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# Intergenerational Business Transfers: What Small Business Owners Need to Know in 2023

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## Overview

Historically, the tax implications of selling corporate shares to family members were far worse than if selling to a third party. In 2021, amendments to the *Income Tax Act* were enacted by Bill C-208 to allow certain intergenerational business transfers to children or grandchildren of the owners of small businesses to be made more tax-efficient. Farming and fishing businesses were included in the types of small businesses which could avail themselves of the more tax-efficient transactions.

However, in the federal government's view, the initial rules for intergenerational transfers were drafted hastily, leaving taxpayers and their advisors uncertain about how to apply the rules. For example, while the law allowed the transfer of a family-owned company to take advantage of the new regulations, it didn't do enough to limit ownership of the business after the transfer. As a result, there could be doubts about whether a genuine intergenerational transfer had occurred.

The 2023 federal Budget ("Budget 2023") proposes to correct some of the loopholes in the previous rules. It outlines the revised scheme for intergenerational transfers, and imposes significantly more demanding conditions to be met. The following is a summary of the initial framework introduced in 2021, along with the significant changes proposed in Budget 2023 that would come into effect for transfers that occur on or after January 1, 2024.

## The Existing Framework

It was originally difficult for children to buy shares of small busi-

nesses, farms, or fishing corporations from their parents if their parents wanted to claim a lifetime capital gains exemption on the sale of those shares. If the shares were sold to a corporation owned by the children, the parents themselves would not have a capital gain and therefore couldn't benefit from the lifetime capital gains exemption. This could result in significant income tax consequences.

The rules introduced in 2021 attempt to fix this issue by allowing a sale to non-arm's length purchasers (such as family members) to result in a capital gain and the ability to use the lifetime capital gains exemption to reduce income tax. However, a number of conditions must be met, such as the purchaser corporation being controlled by one or more of the children or grandchildren of the vendor, aged 18 or older. The purchased shares must not be disposed of within 60 months, and the CRA must be provided with an independent assessment of the fair market value of the shares, together with an affidavit attesting to the disposal of the shares.

The changes also include a rule to ensure that the capital gains exemption only applies to small businesses, not companies with taxable capital over $10 million calculated on an associated group basis. The ability to claim the capital gains exemption does not apply at all if the taxable capital is over $15 million in some cases.

Previously, the transformation of what would be taxable capital gains into intercorporate dividends that were free from taxation was not allowed. Some corporate reorganisations were exempt from this to facilitate the transfer of business, family farm, or fishing assets between family members. In 2021, siblings were recognised as related for the purposes of these regulations, providing much needed relief for specific corporate reorganisations that involve shareholder siblings.

## Recent Revisions

Among numerous other initiatives, Budget 2023 aims to revise the existing scheme to facilitate genuine intergenerational transfers and to avoid the use of inappropriate tax avoidance loopholes.

### Protection of Genuine Intergenerational Transfers

Taxpayers are now eligible for capital gains tax treatment when selling shares in a qualified small business corporation ("QSBC") or capital stock shares in a family farming and fishing corporation ("QFFC") to a corporation that is owned by their child, provided a number of conditions are met. The revised changes maintain that the preferential tax treatment is only applicable when selling QSBC or QFFC shares. Nevertheless, various other conditions have been modified somewhat significantly to guarantee that the treatment is only available for legitimate intergenerational share transfers and to avoid inappropriate tax results. According to a press release from the Department of Finance on July 19, 2021, hallmarks of a genuine intergenerational transfer include:

- full legal and factual control of the business must be transferred;
- it must be the intent of the new owner (i.e., child(ren)) to continue the business for a significant period of time after the transfer;
- all financial interest in the transferred business must be relinquished; and
- the vendor (i.e., parent(s)) must no longer participate in the management and operations of the business following the transfer.

### Dual-Stream Approach: Immediate and Gradual Transfers

The proposed amendments create two options that provide more flexibility in how business owners and their children can avail themselves of the new rules. Taxpayers can choose from one of the two following transfer options:

- an immediate intergenerational business transfer (three-year test) based on arm's length sale terms; or

- a gradual intergenerational business transfer (five-to-10-year test) based on traditional estate freeze characteristics.

The characterisation of a transfer as "gradual" is not exactly as it seems, given that the majority of votes must be transferred immediately in both circumstances to the corporation controlled by the child(ren). The three-year test, however, requires both factual and legal control to be transferred immediately, whereas the gradual test only requires the transfer of legal control. This means that parents may be able to maintain control of the corporation in fact despite not owning a majority of votes by using external agreements established to limit voting rights.

### Conditions To Be Met

In order for both immediate and gradual intergenerational transfers to meet the new requirements, a number of common conditions must be met. The parent must have control of the business (which must be a qualifying QSBC or QFFC) being transferred. The parent must also transfer the majority of the voting shares and at least 50% of the common growth shares of the business to their child(ren), who must be at least 18 years of age. Once the initial transfer is complete, the parent has 36 months to transfer the remaining voting and common growth shares. The parent must completely relinquish legal control of the business, and they cannot own more than 50% of any shares of the business (aside from non-voting shares that meet the definition of "specified class" shares, such as freeze shares). Lastly, the parent and each child must file a joint election in a prescribed form.

In addition to the common conditions to be met for both immediate and gradual intergenerational transfers, the table below outlines a number of unique conditions to be met for each transfer type:

| Condition | Immediate Intergenerational Transfer | Gradual Intergenerational Transfer |
|---|---|---|
| *Economic control and interest transfer* | Parents cannot have legal or factual control following the share transfer. | While parents can still have some economic influence, they must not have legal control following the transfer. They must also reduce their debt and equity interests within 10 years of the transfer by 70% for QSBCs and 50% for QFFCs. |
| *Management transfer* | Within 36 months (or longer if reasonable). | Within 60 months (or longer if reasonable). |
| *Business control retention* | Child(ren) must retain legal control for at least 36 months. | Child(ren) must retain legal control for 60 months or until the transfer is complete (whichever takes longer). |
| *Business engagement* | At least one child must remain actively involved in the business for at least 36 months. | At least one child must remain actively involved in the business for 60 months or until the transfer is complete (whichever takes longer). |
| *Active business* | Active business must be carried on for at least 36 months. | Active business must be carried on for 60 months or until the transfer is complete (whichever takes longer). |

### Other Provisions

Notably, the proposed amendments broaden the scope of eligible recipients of the business to extend beyond just children to include grandchildren, stepchildren, children-in-law, nieces, nephews, grandnieces, and grandnephews. However, the rules now allow for a mutual election between the transferor and the transferee, making the transferee(s) jointly and severally liable for any taxes resulting from the transfer for non-compliance.

Furthermore, the normal reassessment period for these transfers would be extended by three years for an immediate intergenerational transfer and by 10 years for a gradual intergenerational transfer.

Finally, the new rules also propose to provide a 10-year (rather than five-year) capital gains reserve for all share transfers that meet the 10-year conditions.

In general, the new measures introduced in Budget 2023 are far more stringent than those existing under the original scheme. All of these measures will apply to transactions that occur on or after January 1, 2024.

## Conclusion

The intergenerational transfer framework first introduced in 2021 provided a chance for small business owners and family farms or fishing corporations to transfer shares between generations in a more straightforward and tax-efficient way. Now, more demanding measures introduced in Budget 2023 will apply to these types of transactions, increasing the number of conditions that must be met. Small business owners looking to transfer ownership to family members while retaining control of their business until the payment is complete are strongly encouraged to consider completing the transfer before these changes take effect on January 1, 2024.