Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Capital gains exemption on private shares

How you may be able to save over $300,000 in taxes on the sale of your business

If you're thinking about selling your business, you may be able to save a significant amount of tax by claiming the lifetime capital gains exemption (LCGE) if you're selling the shares of an incorporated business that are qualified small business corporation (QSBC) shares. This article describes how you may qualify for the LCGE and some of the factors you may need to consider when claiming the LCGE.

What is the LCGE?

The LCGE reduces or eliminates the taxable capital gains realized on the disposition of certain eligible property. Individuals who are residents of Canada may qualify for the LCGE on the disposition of QSBC shares. The LCGE limit is $1,275,000 for 2026 and is indexed annually.

To provide you with an idea of what the tax savings could be if you claim the LCGE, assume you sell the shares of your incorporated business today and can use an LCGE amount of $1,275,000 against the capital gains realized. If your marginal tax rate is 50%, you can potentially save over $300,000 in taxes by using the LCGE.

When can you use the LCGE?

Aside from a simple sale of the shares of your corporation, you may claim the LCGE in several situations:

- You implement an estate freeze of your incorporated business. An estate freeze may allow you to transfer the future growth of the company to other shareholders, usually family members. During the freeze, you may be able to crystallize the LCGE and increase the adjusted cost base (ACB) of your shares on a tax-deferred basis. Ask your RBC advisor for a separate article on estate freezes for more details.
- You transfer the shares of your corporation to other family members.

- Your corporation is taken over by way of a share purchase or merger with another Canadian or foreign corporation.
- On your death, capital gains are realized on the deemed disposition of the shares of your business.
- You sell certain other types of property, such as qualified farm or fishing property (QFFP).

Qualifying for the LCGE

To claim the LCGE, you must sell qualifying property. Qualifying property includes QSBC shares and QFFP. Although the definition of QSBC shares is quite complex, the general criteria for private company shares to qualify as QSBC shares are as follows (all must apply):

- At the time of disposition, the shares must be those of a Canadian-controlled private corporation.
- At the time of disposition, all or substantially all of the fair market value (FMV) of the assets in the corporation are used principally in an active business carried on primarily in Canada. The Canada Revenue Agency (CRA) generally takes the position that all or substantially all means 90% or more, and principally and primarily generally means more than 50%.
- During the 24 months prior to the disposition, the shares weren't owned by anyone other than you or a person or partnership related to you.
- During the 24 months prior to the disposition, while the shares were owned by you or a person or partnership related to you, more than 50% of the FMV of the assets must have been used in an active business carried on primarily in Canada.

Please note that shares you hold in a registered savings plan, such as a registered retirement savings plan (RRSP), don't qualify for the LCGE.

The criteria have been greatly simplified for the purposes of this article. You should speak with a qualified tax advisor to determine whether your private company shares qualify or could qualify as QSBC shares.

Purifying your corporation

If more than 10% of the FMV of the assets in your corporation aren't used in active business — for example, your corporation holds a substantial amount of portfolio investments — your private company shares won't qualify as QSBC shares. You may need to remove the assets that aren't used in your active business, or "purify" your corporation, prior to the disposition to ensure you can claim the LCGE. Speak with a qualified tax advisor to determine which assets you should remove from your corporation and how best to do so. Some common methods of purifying a company are:

If more than 10% of the FMV of the assets in your corporation aren't used in active business — for example, your corporation holds a substantial amount of portfolio investments — your private company shares won't qualify as QSBC shares.

Non-taxable methods

- Reduce liabilities — for example, repay shareholder loans or reimburse shareholders for business expenses paid by them
- Pay out capital dividends if there's a positive capital dividend account balance in the corporation
- Make return of capital payments to shareholders
- Reinvest surplus funds in your business, such as by purchasing active business assets

Taxable methods

- Pay salaries or bonuses
- Pay taxable dividends
- Sell passive assets to pay down debt or invest in active assets

Tax-deferred method

- Transfer passive assets to another corporation

What if you're not incorporated?

If you're a sole proprietor and you plan on selling your business, you may still be able to benefit from the LCGE. To claim the LCGE, you'll need to create a corporation and sell the shares of that corporation. If you transfer all or substantially all of your business assets into a corporation and immediately sell the shares of the newly formed corporation, you may be able to claim the LCGE. Speak to a qualified tax advisor if you're a sole proprietor and are planning to sell your business.

Past exemptions may impact your current situation

Prior to 1995, there were a number of different capital gains exemptions available. One of these exemptions was the $100,000 general capital gains exemption. This general exemption was available to all taxpayers on gains relating to the disposition of any kind of capital property, including public company shares, bonds, mutual funds, real estate, etc. This general exemption was eliminated in the 1994 federal budget. If you had any unused general capital gains exemption at that time, you could have made a special election on your 1994 income tax return to exempt up to $100,000 of capital gains accrued on any of your capital property. This election would have allowed

you to increase the cost base of your elected capital property. You can no longer make this election.

A $500,000 capital gains exemption continued to exist after February 22, 1994, which could only be used under certain circumstances — for example, on the disposition of QSBC shares. This is the same LCGE that exists today. The $500,000 LCGE was increased to $750,000 in 2007 and to $800,000 in 2014. It was indexed annually after 2014 until June 25, 2024. For dispositions on or after June 25, 2024, the government increased the LCGE to $1,250,000 and indexation resumed in 2026, leading to a limit of $1,275,000 for 2026.

If you used any of the capital gains exemptions in the past, you must reduce your available LCGE by that same amount. In addition, other reductions to the LCGE may occur as a result of claims for allowable business investment losses (ABILs) or certain other deductions, such as net investment losses. If you believe you qualify for the LCGE, speak with a qualified tax advisor to determine the amount you may qualify for.

Multiplying the LCGE and the tax on split income (TOSI) rules

It may be possible to multiply the LCGE on the sale of a single corporation. One way to achieve this is by placing private company shares in a family trust and naming various family members as beneficiaries of the family trust. Upon the disposition of the QSBC shares, any capital gains the trust realizes on the sale may potentially be allocated to the beneficiaries of the trust. The beneficiaries can use their LCGE to reduce or eliminate tax on the capital gains allocated to them.

Capital gains realized by a minor child on the sale of private company shares to a non-arm's length person may be subject to the TOSI rules, also known as the "kiddie tax" rules. Under these rules, the capital gain realized by a minor on the disposition to a non-arm's length person will be re-characterized as a dividend, subject to tax at the highest marginal rate for non-eligible dividends. As a result, the minor can't use their LCGE since the income is considered a dividend, not a capital gain. It's important to note that a minor can still use their LCGE against capital gains realized on a disposition of QSBC shares to an arm's length person, whether they hold the shares directly, or indirectly through a trust.

TOSI may also apply to certain types of income from a private corporation that's paid to an adult family member. However, TOSI doesn't apply to taxable capital gains realized from the disposition of QSBC shares.

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Alternative minimum tax (AMT)

AMT may impact your tax liability for the tax year in which you claim the LCGE. AMT aims to ensure that every Canadian individual pays a minimum amount of tax. The AMT calculation is based on an "adjusted taxable income" which seeks to remove the advantages of certain tax-preferential items such as capital gains. If the AMT calculated is greater than your regular tax liability, the AMT becomes your tax liability for the year. The difference between the AMT you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability when your regular taxes payable exceed your AMT. You should contact a qualified tax advisor to determine if the AMT will be a factor when you claim the LCGE. You can also ask your RBC advisor for a separate article on AMT for more information.

Plan in advance

It's important you plan well in advance of the sale or transfer of your business. As mentioned, there are a number of criteria that must be met for you to be able to claim the LCGE and you may need to implement certain planning strategies to qualify. Speak to a qualified tax advisor to determine if you can benefit from claiming the LCGE.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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