IE INVESTMENT EXECUTIVE

Window closing on family business transfers using Bill C-208

Fed's proposed new rules will be more restrictive

By: Rudy Mezzetta | Source : Investment Executive | October 10, 2023 | 10:00

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Rudy Mezzetta

This article appears in the forthcoming Mid-October issue of Investment Executive.

A client who is ready to sell their business to their child should consider doing so before new tax rules affecting the transfer of family businesses kick in next year.

The government's Budget 2023 proposals impose greater restrictions on how a business can be transferred to the next generation in a tax-efficient manner. The new rules would replace legislation that came into effect two years ago with the passage of Bill C-208.

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"If the kids are indeed ready [to take over the business], why wait for the new rules?" said Kenneth Keung, director of Canadian tax advisory with Moodys Private Client Law LLP in Calgary.

Under those proposals, Keung said, there's a "long, lingering period of restrictions and uncertainty." The proposed rules contain certain requirements, such as for a child to be engaged in the business full-time, that must be met over several years.

"These kinds of restrictions mostly do not exist in the current rules," Keung said. "So, if possible, one should probably try to fit themselves into the rules today."

Brian Ernewein, senior advisor with KPMG LLP in Ottawa and who worked for 35 years in the tax policy branch of the Department of Finance, said the current rules favour business owners who want to transfer some of the company to a child but also keep some control.

The proposed measures, which are yet to be adopted by Parliament, would apply to transfers on or after Jan. 1, 2024.

Despite the drawbacks, the government's proposals allow business owners to pass their businesses to adult children (including grandchildren, nieces, nephews, grandnieces and grandnephews) in a tax-efficient manner, an option that was largely unavailable before Bill C-208, said Kevin Wark, a tax consultant with the Conference for Advanced Life Underwriting (CALU) in Toronto.

The Department of Finance "has made a very good effort to respond to the input they've received and [to] design a system that will be supportive to a number of small-business owners who want to transfer their business to family members," Wark said.

In the 2023 federal budget, the government proposed amending the rules in Bill C-208 to ensure they apply only to genuine intergenerational business transfers.

The proposals include new conditions for a business transfer to qualify as a genuine intergenerational transfer. The conditions could be met using one of two transfer options:an “immediate” option with a three-year test; or a “gradual” option with a five- to 10-year test. Meeting either condition would exclude the transfer from the anti-avoidance provision.

The government believed Bill C-208 allowed a parent to retain some control of their business, Ernewein said. Under either transfer option in the proposed rules, the parent must demonstrate that they’ve passed on legal and factual control of the business.

For a parent ready to hand over the keys, the proposed rules shouldn’t be an obstacle, Ernewein said.

“If you really are the parent who intends to retire to Florida and transfer legal and operational control to your children, then you’ll be fine with the proposals the government has put forward because they’re requiring what you’re already prepared to do,” he said.

And the proposals should provide enough flexibility for most business owners to qualify under one of the transfer options with some planning, said John Oakey, vice-president of taxation with CPA Canada in Dartmouth, N.S. “There are workarounds,” he said.

However, new provisions introduced in the Aug. 4 draft legislation would only apply the favourable tax treatment under Bill C-208 to the first transaction between parent and child. All subsequent transactions would be subject to the deemed-dividend rules in the anti-avoidance provision.

The new provisions were a “surprise,” Oakey said, and could limit the flexibility offered by the two transfer options in the government’s proposed rules.

A parent who sells only 51% of their business to their child, intending to sell the rest later, will only get the exemption on the 51%, Oakey said. “So, you’re kind of forced into doing 100% at once.”

However, such a transaction could increase the chances of an unsuccessful transfer, Oakey suggested.

Under the Budget 2023 provisions, to qualify for the exemption, no one other than the business owner and their spouse can have legal or factual control of the business before the sale. The new provisions added in the Aug. 4 will likely result in business owners transferring all of their equity at once to benefit from the exemption.

Oakey said a parent might wonder, “Why would I sell you a company where I give you 100% of the equity, I give you control, and I start transferring management duties and hope you don’t destroy the company?” CPA Canada has recommended that Finance amend the proposed legislation to allow the parent to transfer a degree of the management and control to the child in advance of a sale. Such a change would give a business owner the opportunity to determine whether a child could manage the business successfully before deciding to sell.

It’s unclear whether the new single-transaction provisions would apply to transactions undertaken using the current legislation — a result that would be a “bit unfair,” Keung said. “That’s like retroactively punishing you for taking advantage of the [current] rules.”

During a 2021 finance committee meeting, the parliamentary secretary to the Minister of Small Business stated “that any amendments [to] Bill C-208 would not be retroactive.”

The Department of Finance said in a statement emailed to *Investment Executive* that it is “currently reviewing the numerous submissions it received. Next steps will be announced in due course.”

In a Sept. 7 submission, CALU asked Finance to drop the single-transaction provisions from the final legislation. Alternatively, the comment stated, the provisions should not apply to business owners who transferred under Bill C-208.

Keung said a drawback of the gradual option is the associated reassessment period, which is an additional 10 years in addition to the normal three years after filing the related tax return.

Factoring in the tax year of the return, that means “there are 14 years where the CRA can monitor how your children are running the business,” Keung said. While the children would be “jointly and severally liable” for any tax assessed, “nobody wants that hanging over their head.”

While some of the government’s family-business transfer provisions “may be a little more excessive than they need to be,” Oakey said, they’re “probably as good as we can get without making [the rules even] more complicated.”

A brief history of family business transfers

Section 84.1 in the Income Tax Act discourages “surplus stripping”, which involves using a corporate reorganization to effectively extract retained earnings as tax-preferred capital gains rather than dividends. The provision applies when the reorganization of the business involves non-arm’s length parties.

The provision, as it was written before June 2021, created an issue for business owners who were succession planning:proceeds of disposition on the sale of a business to a child were taxed as a dividend, while the proceeds of a sale to a third party were taxed at the capital gains rate and would allow the seller to access the lifetime capital gains exemption.

“There was essentially a tax drag or a cost to selling to your own children versus selling to a stranger,” said Brian Ernewein, senior advisor with KPMG LLP in Ottawa.

In 2017, the federal government proposed reforms to the taxation of private corporations. These included proposals to address surplus stripping. However, stakeholders pushed back, with some suggesting the proposals would make selling a business to the next generation even more difficult. The government ultimately abandoned the proposals.

In the 2019 federal budget, the government said it intended to consult with business owners “to develop new proposals to better accommodate intergenerational transfers of businesses while protecting the integrity and fairness of the tax system.”

However, the issue came to a head on June 29, 2021, when Bill C-208, a private member’s bill introduced by Conservative MP Larry Maguire, received royal assent without the support of the federal government. That legislation allowed a business owner, if certain conditions were met, to sell their business to their child without triggering the anti-avoidance provision.

The next day, Finance stated that it would delay the implementation of the bill until Jan. 1, 2022 over concerns that it created an creates an opportunity for tax avoidance “that undermines the equity of Canada’s tax system.”

On July 19, 2021, Finance Minister Chrystia Freeland reversed that announcement, affirming that Bill C-208 was indeed law. However, she said the government would work on legislation to address the issues with Bill C-208.

In Budget 2023, the government released its proposals to allow genuine family business transfers. On Aug. 4, Finance released draft legislation for consultation. The consultation period ended Sept. 8.