



TaxNewsFlash

Canada

Intergenerational Transfers — New Tax Relief Expected Soon

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Small business owners, and owners of family farm or fishing corporations may benefit from new income tax relief for intergenerational transfers. This new legislation, which is currently awaiting Royal Assent, is intended to address certain intergenerational transfers of shares where parents could incur a significantly higher tax bill than they would have incurred if they sold those same shares to an arm's length party, and provides greater flexibility for restructuring family businesses involving siblings. Specifically, these changes include new exceptions to measures affecting the taxation of transfers of qualified small business corporation shares and family farm or fishing corporation shares. These rules are expected to be effective on the date they receive Royal Assent.

Generally, these rules provide that, where a taxpayer transfers shares of a qualified small business corporation or shares of a family farm or fishing corporation to a corporation controlled by their children or grandchildren who are at least 18 years of age, the transfer will not result in a deemed dividend to the taxpayer where certain conditions are met. Where the new exception applies, taxpayers that undertake these transfers may instead be able to realize lower-taxed capital gains and potentially utilize their lifetime capital gains exemption, which is equivalent to the tax treatment that would apply if they sold the shares to an arm's-length party.

Although these changes are expected to be passed into law soon, Finance previously expressed concerns about these measures during a House Standing Committee on Finance meeting on March 11, 2021 and again at a Senate Standing Committee on Agriculture and Forestry meeting on June 10, 2021. Specifically, Finance's view is that the legislation as drafted is too broad, and not targeted enough to the intergenerational

transfers that the rules are intended to facilitate. As a result, it is not yet clear whether these rules may be further adjusted by future amendments.

Background

These new tax changes, which are included in Bill C-208, amend the rules for intergenerational transfers and reorganizations involving siblings.

Prior to these new changes affecting intergenerational transfers, a taxpayer that transferred shares (including shares of a qualified small business corporation, or shares of a family farm or fishing corporation) to a non-arm's length corporation (including a corporation owned by their children or grandchildren) would generally be deemed to have received a dividend on the sale, under section 84.1 of the Income Tax Act (and would not be able to use their lifetime capital gains exemption). However, if the taxpayer had instead sold those same shares to an arm's-length party, they could have realized a capital gain. Considering the tax rate that applies to a dividend in 2021 can be up to 22% higher than the tax rate that applies to a capital gain (depending on the individual's province of residence and the type of dividend received (i.e., eligible or non-eligible)), the cost to a parent of transferring their shares to a corporation owned by their children or grandchildren instead of to an arm's length party could be significant, even before factoring in additional tax that could potentially have been saved if the parent would have also been able to utilize their lifetime capital gains exemption. In 2021, the lifetime capital gains exemption is \$892,218 for dispositions of qualified small business corporation shares, and is topped-up to \$1 million for qualified shares of farm and fishing corporations. The new legislation provides an exception to the deemed dividend rule for the transfer of qualified small business corporation shares or shares of a family farm or fishing corporation to a corporation controlled by the parent's adult children or grandchildren that is intended to instead allow for the same tax treatment of intergenerational transfers as arm's-length sales.

Specifically, the new legislation provides an exception to the deemed dividend rule that otherwise applies where a taxpayer resident in Canada (other than a corporation) disposes of shares that are capital property of the taxpayer (subject shares) of a Canadian-resident corporation (subject corporation) to another corporation (purchaser corporation) with which the taxpayer does not deal at arm's length, and immediately after the transfer, the subject corporation is connected with the purchaser corporation.

Where these rules apply and the purchaser corporation issues shares in consideration for the subject shares, the rules limit the increase in paid up capital (PUC) of the issued shares of the purchaser corporation to the greater of PUC and adjusted cost base (ACB) of the subject shares. In addition, where the taxpayer receives non-share consideration (e.g., cash or debt), the purchaser corporation is deemed to have paid a dividend to the taxpayer equal to the fair market value (FMV) of the non-share consideration less the greater of the PUC and ACB of the subject shares.

The ACB of the subject shares for these purposes includes only "hard ACB", which excludes any amounts arising from V-Day value or from a non-arm's length acquisition where the vendor used their capital gains exemption to shelter the gain.

Additionally, the new changes affect reorganizations involving siblings. Generally, a tax-free intercorporate dividend received may be re-characterized as a capital gain for the recipient corporation under subsection 55(2). This can happen where the dividend exceeds the safe income contributing to the capital gain on the share on which the dividend is received. Certain reorganization transactions may not be subject to this re-characterization rule if they meet certain exceptions, including the "related party exception". However, prior to these changes, reorganizations involving siblings did not often meet this exception, since siblings are otherwise deemed not to be related for purposes of this exception. The new rules provide additional relief by providing that this deeming rule no longer applies in certain circumstances.

Amendments to the rules for intergenerational transfers and reorganizations involving siblings were originally proposed in a private member's bill, which was approved by the House and Senate after all three opposition parties voted in its favour. Previously, the Liberals promised to consider tax measures to facilitate the intergenerational transfer of farms during the 2019 federal election and included this pledge in the Minister of Finance's mandate letter after the election. The House of Commons Standing Committee on Finance also recommended amending the succession planning measures for family businesses and farms concerning intergenerational transfers in its 2020 and 2021 pre-budget report (see *TaxNewsFlash-Canada* 2021-11, "[2021 Federal Budget — On the Trail of Possible Tax Changes](#)").

New exceptions to facilitate intergenerational transfers

The new intergenerational transfer rules provide new exceptions to allow for the transfer of shares in a family business to the next generation without triggering a deemed dividend, in certain circumstances. As a result, if the new rules apply, a taxpayer can instead realize a capital gain on the transfer (which is subject to a lower tax rate than a dividend) and may also be able to use their lifetime capital gains exemption, if applicable. In particular, the new rules deem the taxpayer and the purchaser corporation to be dealing at arm's length (such that the deemed dividend rule in section 84.1 doesn't apply) if the following conditions are met:

- The subject shares are qualified small business corporation shares or shares of the capital stock of a family farm or fishing corporation
- The purchaser corporation is controlled by one or more of the taxpayer's children or grandchildren who are 18 years of age or older

- The purchaser corporation does not dispose of the subject shares within 60 months of their purchase.

If the purchaser corporation disposes of the subject shares within 60 months of their purchase (for a reason other than death), the new exception is deemed to have never applied and the taxpayer is deemed to have disposed of the subject shares to the person who acquired them from the purchaser corporation. The 60-month period is deemed to start when the taxpayer disposes of the subject shares to the purchaser corporation.

Where the new exception applies, taxpayers are also now required to provide the CRA with an independent assessment of the subject shares' FMV, and an affidavit signed by both the taxpayer and a third party attesting to the disposal of the shares.

KPMG observations

If the purchaser corporation amalgamates with the subject corporation before the 60-month time period expires, or if the subject corporation winds up into the purchaser corporation during that time, the rules for a disposition by the purchaser corporation of the subject shares might apply. Taxpayers must also keep in mind the anti-avoidance rules in subsection 55(2) of the Act and consider safe income before paying intercorporate dividends from the subject corporation to the purchaser corporation. However, taxpayers will only be able to rely on the safe income exception to the extent of safe income earned after the acquisition by the purchaser corporation that contributes to an increase in the fair market value of the shares of the subject corporation after the purchaser corporation acquires the shares.

The legislation also lacks certain details regarding timing. For example, the legislation says that the purchaser corporation must be controlled by one or more of the taxpayer's children or grandchildren who are at least 18 years of age, but does not specify a timeframe during which this requirement must be met. The legislation also does not indicate when the taxpayer is required to provide the CRA with the independent assessment and affidavit and in what form this is to be provided to the CRA. In addition, although the legislation specifies when the 60-month period starts, it is not clear when the taxpayer is deemed to have disposed of the shares to the person who acquired them from the purchaser corporation where the 60-month period is not met.

In addition, it is not clear whose death would invoke the exception to the 60-month period rule.

Example

To illustrate how these new rules apply, consider the following simplified example. An individual resident in Ontario (Parent), owns qualified small business corporation shares in a family business with a fair market value of \$1 million and an adjusted cost base and paid up capital of nil. Parent is subject to the top marginal tax rate. Parent wants to retire and transfer these shares to a corporation controlled by one of their adult children (Child), who

will take over the family business. As Child does not have sufficient funds to acquire the shares, Child would like to acquire the shares using a wholly owned corporation, in consideration for a promissory note, such that the earnings of the qualified small business corporation could be used to repay the note.

Prior to the new rules, Parent could face a significant tax cost if they decide to sell their qualified small business corporation shares to their adult child's corporation instead of a third party. Specifically, if Parent sold the shares to a corporation controlled by Child for a note, Parent would realize a deemed dividend equal to \$1 million that would be subject to tax at a rate of either 47.74% (or \$477,400) for a non-eligible dividend or 39.34% (or \$393,400) for an eligible dividend, where an appropriate designation is made. However, if Parent instead sold the shares to an arm's-length party, Parent would have instead realized a capital gain of \$1 million, and would only have been subject to a tax rate of 26.76% (or \$267,600), which could potentially be reduced to as low as \$28,842 (assuming they were able to use their maximum lifetime capital gains exemption of \$892,218 (for 2021), without considering alternative minimum tax). As a result, Parent could potentially pay nearly \$450,000 in additional tax where they chose to sell the shares to Child rather than to an arm's-length party (again, without considering alternative minimum tax).

Under the new rules, if the conditions for the exception are met, Parent could sell their shares to their adult child's corporation with the same tax consequences as selling to the third party (i.e., they would realize a capital gain of \$1 million and would be subject to a tax rate of 26.76% (or \$267,600), which could potentially be further reduced under the lifetime capital gains exemption).

Capital gains exemption

In addition, it appears that where the new exception applies, the intergenerational transfer rules are intended to reduce the capital gains exemption on a straight-line basis for a particular taxation year, where the corporation (or, if a member of an associated group of corporations, that associated group) has taxable capital employed in Canada in excess of \$10 million, such that it is eliminated where taxable capital is \$15 million or more. Taxable capital is computed for this purpose based on the prior or current year, depending on the circumstances.

KPMG observations

Although it appears the new legislation is intended to limit the capital gains exemption as described above, the legislation as drafted does not appear to technically achieve this result. In addition, the legislation does not refer to the "top-up" to the lifetime capital gains exemption that applies to dispositions of shares of family farm and fishing corporations.

Reorganizations involving siblings

The rules further provide a new exception for reorganizations involving siblings, so that intercorporate dividends realized on certain reorganizations may no longer be re-characterized as capital gains. Specifically, the bill provides that siblings will no longer be deemed to be unrelated for purposes of section 55 of the Act. This change applies where the dividend was received or paid, as part of a transaction or event (or series of transactions or events), by a corporation whose share is:

- A qualified small business corporation share (within the meaning of subsection 110.6(1)), or
- A share of a family farm or fishing corporation (within the meaning of subsection 110.6(1)).

KPMG observations

As a result, reorganizations involving siblings could now potentially qualify for the “related party exception”, under paragraph 55(3)(a). Previously, to effect tax-deferred reorganizations involving siblings, it was often necessary to rely on the more onerous “butterfly” rules in paragraph 55(3)(b).

Further changes possible

Finance has raised concerns with these new rules, noting that the legislation as drafted is too broad, and lacks the safeguards needed to ensure it only applies to genuine intergenerational transfers. It is not clear whether Finance may announce new legislation to address these issues or, if so, when it could be introduced.

KPMG observations

If Finance does plan to further amend these new rules, it could look to Quebec, which provides similar relief for intergenerational transfers. Currently, Quebec’s rules will also provide an exception from the equivalent Quebec deemed dividend rules applicable to non-arm’s length transfers where an individual (other than a trust) transfers shares that are qualified small business corporation shares or shares of a family farm or fishing corporation. However, several strict conditions must be met. For the rules to apply, an individual (or the individual’s spouse) must generally:

- Have been active in the business during the 24-month period immediately preceding the sale
- Not have an active role in the business 24 months immediately after the sale (subject to certain exceptions)

- Not control the corporation whose shares were sold nor control a corporation in which that corporation holds an important participation interest prior to the sale (this condition applies for the period that begins 30 days after the sale until the end of the series of transactions that includes the sale)
- Not hold, directly or indirectly, common shares of the corporation nor a corporation in which the corporation holds an important participation immediately before the sale (this condition applies for the period that begins 30 days after the sale until the end of the series of transactions that includes the sale)

In addition, Quebec has enacted complex rules to limit the amount of residual participation in the corporation that an individual may hold after the sale.

The rules also stipulate that at least one shareholder of the purchaser (or spouse of the shareholder of the purchaser) must play an active role in business of the corporation (or a corporation in which the corporation holds an interest) throughout the period that begins immediately after the sale of shares until the end of the series of transactions that includes the sale.

We can help

Your KPMG adviser can help you assess the effect of the new intergenerational transfer rules on your business and personal tax situations. For more details, contact your KPMG adviser.

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