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Tax Alert — Canada

Bill C-208: changes to section 84.1 and section 55

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"The purpose of this bill is straightforward. It will level the playing field by giving families the exact same tax treatment when they transfer their businesses or operations to their children as when they transfer it to a stranger."

Larry Maguire, Conservative MP for Brandon-Souris (Manitoba)
House of Commons, 12 May 2021

On 29 June 2021, private member's Bill C-208, *An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)*, received Royal Assent. Bill C-208 contains amendments to provide exceptions to the application of the capital gains stripping and anti-surplus stripping rules in sections 84.1 and 55 of the *Income Tax Act* in the context of qualified small business corporation (QSBC) shares or shares of the capital stock of a family farm or fishing corporation, and thus to facilitate their transfer to family members. Bill C-208 was adopted without amendment by both the House of Commons and the Senate and without being supported by the current minority government. The Department of Finance has expressed concerns about this bill and has indicated its intention to introduce legislation that would delay the application date of Bill C-208 to 1 January 2022, and it appears, although not explicitly stated in its 30 June 2021 news release, that the government will make further changes.

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Background

In October 2017, the Liberal Party's then-majority government released its fall economic statement, which included commentary related to the proposed private company tax reform measures first announced in July 2017. In this statement, the government indicated that it would "continue its outreach to farmers, fishers and other business owners to develop proposals to better accommodate intergenerational transfers of businesses while protecting the fairness of the tax system." This promise was renewed (with respect to farmers) as part of the Liberal Party's 2019 election platform.

However, in the years since the fall of 2017, legislation intended to facilitate these intergenerational transfers had not been introduced by the government. Prior to Bill C-208, other private members' bills aimed at this objective were tabled over the years (with the earliest being in 2015) but ultimately were not passed by Parliament. Bill C-208, put forth by Conservative Party Member of Parliament Larry Maguire from Manitoba, represents a rare instance of a private member's bill focused on tax measures gaining the support of Parliament, having received Royal Assent on 29 June 2021. The fact that we currently have a minority government no doubt contributed to this result.

On 30 June 2021, the Department of Finance announced the steps it intends to take as it relates to Bill C-208, stating the following:

"*The federal government is committed to facilitating genuine intergenerational share transfers, while preventing tax avoidance that undermines the equity of Canada's tax system. The government proposes to introduce legislation to clarify that these amendments would apply at the beginning of the next taxation year, starting on January 1, 2022*."

Under the *Interpretation Act*, in the absence of a specific reference to an application date, legislation is considered to be in effect from the time it receives Royal Assent (in the case of Bill C-208, from 29 June 2021). The Department of Finance has, however, indicated that it will set a 1 January 2022 application date for Bill C-208 by introducing new legislation. The likelihood and implications of the government's potential changes to Bill C-208 are discussed in greater detail in the final section of this Tax Alert.

The sections that follow will outline the specific amendments to section 84.1 and section 55 of the *Income Tax Act* that are contained in Bill C-208 and analysis and observations related to those amendments.

Changes to section 84.1

Section 84.1 is an anti-surplus stripping rule designed to stop the extraction of corporate surplus as a capital gain. Generally, section 84.1 applies when a taxpayer resident in Canada (other than a corporation) disposes of shares of a corporation resident in Canada (the subject corporation) that are capital property to the taxpayer (the subject shares) to another corporation (the purchaser corporation) with which the taxpayer does not deal at arm's length and, immediately after the disposition, the subject corporation is connected with the purchaser corporation.

In this situation, section 84.1 can reduce the paid-up capital of any shares of the purchaser corporation acquired by the taxpayer, or deem the taxpayer to have received a dividend from the purchaser corporation when non-share consideration is received that exceeds the greater of (i) the paid-up capital of the subject shares, and (ii) the taxpayer's modified adjusted cost base of the subject shares. Related persons are deemed not to deal at arm's length for purposes of the *Income Tax Act*.

This provision would often apply on the intergenerational transfer of shares of a corporation. When parents or grandparents transfer shares of a corporation carrying on the family business to a corporation owned by one or more of their children or grandchildren, section 84.1 would apply and could deem the parents or grandparents to have received dividends rather than realize capital gains. Not only are dividends subject to higher rates of personal tax, but absent the application of section 84.1 the parents or grandparents could use their lifetime capital gains exemptions against capital gains realized on the disposition of QSBC shares or shares of the capital stock of a family farm or fishing corporation. The capital gains exemption would effectively eliminate the tax on up to $892,218 (in 2021), or $1,000,000 in the case of shares of the capital stock of a family farm or fishing corporation, of the capital gain per parent or grandparent shareholder. This is a significant advantage of selling shares to an arm's length buyer rather than selling the shares to a corporation owned by the taxpayer's children or grandchildren.

Bill C-208's amendments provide that the transfer of QSBC shares or shares of the capital stock of a family farm or fishing corporation by a taxpayer to a corporation controlled by one or more of the taxpayer's children or grandchildren who are at least 18 years of age is excluded from the application of the anti-surplus stripping rules in section 84.1, provided that the purchaser corporation does not dispose of the shares within 60 months of their purchase (except in certain cases involving a premature sale by reason of death). In this case, the taxpayer and the purchaser corporation are deemed to be dealing at arm's length for the purposes of section 84.1 even though they are related.

In order to rely on the new rules, a taxpayer must provide the Minister with i) an independent assessment of the fair market value of the subject shares, and ii) an affidavit signed by the taxpayer and by a third party attesting to the disposal of the shares.

Consequently, on the intergenerational transfer of QSBC shares or shares of the capital stock of a family farm or fishing corporation from a taxpayer (other than a corporation) to a corporation controlled by the taxpayer's adult children or adult grandchildren, the taxpayer can receive non-share consideration (e.g., cash or a promissory note) without the anti-surplus rules applying to deem the taxpayer to have received a dividend. In addition, the taxpayer should be able to claim the lifetime capital gains exemption against the capital gain realized. This would give taxpayers similar treatment as if they had sold the shares to an unrelated person, provided the purchaser corporation retains the shares for at least 60 months (subject to a premature death, as noted above). The ability to utilize the lifetime capital gains exemption in these circumstances is reduced where the taxable capital of the subject corporation and its associated corporations exceeds $10 million and is eliminated at $15 million of taxable capital. This limitation will significantly curtail access to the lifetime capital gains exemption in respect of modestly sized businesses or capital-intensive businesses, such as real estate or manufacturing. No such limitation exists in respect of other arm's length sales of shares.

It is interesting to note that, while the purchaser corporation must be controlled by the adult children or adult grandchildren of the taxpayer, the children and/or grandchildren need not control the subject corporation after the transfer. In addition, there is no requirement that the children and/or grandchildren continue to control the purchaser corporation throughout the 60 months that the purchaser corporation must not dispose of the subject shares.

The Province of Quebec enacted a similar anti-surplus stripping rule in 2017 relating to the intergenerational transfer of shares of corporations, but with more onerous conditions that must exist in order for the rule to apply. In general terms, the following seven criteria must be met in order for the anti-surplus stripping rules not to apply to the transfer of shares of a corporation to a corporation controlled by the transferor's children:

- The taxpayer disposing of the shares (seller) must be an individual other than a trust.
- The seller must play an active role in the business during the 24-month period immediately prior to the transaction.
- The seller must not play an active role in the business after the disposition.
- The seller must not have de jure control of the subject corporation following the disposition.
- The seller must not hold, directly or indirectly, common shares of the subject corporation following the disposition.
- Certain conditions must be met related to the amount of residual financial interest (essentially in the form of preferred shares or debt) held in the subject corporation by the seller after the disposition.
- At least one shareholder of the acquirer must play an active role in the business carried on by the subject corporation after the disposition.

It is unknown what criteria the federal government might seek to introduce to ensure that the rules in Bill C-208 are used only for genuine intergenerational transfers. Many taxpayers have found the conditions described above contained in the Quebec rules to be too restrictive to meet. We hope that the Department of Finance takes a practical approach if it decides to make changes to the conditions required for the application of these rules.

Changes to section 55

Bill C-208 also includes an amendment to section 55. More specifically, subparagraph 55(5)(e)(i) has been amended to provide an exception to the rule that deems siblings to deal with each other at arm's length and not be related for purposes of section 55. The exception applies where the dividend otherwise subject to subsection 55(2) 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 its capital stock is a QSBC share or a share of the capital stock of a family farm or fishing corporation within the meaning of subsection 110.6(1).

Subsection 55(2) is a capital gains stripping anti-avoidance rule aimed at recharacterizing tax deductible intercorporate dividends into capital gains under certain circumstances. One exception to the rules in subsection 55(2) found in paragraph 55(3)(a) (often referred to as the "related party butterfly rule") is helpful in facilitating bona fide internal reorganizations on a tax-efficient basis. Bill C-208's amendment to section 55 appears to broaden the potential application of this rule to permit siblings to reorganize their corporate affairs by relying on the related party butterfly rule. Prior to this amendment, siblings generally needed to rely on other exceptions in the *Income Tax Act* (for example, the more onerous butterfly rules in paragraph 55(3)(b), which often require an advance income tax ruling due to their complexity). While the amendment will help facilitate an intergenerational transfer of a qualifying business by, for example, a parent to two or more children, it appears to also be available for other transactions involving siblings without the requirement for there to be a transfer from a parent or grandparent.

A key requirement for the new rule to apply is that the corporation paying or receiving the dividend must have a share that is a QSBC share or a share of the capital stock of a family farm or fishing corporation. It is not clear whether this requirement must be met at the time the dividend is paid or received, at any time in the relevant series of transactions or events, or throughout the series. Of note is that the existing definitions of QSBC share and share of the capital stock of a family farm or fishing corporation require such shares to be held by an individual (other than a trust that is not a personal trust). It is not clear why, for example, the broader "small business corporation" definition (modified to include family farm and fishing businesses) was not used, given that section 55 applies to intercorporate dividends paid or received by corporations that are often held indirectly (rather than directly) by the individuals.

What's next?

What lies ahead for Bill C-208 is largely dependent on the next steps that the government appears determined to take in response to the passing of the bill. The Department of Finance expressed concerns about Bill C-208 to both the House of Commons Standing Committee on Finance and the Senate Standing Committee on Agriculture and Forestry during their respective studies of the bill. As previously mentioned, on the day after the enactment of the bill, the government stated its intention to introduce legislation that would delay Bill C-208's application date to 1 January 2022 and likely make amendments to ensure that the new rules are used only for implementing genuine intergenerational share transfers rather than opening the door to tax avoidance.

The government's announcement raises certain questions that do not appear to have clear answers at this time. In the interim, taxpayers and their advisors must attempt to analyze the implications of the newly enacted rules and the impending government response. Examples of areas of uncertainty include the following:

- Will the Canada Revenue Agency challenge taxpayers who undertake transactions that may not represent bona fide intergenerational transfers in order to strip surplus from their corporations in a manner that appears to comply with the new rules in their current form?

- How will taxpayers who are executing genuine intergenerational transfers in the near term gain comfort that their transactions will not violate the rules, knowing that the Department of Finance intends to introduce changes, but not knowing the details of those changes?
- Is it legally possible for the government to delay the application date of legislation that presumably was already in force as of the time it received Royal Assent? Is it sufficient for the Department of Finance to announce by press release its intent to do so? Will the government then enact transitional rules allowing genuine intergenerational transfers made prior to 1 January 2022?
- Assuming it is not legally possible to delay the application date, will the government's planned changes to the rules have retroactive effect such that they could apply to transactions completed after the time Bill C-208 received Royal Assent but before the enactment of the government's amendments?

Changing Canadian demographics suggest that intergenerational business transfers may become that much more prevalent in the coming months and years. This is one of many reasons why taxpayers will undoubtedly be seeking clarity on the ramifications of Bill C-208 sooner rather than later.

In the absence of any existing rules that facilitate intergenerational transfers, Parliament may have been motivated to pass Bill C-208 notwithstanding its perceived imperfections (in the eyes of the government and many in the tax community), especially in the context of a potential upcoming dissolution of Parliament and a general election call. The enactment of Bill C-208 may very well represent significant progress in allowing for bona fide intergenerational transfers to occur on a more tax-efficient basis. That said, it appears that this new legislation may not survive in its current form. It remains to be seen if and how the rules will be amended to prevent tax avoidance while promoting tax-efficient transfers of family businesses to the next generation without being so restrictive as to limit their practical application to Canadian taxpayers.

Learn more

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