AIRD BERLIS

Bill C-208: Tax Implications for Family Businesses

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On June 29, 2021, Bill C-208 received royal assent. Bill C-208 contains amendments to the *Income Tax Act* (Canada) (the **"ITA"**) that impact the tax consequences of certain intergenerational transfers by providing exceptions that will allow for the extraction of corporate surplus. These amendments can provide benefits to Canadian resident individuals who are reorganizing their family businesses or transferring ownership of their family-owned businesses to their children or grandchildren. Bill C-208 also contains amendments that will allow for more alternatives in the reorganization of family businesses involving siblings.

The federal government has provided that it is committed to facilitating genuine intergenerational share transfers while preventing tax avoidance that undermines the equity of Canada's tax system. It proposes to introduce legislation to clarify that these amendments would apply starting on January 1, 2022.

The benefits provided by Bill C-208 relate to shareholders of corporations the shares of which qualify as qualified small business corporation shares (**"QSBC shares"**) or shares of a family farm or fishing corporation. There are detailed provisions in the ITA that determine whether shares qualify as QSBC shares or shares of a family farm or fishing corporation. A capital gain realized by an individual on the sale of QSBC shares or shares of a family farm or fishing corporation generally qualify for the lifetime capital gains exemption.

You should consult with your tax advisor if you are considering:

(i) an intergenerational transfer of an active business carried on in Canada through a corporation; or

(ii) a reorganization of an active business carried on in Canada through a corporation involving siblings.

Amendments to Section 84.1 of the ITA

One of the benefits coming from the amendments in Bill C-208 relates to an exemption from the anti-surplus stripping rule in section 84.1 of the ITA. Section 84.1 of the ITA is intended to prevent individual taxpayers from extracting corporate surplus on a tax-free basis by deeming amounts that would otherwise be treated as capital gains to be treated as dividends.

Prior to the amendment, section 84.1 would have applied where an individual or trust sold shares of a corporation resident in Canada to another corporation with which the individual or trust did not deal at arm's length, and the two corporations were "connected" after the sale. Where section 84.1 applies, the individual or trust is deemed to have received a dividend (to extent non-share consideration is received on the exchange) or the "paid-up capital" of shares received on the exchange is reduced to the greater of:

(i) the individual's or trust's tax-paid adjusted cost base in the shares; and

(ii) the "paid-up capital" of the transferred shares.

Historically, section 84.1 of the ITA has caused intergenerational sales of businesses to be taxed less favourably than sales to arm's length parties. However, Bill C-208 introduces an amendment to section 84.1 which will facilitate intergenerational sales of businesses in certain circumstances. The amendments to section 84.1 deem an individual taxpayer to deal at arm's length with a purchaser corporation where:

(i) the purchaser corporation is controlled by the individual taxpayer's children or grandchildren who are 18 years of age or older;

(ii) the transferred shares are QSBC shares or shares of a family farm or fishing corporation; and

(iii) the purchaser corporation does not dispose of the shares for a period of at least 60 months.

There is an exception to the requirement that the purchaser corporation not dispose of the shares for a period of at least 60 months if the disposition occurs by reason of death. Without clarification, it is not clear how this exception is meant to apply.

The rules also require the individual taxpayer to provide the Canada Revenue Agency with an independent assessment of the fair market value of the transferred shares.

The amendment also limits the ability of an individual taxpayer to claim the lifetime capital gains exemption on shares that fall within this new exemption from section 84.1 if the taxable capital employed in Canada of that corporation exceeds $10 million. The lifetime capital gains exemption on shares in these circumstances is eliminated when the taxable capital employed in Canada is $15 million or more.

This amendment to section 84.1 may be valuable to taxpayers who are planning on selling their business to their children or grandchildren by changing the tax inequality that has historically favoured third-party sales.

Expansion of Related-Party Exemption for Purposes of Section 55 of the ITA

Another benefit arising from the amendments in Bill C-208 is an expanded exception from the capital gains avoidance regime in subsection 55(2) of the ITA. This regime is intended to prohibit the conversion of a capital gain into an inter-corporate dividend which would be deductible to the recipient corporation. Generally, where a capital gain is avoided by reducing the value of the subject share by payment of a dividend that is otherwise deductible to the recipient shareholder, subsection 55(2) of the ITA will recharacterize the dividend as a capital gain or proceeds of disposition to the extent that the gain is not attributable to "safe income" (that is, generally tax-paid retained earnings).

Where reorganizations meet certain conditions, a "related party exception" from the application of subsection 55(2) of the ITA may be available. However, where the reorganization involves transfers among siblings, the related party exception may not be available because siblings are deemed not to be related for the purposes of section 55 of the ITA.

The amendments in Bill C-208 provide an exception to the rule that siblings are deemed to be unrelated. This deeming rule will not apply where the intercorporate dividend was received or paid, as part of a transaction or event or series of transactions or events, by a corporation a share of which is a QSBC share or a share of a family farm or fishing corporation.

This amendment will broaden the scope of corporations that qualify for the related party exception and will facilitate reorganizations of family businesses involving siblings in certain circumstances.

Questions?

The amendments in Bill C-208 are a welcome change for many business owners and may open the door for tax planning opportunities that have been historically unavailable to family businesses. If you have any questions or would like more information on these changes, please contact Edward Miller, Robert Santia or any member of our Tax Group.

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