New rules will make it easier to transfer family businesses

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The 2023 Federal Budget (the “Budget”), tabled on March 28, 2023, proposes amendments to certain provisions of the *Income Tax Act* (ITA) that would make “genuine” intergenerational business transfers no longer subject to the anti-avoidance rules of section 84.1 and allow the transferor to benefit from their capital gains exemption.

To do so, the Budget establishes new general conditions that the parties must meet, as well as specific conditions that apply to “immediate” transfers, or those made over a period of no more than 36 months, and “gradual” transfers, or those that take five to ten years to complete.

The general conditions that the parties must meet when disposing of a company may be summarized as follows:

- The vendor must be an individual other than a trust.
- Immediately prior to the transfer, the vendor, alone or with their spouse, must control the currently operating company.
- At the time of the transfer, the purchasing company must be controlled by one or more of the vendor’s children, who must be at least 18 years of age. The notion of “child” also includes stepchildren, grandchildren and nieces and nephews.
- The shares of the company being transferred must be qualified small business corporation (QSBC) shares or shares of the capital stock of a family-farm or family-fishing corporation (QFFP).

The specific conditions relate to the transfer of control, economic interests and management of the company, and vary from case to case.

FOR AN IMMEDIATE TRANSFER (36-MONTH TEST)

In the case of immediate transfers, de jure control (being the holding of the majority of shares having voting rights), and de facto control (which includes the economic influence making effective control of the company likely), must be transferred at the time of sale. Voting and participating shares not transferred to the purchasing company at the time of sale must be transferred within the following 36 months, such that after this period, the transferor may hold only preferred shares, that

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is, non-voting or non-participating shares for an indefinite period (vs 10 years in the case of a gradual transfer). Also, the child, or at least one member of the group of children, must participate in the family business on a regular, significant and continuous basis for a minimum period of at least 36 months after the transfer is made. Lastly, the transferor must take reasonable steps to transfer the business's administration and know-how and completely cease to manage the business before the 36th month after the transfer was made.

FOR A GRADUAL TRANSFER (FIVE–TO–TEN–YEAR TEST)

If the transfer is gradual, only de jure control must be transferred at the time of disposition. The balance of the voting and participating shares not transferred at the time of disposition must be transferred within 36 months of the first transfer. However, under the rules respecting gradual transfers, the transferor will only be bound to transfer de facto control of the business within 10 years of the initial transfer. In the case of a transfer of economic interests, the vendor is expected to significantly reduce the value of the equity and advance they have invested in the business within 10 years of the initial sale. The same requirement for a child's active participation in the company and transfer of the management of the business apply, but this time for a period of 60 months after acquisition.

PREVIOUS RULES (Bill C-208)

The provisions of the 2023 Federal Budget have the effect of setting aside certain requirements of Bill C-208 applicable to the realization of a capital gain. Under Bill C-208, for the transferor to benefit from their capital gains exemption, the operating company and the purchasing company could not be amalgamated within 60 months of the sale. The bill also required that an independent assessment of the fair market value of the company's shares be filed with the Canada Revenue Agency, along with an affidavit signed by the vendor.

However, as of January 1, 2024, these criteria are no longer applicable. An assessment will no longer be required, although under section 69 of the ITA, the transfer will still have to be made at fair market value.

The 2023 budget (reinforced by the 2024 Federal Budget) also introduces new rules for the alternative minimum tax, a temporary tax that the transferor in an intergenerational business transfer often has to pay. To avoid having this temporary tax becoming permanent, it's important to understand the subtleties of these new rules.

Our team of tax professionals will be happy to help you and answer any questions you may have about these new legislative changes.

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