Selling the family business?
The tax rules are in flux

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If you are considering transferring your incorporated business to a family member, you may be wondering about the tax implications. Recent tax changes, along with conflicting statements by the Department of Finance, have resulted in confusion regarding the tax treatment of intergenerational business transfers. Let's review the history of the tax rules governing these transfers, how they have changed, and what future amendments we may still expect this fall.

Background

A corporation may distribute its after-tax earnings by paying dividends to its shareholders, who will then pay personal tax on that dividend income. In contrast, when earnings are retained in the corporation, all other things being equal, the value of the shares will increase by the amount of the retained earnings such that a shareholder who sells shares of the corporation will realize a capital gain on that increase in value. This is typically preferrable to dividend treatment since capital gains tax rates are generally lower than dividend tax rates. In addition, a capital gain may be sheltered from tax if the gain qualifies for the lifetime capital gains exemption (the "LCGE")[1]. A shareholder may, therefore, prefer to sell shares and realize a capital gain, rather than receive dividends.

There are, however, "surplus stripping" rules to prevent a shareholder from selling shares to a family member (or other non-arm's length party) simply to realize a capital gain rather than receive dividends. Under these rules, when a business owner sells shares of an incorporated business to a non-arm's length corporation (typically owned by a family member), the seller is treated as if they received a dividend rather than realizing a capital gain. These rules discriminate against sales to family members, since the seller ends up paying more tax than if the shares were sold to an arm's length third party.

In 2017, the Department of Finance ("Finance") indicated that they were reviewing, and might amend, these tax rules so that the sale of an incorporated business to a family member would be treated the same as if the business was sold to a third party.

Before any new rules could be brought forward by Finance, however, a private member's Bill ("Bill C-208") was introduced with favourable tax changes targeting transfers of a business to (grand)children. While it is quite unusual for a private member's Bill containing tax measures to get passed, that's exactly what happened. Bill C-208 became law on June 29, 2021, even though Finance had expressed concerns about the changes proposed in the Bill.

[1] The LCGE may be available where either qualified farm or fishing property is sold, or shares of a qualified small business corporation are sold. Qualified small business corporation shares are shares of a private corporation which is Canadian controlled, and which meets certain threshold tests for the percentage of assets used in an active business. For 2021, the LCGE for corporation is $892,218 and for farming or fishing property is $1,000,000.

Bill C-208 changes

As a result of the tax changes implemented by Bill C-208, which are now in effect, when certain shares are sold to a corporation controlled by the seller's adult (grand)child, it is treated in the same way as a sale to a third party and the seller will realize a capital gain rather than a deemed dividend. To qualify, the shares must be either qualified small business corporation shares or shares of a family farm or fishing corporation, and the (grand)child's corporation must hold the shares for at least five years after the sale[2]. And, if the vendor can use their LCGE, they may avoid tax on some (or all) of the capital gain. Note that the rules do not apply to family members other than (grand)children.

Department of Finance press release

On July 19, 2021, Finance issued a press release[3] indicating its intention to propose amendments to the rules under Bill C-208. Finance indicated that any proposed amendments would honour the spirit of Bill C-208 while helping to ensure the new rules apply only to "genuine intergenerational transfers" and safeguard against "any unintended tax avoidance loopholes that may have been created," such as surplus stripping. Any amendments would be effective from the later of November 1, 2021 and the date that final draft amendments are released.

Some of the issues to be addressed by the proposed amendments include: the requirement to transfer not only legal control, but factual control as well, and how involved the (grand)child must be in the business after the transfer. As for the (grand)parent, the proposed amendments will address the level of ownership a business owner can maintain in the corporation after the sale, and how they must transition involvement in the business to the next generation to qualify for the favourable tax treatment.

Transfers prior to November 1, 2021

Many business owners are now left wondering what types of intergenerational business transfers can be undertaken with a (grand)child before any further changes are made to the new rules in Bill C-208.

Most tax advisors will likely be comfortable that a business owner would get capital gains treatment where there is a genuine intergenerational transfer to a (grand)child who was actively involved in the business prior to the transfer, and remains so afterwards.

The issue is much trickier where the sale appears to satisfy the specific technical wording in Bill C-208 but does not meet the spirit of the Bill. This could happen, for instance, if a (grand)parent sells shares but retains factual control and involvement in the business and the (grand)child may never be involved in the business.

A number of tax advisors have cautioned that the Canada Revenue Agency (CRA) could use the General Anti-Avoidance Rule (GAAR) to reassess transactions that do not appear to be "genuine intergenerational transfers," even if they strictly follow the rules in Bill C-208. A recent decision of the Federal Court of Appeal[4] considered a tax rule which denies the carryforward of losses when there has been an acquisition of legal control of a corporation. The GAAR was applied to deny loss carryforwards where there had been an acquisition of *actual* control of the corporation, even though the technical language of the relevant tax legislation required the acquisition of *legal* control of a corporation. Some tax advisors are concerned that the CRA could use this case as a precedent to reassess intergenerational transfers occurring without a genuine transfer of control, even where the technical requirements of the Bill C-208 rules have been satisfied.

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[2] There are additional requirements to be met.

[3] This July 19, 2021 press release replaced a previous press release which questioned whether Bill C-208 was, indeed, law, despite it having received Royal Assent.

[4] Canada v. Deans Knight Income Corporation, 2021 FCA 160.

Conclusion

Until Finance issues any proposed amendments to the Bill C-208 rules, it's important that business owners tread carefully and obtain independent legal and tax advice before engaging in any type of transaction that might be considered "surplus stripping".

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