

The background features a dark red grid pattern on the left and a 3D bar chart on the right. The bar chart has five bars of increasing height, colored in shades of teal and blue. A large white arrow with a black outline points upwards and to the right, following the trend of the bars. The overall composition is dynamic and suggests growth and financial analysis.

Going Public: Tax Issues to Consider

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Going Public: Tax Issues to Consider

The following summary highlights certain income tax considerations that may be relevant in the context of a private corporation going public.

Small Business Deduction

A corporation is not entitled to the small business deduction (a reduction in federal and provincial income tax in respect of certain types of business income) unless it is a “Canadian-controlled private corporation” (CCPC) throughout a taxation year. Upon the listing of shares of a corporation on a designated stock exchange in Canada (which includes the TSX and Tiers 1 or 2 of the TSX Venture), the corporation will become a “public corporation” and will cease to be a “private corporation” and a CCPC for the purposes of the *Income Tax Act* (Canada) (the Tax Act). Where a corporation ceases to be a CCPC because its shares become listed, it will generally be deemed to have a year-end for tax purposes. Once the corporation becomes a public corporation, it will not be entitled to the small business deduction and the effective federal and provincial tax rates will generally increase for the first \$500,000 of taxable income.

Enhanced Capital Gains Exemption

Capital gains realized by individuals on the disposition of shares of a “qualified small business corporation” are eligible for the enhanced lifetime capital gains exemption of \$800,000. To qualify for the exemption, among other things, the shares must be shares of a “small business corporation” (as defined in the Tax Act) at the time of the disposition. In general terms, a small business corporation is a CCPC substantially all of whose assets are used principally in an active business carried on primarily in Canada.

As described above, when a corporation’s shares are listed on a designated stock exchange in Canada, the corporation becomes a “public corporation” and its shares cease to qualify for the enhanced exemption.

An individual can elect for certain purposes to be treated as having disposed of his or her shares in a small business corporation immediately before the corporation becomes a public corporation by reason of the listing of a class of its shares on a designated stock exchange. The individual may designate an amount that will be considered to be the proceeds of disposition of the shares in a range between the adjusted cost base of the shares and their fair market value. The individual is also treated as having reacquired the shares at a cost equal to the designated proceeds of disposition immediately after the corporation becomes public. By designating an appropriate amount, the individual can take full advantage of any unused portion of his or her capital gains exemption without having to undertake an actual realization transaction.

The election must be made in the form prescribed by the Canada Revenue Agency and, generally, on or before April 30 in the year following the year in which the corporation becomes a public corporation. There is a provision for the late filing of the election on payment of a specified penalty.

Capital Dividend Account

The capital dividend account of a corporation represents, in general terms, the non-taxable portion of net capital gains of the corporation that accrued while the corporation was a private corporation. The amount of the capital dividend account may be distributed as capital dividends free of tax to Canadian resident shareholders provided the appropriate election is filed in respect of the dividend.

In order to qualify as a capital dividend, the dividend must be payable by a “private corporation” (as defined in the Tax Act). A public corporation is not able to pay a capital dividend even if the balance in its capital dividend account accrued while it was a private corporation. Accordingly, it is prudent planning to ensure that any balance in the capital dividend account is distributed as a capital dividend prior to the corporation becoming a public corporation.

It should be noted that the election in respect of capital dividends must be filed on the form prescribed by the Canada Revenue Agency (together with certain other required documents) no later than the day on which the dividend becomes payable or the first day on which any part of the dividend is paid, whichever is earlier. The Tax Act does provide for late filed elections (where the dividend was paid by a corporation at the time it was a private corporation) on payment of a specified penalty.

Stock Options

The rules under the Tax Act with respect to the taxation of stock options granted by a CCPC are generally more favourable than those that apply to options granted by a public corporation.

Where stock options are granted by a CCPC to an employee that was dealing at arm’s length with the CCPC, a taxable benefit is deemed to be received by the employee only when the shares (that are the subject of the option) are in fact sold. The taxable benefit is equal to the excess of the value of the shares at the time the employee acquired them over the amount paid to the corporation for the shares (plus the cost of the option, if any). Where the employee is deemed to receive such a benefit and provided he or she held the shares for two years from their date of acquisition, the employee will be entitled to a deduction equal to one-half of the amount of the deemed benefit.

Stock options granted by a public corporation will generally be subject to less favourable treatment. The taxable benefit will generally be deemed to be received by the employee in the year in which the employee exercises the option and

acquires the shares. The amount of the taxable benefit is computed on the same basis as described above in respect of a CCPC. A deduction equal to one-half of the amount included in the employee's income as a taxable benefit is also available to the employee provided certain conditions are met. These conditions include the requirement that the employee deal at arm's length with the corporation at certain relevant times, that the shares be prescribed shares (generally speaking, a straightforward common share) and that the amount payable by the employee to acquire the shares under the option agreement is not less than the fair market value of the shares at the time the option was granted.

As a result of the more beneficial treatment of stock options granted by a CCPC, it may be advisable for a corporation that qualifies as a CCPC to consider the issuance of additional stock options to employees prior to the date the shares of the corporation are listed. So long as the corporation qualified as a CCPC at the time the options were granted, the more favourable treatment will continue to be applicable even if the corporation ceases to be a CCPC (and becomes a public company) prior to the issuance of the shares pursuant to the exercise of the options.

Qualification for Investment of Listed Shares

Shares listed on a designated stock exchange are qualified investments under the Tax Act for registered retirement savings plans, registered education savings plans, deferred profit sharing plans, registered disability savings plans, registered retirement income funds and tax free savings accounts. Accordingly, by having its shares so listed, a corporation's potential investor base will be broadened. Private company shares are qualified investments only in limited circumstances.

About the Firm

When Heward Stikeman and Fraser Elliott first opened the firm's doors in 1952, they were united in their pledge to do things differently to help clients meet their business objectives.

In fact, they made it their mission to deliver only the highest quality counsel as well as the most efficient and innovative services in order to steadily advance client goals.

Stikeman Elliott's leadership, prominence and recognition have continued to grow both in Canada and around the globe. However, we have remained true to our core values.

These values are what guide us every day and they include:

- Partnering with clients – mutual goals ensure mutual success.
- Finding original solutions where others can't – but they must also be grounded in business realities.
- Providing clients with a deep bench of legal expertise – for clear, proactive counsel.
- Remaining passionate about what we do – we relish the process and the performance that results from teamwork.

A commitment to the pursuit of excellence – today, tomorrow and in the decades to come – is what distinguishes Stikeman Elliott when it comes to forging a workable path through complex issues. Our duty and dedication never waver.

This is what makes Stikeman Elliott the firm the world comes to when it counts the most.

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