until the business transfer is completed</p>
5) Child Works in the Business	<p>At least one child remains actively involved in the business for the 36-month period following the share transfer</p>	<p>At least one child remains actively involved in the business for the greater of 60 months or until the business transfer is completed</p>

Source: Federal Budget March 28, 2023 (p.18)

## Appendix A Amount of Capital Gain Exemption / Deduction (CGE/CGD) - History

<i>Period</i>	QSBC Qualified Small Business Corporation shares		QFFP Qualified Farm or fishing property	
	<u>Exemption</u>	<u>* Deduction (½)</u>	<u>Exemption</u>	<u>* Deduction (½)</u>
since 1985	\$500,000	\$250,000	\$500,000	\$250,000
after March 19, 2007	\$750,000	\$375,000	\$750,000	\$375,000
in 2014 (indexed after)	\$800,000	\$400,000	\$800,000	\$400,000
in 2015 (QFFP: April 21)	\$813,600	\$406,800	\$1,000,000	\$500,000
in 2016	\$824,176	\$412,088	\$1,000,000	\$500,000
in 2017	\$835,716	\$417,858	\$1,000,000	\$500,000
in 2018	\$848,252	\$424,126	\$1,000,000	\$500,000
in 2019	\$866,912	\$433,456	\$1,000,000	\$500,000
in 2020	\$883,384	\$441,692	\$1,000,000	\$500,000
in 2021	\$892,218	\$446,109	\$1,000,000	\$500,000
in 2022	\$913,630	\$456,815	\$1,000,000	\$500,000
in 2023	\$971,190	\$485,595	\$1,000,000	\$500,000
in 2024 until June 24	\$1,016,836	\$508,418	\$1,016,836	\$508,418
in 2024 from June 25	\$1,250,000	\$625,000	\$1,250,000	\$625,000
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in 2026	\$1,275,000	\$637,500	\$1,275,000	\$637,500

\* Lifetime cumulative deduction limit

Deduction represent application of the (actual) inclusion rate on the exemption amount