



TaxNewsFlash

Canada

Small Businesses — Consider Intergenerational Transfers Now

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Owners of small business corporations, and owners of family farm or fishing corporations have a limited time to transfer their shares of these corporations to the next generation in a tax-efficient manner under the existing rules. Finance recently released revised amendments to the intergenerational business transfer rules that, among other changes, will soon require owners to satisfy new transfer conditions to qualify for lower capital gains tax rates on transfers to the next generation (instead of higher dividend tax rates). The revised draft legislation, which generally follows the changes first proposed in the 2023 federal budget with some additional clarifications, is proposed to apply to transactions that occur on or after January 1, 2024. Finance is asking for feedback on the revised draft legislation by September 8, 2023.

This publication provides an overview of the proposals introduced in the 2023 federal budget and also discusses the new changes outlined in the revised draft legislation.

Background

Certain amounts which would otherwise be taxed as capital gains may be recharacterized as dividends under section 84.1. Bill C-208 introduced new intergenerational business transfer rules in June 2021 (i.e., an exception to the recharacterization rule in section 84.1) to address certain intergenerational share transfers where parents or grandparents could otherwise incur a significantly higher tax bill transferring their family business shares to their adult children or grandchildren than they would have incurred if they sold those same shares to an arm's-length party.

Generally, the rules provide that, where an individual taxpayer transfers shares of a qualified small business corporation (QSBC) or shares of a family farm or fishing

corporation (FFFC) to a purchaser corporation controlled by one or more of their children or grandchildren who are at least 18 years of age, the transfer will not be recharacterized as a dividend transaction to the taxpayer where certain conditions are met. Where these conditions are satisfied, taxpayers that undertake these transfers may instead be able to realize 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.

Specifically, the taxpayer and the purchaser corporation may be deemed to be dealing at arm's length (such that the recharacterization rule in section 84.1 does not apply) where the following conditions are met:

- The subject shares being sold are QSBC shares or FFFC shares
- The purchaser corporation is controlled by one or more children or grandchildren of the taxpayer who are at least 18 years of age
- The purchaser corporation does not dispose of the subject shares within 60 months of their purchase
- The taxpayer provides the CRA with an independent assessment of the fair market value (FMV) of the subject shares, as well as an affidavit signed by the taxpayer and a third party attesting to the disposal of the shares.

Note that the exception to the recharacterization rule in section 84.1 is deemed never to have applied and the taxpayer is deemed to have disposed of the subject shares to the person who acquired them from the purchaser corporation if, otherwise than by reason of death, the purchaser corporation disposes of the subject shares within 60 months of their purchase.

These rules came into effect on June 29, 2021, the date Bill C-208 received Royal Assent.

Finance subsequently introduced amendments to tighten the conditions of these rules in the 2023 federal budget, for transactions that occur on or after January 1, 2024 (see *TaxNewsFlash-Canada* 2023-17, "[2023 Federal Budget Highlights](#)").

Intergenerational business transfers — New transfer options

The proposed amendments, as originally announced in the 2023 federal budget, and as reflected in the August 4, 2023 revised draft legislation, introduce two transfer options for taxpayers to qualify for capital gains treatment and potentially the lifetime capital gains exemption, rather than dividend treatment. These options are an immediate intergenerational business transfer and a gradual intergenerational business transfer, and are proposed to apply for transactions that occur on or after January 1, 2024.

Immediate intergenerational business transfer

To qualify for an immediate intergenerational business transfer under the proposals, taxpayers must satisfy the following conditions:

- Control of the business — The parent must transfer both legal and factual control of the subject corporation, as well as any relevant group entity that carries on the business of the corporation. To satisfy this condition, the parent must generally transfer the majority of the voting shares of the subject corporation immediately and the balance within 36 months.
- Transfer of economic interest — The parent must transfer the majority of the common growth shares of the subject corporation immediately and the balance within 36 months.
- Transfer of management — The parent must take reasonable steps to transfer management of the business to at least one of their children generally within 36 months. The parent must also take reasonable steps to cease to manage the business generally within 36 months.
- Child retains control — The child (or children) retains legal control of the subject corporation and the purchaser corporation for 36 months after the initial share transfer.
- Child works in the business — At least one child is actively involved on a regular, continuous and substantial basis in the business for 36 months after the initial share transfer. Note that the business must be carried on as an active business.

Gradual intergenerational business transfer

For a gradual intergenerational business transfer, taxpayers must satisfy the following conditions:

- Control of the business — The parent must transfer legal control of the subject corporation, as well as any relevant group entity that carries on the business of the corporation. To satisfy this condition, the parent must generally transfer the majority of the voting shares of the subject corporation immediately and the balance within 36 months.
- Transfer of economic interest — The parent must transfer the majority of the common growth shares of the subject corporation immediately and the balance within 36 months. In addition, within 10 years (i.e., at the time of the “final sale”), the parent must not own debt or equity interests in the subject corporation, purchaser corporation or relevant group entity with a FMV that exceeds 30% of the FMV of all their interests at the time of the initial share transfer (or 50% of the FMV of all their interests at the time of the initial share transfer, for a transfer of FFFC shares).

- Transfer of management — The parent must take reasonable steps to transfer management of the business to at least one of their children generally within 60 months. The parent must also take reasonable steps to cease to manage the business generally within 60 months.
- Child retains control — The child (or children) retains legal control of the subject corporation and the purchaser corporation for the greater of 60 months after the initial share transfer or until the “final sale” is completed.
- Child works in the business — At least one child is actively involved on a regular, continuous and substantial basis in the business for the greater of 60 months after the initial share transfer or until the “final sale” is completed. Note that the business must be carried on as an active business.

Other related changes

In addition to the two transfer options, the 2023 federal budget proposals also included further changes to the intergenerational business transfer rules that are reflected in the revised draft legislation. In particular, these proposals provide that the transferor and the child (or children) must jointly elect for the transfer to qualify. Where this election is made, the children are jointly and severally liable for additional tax owing under section 84.1, if any.

The proposals specify that, where the election is made, the capital gains reserve period is extended to 10 years. In addition, the limitation period for assessing a return is extended three years for an immediate intergenerational business transfer and 10 years for a gradual intergenerational business transfer.

The proposals also extend the intergenerational business transfer rules so that they will apply to transfers of subject shares to purchaser corporations controlled by the transferor’s children, grandchildren, great grandchildren, stepchildren and children-in-law. The rules will also apply to nieces and nephews and their spouse (or common-law partner), and grandnieces and grandnephews.

Finance also introduced relieving changes where there is a subsequent arm’s-length share transfer, or death or disability of a child.

Finally, the proposals eliminate the condition that the purchaser corporation not dispose of the subject shares within 60 months of the share transfer. The proposals also eliminate the condition that the taxpayer provide the CRA with an independent assessment of the FMV of the subject shares, as well as an affidavit signed by the taxpayer and a third party attesting to the share transfer. In addition, the proposals eliminate the taxable capital grind for purposes of determining the taxpayer’s lifetime capital gains exemption.

Additional changes in revised draft legislation

Finance's revised draft legislation for the intergenerational business transfer rules also clarifies certain aspects of the proposals outlined in the 2023 federal budget. In particular, the revised draft legislation introduces relieving changes where there is a subsequent share transfer to another child (or group of children) of the taxpayer, or where the business is no longer carried on subsequently because all the assets used in the business were disposed to satisfy debts owed to creditors.

In addition, the revised draft legislation now prohibits a taxpayer from transferring a business more than once under the intergenerational business transfer rules. More specifically, the proposals prohibit a taxpayer from undertaking successive transfers of subject shares which derive their value from a business used to determine whether a prior share transfer satisfied the intergenerational business transfer rules.

The revised draft legislation also clarifies that a subject corporation is considered to be controlled by a taxpayer and their spouse (or common-law partner) if the subject corporation is controlled by the taxpayer's spouse (or common-law partner). The proposals also clarify that the word "management" refers to the direction or supervision of business activities but does not include the provision of advice.

Finally, the revised draft legislation provides guidance to determine whether a taxpayer owns directly or indirectly equity (which includes shares) or debt of a subject corporation, purchaser corporation or relevant group entity. The revised draft legislation also provides guidance to determine whether a taxpayer controls a partnership that is a relevant group entity.

We can help

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