THE ENTREPRENEURSHIP GAP: IS CANADA'S QSBC REGIME FIT FOR PURPOSE?

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Canada's personal tax system provides some incentives for startups, but these incentives are considerably less generous than corresponding US rules. To level the playing field, we recommend that Canada adopt a streamlined version of corresponding US incentives to encourage innovators and entrepreneurs to incorporate and remain in Canada.

Background

The 2025 Liberal election platform stated that "Canada creates the greatest innovators and entrepreneurs there are, but too many of them have been drawn away from Canada." Parliament subsequently enacted several measures designed to encourage business investment by permitting the immediate expensing of certain capital investments, including the reinstatement of the "accelerated investment incentive." A November 2025 press release promoted these measures as the "productivity super-deduction," claiming that they would make Canada more competitive by reducing the so-called marginal effective tax rate (METR) of affected investments.

While welcome, these changes seem unlikely to move the needle on attracting and retaining mobile entrepreneurial activity. Critically, they do not address the personal tax treatment of founders and early investors in connection with exit transactions. The problem is compounded by the more generous regime south of the border. By focusing only on the METR, the Canadian reforms seem unlikely to stem the outflow of innovators and entrepreneurs.

Canada Has Fallen Behind in Startups

A 2025 Leaders Fund study (*The Future at Risk: Canada's Shrinking Startup Pipeline*) tracked almost 3,000 startup companies founded by Canadians between 2015 and 2024. The study found that Canada has fallen behind. In 2015, the United States produced 11 times as many high-potential startups—companies raising more than US$1 million—as Canada. By 2024, that multiple had risen to 45 times. Furthermore, of the high-potential startups formed in Canada, the United States, the European Union, and Israel, Canada's share fell from 4.3 percent in 2015 to 1.5 percent in 2024. Startups tend to create high-value jobs, enhancing not only productivity but also the tax base. It is important for Canada to catch up.

The study recommended that Canada adopt more favourable tax incentives for startups—specifically, a more generous version of the US qualified small business stock (QSBS) incentive under the Internal Revenue Code (IRC). Others have made similar observations. A 2025 article by Gary Marshall ("Should Founders Incorporate Their Startups in Canada or the United States?") compared the advantages and disadvantages of incorporating a startup in Canada and the United States. It concluded that eligibility for the US QSBS regime was an important advantage of US incorporation. Canadian incorporation can provide access to the lifetime capital gains exemption (LCGE) through Canada's qualified small business corporation (QSBC) regime, but that regime is much less generous than the US QSBS rules.

Canada's legislative drafters are no doubt aware of the US QSBS regime. Indeed, in 2024, when the federal government proposed the (since-abandoned) increase in the capital gains inclusion rate, it simultaneously proposed a reduced inclusion rate under the so-called Canadian entrepreneurs' incentive (CEI). The CEI would have provided a reduced inclusion rate on up to Cdn$2 million of capital gains on shares held by "founders," and it would have shared some design features with the QSBS regime. But the proposed relief was far more modest than what was available under the QSBS rules, and the measure has since been abandoned.

Overview of the US QSBS Regime

The IRC provides individuals (and certain other non-corporate taxpayers) with a capital gains exemption—structured as an exclusion from gross income—for gains realized on the sale of QSBS, provided those shares are held for a specified period, generally five years. To qualify for QSBS treatment, the following conditions must be met:

1. The shares must be issued by a US "C" corporation (rather than, for example, a Canadian or other non-US corporation) directly to the taxpayer at original issuance in exchange for money, other property, or services.
2. The issuing corporation must be a "qualified small business," meaning that, at the time of issuance and immediately afterward (taking the proceeds of issuance into account), its aggregate gross assets—cash plus the adjusted basis of its other property—must not exceed a statutory ceiling (US$50 million for shares issued on or before July 4, 2025, and US$75 million for shares issued thereafter).
3. During substantially all of the taxpayer's holding period, the corporation must meet an active business requirement: at least 80 percent (by value) of its assets must be used in the active conduct of one or more "qualified trades or businesses," a defined term that excludes most professional and financial services, farming, hotels and restaurants, and similar businesses.

The QSBS rules are in some respects quite flexible.

First, the QSBS asset cap (item 2, above) applies only at a specific point in time: the issuing corporation's aggregate gross assets are tested only at issuance and immediately afterward (taking the proceeds of issuance into account), not on an ongoing basis; shares that qualify at issuance retain their status even if the corporation's assets later grow well beyond the ceiling. There is therefore no tax incentive for a small startup to remain small.

Second, "aggregate gross assets" are measured by the adjusted tax basis of the corporation's property, not its fair market value (FMV). This means that a corporation can have substantial self-created intangible value (for example, goodwill) without exceeding the asset cap.

Third, the original-issuance requirement is narrower than it sounds. It bars a direct secondary purchase of existing shares from another shareholder but does not prevent a work-around that uses a new holding company. For example, in a common planning structure, a newly formed holding company issues its own shares to investors for cash and then uses that cash to acquire shares of the target from a selling shareholder. The holding company's shares are considered to have been originally issued and may qualify as QSBS, even though the underlying business is an established one and the holding company acquired shares from existing shareholders.

The 2025 One Big Beautiful Bill Act (OBBBA) enhanced the QSBS exemption for shares issued after July 4, 2025. For shares issued before these changes, up to 100 percent of eligible gains could be exempt, but only if the shares were held for more than five years. If the holding period is shorter, no exemption is available. The OBBBA loosened these rules for shares issued after July 4, 2025. The five-year cliff was replaced with a graduated exemption: 50 percent after three years, 75 percent after four years, and 100 percent after five years. The non-exempt portion is taxed at 28 percent, a higher rate than the generally applicable US long-term capital gains rate.

The original rules also imposed a per-issuer, per-taxpayer cap (but not a lifetime cap), generally equal to the greater of (1) US$10 million and (2) 10 times the tax basis of the assets contributed to the corporation in exchange for the shares. In addition, the tax basis of the corporation's assets could not exceed US$50 million when the shares were issued. For newly issued shares, the OBBBA generally increased the per-issuer, per-taxpayer cap to US$15 million, and the qualified small business asset ceiling to US$75 million. Both amounts are now indexed to inflation.

As explained below, the QSBS regime is considerably more favourable than Canada's QSBC rules. Although Canada's rules generally allow a shorter holding period, the US exemption is otherwise considerably more generous.

Key Features of the QSBC Regime

The QSBC regime provides individuals with a lifetime capital gains exemption on the disposition of QSBC shares. The exemption was recently increased to Cdn$1.25 million per individual and is now indexed to inflation ($1.275 million in 2026). However, alternative minimum tax (AMT) can partially offset the benefit of the exemption in a way that can be difficult to predict.

The "s" in QSBC stands for "small," but in fact these rules (unlike the small business deduction rules) do not require the issuer to be small. Relief is broadly available to qualifying shareholders of CCPCs that meet the regime's asset and activity tests. In simplified terms, the most relevant of those tests are as follows: (1) at least 90 percent of the corporation's assets must be used principally in an active business carried on primarily in Canada; (2) the shares must be held for a minimum of 24 months; and (3) throughout the preceding 24 months, at least 50 percent of the corporation's assets must have been used principally in an active business carried on primarily in Canada.

Together, these tests require a sufficient level of active business activity in Canada and limit the corporation's "passive" assets. Because relief is limited to CCPCs, the exemption is denied if, for example, the relevant corporation is controlled by non-residents or public corporations or is not incorporated in Canada. The requirement that assets be used in a business carried on primarily in Canada effectively discourages aggressive foreign expansion—an effect that can be contrary to business needs, given Canada's relatively small market.

A myriad of technical requirements and anti-avoidance rules exist to preserve the integrity of the basic rules, but they

Policy Recommendations

We recommend that Canada introduce a "QSBC super-deduction" to provide meaningful tax relief comparable to that offered by the QSBS regime. The new regime would draw on the QSBS rules and provide roughly similar benefits to Canadian entrepreneurs, encouraging them to stay and incorporate in Canada. The new regime would also share features with the existing QSBC system. Like the ill-fated CEI, the new regime would operate alongside the QSBC regime, providing greater relief where competitiveness concerns warrant it. We suggest the following features.

Enhanced Relief Amounts

The super-deduction should be large enough to make a meaningful difference. A per-issuer, per-taxpayer exemption cap of Cdn$20 million would be competitive relative to the US$15 million cap under the US rules.

Restrict Eligibility to Mobile Industries

The passive asset restrictions and Canadian activity requirements of the existing regime should be retained. The enhanced benefit, however, should be available only to businesses in industries that could realistically relocate to the United States—technology, life sciences, clean energy, and similarly mobile sectors. Professional services and businesses that are inherently local need no retention incentive of this kind. Carving them out, as the CEI proposed to do, would reduce the fiscal cost.

Remove the Lifetime Cap

The QSBS exclusion is capped per issuer and per taxpayer, but there is no lifetime limit for each individual. A serial entrepreneur can therefore access a fresh cap for each qualifying issuer across multiple ventures. Like the QSBS, the super-deduction should be available to each qualifying issuer rather than being subject to a taxpayer-specific lifetime limit that is reduced with each use.

Remove the Original-Issuance Requirement

The QSBS regime restricts the exclusion to original-issue shares—a limitation that can be planned around. Canada should not replicate it. Concerns about potential abuse can instead be addressed through GAAR.

Preserve Trust Multiplication

Under US rules, an individual can gift QSBS to certain kinds of trusts on a tax-deferred basis, effectively allowing multiplication of the exemption. Although Canadian rules do not permit such tax-deferred gifts, it is currently possible to multiply the LCGE through the use of trusts. To maintain competitiveness with the US regime, the existing multiplication opportunities under the LCGE regime should apply to the new super-deduction.

Do Not Mirror the QSBS Asset Cap, Remove AMT Exposure, But Retain the QSBC Holding Periods

market value. Accordingly, relief is regularly available for entities whose actual values are well above the asset caps. To make the super-deduction attractive, relief should be broadly available to CCPCs, regardless of size. Retaining the 24-month holding period, rather than adopting the five-year holding period required for the full QSBS exemption, could provide a competitive advantage to the Canadian regime. It would also be advisable to exclude this incentive from the AMT regime, given that AMT exposure would significantly curtail the relief available.

Follow the United States Downward

If the United States narrows the QSBS exclusion, as some American commentators have urged, Canada should recalibrate its regime to avoid providing relief beyond what competitiveness requires.

A Note on Competing Considerations

These recommendations will attract criticism on familiar policy grounds. Restricting the super-deduction to mobile industries creates horizontal inequities between otherwise similar businesses in different sectors. The design also adds to the problem of tax complexity, and the relief reduces the progressivity of the tax system. We acknowledge these objections. In our view, however, the competitiveness concern is serious enough to justify some policy compromise.

Conclusion

A better-designed tax incentive for entrepreneurs who sell their businesses—if it keeps a meaningful share of mobile founders in Canada—may well justify its fiscal and policy costs. At the very least, a Canadian regime that is broadly understood to be less generous than its US counterpart is ill-suited to the competitive pressures facing Canada.

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