QSBC SHARES AND THE LIFETIME CAPITAL GAINS EXEMPTION

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QSBC SHARES AND THE LIFETIME CAPITAL GAINS EXEMPTION

A. Introduction

This paper was originally planned as a review of the conditions required for shares to be qualified small business corporation shares[1] ("QSBC shares") for the purpose of the lifetime capital gains exemption ("LCGE") in s. 110.6 of the *Income Tax Act*.[2] The announcement on July 18, 2017 of the proposals relating to the taxation of private corporations,[3] and in particular the proposals intended to constrain the use of strategies used to multiply the LCGE, put this topic in a fresh light. On the one hand, the effect of the proposals will be to reduce the overall significance of the LCGE, perhaps especially as it applies to QSBC shares. On the other hand, the inclusion in the proposals of transitional rules allowing taxpayers to continue to use the LCGE under the current rules for the balance of 2017 or to use the current rules for certain crystallizations and actual dispositions in 2018 makes it important that practitioners understand the rules so they can properly advise their clients between now and the end of 2018.

Accordingly, the purpose of this paper is to provide a reasonably thorough discussion of the July 18 proposals insofar as they relate to constraining the use of the LCGE before turning to a discussion of the requirements for QSBC shares. Consideration will be given to the transitional rules included in the July 18 proposals and to steps practitioners should consider carrying out in the remainder of 2017 or during 2018 to make the best use of the current provisions of the Act and the transitional rules. The paper is not intended to be a comprehensive review of all the issues that may arise in in connection with the LCGE or determining whether or not a share qualifies as a QSBC share.[4] As well, the paper will not cover the exemption as it relates to dispositions of "qualified farm or fishing property".

B. The Lifetime Capital Gains Exemption ("LCGE")

1. Summary of July 18 Proposals Relating to the LCGE

The capital gains exemption under the Act allows an individual other than a trust who was resident in Canada throughout a taxation year to shelter certain gains from the disposition of certain qualified small business corporation shares, or qualified farm or fishing properties in the year or a

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[1] The definition "qualifying small business corporation share" is contained in s. 110.6(1) of the Act. They will sometimes be referred to in this paper as "QSBC shares".
[2] *Income Tax Act*, R.S.C. 1985, c. 1(5th Supp.), as amended (the "Act")
[3] The Legislative Proposals Relating to the Income Tax Act and the Income Tax Regulations, Explanatory Notes and Consultation Paper are collectively referred to in this paper as the "July 18 Proposals". For ease of readability the legislative proposals will be discussed on the assumption that they will be enacted as proposed, except where specific mention is made of changes that should be considered.
[4] For a more detailed discussion of the capital gains exemption, see Craig K. Hermann, "The Capital Gains Exemption: a Comprehensive Review," in *Report of Proceedings of the Fifty-Second Tax Conference* (Toronto: Canadian tax foundation, 2000), 29:1-59. For a recent discussion on QSBC shares, see Matthew Mammola and Jacob Youn, "The Capital Gains Exemption: Selected Planning Issues Related to Qualified Small Business Corporation Shares," (2017) 65:1 *Canadian Tax Journal* 191-213.

preceding year. The deduction is subject to a cumulative lifetime limit. For 2017, the exemption limit will allow such a taxpayer to shelter up to $835,716 of gains on QSBC shares (and $1,000,000 on a qualified farm or fishing property). Because the exemption actually operates as a deduction in computing taxable income, the maximum deduction in computing taxable income in 2017 is actually $417,858.[5] The amount is indexed to inflation and adjusted annually.

Understanding the definition “qualified small business corporation share” has always been critical to making a proper claim of the capital gains exemption. Although there are number of traps for the unwary which can limit access to the LCGE, until this year it was generally correct to say that if a taxpayer had disposed of a QSBC share in the taxation year, the taxpayer should be able to claim the exemption in computing his or her income for the year. Similarly, if a personal trust or employee share ownership trust had disposed of a QSBC share in the year, allocated the proceeds[6] to the taxpayer and made the appropriate designations in its T3 Trust Tax and Information Return for the year, the taxpayer would be deemed to have disposed of the share for purposes of the LCGE rules and would be able to use the exemption to shelter the gain.[7] However, under the July 18 Proposals a number of new restrictions on the availability of the exemption will be introduced. These restrictions will be applicable for the 2018 and subsequent taxation years. However, the proposals also include transitional rules under which the current rules may be applied to certain elective crystallizations and actual dispositions in 2018.

Under the July 18 Proposals, the LCGE will no longer be available for:

1. Gains accrued or realized before the end of the year in which the individual claiming the exemption turned 17

2. Gains that are included in the split income of the taxpayer reporting the gain

3. Gains accrued on property while it is held by a trust (other than a spousal trust, alter ego trust, joint spousal or common-law partner trust or so-called self-benefit trust), whether the gains are realized by the trust and allocated to a beneficiary, or by the beneficiary after the property has been rolled out to the beneficiary.

These changes will be implemented by amending s. 104(21.2) to provide that only an eligible LCGE trust may make a designation in respect of the gain from the disposition of a qualified small business corporation share or farm or fishing property, and by introducing several new subsections in s. 110.6 which will reduce the amount that can be deducted by an individual under the LCGE.

The effect of these restrictions will be to make the LCGE unavailable to most taxpayers, except adults who are either (1) active in the business giving rise to the gain that is the subject of the exemption, or (2) are not related or otherwise connected to an individual who is active in that business.

[5] This is a bit of an oversimplification as s. 110.6 includes complex rules adjusting the amount for differences in the capital gains inclusion rate over the years.
[6] That is, actually paid the taxable portion of the proceeds to the taxpayer, or made them payable to the taxpayer.
[7] Act, s. 104(21.2). These rules were discussed by Mammola and Youn in “The Capital Gains Exemption: Selected Planning Issues Related to Qualified Small Business Corporation Shares”, *supra* fn. 4, at pp. 198-200

2. New Definitions in s. 110.6

Subsection 110.6(1) will be amended by the introduction of definitions for the new terms "eligible employee beneficiary" and "eligible LCGE trust". It will make sense to discuss these definitions in the reverse order – that is beginning with the definition "eligible LCGE trust".

In concept, a trust will be an "eligible LCGE trust" if it is either a life interest trust that qualifies as a personal trust (referred to in this paper as '*qualifying beneficiary trust*') or an employee share ownership trust referred to in s. 7(2) that holds shares of a corporation for arm's length employees (referred to in this paper as an '*employee share ownership trust*').

A '*qualifying beneficiary trust*' for a taxation year will be a trust that meets the following conditions:

1. The trust is

   (a) throughout the relevant year a personal trust, and

   (b) a trust for which a day is to be determined under s. 104(4)(a), (a.1) or (a.4) by reference to the death or later death of an individual (referred to in this paper as a '*qualifying beneficiary*') - essentially a spousal trust, alter ego trust, joint spousal or common-law partner trust, or so-called self-benefit trust (and referred to in this paper as a '*life interest trust*').

2. The trust has not in the trust year distributed property on a rollover basis to any person other than a *qualifying beneficiary*, and

3. The trust has not in the trust year designated any capital gains to a beneficiary other than a *qualifying beneficiary*.

Note that there is no provision in the proposed rules for trusts for orphaned minors (such as in the rules relating to principal residences, or as contemplated by the definition "excluded amount" in s. 120.4). The policy reason for this omission is not obvious.

An '*employee share ownership trust*' for a taxation year of the trust will be a trust that meets the following conditions:

1. The trust is throughout the trust year a trust referred to in s. 7(2) that holds shares of a corporation (the "*issuer corporation*").

2. The trust has not in the trust year rolled property to a beneficiary other than shares of the *issuer corporation* to an *eligible employee beneficiary*.

3. The trust has not in the trust year allocated a capital gain to any person other than a person who is an *eligible employee beneficiary* in respect of the issuer corporation and the trust.

An individual other than a trust will be an "eligible employee beneficiary" if the individual is not a trust and:

1. The individual's interest as a beneficiary was acquired by the individual (a) because of the individual's employment with, and (b) in connection with, a stock option agreement to acquire shares of the issuer corporation or a corporation with which it does not deal at arm's length.

2. The individual is not at any time at or before that time

   (a) a specified employee of, or a connected individual in respect of the corporation or any corporation with which the corporation does not deal at arm's length, or

   (b) related to an individual described in subparagraph (i), or a specified shareholder of a corporation referred to in clause (i)(A) or (B).

For the purpose of this rule, the term "related" will have the extended meaning given to that term in s. 120.4.[8] That is, a person will be related to each aunt, uncle, niece or nephew and to a trust with which the individual does not deal at arm's length.[9]

3. Amendment to s. 104(21.2)

With an understanding of the new definitions "eligible LCGE trust" and "eligible employee beneficiary", one can understand the proposed amendments to s. 104(21.2). Currently, s. 104(21.2) deems a beneficiary to whom a gain from the disposition of LCGE eligible property has been allocated by a trust to have disposed of the particular property for purposes of s. 110.6. It applies where "a personal trust or a trust referred to in subsection 7(2)" designates net taxable capital gains to a beneficiary. Subsection 104(21.2) will be amended so it applies only for a trust that is an "eligible LCGE trust" for a taxation year. In effect, a beneficiary of a trust will only be able to use the LCGE to shelter capital gains on shares held by a trust if the trust is a *life interest trust* or an *employee share ownership trust*. This will eliminate the ability to proliferate the capital gains exemption by having a trust allocate realized capital gains to multiple beneficiaries in the year the gains are realized.

4. New ss. 110.6(12) and (12.1) - Restrictions on the Availability of the LCGE

The availability of the LCGE will also be restricted by new ss. 110.6(12) and (12.1). This subsection will reduce the amount that may be deducted by an individual under s. 110.6 in computing the individual's taxable income for a taxation year in respect of the individual's capital gain for the year from the disposition of any property (such property is referred to in ss. 110.6(12) and (12.1) as the "disposition property"). The following gains will be affected:

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[8] Act, s. 110.6(1, definition "eligible employee beneficiary", subparagraph (b)(ii)
[9] Act, s. 120.4(1.1)

1. Gains realized by the individual before the end of the year in which the individual turns 17;[10]

2. Gains allocated to the individual under s. 144(4) by an employees profit sharing plan;[11]

3. Gains accrued before the end of the year in which the individual turned 17;[12]

4. Gains that are included in para. (e) of the definition "split income";[13]

5. Gains that accrued while property was held in a trust other than an LCGE trust;[14] and

6. Gains on property that are indirectly attributable to property acquired from a trust on a tax-deferred basis[15].

It appears that s. 110.6(12) includes a drafting error - actually six of them. Section 110.6 provides for a deduction in computing taxable income, which includes only the taxable portion of capital gains. The language in s. 110.6(12) will reduce the amount that may be deducted in computing taxable income by the full amount of the restricted gain – *i.e.* twice the taxable portion.[16] There is no good reason that the deduction in computing taxable income should be reduced by twice the amount of the offending taxable amount.

Each of the restrictions set out in s. 110.6(12) is discussed in turn below.

(a) Paragraphs 110.6(12)(a) and (c) (with s. 110.6(12.1)(a)) serve a similar purpose, which is to deny the availability of the capital gains exemption in respect of gains that accrue to or are realized by a minor. Specifically, s.110.6(12)(a) operates to prevent an individual from using the LCGE to shelter gains that are realized before the end of the year in which the individual turns 17. The "relevant conditions" for the application of s. 110.6(12)(c) are set out in s. 110.6(12.1)(a). These two paragraphs work together to prevent an individual from using the LCGE to shelter gains that have accrued before the end of the year in which the individual turns 17 but are realized in a subsequent year. It appears that neither s. 110.6(12)(a) nor (c) will require a reduction for an individual who disposes of a QSBC share a particular time if the individual was 17 at the beginning of the year including that time and dies after the particular time and before attaining the age of 18, but this small gap does not present much in the way of planning opportunities. It is likely that in most such instances the reduction in subparagraph (d) would apply in any event.

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10 Act, s. 110.6(12)(a)
11 Act, s. 110.6(12)(b).
12 Act, s. 110.6(12)(c) and (12.1)(a)
13 Act, s. 110.6(12)(d)
14 Act, s. 110.6(12)(e) and (12.1)(b)
15 Act, s. 110.6(12)(f) and (12.1)(c)
16 Paragraphs (a) and (b) refer to the "amount of the capital gain"; paragraphs (c), (e) and (f) generally refer to the amount by which the fair market value of the disposition property exceeds its cost, and paragraph (d) refers to "twice the amount of the individual's taxable capital gain".

(b) Paragraph 110.6(12)(b) applies to gains allocated to an individual under s. 144(4) by an employees profit sharing plan. Subsection 144(4) provides that capital gains and capital losses that are allocated to a beneficiary under an employees profit sharing plan retain their character as capital gains and capital losses in the hands of the beneficiaries to whom they are so allocated, and that for the purpose of s. 110.6 such gains will be treated as gains in the hands of the employee beneficiary from the disposition of the relevant property. It will be amended to no longer apply for the purpose of s. 110.6. However, this will not necessarily preclude the use of the LCGE to shelter gains realized by an employees profit sharing plan on the disposition of a QSBC share. An employees profit sharing plan that is an eligible LCGE trust will still be able to designate capital gains to its employee beneficiaries under s. 104(21.2), subject to the requirements under that subsection.[17]

(c) Paragraph 110.6(12)(d) applies to gains that are included in the split income of an individual who has attained the age of 17 before the year under paragraph (e) of the definition "split income". For this purpose, the individual's split income is to be determined without regard to s. 120.4(1.1)(e)(i), which deems an individual's split income for the year to be nil where the individual is otherwise subject to tax at the top marginal rate (*i.e.* even without the inclusion of the split income). The reduction under this subparagraph will apply to gains from the disposition of QSBC shares, shares of the capital stock of a family farm or fishing corporation and (if the conditions in subclause (e)(ii)(B)(II) are met) an interest in a family farm or fishing partnership, unless they are an "excluded amount"[18] and thus not split income. Gains from the disposition of qualified farm or fishing property that is not a share of the capital stock of a family farm or fishing corporation or an interest in a family farm or fishing partnership will not be subject to the exclusion in s. 110.6(12)(d) because they are not included in paragraph (e) of the definition "split income".

As is mentioned above, it appears there is a drafting error in this paragraph, in that it reduces the amount that may be deducted in computing taxable income by *twice* the amount of the offending taxable capital gain. However, there is a second error, such that even where a portion of the taxable capital gain is an excluded amount (and thus not split income), the individual may not be able to shelter that portion of the gain with the LCGE. Consider the examples in Table 1 below, which illustrates the consequences of realizing capital gains on the disposition of QSBC shares in amounts of $835,716, $1 million and $2 million In each case, one-half of the gain is assumed to be a reasonable return on the shares, such that one-half of the taxable capital gain will be considered an excluded amount and thus not split income, while the other half of the taxable capital gain will be (or would be, but for s. 120.4(1.1)(e)(i)) included in computing split income. Assume as well that s. 110.6(12) will be corrected to delete the word "twice". Paragraph 110.6(12)(d) appears to operate as intended for gains of up to $835,716 (*i.e.* twice the

[17] Explanatory Notes, pp. 28-29

[18] The expression "excluded amount" is defined in s. 120.4(1) and for this purpose will be an amount that is not a "split portion", as defined in s. 120.4(1). A full discussion of these concepts and the TOSI rules in general is beyond the scope of this paper is beyond the scope of this paper, but will be covered by David Badalucco and James Radelet in a separate paper for this conference.

individual's annual gains limit for the year). However, where the gain exceeds that amount, the effect of the reduction under s. 110.6(12)(d) will be to grind the amount that one would think should be deductible in respect of the portion of the taxable capital gain that is not included in split income. The impact of this error will accelerated if the word "twice" is not removed from the provision.

Table 1 - Application of Proposed s. 110.6(12)(d)

(Assumes amendment to delete word "twice")

Assumptions			
Gain from Disposition of QSBC Shares	835,716	1,000,000	2,000,000
Resulting Taxable Capital Gain	417,858	500,000	1,000,000
Current Rules			
Amount Currently Deductible Under Current s. 110.6(2.1)	417,858	417,858	417,858
Taxable Income		82,142	582,142
Effect of Proposed Amendments			
"Reasonable Return" on Shares	417,858	500,000	1,000,000
Excluded Amount included in Taxable Capital Gain	208,929	250,000	500,000
Amount From Disposition To Be Included in Split Income	208,929	250,000	500,000
Amount Deductible Under s. 110.6(2.1) before applying (12)	417,858	417,858	417,858
Reduction in Amount that Can be Deducted under s. 110.6(2.1)	208,929	250,000	500,000
Amount Deductible Under s. 110.6 after applying (12)	208,929	167,858	
Taxable Income	208,929	332,142	1,000,000

(d) The relevant conditions for the application of s. 110.6(12)(e) are set out in s. 110.6(12.1)(b). The two paragraphs work together to prevent an individual from using the LCGE to shelter gains that have accrued on a disposition property while it was held in a trust where the property is rolled out to a beneficiary under s. 107(2)(b) of the Act after 2017 and subsequently disposed of by the beneficiary. It does not apply where the trust was an eligible LCGE trust for its taxation year in which the property was distributed, so it will still be possible for an individual to claim the LCGE in respect of gains accrued on a share while it was held in an eligible LCGE trust. As well, it will not apply to a property that was held in a trust before 2018, but rolled to the beneficiary before 2018.

(e) The relevant conditions for the application of s. 110.6(12)(f) are set out in s. 110.6(12.1)(c). The two paragraphs appear to operate together as a form of antistuffing rule.[19] Paragraph 110.6(12.1)(c) states that the relevant conditions for the application of s. 110.6(12)(f) are as follows:

(i) a person or partnership either:

(A) acquires a property other than the disposition property (the "distributed property") from a trust after 2017 on a tax deferred rollover basis under s. 107(2)(b); or

(B) holds an interest as a beneficiary under a trust that holds a property other than the distribution property, if the person or partnership's rights under the trust are affected by the exercise or failure to exercise a discretionary power (a "decision") in respect of a distribution from the trust after 2017, and the fair market value of the interest increases as a result;

(ii) the fair market value of the disposition property (i.e. the QSBC share) increases as a result of the acquisition in clause (A) or the decision in clause (B);

(iii) the disposition of the disposition property and the acquisition or decision referred to subparagraph (i) occur as part of the same series of transactions or events; and

(iv) The disposition of the disposition property occurs before any other disposition of that property at fair market value after the acquisition or decision referred to in subparagraph (i).

Clause (A) could apply would be where a trust distributes property on a rollover basis to a corporation which is a beneficiary of the trust, with the result that the value of the beneficiary corporation's shares is increased.[20] If an individual who holds QSBC shares of the beneficiary corporation disposes of those shares of as part of the same series of transaction or events as the distribution from the trust to the beneficiary corporation,[21] s. 110.6(12)(f) will reduce the amount that can be claimed by the individual under s. 110.6 in respect of that disposition by the amount by which the value of any shares in the beneficiary corporation held by the individual increased as a result of the distribution.

Clause (B) could apply in a similar situation, except that instead of the property being actually distributed to the corporation, the trustee of the trust merely exercises a discretion (in a manner that binds the trust) to make the property distributable to

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[19] The explanatory notes state that this rule intended to prevent the LCGE from being claimed in respect of property the value of which is derived from a trust, or from a non-taxable transfer of value to a beneficial interest in a trust. However, they are frustratingly unhelpful and provide no examples.
[20] Thus satisfying the condition in s. 110.6(12.1)(c)(ii)
[21] Thus satisfying the conditions in ss. 110.6(12.1)(c)(iii)

the corporation. The value of the corporation's interest in the trust will presumably increase as a result of that decision,[22] so the condition in clause (B) will be satisfied. Again, if an individual who holds QSBC shares of the beneficiary corporation disposes of those shares as part of the same series of transactions or events as the distribution from the trust to the beneficiary corporation,[23] s. 110.6(12)(f) will reduce the amount that can be claimed by the individual under s. 110.6 in respect of that disposition. The reduction will be equal to the amount by which the value of the QSBC shares in the beneficiary corporation held by the individual increased as a result of the decision to make the distribution.[24]

These rules apply only where the offending transfer from a trust, or trustee's decision, takes place after 2017.

Paragraph 110.6(7)(b) of the Act provides that no deduction is permitted under s. 110.6 in respect of a capital gain if the gain is from the disposition of property as part of a series of transactions or events in which property is acquired by a corporation or partnership for consideration that is significantly less than its fair market value at the time. However, it includes an exception for an acquisition that is a distribution of property of a trust in satisfaction of all or part of a corporation's capital interest in a trust. If ss. 110.6(12)(f) and (12.1)(c) are enacted in the form proposed form, the relevance of this exclusion in s. 110.6(7)(b) will be significantly reduced.

Subsection 110.6(12) contains rules to prevent amounts that are described in more than one of the limitations from being double-counted in reducing the amount of the LCGE that can be claimed by an individual in a year. Thus, for example gains realized on the disposition of a QSBC share by an individual who received them from a trust under which he or she was a beneficiary may have accrued while the share was held in the trust and the beneficiary was a child. In such a case, the reduction for gains accrued while the share was held in a trust in paragraph (e) would not apply to the extent it was included in the amount determined under paragraph (c) for gains accrued before the year in which the individual turned 18.

5. Transitional Rules - General

Under new ss. 110.6(18) and (18.1), individuals and trusts may be able to elect a deemed disposition of eligible property in 2018. Where an election is made, the current rules applicable to claims under the LCGE will apply and the new ones will not.[25] The election will not be available

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[22] Generally, in such a situation, one would assume that until the trustee exercised the discretion to make the distribution, the corporation's interest had little or no value, but once it had acquired the right to a distribution under the trust, the value of the interest increased.
[23] Thus satisfying the conditions in ss. 110.6(12.1)(c)(iii)
[24] The reduction in the amount that can be deducted should be half of this amount, to reflect the taxable portion.
[25] Similarly, the current rules relating to the tax on split income ("TOSI") under s. 120.4 will apply and the new ones will not.

in respect of shares[26] where the electing taxpayer is an individual who has not turned 17 before 2018, or a trust which will allocate any part of the resulting gain to such an individual.[27]

Where a valid election is made, the 24-month eligibility periods in the definitions "interest in a family farm or fishing corporation", "share of the capital stock of a family farm or fishing corporation" and "qualified small business corporation share" in s. 110.6 will be reduced to 12 months.[28]

Although the mechanics for making the election will look familiar to a practitioner who remembers the rules for making elections effective on February 22, 1994, the conditions for making the election are not quite the same and should be learned from the beginning.

6. Transitional Rules - Definitions

It is easiest to begin with a summary of some new definitions that will be introduced in s. 110.6(1). An "eligible taxpayer", for a taxation year, will be an individual (other than a trust), or a trust that is throughout the year a personal trust or employee share trust. The eligible taxpayer will be able to make the election effective on any day in 2018, which day is defined as the "disposition day"; the election will be effective at the beginning of that day, and that time is defined as the "disposition time". The taxation year of the eligible taxpayer that includes the disposition day will be the taxpayer's "election year".

The election can only be made in respect of an "eligible property" of a taxpayer.[29] To be an eligible property of a taxpayer, a property must satisfy the following tests:

1. It cannot be property in respect of which any of ss. 74.2, 74.3, 75 and 75.1 apply.

2. It must be owned by the taxpayer continuously from the end of 2017 until the end of the taxpayer's disposition day.

3. It must be capital property of the taxpayer at the taxpayer's disposition time.

4. It would be, at the taxpayer's disposition time, either a qualified farm or fishing property or a qualified small business corporation share of the taxpayer, if the 24/12 month periods referred to in the definitions "interest in a family farm or fishing corporation", "share of the capital stock of a family farm or fishing corporation" and "qualified small business corporation share" in s. 110.6 were read as references to 12 month periods.

These requirements mean that it will not be possible to make an election in respect of certain property that would normally be eligible for LCGE treatment. For example, a property will be an eligible property only where it is owned by the eligible taxpayer making the election continuously

[26] This exclusion will apply to both QSBC shares and shares of the capital stock of a family farm or fishing corporation.
[27] However, new s. 110.6(30.1) will provide similar relief where an individual or a trust of which the individual is a beneficiary actually disposes of a share in 2018 and the individual has not turned 17 before 2018. This section is discussed in more detail below.
[28] Similar adjustments are made for the 24/12 month periods provided for in ss. 110.6(1.3)(a)(ii)(B) and (ii)(B).
[29] As defined in s. 110.6(1).

from the end of 2017 until the end of the taxpayer's disposition day. Although the applicable holding period will be shorter than the general rule, the ownership requirement will be more rigourous than it is under the general rule, which allows a QSBC share to have been owned by a related person (or not at all, in the case of certain treasury shares) during the applicable holding period. Further, as will be discussed later in this paper, the QSBC share definition allows an individual to claim the LCGE in respect of shares that are disposed of by a person who is the individual's spouse or common law partner, or a partnership related to the individual. However, this will not be permitted on an election due to the exclusion of property that is subject to any of the attribution rules in ss. 74.2, 74.3, 75 and 75.1 and the requirement that the property have been owned by the taxpayer making the election. The explanatory notes do not provide a reason for this limitation. One might speculate that it is a response to perceived abuses of the allowance for spouses and common-law partners in the QSBC share definition such as the use of so-called half-loaf strategies. However, it is not difficult to conceive of situations in which the rule could produce an unfair result.

Whatever the reason for these restrictions, the important thing for practitioners to note is that care must be taken to ensure an eligible property is owned by the appropriate taxpayer no later than the end of 2017 if an election is to be made in respect of it.

Another inequity may arise where a taxpayer dies unexpectedly in 2018. Paragraph 110.6(14)(g) is a relieving provision that deems a share that was owned by a deceased taxpayer at the time of death to have been a QSBC share at the time of death if (1) the share would have been a QSBC share at the time of death, but for the fact that it was not at that time a share of a small business corporation, and (2) it was a share of a small business corporation at any time within the 12-month period immediately preceding the death. It does not appear that this relieving provision can apply in the context of an election under s. 110.6(18). Consideration should be given to making this relieving provision available where a taxpayer's disposition day is the day of the taxpayer's death in 2018.

7. Transitional Rules – Making the Election

The actual election is made under s. 110.6(18). An eligible taxpayer may make the election in respect of an *eligible property* of the taxpayer if the following conditions are met:

1. If the taxpayer is not a trust:

    (a) the election must result in an increase in the amount deductible in computing the taxpayer's income for the year under ss. 110.6(2) to (2.2), and

    (b) If the taxpayer has not turned 17 before the year, the property is not a share[30]

2. If the taxpayer is a trust:

[30] As is mentioned above and will be discussed in more detail below, a different transitional rule applies for actual dispositions of shares by such taxpayers.

(a) It must be reasonable to conclude that the resulting taxable capital gain will be included in the income of one or more individual beneficiaries each of whom was:

(i) A beneficiary under the trust continuously from the end of 2017 to the end of the disposition day, and

(ii) resident in Canada throughout his or her taxation year in which the trust's election year ends;

(b) If any such beneficiary has not turned 17 before the year, the property cannot be a share; and

(c) If the trust is governed by an employees profit sharing plan, the trust does not make an election under s. 144(4.2) in respect of the property.

An election under s. 110.6(18) must:

1. be made an eligible taxpayer in prescribed form and manner[31];

2. be filed on or before the balance-due day for the taxpayer's election year;

3. identify the disposition day and include a description of the property; and

4. if it is made by a trust, include the name, address, SIN or TIN of each beneficiary under the trust in respect of which (A) an amount is designated by the trust under s. 104(21) or (B) to whom property has been rolled out under s. 107(2) in the year.

Subsection 110.6(18.1) sets out the consequences of a valid election. The basic consequences will be as follows:

1. The electing taxpayer will be deemed to have disposed of the eligible property for proceeds of disposition equal to the greater of the designated amount and the adjusted cost base to the taxpayer of the property immediately before the disposition time.[32]

2. Subject to certain rules applicable to excess elections (discussed below), the taxpayer will be deemed to have reacquired the property at the designated amount.[33]

3. The old TOSI rules will apply (and new ones will not) and, if the election is made by a trust, the trust will be deemed to be an eligible LCGE trust for the year.[34]

[31] No prescription has yet been made in this regard.
[32] Act, s. 110.6(18.1)(a)(i)
[33] Act, s. 110.6(18.1)(a)(ii)
[34] Act, ss. 110.6(18.1)(d) and (e)

4. For the purpose of determining whether the eligible property is qualified farm or fishing property or a qualified small business corporation share of the taxpayer, the references to “24/12 months” in the definitions of those terms will be read as “12 months”.[35]

In applying these consequences, income under s. 7 (stock options) and s. 35 (prospector/grubstaker shares) will be deemed not to have been received and will be carved out for purpose of computing the gain. This will allow a taxpayer to elect to crystallize an accrued capital gain on such a share without having to recognize the income inclusion that would normally be triggered by a disposition of the share.[36] As well, if the eligible property is a partnership interest, adjustments will be made in respect of any income or loss for the current fiscal period that is reflected in the value of the partnership interest but that would not otherwise be reflected in the adjusted cost base of the interest until the end of the period.[37]

Care should be taken not to designate an amount that that is too high. If the designated amount exceeds the fair market value of the eligible property, the proceeds of disposition will be deemed to be the designated amount, so the taxpayer making the election will be using LCGE room (or paying tax) on a non-existent gain.[38] However this will not be offset by a higher cost base that can be used to advantage on a future disposition since the deemed reacquisition cost will never exceed fair market value, and may be less. If the designated amount is not more than 110% of the fair market value, the cost of the eligible property to the electing taxpayer will be the fair market value of the eligible property.[39] The consequences are worse if the designated amount is more than 110% of the fair market value.[40] First, the reacquisition cost to the electing taxpayer will be subject to an a grind equal to the amount by which the designated amount exceeds 110% of fair market value[41], and can even be a negative amount where the excess amount is greater than the fair market value of the eligible property.[42] Second, the taxpayer will not be permitted to revoke the election.

Given the potentially significant adverse consequences of getting the value wrong, and the inherent uncertainty of fair market value in a crystallization transaction where there is not actual transaction, consideration should be given to obtaining a valuation of the eligible property where an election under s. 110.6(18.1) is being considered.

Subsection 84.1(2.01) of the Act sets out certain deeming rules that are relevant in calculating so-called “soft cost base” under s. 84.1(2)(a.1). Under s. 84.1(2.01)(b), a taxpayer who is deemed to have reacquired a share as a result of an election under s. 110.6(19)(a) is deemed to have acquired the share at the beginning of February 23, 1994 from a person with whom the taxpayer was not dealing at arm's length. This was intended to ensure that the cost base resulting from a s. 110.6(19) election was soft cost base for the purpose of s. 84.1. The Proposals do not include an equivalent

[35] Act, s. 110.6(18.1)(f) and (g)
[36] Act, s. 110.6(18.1)(b)
[37] Act, s. 110.6(18.1)(c)
[38] Act, s. 110.6(18.1)(a)(i)
[39] Act, s. 110.6(18.1)(a)(ii)
[40] Special rules apply for an interest in a partnership that has a negative adjusted cost base at the disposition time: Act, s. 110.6(28)(a)
[41] Act, s. 110.6(18.1)(a)(ii)
[42] Act, s. 110.6(18.1)(a)(h)

for elections made under s. 110.6(18) because the amendment to s. 84.1 in the July 18 Proposals will make it unnecessary. The rules for computing a taxpayer's cost base in s. 84.1(2)(a.1) will apply to acquisitions from any person rather than only persons with whom the acquirer is dealing at arm's length, and s. 84.1(2)(a.1)(ii) will reduce the taxpayer's adjusted cost base for the purpose of s. 84.1(2)(a.1) by the amount of any gain in respect of a disposition "by the taxpayer or an individual with whom the taxpayer did not deal at arm's length".

8. Phantom Income – The Need to Allocate the Deemed Taxable Capital Gain

It is important to note that the transitional rules do not obviate the need for a trust that makes an election to pay or make payable to a beneficiary under the trust who is an individual (other than a trust) the taxable portion of the resulting capital gain in the same year so that the beneficiary can claim the LCGE. If the trustee does not make do so, the taxable capital gain resulting from the disposition will be taxed in the trust, which cannot itself claim the LCGE to shelter the gain.[43] Canada Revenue Agency has expressed the view that a deemed capital gain is not regarded as income or capital (and is a "nothing") for trust law purposes and that to make the deemed taxable capital gain payable to a beneficiary the terms of the trust must specifically permit an amount equivalent to the deemed taxable capital gain to be paid or payable, or the trustee must have the discretionary power to pay out amounts that are defined as income under the Act. Where the trust is discretionary, the trustees must exercise their discretion to make the deemed taxable capital gain payable before the end of the trust's taxation year (*i.e.* its election year) and the exercise must be irrevocable with no conditions attached to the beneficiary's entitlements to enforce payment of the amount in the year. Furthermore, the beneficiary must be advised before the end of the trust's taxation year. The trustees' exercise of discretion and notification to the beneficiary should be in writing, for example in a resolution signed by the trustees or in minutes of a trustees' meeting. Where a trust is non-discretionary, the trust indenture must provide that the amount equivalent to the deemed taxable capital gain is to be paid or payable to the beneficiaries by the end of the trust's taxation year.[44]

Another approach is to make a distribution in kind of the property in respect of which the election is made. In that case, CRA says that the resolution authorizing the distribution should indicate that the payment is in respect of the amount of the deemed taxable capital gain and not in satisfaction of a beneficiary's capital interest in the trust. Where the fair market value of the property distributed in-kind exceeds the amount of the deemed taxable capital gain, the difference would represent a distribution in satisfaction of the beneficiary's capital interest in the trust as contemplated under subsection 107(2) assuming the conditions in that provision are otherwise met and no other trust income is being distributed.[45]

9. Filing, Amending and Revoking the Election

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[43] Act, s. 104(24). Until 2016, s. 110.6(12) provided an exception allowing spousal trusts to claim the LCGE in respect of gains triggered by the deemed disposition on the death of the spouse under s. 104(4)(a) or (a.1). This relieving rule was repealed in connection with the introduction of amendments to s. 104 which were initially crafted to cause the gain to be allocated to and taxed in the hands of the spouse. However, when those amendments were reversed to put the gain back into the

[44] CRA Views Doc. 2016-0634921C6 [2016 STEP Round Table, Q. 12]

[45] *Ibid.*

Subject to certain restrictions, an election may be revoked, late-filed, or amended at any time before 2021.[46] Where trust files a revocation, late election or amended election, it must be filed with a prescribed form amending the trust's tax return for its election year and include an election for the revocation, amendment or late-filed election, as the case may be, to apply, made jointly made with each beneficiary in respect of whom a net taxable capital gain of the trust is or was designated under s. 104(21), both prior to the filing and as a result of the filing. This appears to be without regard to whether the amount designated to the beneficiary was in respect of the eligible property, or whether the beneficiary actually claimed or will claim the LCGE in respect of the gain.[47]

A late-filed or amended election must be accompanied by a penalty calculated as 1/3 of one percent of the taxable capital gain resulting from the election for each month or part month that the late-filed or amended election is made after the balance due day of the taxpayer making the filing. The penalty is computed on a property-by-property basis and the penalty on the increase in the designated amount on one property will not be offset by a revocation or another election or a decrease in the designated amount of another property.[48]

Based on the 2017 maximum capital gains limit of $417,858 (or $500,000 for farming and fishing property), the maximum penalty is $1,392.86 per month ($1,666.67 per month for farming or fishing property) and the effective maximum penalty for an individual filing in December 2020 would be $27,857.20 ($33,333.40 for farming or fishing property). As is illustrated in the following table, this will be the highest penalty for a late-filed election under any provision of the Act:

[46] Act, ss. 110.6(25) – (27)
[47] Act, s.110.6(28.1)
[48] Act, s. 110.6(29); Explanatory Notes, p. 38

Late Filed Election	Maximum Penalty Per Month
s. 15(2.13) PLOI election under s. 15(2.11)	100.00
s. 48.1 election to crystallize gain when SBC becomes publicly listed	100.00
s. 83(5) Capital Dividend Election	41.67
s. 85 / T2057 Rollover to Corporation	100.00
s. 96(6) / T2058 Rollover to Partnership	100.00
s. 212.3(13) Election under foreign affiliate dumping rules	100.00
s. 110.6(29) for February 22, 1994 elections	250.00
s. 110.6(29) for 2018 LCGE elections	1,666.67

10. Transitional Rules For Shares Held by (Trusts For) Minors

As is mentioned above, it is not possible to elect under s. 110.6(18.1) in respect of property that is a share, if the electing taxpayer is an individual who has not turned 17 before 2018, or a trust which will allocate any part of the resulting gain to such an individual. However, such an individual or trust can access the current rules for an actual disposition to an arm's length person in 2018.[49] Specifically, where an individual or a personal trust under which the individual is a beneficiary disposes of a share in 2018, the individual had not turned 17 before 2018, and the share was owned continuously from the end of 2017 to the time of disposition:

1. The old TOSI rules will apply (and new ones will not) and, if the disposition is by a trust, the trust will be deemed to be an *eligible LCGE trust* for the year; and

2. For the purpose of determining whether the *eligible property* is qualified farm or fishing property or a qualified small business corporation share of the taxpayer, the references to "24/12 months" in the definitions of those terms will be read as "12 months".

11. July 18 Proposals – Conclusion

As can be seen, the July 18 Proposals will significantly curtail the availability of the LCGE starting in 2018. However, the July 18 Proposals also include transitional rules which will allow taxpayers the opportunity to elect to crystallize certain gains and apply the current version of the LCGE rules. In the case of gains accrued on shares held by minors, or by trusts for the benefit of minors, the gains must be actually realized on an arm' length disposition in 2018 for the current rules to be available. A taxpayer who is considering making use of these transitional rules to use the LCGE with respect to QSBC shares will need to consider, among other things, whether the shares are in fact QSBC shares.

[49] If the disposition is not to at arm's length, s. 120.4(4) will deem the taxable capital gain not to be a taxable capital gain and to be a taxable dividend that is not an eligible dividend. Although a full consideration of this issue is beyond the scope of this paper, I wonder whether s. 120.4(4) is still necessary in light of the proposed amendments to s. 84.1 and new s. 246.1.

C. What Does It Take To Be A "QSBC Share"?

The capital gains exemption is only available in respect of a share if the share is a "qualified small business corporation share" within the meaning of that term in s. 110.6(1) of the Act. Although the details contained in the definition can be baffling, its conceptual elements can be stated without too much difficulty. To be a QSBC share, a share must meet three basic tests:

1. The Small Business Corporation Test: At the time of disposition, it must be a share of a small business corporation owned by the individual claiming the exemption, that individual's spouse or common-law partner, or a partnership related to that individual;

2. The Holding Period Ownership Test: Throughout the 24/12 months immediately preceding the time of disposition, it must not have been owned by any person other than the individual claiming the exemption or a person or partnership related to that individual; and

3. The Holding Period Asset Test: Throughout the period when the share was so held, the share must have been a share of a Canadian-controlled private corporation more than 50% of the value of the assets of which must been principally attributable to assets used in an active business carried on primarily in Canada by the corporation or a corporation related to it, or to shares or indebtedness of one or more qualifying connected corporations, or some combination of the two.

Each of these tests is examined in turn below.

1. The Small Business Corporation Test

The relevant time for determination of a QSBC share is the time it is disposed of. This time is the "determination time". Paragraph (a) of the definition QSBC share requires that at the determination time the corporation must be a "small business corporation" ("SBC") and the share must be held by the individual claiming the exemption, the individual's spouse, or a partnership related to the individual. Extending the definition to shares owned by a taxpayer's spouse allows the exemption to be claimed where the gain (or a portion of it) is attributed back to the taxpayer. However, as is discussed above, an election under s. 110.6(18) can only be made by the person who owns the property in respect of which the election is made, and it cannot be made in respect of property that is subject to an applicable attribution rule.

The term "small business corporation" is defined in s. 248(1) of the Act. The relevant parts are as follows:

> "small business corporation," at any particular time, means, subject to subsection 110.6(15), a particular corporation that is a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which at that time is attributable to assets 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 at that time connected with the particular corporation (within the meaning of subsection 186(4))[50] on the assumption that the small business corporation is at that time a "payer corporation" within the meaning of that subsection), or

(c) assets described in paragraphs (a) and (b).

The definition "Canadian-controlled small business corporation" ("CCPC") is set out in s. 125(7) of the Act. The definition is generally well understood and will not be discussed in detail here. However, it is worth noting that s. 110.6(14)(b) of the Act provides that in determining whether a corporation is a SBC or a CCPC, a right referred to in s. 251(5)(b) shall not include a right under a purchase and sale agreement relating to a share of the capital stock of a corporation. This is a relieving rule intended to ensure that a share will not be disqualified as a QSBC share at the time it is disposed of where a purchaser that is a public corporation or a non-resident has entered into an agreement to acquire the shares before the time of closing. In the absence of this paragraph, s. 251(5)(b) could deem the buyer to control the company from the time the agreement is made such that it would not qualify as a CCPC and SBC at the time the share is disposed of.

The term "all or substantially all" is not defined in the Act. The Canada Revenue Agency ("CRA") generally interprets it to mean 90 percent or more. Although this not necessarily a bright line test,[51] where it it is possible to satisfy it, it will typically be preferable to do so rather than take on the chance of having to convince an auditor to apply a more flexible analysis depending on the facts of a given situation.

Since the 90 percent test is applied to the fair market value of assets rather than their cost or book value, it is not sufficient to simply look at the corporation's balance sheet. Adjustments must be made to the book value of assets shown on the balance sheet to reflect their actual value, for example where they have significant accrued gains or where the cost reflects excess or inadequate depreciation. Consideration must also be given to any assets that are not shown on the balance sheet, such as goodwill and insurance policies. In fact, goodwill will often be a significant factor in determining whether or not shares will meet the all or substantially all test, even though it may not appear on the balance sheet at all if it is entirely internally generated. As well, insurance

[50] At first glance, the parenthetical clause "(within the meaning of subsection 186(4))" would appear to exclude corporations that are connected by virtue of s. 186(2) of the Act. However, s. 186(7) of the Act provides that where a provision of the Act indicates that the term "connected" has the meaning assigned by s. 186(4), that meaning shall be determined by taking into account the application of s. 186(2) unless the provision expressly provides otherwise. Seriously.

[51] CRA has acknowledged that each case must be considered on its facts: Views Doc. 2013-0495631C6. In *Reluxicorp Inc.* v. *The Queen*, 2011 TCC 336, Lamarre J. held that the meaning to be given to the expression "all or substantially all" must be left to the discretion of the trier of fact according to the circumstances of the case and that the figure must be "closer to the totality than half-way between the majority and the totality". In *Elim Housing Society* v. *The Queen*, 2015 TCC 282, a GST case, Woods J. held that "judicial interpretations of the "all or substantially all" test in other tax contexts, which are numerous, do not support the bright line test suggested by the parties. Something less than this will suffice."

policies or the proceeds from them, can be problematic. In most instances, the value of an insurance policy on the life of a shareholder would not be considered an asset used in an active business. If the policy has value, or the proceeds are paid to the company, the amount involved could easily be sufficient to prevent the company from meeting the 90 percent test. However, the reference in the definition "small business corporation" to s. 110.6(15)(a) provides some relief in this regard. Where a corporation holds a life insurance policy on the life of a shareholder, the fair market value of the policy at any time prior to the shareholder's death is deemed to be its cash surrender value at the time. As well, the proceeds or the right to receive the proceeds from such a policy will be deemed not to exceed the cash surrender value of the policy immediately prior to the shareholder's death to the extent that they are used, directly or indirectly, to redeem, acquire, or cancel shares of that corporation (or shares of certain corporations that have a connected relationship with the corporation) that were owned by the insured immediately before his or her death.

Only assets are considered in determining whether or not the 90 percent test is met. Debts and other liabilities do not reduce the values of the assets for this purpose. The value of leased assets should not be considered in computing the fair market value of assets of the lessee, as they are not owned by the lessee.[52]

To be included in making a determination of whether the 90 percent test is satisfied, an asset must be used "principally" in an active business. Again, the term "principally" is not defined in the Act. The CRA generally interprets it to mean more than 50 percent and says it must be applied on an asset by asset basis.[53] Even so, questions can arise as to how the "principally used" test is to be determined or measured, for example by time, space or value. This determination is a question of fact and there are no set guidelines as to which factors to use in different situations.[54]

One type of property that can be difficult to assess is cash. A business will typically have at least some cash on hand. In an actual disposition, it is customary for the buyer to remove most or all of the cash on hand, except perhaps a minimum amount of working capital (which it should be easy to justify as used in the business), so this will be more of an issue in the holding period assets test discussed below. However, in the context of a crystallization transaction, the amount of cash on hand may be greater. How much cash can be held before it is considered to be an asset that is not used principally in the business? CRA has provided the following comments on more than occasion:[55]

1. The question of whether a particular asset is an "asset used principally in an active business" is one of fact which must be determined based on all the relevant facts and circumstances of each case. The relevant circumstances include the actual use to which the cash or near cash properties are put in the course of the business, the nature of the business and the practice in the particular business.

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[52] CRA Views Doc. 2016-0652941C6 (2016 APFF q.11)

[53] See for example CRA Views Doc. 9808635.

[54] As an example, CRA has issued contradictory technical interpretations saying that with a building, consideration should be given to both the square footage use of the building and to fair rental value: *Canada Trust Co.* v. *The Minister of Revenue*, 85 D.T.C. 322 (TCC); CRA Views Document No. 2009-0307931E5.

[55] CRA Views Doc. 9801925; CRA Views Doc. 9605165.

> 2. Cash or near cash property is considered to be used principally in the business if its withdrawal would destabilize the business.
>
> 3. Cash which is temporarily surplus to the needs of the business and is invested in short-term income producing investments could be considered to be used in the business.
>
> 4. Cash balances which accumulate and are then depleted in accordance with the annual seasonal fluctuations of an ongoing business will generally be considered to be used in the business but a permanent balance in excess of the company's reasonable working capital needs will generally not be considered to be so used.
>
> 5. The accumulation of funds in anticipation of the replacement or purchase of capital assets or the repayment of a long-term debt will not generally in itself qualify the funds as being used in the business.
>
> 6. Cash or near cash property is considered to be used principally in the business if its retention fulfils a requirement which had to be met in order to do business, such as certificates of deposits required to be maintained by a supplier.
>
> 7. The Department recognizes that prudent financial management requires businesses to maintain current assets (including inventories and accounts receivables, as well as cash and near cash properties) in excess of current liabilities and will consider this requirement in assessing whether cash or near cash assets are used principally in a business. In the Department's view, cash and near cash assets held to offset the non-current portion of long term liabilities will not generally be considered to be used in the business.
>
> We stress that the above guidelines are necessarily of a general nature and that the Department makes its determination after a review of all the relevant circumstances, including the actual use to which the cash or near cash property was put in the course of the business, the nature of the business involved and the practice in the particular industry.

Judicial support for many of these comments can be found in case law,[56] although there have not been many cases on this issue in recent years. One of the more recent decisions was given in *Skidmore* v. *The Queen*.[57] In *Skidmore*, the Federal Court of Appeal upheld the decision of the lower court whereby the taxpayer was denied the exemption on the basis that corporation in which he owned shares was not an SBC because of the excessive amount of term deposits held in the company. The taxpayer argued that these cash reserves were a necessary asset in its tree-growing business due to the fact that they would be required in the event that the company experienced certain misfortunes in its business operations, such as a crop failure. The court determined that the cash reserves were not an integral aspect of the business operations, nor was there a relationship of significant financial dependence between the business and the amounts in question. The holding of cash reserves for a "rainy day" was simply not a strong enough argument.

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[56] See especially *R.* v. *Ensite Ltd.*, 86 D.T.C. 6521 (SCC) and the cases considered therein.

[57] *Skidmore* v. *R.*, [2000] 2 C.T.C. 325 (FCA) ("*Skidmore*")

A property does not have to be used in the business of the particular SBC under consideration. It can qualify if it is used in an active business carried on by a corporation related to the particular SBC, as defined in subsection 251(2). A company that holds the real estate in which the business of a related corporation is operated will typically meet the SBC definition. This is useful where the real property is held in a separate corporation, for example to protect it from claims of creditors against the operating business.[58]

Finally, a share of an SBC that is connected with the particular corporation can be included in the 90 percent test. Connectedness (if that is a word) is defined in s. 186 of the Act. It is helpful remember that connectedness is not necessarily a two-way relationship, and generally looks upstream – that is, a subsidiary corporation is connected with its parent, but the reverse is not the case. The corporation in the subsidiary role is referred to in the Act as the "payer corporation" and the corporation in the parent role is referred to as the particular corporation.[59] Under s. 186(4), a payer corporation is connected with a particular corporation if (a) the particular corporation controls the payer (other than by virtue of a right referred to in s. 251(5)(b)), or (b) the particular corporation owns shares having more than 10 percent of the votes and value of the payer. Subsection 186(2) expands this concept by deeming one corporation to be controlled by another corporation if more than 50 percent of its issued share capital (having full voting rights under all circumstances) belongs to the other corporation, to persons with whom the other corporation does not deal at arm's length, or to the other corporation and persons with whom the other corporation does not deal at arm's length. This expanded definition will cause sister corporations to be connected with one another even though neither holds shares in the other – that is, where connectedness is based on s. 186(2) it is a two-way relationship and the corporations are connected in both directions except to the extent the Act specifies otherwise. Thus, an advance from a sister corporation will be eligible for inclusion in the 90 percent test as long as the debtor corporation is itself an SBC.

Although an interest in a partnership is itself a property for the purpose of the Act, the CRA's position is that where a corporation holds an interest in a partnership, it is the underlying partnership assets (to the extent of the corporation's interest therein) that are used in determining whether all or substantially all of the corporation's assets are used in an active business. Provided that these assets are used in an active business carried on primarily in Canada by the partnership, they will qualify.[60] However, where a corporation advances or lends funds to a partnership, the CRA considers the loan to be made proportionately to each of the partners on the basis of their

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[58] As well, it may be possible to sell the shares of such a property holding company to a buyer without a significant discount for the pregnant gain on the underlying property, because the buyer will be able to bump up the cost of the land in the corporation with a simple amalgamation using s. 88(1)(d) of the Act. However, in practice I have found this to be difficult to implement.

[59] This is exactly the opposite of how relationships work in my family, where I am typically the payer and my children are the particular ones.

[60] See *Interpretation Bulletin* IT – 486R, "Intergenerational Transfers Of Shares Of A Small Business Corporation," December 31, 1987 (cancelled September 26, 1980), para. 6. This approach is supported by the decision of the British Columbia Court of Appeal in *Seven Mile Dam Contractors* v. *British Columbia* (1979), 104 D.L.R. (3d) 274, aff'd (1980), 116 D.L.R. (3d) 398. However, if the partnership is a limited partnership, consideration should be given to the decision of that court in *Edenvale Restoration Specialists Ltd.* v. *Her Majesty the Queen in right of the Province of British Columbia*, 2013 B.C.C.A. 85

respective interests in the partnership. Therefore, the loan will qualify only to the extent that those partners are connected SBCs.

2. The Holding Period Ownership Test

Paragraph (b) of the QSBC share definition requires that throughout the 24/12 months[61] immediately preceding the determination time, the share not have been owned by anyone other than the individual claiming the exemption or a person or partnership related to the individual. Note that it does not require that the shares have been owned throughout that time by a related person – only that they not have been owned by an unrelated person or partnership. As a result, shares issued during the 24/12 month period immediately preceding the determination time can meet this test even if they did not exist throughout that period.

As is mentioned above, under the transitional rules in the July 18 Proposals, the 24/12 month period prescribed by this test will be reduced to 12 months for gains triggered by an election under s. 110.6(1)(18.1), and for actual dispositions of QSBC shares in 2018 by a taxpayer who has not turned 17 before 2018 or a trust which will allocate any part of the resulting gain to such an individual. However, the transitional treatment is only available where the taxpayer disposing of the QSBC share in 2018 has owned it continuously from the end of 2017 until the time of disposition. This means that for gains to which the transitional rules apply, the holding period ownership test can be satisfied for a QSBC share acquired by an electing taxpayer or trust under which the taxpayer is a beneficiary as late as December 31, 2017. Practitioners who engage in planning to position corporations late in 2017 to take advantage of the transitional rules under s. 110.6 should take care not to cut the abbreviated holding period under the transitional rules too closely: CRA has said that a holding period of exactly two years does not qualify, so that one more day is needed.[62]

Subsection 110.6(14) includes several provisions which are relevant in applying the holding period ownership test.

(a) Identical Shares – FIFO Rule

Paragraph 110.6(14)(a) deems a taxpayer to have disposed of shares that are identical properties in the order in which the taxpayer acquired them – *i.e.* on a first in, first out (FIFO) basis. Thus, where a taxpayer holds some shares that satisfy the holding period ownership test and others that do not, the taxpayer can dispose of the qualifying shares and use the LCGE to shelter the resulting gain, while retaining the non-qualifying shares. Although this is presumably intended to operate as a relieving rule, it has some limitations. First, the averaging rule in s. 47 will still apply to all of the shares owned by the taxpayer, so where the earlier-acquired shares were acquired at a lower cost than the later-acquired shares, it may not be possible to shelter all of the gains attributable to the older shares. Second, the rule is mandatory and can work against the taxpayer in some situations. For example, CRA has stated that where a taxpayer sells some shares to a holding

[61] As is discussed above, for purposes of elections and dispositions under the transitional rules, the 24 month periods referred to in s. 110.6 are to be read as 12 months, so in the balance of this paper, references to those periods will be stated as "24/12 month period" or "24/12 months").
[62] CRA Views Doc. 2011-0411831C6

company in order to purify a corporation must use the FIFO method. If the remaining shares do not meet the holding period ownership test then access to the LCGE may be lost on a subsequent transaction.[63]

(b) Shares Held by Trusts and Partnerships

Paragraph 110.6(14)(c) deems a personal trust to be related to a person or partnership for any period throughout which the person or partnership was a beneficiary of the trust. As well, a trust is deemed to be related to a person from whom it has acquired a share where, at the time the trust disposes of the share, all of the beneficiaries of the trust (other than registered charities) of the trust are related to the person from whom the shares were acquired or would have been so related if that person were still alive at the time. These deeming rules, combined with s. 104(21.2), provide relief for shares that have been transferred to or distributed from a personal trust.

Note that where a trust distributes a QSBC share to a beneficiary who then realizes a gain on the share (whether on a sale or crystallization), the beneficiary will be able to satisfy the holding period ownership test in respect of a period during which the trust was owned by the trust only if the beneficiary was a beneficiary of the trust during that time. If the recipient was added as a beneficiary of the trust immediately before the distribution, the holding period will begin at that time. However, where a trust disposes of a QSBC share and designates the resulting gain to a beneficiary, it is unnecessary for the beneficiary himself or herself to satisfy the holding period ownership test – that is, the beneficiary need not have been related to the trust at any time before the sale. [64] Subsection 104(21.2) will deem the beneficiary to have disposed of a QSBC share and the beneficiary will be able to claim the LCGE.

Paragraph 110.6(14)(d) deems a partnership to be related to a person throughout the period in which the person was a member of a partnership. Paragraph 110.6(14)(d.1) provides a look-through rule that deems a person who is a member of a partnership to be a member of any underlying partnerships in a tiered partnership situation.

(c) Treasury Shares

Shares issued from treasury are not owned by anybody before they are owned. Until June 13, 1988, the holding period ownership test effectively did not apply to newly issued shares. Paragraph 110.6(14)(f) was introduced to address this. It provides that a share issued after June 13, 1988 is deemed to have been owned immediately before it was issued by a person who was not related to the person to whom it was issued. However, there are three exceptions to this rule.

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[63] CRA Views Doc. 2013-0481361E5. See also Georgina Tollstam, FIFO Derails QSBC Planning (2013) 21:9 *Canadian Tax Highlights* 9-10.

[64] CRA Views Doc. 2012-0439271E5; CRA CRA Views Doc. 9607525 considered a situation where a personal trust proposed to sell QSBC shares and then designate the resulting net taxable capital gain to an individual who had only been a beneficiary of the trust for 12 months prior to the share sale, and held that as long as the particular personal trust itself that the holding period test, the particular beneficiary would not necessarily be precluded from claiming a capital gains deduction under s. 110.6(2.1) of the Act solely because he or she was not a beneficiary of the trust throughout the entire 24/12 month period prior to the sale of the QSBC share by the trust. No mention was made of s. 110.6(14)(c).

Under the first exception,[65] the rule will not apply to a share that is issued as consideration for other shares. This permits shares issued under tax deferred rollovers, such as in freeze transactions, to be eligible for the LCGE even if the exchange occurred within the applicable holding period. However, this relieving rule must be read in the light of paragraph (e) of the QSBC share definition, which will prevent the substituted share from being a QSBC share unless the original share itself qualified under both the holding period ownership test and the holding period asset test during that part of the applicable holding period prior to the exchange.

Under the second exception,[66] a treasury share will not be deemed to have been owned by an unrelated person prior to its issuance where the share was issued to a person or partnership as part of a transaction or series of transactions in which the person or partnership disposed of property to the corporation that consisted all or substantially all of the assets used in an active business carried on by that person or partnership, or of an interest in a partnership all or substantially all of the assets of which were used in an active business carried on by its members. This provision effectively allows an individual or partnership to incorporate a business and then immediately sell the shares without waiting for the applicable holding period to run. In most cases, it should not be a concern that the resulting shares are inventory, despite an intention to sell them shortly after acquiring them, since s. 54.2 will deem them to be capital property.

The third exception[67] applies to shares issued as a stock dividend. A practitioner who is relying on this exception should take heed of s. 248(5)(b), which will deem a share issued as a stock dividend to be property substituted for the share in respect of which the dividend is paid. As a result, paragraph (e) of the QSBC share definition will prevent the substituted share from being a QSBC share unless the share on which the dividend was paid would itself have qualified.

3. The Holding Period Asset Test

The holding period asset test is set out in paragraph (c) of the QSBC share definition. Paragraph (d) contains a number of rules of application dealing with shares and debt of connected corporations. Again, although the details are intricate, the concept is relatively simple: throughout the applicable holding period, the share must have been a share of a corporation that would have been an SBC if the 90 percent test were read as a 50 percent test. That is, throughout the applicable holding period, the share must have been a share of a CCPC, more than 50 percent of the fair market value of the assets of which was attributable to:

1. assets used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it;

2. shares of the capital stock or indebtedness of one or more other corporations that were connected with the corporation; or

3. a combination of assets described in either of the preceding two subparagraphs.

[65] s. 110.6(14)(f)(i)
[66] s. 110.6(14)(f)(ii)
[67] s. 110.6(14)(f)(iii)

If the corporation has sufficient assets throughout the applicable holding period to satisfy the test in subparagraph (i) of the definition, the determination will be simple and it will be unnecessary to consider the assets described in subparagraph (ii). However, if the corporation does not have sufficient assets throughout the applicable holding period to satisfy the test in subparagraph (i), it will be necessary to consider the test in subparagraph (ii) and the complicated rules of application that apply in respect of it.

Clauses (ii)(A) and (B) of the definition add two additional requirements with respect to any shares or indebtedness of connected corporations that are held by the particular corporation being assessed. In effect, they apply a version of the holding period ownership test and the holding period asset test to the share or indebtedness held by the corporation, as follows:

Clause (A) provides that where the share or debt was acquired during the 24/12 months immediately preceding the determination time, it must not have been held by anyone other than the corporation, or persons or partnerships related to it, from the beginning of the 24/12 month period to the time it was acquired by the corporation.[68] The rules of application in s. 110.6(14)(f) will apply for the purpose of making this determination. Remember that treasury shares will be deemed to have been acquired from an unrelated person unless they meet one of the exceptions described in that paragraph. As a result, the simple act of acquiring treasury shares from a subsidiary can interfere with the ability of a corporation to meet the QSBC share definition if those shares have sufficient value.

Clause (B) provides that throughout the 24-month period while the shares or debt were owned by the corporation or a related party, more than 50 percent of the fair market value of the assets of the corporation connected to the particular corporation must be attributable to active business assets or shares[69] or indebtedness of one or more other corporations that are connected with the corporation. However, the application of this test is made more complicated and more rigourous by paragraph (d) of the definition, such that in a vertical chain of corporations, the 50 percent test will be converted to a 90 percent test if any of the other corporations in the chain do not satisfy a 90 percent test. Once one corporation in the chain fails the 90 percent test, each downstream corporation that is connected to it must itself pass the 90 percent test – this is designed to prevent the 50 percent test from being circumvented by spreading non-qualifying assets throughout a vertical chain of corporations. Note that this rule applies a narrower definition of the expression "connected" for this purpose, such that a corporation will be connected with another corporation only if the second corporation holds at least one share (directly or indirectly through one or more other corporations) in the first. That is, where two corporations are connected to one another by virtue of being sister corporations under common control, but neither holds shares in the other (whether directly or indirectly), the rule will not apply.

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[68] It is the ownership of the share or indebtedness prior to its acquisition by the corporation that matters for the purpose of this test. A disposition of such a share or debt to an unrelated party during the 24/12 month period will not disqualify the share or indebtedness. Accordingly, it would not exactly be correct to say that the share or debt must not have been owned by anyone other than the corporation or persons or partnerships related to it during the 24/12 months immediately preceding the determination time.

[69] Where the share is a substituted share, consideration must be given to paragraph (f) of the QSBC share definition. That paragraph is similar to paragraph (e), but instead of applying to the QSBC share it will apply to any share referred to in subparagraph (c)(ii). A substituted share will not qualify under that subparagraph unless the share for which it was substituted was not owned by an unrelated person at any time during the 24/12 month holding period and during that time the corporation in which the old share was held met the holding period asset test.

The rules of application in paragraphs (c)(ii) and (d) of the QSBC share definition are complex and easily breached. A full exposition of them is beyond the scope of this paper, and the foregoing comments are a summary intended only to give an indication of the considerations that will be relevant in applying them. Where consideration is being given to utilizing the LCGE either on a disposition or crystallization of shares of a corporation that has two or more subsidiaries, special care must be taken to ensure that all of the tests in the holding period asset test are satisfied *throughout the applicable holding period*. Note that in this regard, even where the applicable holding period in respect of the shares of the QSBC share corporation is less than 24/12 months, the full 24/12 months must be considered in applying the holding period tests in subparagraph (c)(ii).[70]

(a) Upstream Debt and Shareholdings: Paragraph 110.6(15)(b)

Paragraph 110.6(15)(b) deals with a potential circularity issue in assessing QSBC share status in tiered structures, where a downstream corporation owns shares or indebtedness of an upstream corporation with which it is connected. In such cases, it deems the value of the shares or indebtedness to be nil. However it applies only for the purpose of determining whether the upstream corporation is an SBC or whether its shares are QSBC shares. It does not provide for a corresponding reduction in the value of the shares of the downstream corporation in applying the QSBC share definition to the upstream corporation.

Note that s. 110.6(15)(b) will only apply when two conditions are satisfied. The first requires that the downstream corporation be connected with the upstream corporation. For the purpose of this condition, the "connected" concept is the same as that found in paragraph (d) of the QSBC share definition and requires that the upstream corporation have direct or indirect ownership of one or more shares of the downstream one. The second requires that the upstream corporation *not* be connected to the downstream corporation. Fortunately, in applying this condition, the meaning of “connected” is limited to the meaning it has under s. 186(4) (*i.e.* without reference to s. 186(2)); even so, if the downstream holds shares in the upstream corporation having more than 10 percent votes and value, s. 110.6(15)(b) will not apply.

4. QSBC Shares and the LCGE – Other Considerations

The foregoing discussion considers the requirements for eligibility for QSBC Shares. There are many other factors that should be considered before claiming the LCGE in respect of a deemed or actual disposition of shares. For example, a positive CNIL balance, previous ABIL claims, transfers for consideration below fair market value and insufficient dividends paid on the QSBC shares may limit the amount that can be claimed or preclude the LCGE claim altogether. Even where the exemption is fully available, the taxpayer may be subject to alternative minimum tax, or be unwilling to have old age security payments clawed back based on the increased income that will be result from the gain, or may be subject to restrictions in claiming ABILs in future years as a result. Where a crystallization transaction or election is being considered, the increased cost base will be of limited utility if the shares are not sold to an arm’s length purchaser in the future and the

[70] An excellent and much more extensive discussion of paragraphs (c)(ii) and (d) of the QSBC share definition can be found at Hermann, supra fn . 4, at pp. 29:15-20.

taxpayer will want to weigh the costs (i.e. professional fees) and inconvenience of the crystallization against the expected benefit.

D. Conclusion

The LCGE is an important and valuable incentive in Canadian income tax planning. In recent years it has been common practice for tax planners to recommend structures under which shares potentially available for the LCGE are held in trusts so as to allow their clients to multiply the exemption. The July 18 Proposals will significantly curtail the efficiency of these structures, and in most cases will militate against holding potential shares in trusts where a future gain may be sheltered with the LCGE. The proposals include relatively generous transitional rules, and practitioners are advised to become familiar with those provisions, and to give consideration to what steps should be undertaken in the balance of 2017 and through 2018 to make best use of those rules. An obvious starting point in any such consideration will be with a review of whether or not a given share qualifies as a QSBC share, or will so qualify at the time when an election is made or the share is sold. This paper has attempted to provide a roadmap to practitioners who will be undertaking these analyses.