

Intergenerational Transfers of Family Businesses – Proposed Tax Changes

July 2023

The Canadian tax legislation contains a number of anti-avoidance tax measures such as those which seek to prevent corporate “surplus stripping,” that can create a higher tax cost on the transfer of a business to a family member versus a sale to a third-party purchaser. This article focuses on important recent developments addressing this inconsistency in the tax legislation, as it relates to an anti-avoidance rule applicable to certain intergenerational transfers of shares. It also outlines the government’s latest response to ensure proper facilitation of genuine intergenerational share transfers, while preventing tax avoidance that could compromise the integrity of Canada’s tax system.

Generally, when a business owner sells shares of their incorporated business, the transaction results in a capital gain, which may be eligible for the Lifetime Capital Gains Exemption (“LCGE”). For 2023, the LCGE limit is \$971,190 for Qualifying Small Business Corporation (“QSBC”) shares (or \$1,000,000 for shares of a qualifying Family Farm or Fishing Corporation)¹. However, the shares are often sold to a purchaser corporation as a means of accessing the cash assets of the business being sold to provide funding for the purchase price. This is particularly common in an intergenerational transfer, as the younger generation family member(s) typically do not have sufficient personal liquidity (or access to lending) to enable a purchase of the shares from parents directly. Although this is allowable when the purchaser is an unrelated third party, where the purchaser is a corporation controlled by a non-arm’s length person, such as a family member, these anti-avoidance – “surplus stripping” – rules would typically apply to convert the capital gain into a taxable dividend (which is subject to a higher tax rate than a capital gain, and is ineligible for the LCGE). In effect, the tax legislation has historically encouraged the arm’s length sales of small businesses, farm and fishing corporations to the detriment of next generation family members.

In its 2019 Federal Budget, the Liberal government acknowledged this issue and indicated that it would reach out to farmers, fishers and other business owners “to develop new proposals to better accommodate intergenerational transfers of businesses while protecting the integrity and fairness of the tax system.” However, prior to the introduction of specific measures by the Federal government to address this concern, on June 29, 2021, private members’ Bill C-208, *An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)*, received Royal Assent. This legislation attempted to address this longstanding issue by seeking to apply a consistent tax treatment regardless of whether a business owner sells their business, family farm or fishing corporation to an arm’s length third party, or to their own family members.

Specifically, the legislation in Bill C-208 sought to limit the application of the aforementioned anti-avoidance rule in the case of certain intergenerational transfers of shares, to address the perceived unfairness of the prior legislation.

As enacted, the revised legislation in place currently excludes taxpayers from this anti-avoidance rule (and allow capital gains treatment) where:

- The shares transferred are QSBC shares or shares of a family farm or fishing corporation;
- The purchaser corporation is controlled by one or more children or grandchildren (aged 18 or older) of the taxpayer (vendor); and
- The purchaser corporation does not dispose of the transferred shares within 60 months of the purchase.

Furthermore, the existing legislation requires that the taxpayer must provide “an independent assessment of the fair market value of the subject shares and an affidavit signed by the taxpayer and by a third party attesting to the disposal of the shares.”²

Bill C-208 also modified the prior tax legislation to facilitate certain other corporate restructurings involving family businesses, by allowing siblings to divide the assets of a corporation on a tax-deferred basis (in a more simplified manner than a complex “butterfly” transaction), provided the shares of the corporation involved are QSBC shares or shares of a family farm or fishing corporation.

However, since the introduction of Bill C-208, many tax practitioners have raised concerns that this new legislation does not integrate properly with the existing provisions of the Income Tax Act, creates many uncertainties as to how the new rules will be applied, and provides only limited safeguards against abusive tax avoidance which could produce unintended results.

Moreover, the Department of Finance expressed concerns about this Bill during its ascent through the legislature. To that end, in a press release issued shortly after Bill C-208 was enacted, the Federal government clarified that it would introduce amendments to the Income Tax Act 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, such as “surplus stripping” (i.e., where dividends are converted to capital gains to take advantage of the lower tax rate), without any genuine transfer of the business actually taking place.

Subsequently, in its 2022 Federal Budget, the government announced a consultation process (which ended on June 17, 2022) for stakeholders to share their views as to how the existing rules could be strengthened to protect the integrity of the tax system, while continuing to facilitate genuine intergenerational business transfers. Following this consultation, in the March 28, 2023 Federal Budget, the government proposed amendments to the enacted Bill C-208 legislation to ensure that these provisions

would apply only where a “genuine” intergenerational business transfer takes place.

2023 Federal Budget Proposals

Specifically, as outlined in the 2023 Federal Budget, the government expressed concerns that the current legislation enacted by Bill C-208 does not require that:

- the parent cease to control the underlying business of the corporation whose shares are transferred;
- the child have any involvement in the business;
- the interest in the purchaser corporation held by the child continue to have value; or
- the child retain an interest in the business after the transfer.

As a result, the 2023 Federal Budget proposes that a “genuine” intergenerational share transfer would constitute a transfer of shares of a corporation (the Transferred Corporation) by an individual (the Transferor) to another corporation (the Purchaser Corporation) where a number of specific conditions are satisfied.

The following existing conditions would be maintained from the current Bill C-208 legislation enacted:

- Each share of the Transferred Corporation must be a “qualified small business corporation share” or a “share of the capital stock of a family farm or fishing corporation” (both as defined in the Income Tax Act), at the time of the transfer; and
- The Purchaser Corporation must be controlled by one or more persons each of whom is an adult child of the Transferor (the meaning of “child” for these purposes would include grandchildren, step-children, children-in-law, nieces and nephews, and grandnieces and grandnephews).

To ensure that only genuine intergenerational share transfers are excluded from the application of the above anti-avoidance rules, additional conditions are proposed to be added. To provide flexibility, the 2023 Federal Budget proposed that taxpayers who wish to undertake a genuine intergenerational share transfer may choose to rely on one of two transfer options:

1. An immediate intergenerational business transfer (3 year test) based on arm’s length sale terms; or
2. A gradual intergenerational business transfer (5-10 year test) based on traditional estate freeze characteristics.

The immediate transfer rule would provide finality earlier in the process, though with more stringent conditions, whereas the gradual transfer rule would provide additional flexibility.

The 2023 Federal Budget outlines the proposed conditions in detail under each of the two transition methods, both of which are intended to reflect the hallmarks of a genuine intergenerational business transfer. The Budget also proposes the following conditions, and outlines the differences between each of the two methods:

- Transfer of control of the business – identifying when legal and factual control is required to be transferred to family members;
- Transfer of economic interests in the business – required timing on transfer of common growth shares and reduction of parent’s economic interest in the business;
- Transfer of management of the business – by parents to their child(ren);
- Child retains control of the business – the length of time required for the next generation of family members to retain legal control of the business; and
- Child works in the business – outlining the required amount of time a child must be actively involved in the business following the share transfer.

The Transferor and child (or children) would be required to jointly elect for the transfer to qualify as either an immediate or gradual intergenerational share transfer. Recognizing that the actions of the child(ren) could potentially cause the parent to fail the conditions and to be reassessed for taxes owing, the child(ren) would be jointly and severally liable for any additional taxes payable by the Transferor, because of any anti-avoidance rules applying, in respect of a transfer that does not meet the above conditions.

Furthermore, limitation periods for reassessing a Transferor’s tax liability that may arise on the transfer are proposed to be extended by 3 years for an immediate business transfer, and by 10 years for a gradual transfer, to provide the CRA the ability to monitor compliance with the proposed conditions on genuine business transfers.

Lastly, the 2023 Federal Budget also proposes to provide a ten-year capital gains reserve for genuine intergenerational share transfers that satisfy the above conditions. All proposed measures would apply to transactions that occur on or after **January 1, 2024**.

Seek advice

As a result of these recent developments, family business owners – particularly those contemplating an intergenerational transfer in the near future – should take steps to better understand the recent 2023 Federal Budget proposals which seek to limit the application of the current tax legislation to “genuine” intergenerational share transfers occurring after 2023. Specifically, family business owners should consult with their tax advisors for direction in their particular situation and determine what, if any, action should be undertaken prior to the January 1, 2024 proposed implementation date of these important changes to the income tax legislation affecting family businesses.

For more information, please speak with your BMO financial professional.



¹ For more information, ask your BMO financial professional for a copy of our publications, *Tax Planning for Small Business Owners* and *Tax Planning for the Family Farm*.

² The Canada Revenue Agency (“CRA”) provided details regarding the required valuation report and affidavit in the following link: Affidavits and valuations for the transfer of a small business, family farm or fishing corporation (Bill C-208) <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-12700-capital-gains/whats-new-capital-gains/affidavits-valuations-transfer-small-business-family-farm-fishing-corporation-bill-c-208.html>

BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual’s particular tax position should be obtained in respect of any person’s specific circumstances.

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, and philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. Estate, trust, and custodial services are offered through BMO Trust Company. BMO Private Wealth legal entities do not offer tax advice. BMO Trust Company and BMO Bank of Montreal are Members of CDIC.

© Registered trademark of Bank of Montreal, used under license.

All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth.