

# In The Trenches\_ Conversation with Kali Baraniski

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## SUMMARY KEYWORDS

Lifetime capital gains exemption, CCPC status, tax planning, capital gains tax, qualified small business corporation, corporate tax rate, stock option deferral, scientific research and experimental development, Canadian control, asset sales, share sales, carry earnings, holding period test, small business corporation test, value crystallization.

## SPEAKERS

Steve Divitkos, Kali Baraniski

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**S** Steve Divitkos 00:00  
Kali, welcome to the show.

**K** Kali Baraniski 00:01  
Yeah, thanks for having me Steve.

**S** Steve Divitkos 00:03  
It is great to have you here. We are on to the Canadian portion of this show. So let's begin at a very kind of foundational level. Give us the basics on the lifetime capital gains exemption, the basics on CCP status, and maybe you can just speak to speak to like, why should CEOs and their investors care? Why should they bother listening to the next 45 minutes of this conversation?

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Kali Baraniski 00:27

Sure, yeah, so I think it'd be important maybe before we dive in, I think it's important to set the stage and caveat that there were proposals put put forward by the government in its 2024 budget. Many of these proposals were not legislated or enacted, as most listeners will be aware. You know this relates to the 50% versus 60% or 66% capital gains inclusion rate, and the recent proroguing of Parliament really created some uncertainty around these proposals. So for purposes of this discussion today, I just want to focus in on the basics of the program, CCPCs, lifetime capital gains exemptions, and kind of just leave most of the numbers to the side, because there could be a chance that those could change in the near future. But to really start off the just talking about the capital gains exemption and CCPCs, any individual today that sells capital property is subject to capital gains tax, which is really typically in around the 27% or 50% of the highest income tax bracket in Ontario. So the lifetime capital gains exemption allows Canadian taxpayers to exempt up to about 1.1 6 million as of 2024, capital gains in taxation when they sell shares of what we refer to as a qualified small business corporation or even QSBC. So this equates to around \$270,000 in tax savings, which is quite substantial. So CCPC status is essential because it qualifies a corporation for the lifetime capital gains exemption, which can significantly reduce this tax liability upon exit. As for the CEOs and their investors, they should really care about these aspects, because they directly impact their financial returns, their investment strategies and overall tax planning that could be done when they're structuring a transaction. So understanding these tax benefits can lead to more informed decisions regarding investments and then their ultimate exit strategy.

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Steve Divitkos 02:37

Okay, so we've got a big bucket of money in this case, it's called the lifetime capital gains exemption, and I think you said it's about 1.1 million. And so long as you haven't utilized that in the past, that is a bucket of money that you can shield from tax, so long as you are selling shares in something called a CCPC. So before we get into how one qualifies to become a CCPC, can you just speak to like, the general idea behind the program? Like, what was the government looking to achieve or encourage when they first put this plan into place?

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Kali Baraniski 03:09

Yeah, so I think what the government was really looking for was to allow Canadian taxpayers to invest in the Canadian economy, grow businesses, and ultimately, when they go to grow and sell that company, take those proceeds and reinvest them back into the Canadian economy. I'll touch on this a little bit later. But in addition to kind of the tax savings on an exit, there's a lot of other benefits that really help entrepreneurs and Canadians grow those businesses to ultimately scale them up to kind of sell in the future.

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Steve Divitkos 03:45

Okay, so we're looking to encourage, or at least the government was looking, to encourage, investment in Canadian businesses. You actually segue quite well to my next question, which is, we know that there's a benefit with respect to the tax rate that one pays on exit proceeds, but you mentioned that there are other benefits associated with CCPC status. So can you just talk to those at a general level, like, how else does one benefit to the extent that they are a CCPC?

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Kali Baraniski 04:12

Yeah, I think one of the big ones would actually be the the corporate tax rate. So there is an effective lower corporate tax rate for qualifying small business corporations or CCPCs, really on the first \$500,000 of income, 600,000, depending on which province you ultimately located in. But in Ontario, for example, that effective tax rate will be 26 and a half percent versus 12.2%, so it's quite a significant spread, which allows, really those investors and entrepreneurs to take the excess differential and reinvest it back into the business. So I think that's number one. Number two, which is, again, a really lucrative tax program, is the scientific research and experimental development, or what you'll sometimes hear referred to as shred and those tax credits as a CCPC can actually be refundable. So they aren't applied to any tax owing, but you will actually get a refund and a higher percentage if you are kind of a smaller CCPC that is doing a lot of research and experimental development in Canada, and that can be applied to things, for example, like salaries. So that's another one that allows some of our entrepreneurs to kind of grow the business. But I think another one that's actually really important, and actually might be more relevant to some of the listeners on this call, is the stock option deferral for CCPCs. So this ultimately relates to stock options that are granted to key executives, sometimes, whether it be management or just key employees in the accounting or the tax function, or whatever it might be, and you can actually get a full deferral on the exercise when you have a CCPC, which isn't the case with other private companies. So I think that's one that people should really start to look into more, because it is a big benefit when you're trying to attract key talent.

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Steve Divitkos 06:15

interesting. So when you say a full deferral on the exercise, does that mean if I gave my CFO some options, and she decided to exercise them, and she bought the shares for less than they are worth. Does that mean that she can defer that otherwise taxable event?

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Kali Baraniski 06:31

She could. Yes, exactly. Yeah.

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Steve Divitkos 06:34

Okay, got it. Okay. So not only can we shield upwards of a million dollars from capital gains tax on exit. We're paying about half of the effective tax rate on the first \$500,000 of corporate income, and we're getting these really interesting things called shred credits, something that I actually took advantage of when I was running a software company, and indeed, many software and technology executives take advantage of due to like, the nature of the work that they do. Okay, so we've got people excited at this point. Now let's get into the boring details, which is, how does one qualify as a CCPC? How do we get all this stuff?

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Kali Baraniski 07:07

Sure, yeah, yeah. So I can kind of touch, kind of just on the basics, I think. But so a few things. So number one, it must be a private corporation, meaning that it cannot be publicly traded. Number two, it must be resident in Canada, which typically means it's incorporated in Canada or it has its central management and control in Canada. And number three, it must not be controlled directly or indirectly by non residents or public corporations. So this one gets a little bit tricky, where it's not so much it's controlled by a Canadian or Canadian residents, but that it's not controlled by foreign residents. So you could still have 50% on each side, but that would still lead you likely, you know, assuming all facts are similar, but 50% on each side would still lead you to be a CCPC.

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Steve Divitkos 07:58

So, let's talk about this idea of control. Because a seemingly simple concept, like all things income tax related, is almost never as simple as it might seem. So when we say Canadian control, what does that actually mean? Does control mean, you know, who gets to nominate the board? Does control mean greater than 50% of the cap table has to be from Canadian residents? Is it either? Is it both? And the reason why I asked that question is because folks listening to this might be thinking about fundraising as we speak. And of course, one of the nuances they have to consider is, well, who do I raise money from? And so that's why I'm asking specifically, what do we mean when we say controlled?

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Kali Baraniski 08:40

Yeah, yeah. And I think from a tax perspective, there's really two types of control, right? There's legal control and there's factual control. So I think you mentioned it that you know, our legal control would be your cap table and your ownership. So who is it that legally controls the company? But when we start looking at factual control, well you might have a scenario where your board of directors, or the right to elect the board of directors, maybe is leaning towards the US side, even though you have your cap table and your legal control saying it's over 50%, that could really push you to the other side, where you're ultimately being controlled by a non resident.

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Steve Divitkos 09:21

I see. So if I'm a Canadian resident running a Canadian company with Canadian employees, however, 100% of my investor base is from the United States. There's an argument to say that I'm not a Canadian controlled private corporation.

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Kali Baraniski 09:34

Yeah, I think it'll come down to all the facts at the end of the day. But I think there's an argument that it could be swinging towards the US side in that case.

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Steve Divitkos 09:41

Okay, got it. In the little ecosystem in which I operate, of acquisition entrepreneurship, I often say that the Canadian the US ecosystems are more similar than they are different, but there's a couple little quirks that differentiate the two countries. One of those quirks is the prevalence of asset sales versus share sales. In my experience, asset sales are very common in the US, share sales are much more common in Canada. You tell me, but I suspect it has to do with a CCPC wrinkle. So can you just talk about the difference between asset sales and share sales and why that is important in the context of CCPC?

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Kali Baraniski 10:22

Yeah, so I think in this case, right? So the distinction between asset sales and share sales is vital, because only share sales can benefit from the lifetime capital gains exemption, right? So in an asset sale, the company may not qualify for the same tax benefits which can affect the overall financial outcome for investors and sellers. However, we need to look at in certain circumstances, a purchaser may still purchase a company via an asset sale, and typically they want to do the asset sale because they will get the bump in the asset base, which means that they can ultimately go and start depreciating some property. However, in the share sale, all of their basis, what I'll say is going to be trapped in the shares. So they're not really going to get that right off on any types of assets. So you'll see that typically share sales might have a lower purchase price than asset sales, and it's really because there's a lot of emphasis from the seller that they want this first million dollars almost tax free. And in some case, in some cases, depending on the structure, you might have multiple lifetime capital gains exemptions at risk, so there could be significant value to the investor base, or the shareholders, to get that share sale versus the asset sale.

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Steve Divitkos 11:46

Right. So all else being equal, and I mentioned this specifically for US based acquirers who are looking to acquire small Canadian businesses. All else being equal, is it fair to say that they should reasonably expect a share sale as opposed to an asset sale, assuming that their seller is looking to benefit from some of the benefits that we've talked about so far.

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Kali Baraniski 12:06

Yeah, I'd say when the US investors are coming in. I wouldn't say they're typically buying the assets, because they're really just creating an establishment in Canada when they're doing that anyway. So typically, they're already going to be setting up a Canadian company. So for them to buy the Canadian company, I wouldn't say it's too much of an issue, but again, it's going to come down to the nature of the assets and what's ultimately being purchased within that company.

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Steve Divitkos 12:30

Right. Okay, so this next question is very tactical and very detailed, and at the risk of putting people to sleep, I did want to ask it, because I personally got burned on this, and so I want to highlight it for folks. And the question is, as a CEO or entrepreneur, we are able to earn carry on our exit proceeds. However, where that carry is earned actually matters. If you earn carry in your personal capacity, or if you have your carry directed to a corporation, this actually matters if one wants to take advantage of the lifetime capital gains exemption. So this is bringing up some PTSD for me that notwithstanding. Can you please walk us through where that carry ought to reside if one wants to benefit from this program?

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Kali Baraniski 13:14

Yeah, and I can probably see where you maybe got caught on this one. So for the lifetime capital gains exemption, you do have to sell the shares of a qualifying small business corporation, and that will typically be kind of the operating entity that gets you in there. So if you're holding that carry through a corporation, and you ultimately want to go sell your interest, you'd be selling your interest that's held by the hold coat into the underlying business, which may or may not get you into the lifetime capital gains exemption. Therefore, in most situations, it's easiest, I would say. And you know, there are tax structuring ways around it, but it is easiest for the individual to hold that directly, because then they are the direct owner and holder when it goes to claim the lifetime capital gains exemption.

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Steve Divitkos 14:09

Right. So okay, so there's more nuance than what I'm about to suggest, but maybe the starting point for entrepreneurs who are looking to structure this is start with the idea of having the carry flow to you personally or to a family trust, which kind of replicates your standing as an individual, as opposed to a corporation, and again, not tax advice. There's probably a million nuances that I'm missing. But is it fair to say, like, that's a reasonable starting point?

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Kali Baraniski 14:34

Yeah, I think that's fair, right? Because you always have the opportunity to, let's say, a couple years down the road, to go and restructure your holdings if you know you aren't going to sell for quite some time, because it is important, right, that they're the the QSBC or the qualifying small business corporation rules. There's really three tests that have to be met in order to qualify. I'm not going to go into a whole lot of detail, but we really refer to them as the small business corporation test, the holding period test and the fair market value asset test. And as long as you're meeting those three requirements at the time of sale, then you can typically actually, in all scenarios, get the lifetime capital gains exemption. So you do have time if you knew a sale was going to be up and coming, call it within at least two years. Kind of 24 months is the magic timeline. But within two years, you have some time to structure if you were looking to sell.

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Steve Divitkos 15:36

Right. So you mentioned a holding period minimum. Can you just speak to that a little bit?

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Kali Baraniski 15:42

Sure. Yeah. So throughout the 24 months, immediately before the share was disposed of, the share must not have been owned by anyone other than the individual or person or partnership related to the individual. So in other words, if you go and buy a company, if I buy a company from you, let's say today, and I go and I grow that company and I want to sell it within six months, I wouldn't be able to get that lifetime capital gains exemption, because I need to hold it for the full 24 months.

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Steve Divitkos 16:15

Got it. Got it. Okay, so we have a private company. We're comfortable that it is Canadian controlled. We know that we're going to hold it for greater than two years. Thus far, we've talked about the perspective of like the entrepreneur, the CEO. Let's talk briefly about the investor's perspective. Are there any commercial or strategic reasons why either a Canadian investor or a US investor might not want CCPC status to be conferred upon a portfolio company?

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Kali Baraniski 16:48

I don't think there's any reasons you wouldn't want to see a CCPC. I think typically, you know, there are a lot of benefits too, and even investors, right, would look to incentives that the company has that are ultimately growing that business. So I don't think there's anything that would deter an investor from being a CCPC.

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Steve Divitkos 17:09

And in fact, as a Canadian investor, to the extent that you have room within that lifetime capital gains budget, to the extent that you sell your shares as an investor, you yourself can benefit from that same treatment.

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Kali Baraniski 17:19

Correct. Yeah, right.

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Steve Divitkos 17:20

Okay. Are there any exceptions that we need to be aware of? So earlier in this episode, I was speaking to folks about Section 1202 or qsbs in the United States, and they have some industry related exceptions. All else being equal. You know, product companies tend to qualify more so than service companies. Are there any like industry or maybe even company size restrictions that we should be aware of?

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Kali Baraniski 17:46

So certain industries, so think of like financial services is one, or like highly regulated industries for professionals might be carved out that kind of disqualified them from CCPC status. Nothing notable on size. Again, it's going to come down to control, and whether it's legal or factual control. Yeah, I don't know if there's anything else really, other than I'm just trying to think, if you're too large, you could get pulled out of, let's say, like the shred credits, for example, that could get pulled out, or the small business deduction, right, where I said 500,000 versus 26 and a half percent versus 12.2 that might get ground down. But again, I don't think there's anything overly notable on this one.

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Steve Divitkos 18:40

Are there any common deal structuring mechanisms that might complicate or preclude CCPC treatment? So when I say deal structuring mechanisms, I'm talking about if I were to buy your company, there would be some element of a seller note that you issued to me as the buyer, or an earn out, or maybe you're rolling some equity into the post, close entity, any common deal structuring mechanisms like that that would complicate or preclude CCPC treatment?

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Kali Baraniski 19:10

Yeah, so I think there are some. So structures just involving like notes or earn outs or equity roles, they could complicate the CCPC treatment when there is a retained interest by foreign owners. So you might want to limit the amount that foreign ownership has, because again, we're always looking at that whether you have a non resident controlling the Canadian company. But again, if you're kind of looking at this after the fact that you've already sold. So let's say you were a CCPC, you sold your company, you claimed your capital gains exemption. Well, maybe it's less so relevant, because you only have one capital gains exemption anyway. So it's kind of something just to think of the timing and maybe what the approach is going forward. It'd be nice if you kind of had this, you know Qualifying or the lifetime capital gains exemption on every transaction that you were to do, but you really only get one shot at it, so it kind of comes down to timing.

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Steve Divitkos 20:10

Got it, another question that is definitely going to elicit some PTSD from me is the following. So let's say that there is a Canadian entrepreneur listening to this, and she bought a company 12 to 24 months ago, and uh oh, she didn't know about everything that we've just talked about. Now that they're aware of the benefits of the CCPC program, the lifetime capital gains exemption, they do now want to pursue it for all the benefits that we've discussed today. My question to you is like, is it too late for her, or does she have some options? And if so, what are they?

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Kali Baraniski 20:47

No, I think, I think there's a few options still available, right again, I think the key one that we kind of mentioned was that holding period test, or the 24 months that you want to hold those shares before you sell. The next one is going to be the small business corporation test. So this one really is at the time of disposition, the shares must be a share of the capital stock of a small business corporation. And again, this really goes to where are your assets located. So where you kind of run into issues are, if you have a Canadian company, but most of the value is being derived underneath from a US subsidiary. Well, you might not qualify as a qualifying small business corporation, so there are some options there, if all of a sudden she's thinking, Well, you know, I really want to qualify as a QSBC because I'm looking to sell call it within the next year or two. There's some planning that can be done to kind of clean out that corporation to meet all three of those tests, so that when she does go to sell that she's a clean qualifying small business corporation.

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Steve Divitkos 21:52

Okay, and the mechanics, correct me if I'm wrong, but let's say, for the past two years, they have not been claiming shred credits. They have been not they have not benefited from that lower tax rate in the first 500k of corporate income. But now they want to start taking advantage of it. My very rudimentary understanding of the mechanics is they would have to have like a value crystallization event, where they kind of lock in the value of the company today and any value created over the next several years, over and above the quote, unquote crystallization date, that value will at least benefit from the lifetime capital gains exemption once they do, I guess, qualify as a CCPC. Is that directionally accurate?

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Kali Baraniski 22:37

I think directionally right. I think where that's more common is actually when you're introducing maybe even more shareholders. So let's say, you know, she's kind of been there from day one, but maybe she has a spouse or a family or kids that maybe could also benefit from that lifetime capital gains exemption. That's really common when we'll see that crystallization transaction, because what she's doing there is she's freezing the value today of what her growth was in that company, and then she's introducing other shareholders that will benefit from that future growth going forward. So I would agree.

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Steve Divitkos 23:12

Okay, so the short of it is it's not too late, if you have been running it the past couple of years, and now this is something that you want to pursue.

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Kali Baraniski 23:19

Yeah, but pursue it, I think sooner rather than later, just because there are a lot of nuances with the rules and the legislation and all of that. So I think just get ahead of it. It's not something that you want to tell your tax advisor two to three weeks before closing a transaction. I think speaking from experience, I think we'd like a little more time. But yeah, I think that's probably the best approach.

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Steve Divitkos 23:44

Kali, thank you so much for joining us today. Really appreciate your time.

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Kali Baraniski 23:48

Thanks so much, Steve.