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Easing of Family Business Transfer Rules

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Tax News

An individual can benefit from a capital gains exemption (CGE)[1] when disposing of the qualified shares of a private corporation. For the acquirer, it is usually more beneficial to purchase the shares by means of a corporation. However, the tax laws provide for rules preventing taxpayers from claiming the CGE when disposing of qualified shares to a non-arm's length corporation.[2] By virtue of these provisions, the gain realized on the sale of the shares to such a corporation are treated as a deemed dividend rather than as capital gain. Consequently, these anti-avoidance rules limit access to the CGE when a business is transferred to family members, including inter-generational transfers.

In Quebec, easing measures to make it easier to transfer family businesses have been in effect since March 17, 2016. Since these rules only apply for Quebec tax purposes and are subject to very stringent conditions, they are seldom used in practice.

No federal easing measure was provided at the federal level until recently. Bill C-208, assented to on June 29, 2021, introduces some measures to make intergenerational share transfers easier.

The *Tax News* summarizes these easing measures.

Raymond Chabot Grant Thornton has been lobbying for more than a decade for the relaxation of the rules on inter-generational share transfers. For more information, see the report entitled *La transmission d'entreprises : problématiques et pistes de solutions* (December 2010). Bill C-208 is therefore a step in the right direction.

Bill C-208 came into force on June 29, 2021, that is, the date it received Royal Assent. However, in a July 19, 2021 news release, the Department of Finance Canada indicated its intention to table a bill to amend these measures. The news release states the amendments would apply on November 1, 2021 at the earliest,[3] however, it is not clear whether they might apply retroactively or to a series of transactions that are in process on the date they come into effect. In addition, as Bill C-208 may have created certain loopholes, the tax authorities could potentially challenge their application to the extent that they consider that they have been used for tax avoidance purposes. Accordingly, although the amendments are technically in force as of June 29, 2021, there is still some uncertainty as to their overall application, pending the release of legislative proposals by the Department of Finance.

FEDERAL EASING MEASURES

The measures introduced in Bill C-208 amend the scope of two ITA provisions that result in limiting potential transactions by family businesses: ITA Section 84.1 and ITA Section 55.

Easing of ITA Section 84.1[4]

ITA Section 84.1 is amended to exclude some intergenerational share transfers. These amendments would allow a seller to realize a capital gain and, within certain limits, claim the CGE, while allowing the buyer to acquire through a corporation to facilitate financing.

The following conditions must be satisfied:

- Seller disposes of qualified small business corporation (QSBC) shares or shares of a family farm or fishing corporation (hereafter, the "relevant shares");[5]

[1] The 2021 cumulative indexed CGE limit is $892,218 for eligible small business corporation shares ($1M non-indexed annually for shares of a family farm or fishing corporation).

[2] Section 84.1 of the *Income Tax Act* (ITC), for federal purposes and Sections 517.1 and following of the *Taxation Act* (TA) for Quebec purposes.

[3] The news release states that the legislative proposals will be published for consultation and then introduced in a bill and apply as of the later of either November 1, 2021 or the date of publication of the final draft legislation.

[4] An example of the application of ITA Section 84.1 in an intergenerational transfer is provided in the attached appendix.

[5] That is, essentially, shares that qualify for the CGE.

- The shares are acquired by a corporation ("Buyer") controlled by one or more of Seller's children or grandchildren who are at least 18 years of age;
- Buyer does not dispose of the relevant shares within 60 months of acquiring them (for reasons other than death[6]);
- Seller provides an independent assessment of the fair market value (FMV) of the relevant shares to the Canada Revenue Agency (CRA), together with an affidavit signed by Seller and a third party certifying the disposition of the shares.

As currently drafted, the easing measures do not require that the children or grandchildren controlling Buyer be involved in the corporation's operations or have an interest in its appreciation. In addition, since the shareholding requirement applies to Buyer (the corporation that acquired the shares), it would seem there is nothing preventing the children or grandchildren from disposing of their shares in the corporation. In short, the current requirements do not ensure that this is a true intergenerational transfer. The Department of Finance has announced that it intends to amend the following issues with respect to relief measures introduced in Bill C-208:

- The requirement to transfer legal and factual control of the corporation carrying on the business from the parent to the child or grandchild;
- The level of ownership of the corporation carrying on the business that the parent can maintain for a reasonable time after the transfer;
- The requirements and timeline for the parent to transition his or her involvement in the business to the next generation; and
- The level of involvement of the child or grandchild in the business after the transfer.

CGE restrictions

It would seem, under Bill C-208 that sellers who benefit from the previously-mentioned easing measure could claim the CGE on the capital gain realized on the sale of their shares, to the extent that the corporation's taxable capital is not more than $10M at the time of the sale. The CGE the seller could claim would be gradually reduced when taxable capital is between $10M and $15M (nil after that).

While the provisions of Bill C-208 are intended to cap the amount of CGE that can be claimed based on the size of the corporation being sold, the current wording does not technically achieve this objective. Additional amendments to the ITA will be required to achieve this objective.[7]

Amendments to ITA Section 55

Subsection 55(2) in brief

A corporation's retained earnings are reflected in the FMV of its shares and increase the capital gain realized by shareholders on the disposition of the shares. In order to minimize such an unrealized capital gain, an attempt could be made to reduce the value of the operating corporation by paying a substantial dividend to a corporate shareholder before the sale of the shares. To the extent that dividends paid between two Canadian corporations are generally not taxable, such a transaction would have the effect of converting an unrealized capital gain into a tax-free intercorporate dividend.

The specific purpose of ITA subsection 55(2) is to prevent such an outcome. Under this subsection, the tax-free dividend amount that can be paid by an operating corporation in such a context is generally limited to its "safe income".[8] Any dividend paid over this amount is considered to be capital gain on the share.

An exception stipulates that ITA subsection 55(2) does not apply to certain transactions that involve only related parties. To this end, siblings are not considered to be related to each other, such that the exception generally does not apply when siblings are shareholders of the corporation.

Amendments with respect to siblings

Under the amendments included in Bill C-208, siblings will be treated as related for purposes of ITA Section 55 provided the transaction is carried out by a corporation whose shares are QSBC shares or shares of a family farm or fishing corporation.

ITA Section 55 is one of the main ITA provisions intended to prevent corporate surplus stripping and the tax authorities tend to apply a very restrictive interpretation of it.

In its current wording, the amendment proposed in Bill C-208 would apply as soon as the corporation's shares qualify as QSBC shares or are shares of a family farm or fishing corporation. At first glance, the scope of this new relief appears to be rather broad, since no other conditions are required for this purpose. In this context, this new measure could open the door to surplus stripping transactions which the tax authorities would consider abusive.

In her July 19, 2021 news release, the Finance Minister confirms her intention to present amendments to Bill C-208 that "honour the spirit of Bill C-208 while safeguarding against any unintended tax avoidance loopholes that may have been created by Bill C-208". The upcoming legislative proposals could include adjustments to this new measure.

Application date and comments

Bill C-208 came into force on the date it received Royal Assent, on June 29, 2021. However, on June 30, 2021, the Department of Finance Canada issued a news release indicating its intention to table a bill will to postpone the coming into force until January 1, 2022. In a new news release published on July 19, 2021, the Finance Minister affirmed that the Bill C-208 measures were in effect since it received Royal Assent, but reiterated her intention to amend them by proposing new measures that would apply as of November 1, 2021, at the earliest.

Therefore, while the amendments are technically effective since June 29, 2021, they will change and the exact scope of these amendments will not be known until the Finance Minister publishes the legislative proposals.

Bill C-208 is a private member's bill, which means that it was introduced by an MP (in this case, Conservative MP Larry McGuire of Manitoba). It is extremely rare for tax and economic measures to go through such a process. Typically, such measures are drafted by the

[6] The Act does not specify whose death. Since the shares are acquired by a corporation, some clarification is required in this respect.

[7] Additional amendments are also needed to resolve other technical issues with ITA Section 84.1.

[8] Safe income is essentially tax earnings (after tax) retained by the corporation. There are various rules governing this calculation as well as the allocation of safe income among various classes of a corporation's outstanding shares.

Department of Finance before being tabled for passage in the House of Commons with the support of the governing party. Parliamentarians have sent a clear message to the Minister of Finance that it is time to put an end to the apparent tax inequity of intergenerational transfers from family businesses.

The measures in Bill C-208 are intended to restore some neutrality to business transfers by treating children and grandchildren on the same basis as third-party purchasers. However, this Bill's adoption process has had some adverse effects: the wording of the measures is in some respects technically incomplete, preventing them from achieving some of their objectives and opening the door to transactions that may be perceived as abusive.

The tax authorities seem to want to provide a better framework for these new rules. However, there is still some uncertainty about the extent of the upcoming changes. While the July 19, 2021 release suggests that the current rules will not be changed until the fall, some of the changes may apply retroactively. In addition, the tax authorities may scrutinize transactions undertaken between now and then to identify taxpayers who have taken advantage of certain loopholes in a manner that they consider abusive and contrary to the spirit of the Act.

This situation creates uncertainty for tax professionals and for entrepreneurs wishing to plan their succession. In this context, your Raymond Chabot Grant Thornton advisor can help you make an informed decision based on your situation.

QUEBEC EASING MEASURES

The easing measures implemented by the Quebec government on March 17, 2016 enable shareholders to realize capital gains qualifying for the CGE when transferring certain qualified shares to a non-arm's length corporation. Therefore, a shareholder can claim a CGE on the capital gains resulting from the disposition:

- Of qualified shares of a corporation;
- To a non-arm's length corporation;
- As part of a transfer of a qualified family business.

Qualifying consideration

When shareholders sell their shares to a corporation, they may receive, as a consideration, either shares from the acquirer, or payment other than in shares (namely a cash payment or a promissory note), or a combination thereof.

The easing measure only applies to the consideration other than shares (e.g. money, note, etc.) received by the seller. Therefore, insofar as all other conditions are satisfied, the seller may generally claim the CGE up to the lower of the following amounts:

- The available CGE balance;
- The consideration other than shares included in the transaction.[9]

Qualified shares

The easing measure applies to the disposition of qualified shares, including:

- A share of the capital stock of a family farm business;
- A share of the capital stock of a family fishing business;
- A qualified small business corporation share.

The concept of qualified shares of a small business corporation and shares of a family farm or fishing corporation is that used for the purposes of qualifying for the CGE.

Transfer of a qualified family business

Basically, the easing applies when the seller, who must have played an active role in the business before the sale, withdraws from the business by disposing of shares to an acquirer who then in turn will play an active role in the business. More specifically, the following conditions must be satisfied for the transfer to qualify as a transfer of a qualified family business.[10]

- The taxpayer who disposes of the shares must be an individual, other than a trust;
- The taxpayer (or the taxpayer's spouse) played an active role in a business carried on by the corporation in question,[11] during the 24-month period immediately preceding the disposition of shares;[12]
- After the disposition of shares, the taxpayer (or the taxpayer's spouse) does not play an active role in a business actively carried on by the acquirer or by the corporation in question, except for:
  - An active role aimed at fostering a harmonious transfer of the knowledge on the corporation sold;[13]
  - An active role in a business of which 90% or more of the income is from a business other than that carried on by the corporation in question or by the acquirer.
- After the disposition of shares, the taxpayer (or the taxpayer's spouse) does not have de jure control of the corporation and neither the taxpayer nor his or her spouse belong to a group of persons having de jure control;
- After the disposition of shares, the taxpayer (or the taxpayer's spouse) does not hold common shares of the corporation in question;
- The FMV of all residual financial interests[14] held by all of the taxpayers having benefitted from the easing measure, and their respective spouses:
  - Must not be greater than 60% of the total FMV of the corporation in question[15] (80% for farming and fishing businesses), after the disposition of shares;

[9] If the adjusted cost base of shares disposed under the TA differ from that applicable under the ITA, the easing will apply to the lower of the deemed dividend calculated for federal purposes and that calculated for Quebec purposes.

[10] Several terms and conditions and exceptions are provided for the application of these criteria. Additionally, contrary to what had been initially announced, it will not be necessary to obtain a government-issued qualification certificate in respect of these criteria.

[11] Or by a corporation in which the corporation in question held a significant interest, as defined in ITA Subsection 191(2).

[12] Some exceptions apply, particularly with respect to disability or death.

[13] As applicable, the seller's annual compensation for his or her involvement in the business should not exceed the maximum amount of insurable gains for the purposes of the *Régime des rentes du Québec*.

[14] This residual participation (shares or debt) must also meet the prescribed conditions, particularly with respect to the performance rate (interest or dividend rate), as well as the redemption or conversion terms and conditions.

[15] This percentage applies on the basis of the corporation's FMV immediately before the beginning of the series of transactions in which the disposition takes place.

- Must be reduced to 30% of the FMV of the corporation[14] (50% for farming and fishing businesses), in accordance with the related conditions of repayment or redemption, no later than ten years after the disposition of shares.

- After the disposition of shares, at least one person participating in the body of shareholders of the acquirer (or the spouse of such a person) plays an active role in carrying on the business carried on by the corporation in question.

Do not hesitate to contact your Raymond Chabot Grant Thornton advisor who can help you determine which measures apply to your situation and assist you with the steps needed to benefit from these measures.

For further information, visit our website at rcgt.com.

Appendix – Illustration of the Application of ITA Section 84.1 in Connection with an Intergenerational Share Transfer (Before the Easing Measures)

Generally, when a shareholder disposes of a corporation's shares to a third party, the shareholder realizes a capital gain equivalent to the appreciation of the shares (that is, the excess of the FMV over their tax cost at the time of the transfer), regardless of whether the buyer is an individual, corporation or other entity (trust or other entity). Generally, if an individual transfers the shares of his or her corporation to a non-arm's length corporation[16] and the conditions under ITA section 84.1 apply, for tax purposes, the individual's gain will be treated as a dividend rather than a capital gain.

This rule results in an unfavourable tax treatment in the case of an intergenerational share transfer, as shown in the example of Mr. Thompson who wants to sell his shares in Opco to his daughter, Mary. The FMV of the shares is $1M and the tax cost is $1,000. Mr. Thompson has two options for the transfer.[17]

Scenario 1 – Sell of shares to Mary

By selling the shares directly to Mary, Mr. Thompson could use the $892,218 capital gain exemption (CGE).[18] He would then receive net cash of approximately $970,000.

Tax impact for Mr. Thompson		
Proceeds of disposition received		$1,000,000
Capital gain	$ 999,000	
Capital gain exemption	$(892,218)	
Taxable capital gain	$106,782	
Tax on capital gain (26.65%)		$(28,457)
Post-transaction net cash		$971,543

However, Mary must personally pay the purchase price. In order for her to have the cash needed to pay the $1M purchase price, Opco must pay her taxable dividends of about $1,924,000.

Cash needed for Mary to pay the purchase price	
Taxable dividends paid by Opco	$1,924,000
Tax on ordinary dividends (48.02%)	$(923,905)
Net post-transaction cash	$1,000,095

Scenario 2 – Sell of shares to a holding company owned by Mary

To facilitate financing the purchase price, Mary could acquire Opco's shares through a holding company (Holdco). In this case, Holdco could pay the shares from a $1M dividend received from Opco. As the dividend would be tax free,[19] the transaction cost would be considerably lower for Mary.

Cash needed for Holdco to pay the purchase price	
(Non-taxable) dividend paid by Opco	$1,000,000
Tax on intercorporate dividend	----
Net after-tax cash	$1,000,000

[16] Individuals connected by blood relationship, marriage or common-law partnership or adoption are considered to be related; this generally includes children, parents, grandparents, brothers and sisters and their respective spouses. These individuals are deemed to be related to the corporations where they hold a majority ownership, either alone or through a related group. Individuals related to such individuals are also related to these corporations. Lastly, unrelated individuals and corporations may be at non-arm's length if they are acting in concert with a common purpose.

[17] It is assumed in this example that the individual resides in Quebec and is subject to the maximum marginal tax rate of 26.65% for the capital gain and 48.02% for ordinary dividends in 2021.

[18] Ceiling for 2021.

[19] Intercorporate dividends are generally not taxable under tax legislation.

However, because Mr. Thompson and Holdco are not at arm's length, ITA section 84.1 provisions would apply. As a result, Mr. Tremblay's gain on the sale of Opco's shares would be treated as a taxable dividend, preventing him from claiming the CGE. Mr. Thompson's net cash received would be considerably lower since no part of his gain would be tax exempt and the tax rate applicable to a dividend is significantly higher than the rate on a capital gain.

Tax impact for Mr. Thompson		
Proceeds of disposition received		$1,000,00
Gain deemed to be a taxable dividend	$999,000	
Tax on ordinary dividend (48.02%)		$(479,720)
Net post-transaction cash		$520,280

Conclusion

If Mr. Thompson had sold his shares to a corporation owned by a third party, he would have realized a capital gain that qualifies for the CGE and the buyer could have financed the acquisition from Opco's future earnings, by paying tax-free dividends to the purchasing corporation. By selling to his daughter, Mr. Thompson is at a disadvantage in any scenario considered. This is what the easing measures described in the Tax News are intended to address. Thus, if the easing measures included in Bill C-208 are maintained in their essence and Quebec harmonizes with them, Mr. Thompson will be able to sell his shares to Mary's corporation (Holdco) and realize a capital gain that is eligible for the CGE, leaving him with a net cash position of $971,543. To finance this acquisition, Opco would pay a $1M tax-free dividend to Holdco.