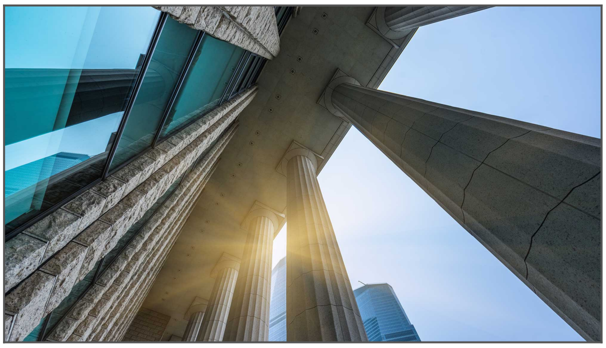
Intergenerational Business Transfer Bill C-208

Authors: Leilani Kagan, K.C. Leo E.K. Palay

published 07/21/2021

[This article was originally published on June 30, 2021 and was updated July 21, 2021]



Intergenerational Business Transfer Bill C-208

Building on our **previous article** dated May 19, 2021, Bill C-208 passed its third reading in the Senate on June 22, 2021 and received royal assent on June 29, 2021. Overall, Bill C-208 is a positive change for owners of qualified small business corporations and family farm or fishing corporations.

On June 30, 2021, the Minister of Finance took the original position that they may not consider Bill C-208 to be "good law", and that there would potentially be retroactive changes to close loopholes on January 1, 2022. This position was walked back by the news release on July 19, 2021, where the Department of Finance stated that, "Bill C-208 has been passed by Parliament, received Royal Assent, and has become part of Canada's *Income Tax Act*. The changes contained in this legislation now apply in law". The Department of Finance is now planning on introducing new legislation on November 1, 2021 to close the "loopholes" that may be in place, as explained further below. In particular, the loophole that they will be targeting to close will be "surplus stripping" (the act of converting taxable dividends into capital gains).

That being said, care must be taken before entering into transactions that rely on the strict wording of the amendments taking into account unclear language, as well as the potential for the Minister to apply the general anti-avoidance rule if these provisions are used for anything other than *bona fide* intergenerational transfers. We recommend you contact one of our TDS tax lawyers before proceeding with any transactions that rely on these amendments.

A Closer Look at the Amendments

Paragraph 55(5)(e)(i) amendments

Subsection 55(2) is an anti-avoidance rule intended to prevent corporations from converting amounts that would otherwise be taxable capital gains into tax-free intercorporate dividends.

Before Bill C-208, paragraph 55(5)(e)(i) of the *Income Tax Act* (Canada) (“ITA”) deemed siblings not to be “related” for purposes of subsection 55(2), thus preventing various tax-deferred corporate reorganizations among siblings.

The amendments contemplated in Bill C-208 alter paragraph 55(5)(e)(i) to provide an exception to this deeming rule. This exception deems siblings to be related (in applying s. 55(2)) “…where the dividend was received or paid, as part of a transaction or event or a series of transactions or events, by a corporation of which a share of the capital stock is a qualified small business corporation (“QSBC”) share or a share of the capital stock of a family farm or fishing corporation within the meaning of subsection 110.6(1).”

Given the new exception to section 55(5)(e)(i), there may be an opportunity for tax deferral through corporate reorganizations among siblings who are owners, provided that the shares in question are QSBC shares or shares of a family farm or fishing corporation.

The most notable practical implication of the amendment to section 55(5)(e)(i) is that it enables corporate reorganizations among siblings to take place under subsection 55(3)(a). These reorganizations, also known as related-party butterfly transactions, permit related parties who are shareholders of one corporation to split up the underlying assets of the corporation into two separate corporations. These reorganizations are common on the termination of a business relationship, a marriage, or among family members who no longer have the same investment goals. Before this amendment, parents of the siblings intending to carry out a divisive reorganization would need to either have been brought in or remain invested in the business, solely because otherwise splitting up the business would trigger tax under subsection 55(2). This obstacle was inconvenient and counter productive in many family succession plans.

Section 84.1 amendments

Generally, subsection 84.1(1) applies when a taxpayer (other than a corporation) disposes of shares of a corporation (the subject corporation) to another corporation with which the taxpayer does not deal at arm’s length (the purchaser corporation). Immediately after the disposition, the subject corporation is connected with the purchaser corporation. Under this section, when a related person claims the Lifetime Capital Gains Deduction (commonly referred to as the Lifetime Capital Gains Exemption, “LCGE”) under subsection 110.6 of the ITA, whereby their adjusted cost base of the shares was increased, the increased adjusted cost base (the “soft” cost base) would be reduced by the amount of LCGE claimed. This resulting decreased cost base is referred to as the “hard” cost base of the shares. If subsection 84.1(1) applies, there are the following punitive consequences:

- the paid-up capital (“PUC”) of the shares of the purchaser corporation issued as consideration for the shares of the subject corporation (the exchanged shares) is reduced (the “PUC Reduction”) to the extent that the non-share consideration (ie. cash or assumption of debt) and PUC exceed the “hard” cost base (or their PUC, if that is greater) of the shares sold; and

- the taxpayer is deemed to have received a taxable dividend equal to the amount by which the non-share consideration received (after accounting for the PUC reduction) exceeds the greater of the PUC and the "hard" cost base of the exchanged shares.

The proposed new paragraph 84.1(2)(e) will exclude certain share sales from the anti-avoidance rule set out in 84.1(1) by deeming the taxpayer and the purchaser corporation referenced in section 84.1(1) to be dealing at arm's length when the following facts are present:

- the subject shares are QSBC shares or shares of the capital stock of a family farm or fishing corporation;
- the purchaser corporation is controlled by one or more children or grandchildren of the taxpayer (who are 18 years or older); and
- the purchaser corporation does not dispose of the subject shares within 60 months of their purchase

New subsection 84.1(2.3)(a) sets out the punitive consequences for how a disposition is to be taxed in the event that the first and second requirements of new section 84.1(2)(e) are met, but the purchaser corporation disposes of their subject shares within 60 months.

New subsection 84.1(2.3)(b) will reduce the amount of the LCGE set out in sections 110.6(2) or (2.1) for large corporations (taxable capital employed in an amount greater than $10 Million).

New subsection 84.1(2.3)(c) requires taxpayers to provide the Minister with an independent assessment of the fair market value of the subject shares as well as an affidavit (to be signed by the taxpayer and a third party) attesting to the disposal of the shares.

Possible Concerns with New Rules

Many of the measures undertaken to prevent perceived or actual abuse of the new legislation may not be stringent enough to restrict these transactions to the *bona fide* transfers of qualified small business corporations or family farm or fishing corporations between generations of a family.

One way in which the legislation seeks to limit the applicability of section 84.1 is by the requirement that adult children or grandchildren of the selling taxpayer have control of the purchaser corporation. While this requirement may limit transfers to some extent, there are no obligations as to the adult child's or grandchild's involvement in the business or restrictions on the types of shares to be held.

Additionally, the new paragraphs added to section 84.1(2.3) may not have the effects intended by Parliament as these paragraphs apply only to section 84.1(2)(e) rather than being more generally applicable to similar sections of the *ITA*, such as the other provisions which address the use of the LCGE.

Greater guidance around what constitutes an “independent assessment” would be valuable. There is no clear mechanism by which the “independent assessment” of the value of the subject shares (as contemplated in section 84.1(2.3)(c)) is to be provided to the Minister.

Please **contact our TDS tax lawyers** regarding the effect of Bill C-208 on your business’ succession plans.
