

Tax Relief Proposed for Intergenerational Transfers of Family Businesses

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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 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 2022, the LCGE limit is \$913,630 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 often 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, no proposals have yet been introduced by the Federal government to address this concern.

Instead, 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 new legislation attempts 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 seeks 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 will exclude 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 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 on July 19, 2021, the Federal government clarified that it intends to bring forward 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.

Specifically, the press release provided the following list of issues the amendments to Bill C-208 would seek to address:

- The requirement to transfer legal and factual control of the corporation carrying on the business from the parent to their child(ren) or grandchild(ren);

- The level of ownership in 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 their involvement in the business to the next generation; and
- The level of involvement of the child(ren) or grandchild(ren) in the business after the transfer.

While acknowledging that Bill C-208 is now law, the Federal government stated its intention last year to bring forward draft legislative amendments for consultation to ensure that the revised legislation will facilitate genuine intergenerational transfers and cannot be used for artificial tax planning purposes. At that time, the government indicated that the amended legislative proposals would not be effective prior to the date of publication of the final draft legislation.

Although this draft legislation was anticipated in the April 7, 2022 Federal Budget, the Budget did not propose any specific measures to address the government’s concerns related to the enacted provisions from Bill C-208. Instead, the Budget announced a consultation process 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. The government reiterated that it is committed to bringing forward the necessary legislation to address this specific issue, which could be tabled in the fall of 2022 following the conclusion of the consultation process (which ends on June 17, 2022).

Seek advice

As a result of these recent developments, much uncertainty remains about the new legislation enacted in Bill C-208, given the forthcoming amendments expected from the Federal government later this year which will seek to limit the application of these new rules to “genuine intergenerational share transfers.” Accordingly, taxpayers should be cautious in taking action based on the current legislation from Bill C-208 and should consult with their tax advisors for direction in their particular situation as we await further announcements from the Department of Finance on this important development for 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") recently published 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>

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