Wealth Management


INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

# Intergenerational business transfers

## Some tax relief for business succession within your family

Please contact us for more information about the topics discussed in this article.

You've worked hard over to years to build a successful business and it's your wish to pass it to the next generation. However, the Income Tax Act (ITA) contains long-standing anti-avoidance rules that made it more attractive, from a tax perspective, to sell your shares of a qualified small business corporation (QSBC) or shares of the capital stock of a family farm or fishing corporation (FFFC) to an arm's-length third party rather than a family member.

To address this inequality between family and non-family business sales, Bill C-208, a private member's bill, was introduced and received Royal Assent on June 29, 2021. The rules outlined in the Bill became effective immediately on this date. The legislation in Bill C-208 amended the ITA to provide that, under certain conditions, the transfer of QSBC or FFFC shares by a taxpayer to a corporation controlled by the taxpayer's child or grandchild, who is at least 18 years of age, is excluded from the anti-avoidance rules, and in the case of a reorganization of a business involving QSBC or FFFC shares, siblings are now considered related for this purpose.

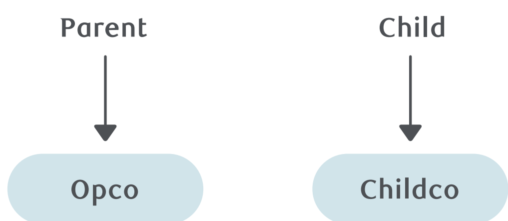
The 2023 Federal Budget, the revised August 4, 2023 draft legislation, and now Bill C-59, have proposed changes to the existing rules introduced by Bill C-208 to ensure that only "genuine" intergenerational business transfers benefit from the exceptions to the anti-avoidance rules. This article provides an overview of the very complex rules and proposals.

## Sale of family business to your adult child

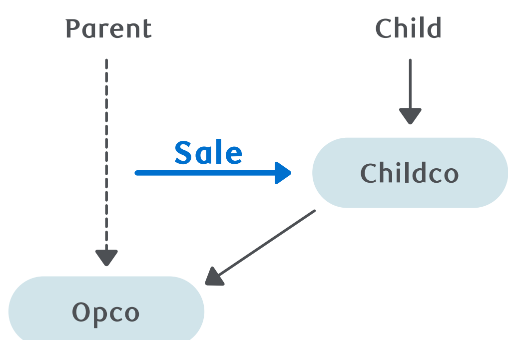
As mentioned, an existing anti-avoidance rule in the ITA provides that, where you transfer your QSBC shares or shares of an FFFC to another corporation that you do not deal at arm's length with, the transfer may result in a deemed dividend instead of a capital gain. As a result, you may pay much more tax, as the rate of tax on a dividend is generally much higher than a capital gain. In addition, you would not be able to claim the capital gains exemption on the sale of your shares. This conversion of a capital gain to a deemed dividend would not occur if you sold the shares of your corporation to an arm's-length third party.

The following diagram shows a very simplified example of the structure before and after the sale. In the example, you are not dealing at arm's length with Childco, as you're related to the person who controls Childco.

**Before the sale of your QSBC/FFFC to your adult child's corporation**




**After the sale of your QSBC/FFFC to your adult child's corporation**




The legislation introduced by Bill C-208 attempted to fix this issue by providing exceptions to the anti-avoidance rule for certain transfers of QSBC shares or shares of an FFFC from an individual to corporations owned by their child (definition of "child" to be discussed later). However, the rules introduced by Bill C-208 contained insufficient safeguards and applied even where no transfer of a business to the next generation had taken place.

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The proposed rules contained in Bill C-59 will amend the rules introduced by Bill C-208 to ensure they apply only where there's a genuine intergenerational business transfer. These proposed rules are applicable for transactions that occur on or after January 1, 2024.

A genuine intergenerational transfer would be a transfer of shares of a corporation (the subject corporation) by a natural person (the transferor, referred to as the "parent" in this article) to another corporation (the purchaser corporation) where several conditions are satisfied. These rules apply where all of the following are met:

- Each share of the subject corporation is a QSBC share or a share of an FFFC at the time of the transfer;
- The purchaser corporation must be controlled by one or more persons, each of whom is an adult child of the transferor; and
- The transferor must not have used this exception for a previous disposition of shares in respect of the same business (other than if the exception was used before January 1, 2024).

The meaning of "child" for these purposes would include the transferor's or their spouse's child, grandchild, great-grandchild and their respective spouses; it would also include the transferor's or the transferor's spouse's niece or nephew and the niece or nephew's spouse or child. In this article, wherever "spouse" is used, it also includes a common-law partner.

The proposed conditions to be considered a genuine intergenerational business transfer would include the following (these will be discussed in more detail later):

1. Transfer of factual and legal control of the business;
2. Transfer of economic interest in the business;
3. Transfer of management of the business;
4. Child retains control of the business;
5. Child works in the business.

To provide flexibility, the proposed legislation also introduced two transfer options to undertake a genuine intergenerational share transfer:

- An immediate intergenerational business transfer completed within 36 months;
- A gradual intergenerational business transfer completed over a period of up to 10 years.

The conditions and rules for immediate versus gradual transfers are different but overlap in some circumstances. These rules are complex and a detailed discussion is beyond the scope of this article. The following chart provides a brief summary of some of the key requirements.

<table>
<tr><th></th><th>Immediate transfer</th><th>Gradual transfer</th></tr>
<tr><td>1. Control of the business</td><td>The parent, together with a spouse, must not have legal or factual control of the subject corporation, as well as any relevant group entity that carries on the business of the corporation, at any time after the transfer.</td><td>The parent, together with a spouse, must immediately transfer legal control of the subject corporation, as well as any relevant group entity that carries on the business of the corporation, but the parent and their spouse may retain some factual control until the close of the transaction, which may be up to 10 years.</td></tr>
<tr><td rowspan="2">2. Economic interest in the business</td><td colspan="2">The parent, either alone or together with their spouse, must not own 50% or more of any class of the voting common shares of the subject corporation, the purchasing corporation, or a relevant group entity after the transfer for the immediate transfer option, or within 36 months for the gradual transfer option.<br><br>The parent and their spouse may continue to hold indefinitely fixed value shares that are non-voting, non-convertible where the dividends on the shares must be fixed at amount not exceeding a prescribed limit.</td></tr>
<tr><td></td><td>Within 10 years of the transfer, the parent, together with their spouse, must not own debt or equity interests in the subject corporation, purchaser corporation or relevant group entity with a fair market value (FMV) that exceeds 30% of the FMV of all their interests at the time of the initial transfer (for a transfer of shares of an FFFC, the threshold is 50% instead of 30%).</td></tr>
<tr><td rowspan="2">3. Management of the business</td><td colspan="2">The parent and their spouse must take reasonable steps to:<br>• Transfer management of each relevant business of the subject corporation and any relevant group entity to the child, or at least one member of the group of children, who are actively engaged on a regular, continuous and substantial basis; and<br>• Permanently cease to manage all relevant businesses of the subject corporation and any relevant group entity.</td></tr>
<tr><td>The transfer of management of the subject corporation's business from parent to child must generally be completed within 36 months of the transfer date.</td><td>The transfer of management of the subject corporation's business from parent to child must generally be completed within the later of 60 months and the completion of the transfer which could be up to 10 years.</td></tr>
</table>

| | Immediate transfer | Gradual transfer |
|---|---|---|
| **4. Retention of control of the business by the child** | The adult child (or children) must retain legal control of both the subject and the purchaser corporations for 36 months after the transfer. | The adult child (or children) must retain legal control of both the subject and the purchaser corporations for the later of 60 months after the initial transfer or until the close of the transaction, which may be up to 10 years. |
| **5. Child's involvement in the business** | Within 36 months of the transfer, at least one child is actively involved on a regular, continuous and substantial basis in the relevant businesses of the subject corporation or a relevant group entity and these businesses continue to be carried on as active businesses. | Within the later of 60 months or the completion of the transfer (which could be up to 10 years), at least one child is actively involved on a regular, continuous and substantial basis in the relevant businesses of the subject corporation or a relevant group entity and these businesses continue to be carried on as active businesses. |
| | Active involvement generally means working at least 20 hours per week. | |
| **Joint tax election required** | The parent and child (or children) need to file a joint tax election in prescribed form to take advantage of these proposed rules. The election must be filed on or before the parent's filing due date for the taxation year that includes the date of initial transfer.<br><br>The child (or children) would be jointly and severally liable for any additional taxes payable by the parent, in respect of a transfer that does not meet the conditions. The joint tax election and joint and several liability recognize that the actions of the child could potentially cause the parent to fail the conditions and to be reassessed. | |
| **Capital gains reserve** | Where the election is made, the parent may be able to claim a capital gains reserve over a period of up to 10 years. | |
| **Normal reassessment period** | The reassessment period for the year of transfer is extended by three years. | The reassessment period for the year of transfer is extended by 10 years. |

The proposed legislation recognizes that some of the mentioned tests may not be met due to certain triggering events (for example, when the shares in the hands of the child (or children) are sold to an arm's-length party, upon the death or physical or mental impairment of an active child or an insolvency event). In these scenarios, the relevant tests are deemed to have been met.

## Siblings involved in the reorganization of a family business

Existing rules in the ITA may convert an otherwise tax-free intercorporate dividend into a taxable capital gain in certain circumstances. However, there is an exception to these rules where related parties are involved. Although siblings are generally considered related for most provisions of the ITA, they were considered unrelated under these particular rules. As a result, they couldn't rely on this exception and reorganizations of a family business where siblings were involved could be extremely complex.

The legislation introduced by Bill C-208 provides a new exception so that siblings will be considered related in the case where the dividend was received or paid, as part of a transaction or event, or a series of transactions or events, by a QSBC or an FFFC.

As a result of these new rules, reorganizations involving siblings may be much less cumbersome. These rules became effective when Bill C-208 received Royal Assent on June 29, 2021.

## Conclusion

If you have a QSBC or an FFFC that you intend to transfer to the next generation, or where you're contemplating a reorganization involving your siblings, you should consult with your qualified tax advisor to see if you can take advantage of these new rules and proposals. In addition, you will have many non-tax considerations before transferring your family business to the next generation. You and your family may need to have open discussions on issues such as who's going to take over the business, how to structure your retirement funding and how to equalize your estate, etc. It's important that you start the process early to have sufficient time for proper planning.

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