MNP LLP

SUBMISSION TO THE DEPARTMENT OF FINANCE – INTERGENERATIONAL SHARE TRANSFERS

June 16, 2022

Submitted electronically at: intergenerational-transfers-transferts-intergenerationnels@fin.gc.ca

MNP LLP (MNP) is pleased to make a submission in response to the Department of Finance Canada (the "Department") invitation to share comments on the legislation previously introduced by Bill C-208 regarding genuine intergenerational share transfers. We appreciate the opportunity to provide our comments and recommendations on how to continue to facilitate these transfers while protecting the integrity of the Canadian income tax system.

MNP is a leading national accounting, tax and business consulting firm in Canada. MNP proudly serves and responds to the needs of our clients which include more than 280,000 private enterprise and small business clients throughout Canada.

Our submission is comprised of the following:

1. Executive Summary: Bill C-208 Intergenerational Transfers of Family Businesses

2. Technical Discussion
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Executive Summary: Bill C-208 Intergenerational Transfers of Family Businesses

The intergenerational transfer of a family business has historically been subject to a different, more punitive tax treatment in Canada when compared to a business sold to a third party. When selling to a third party purchaser, a vendor could sell the shares to the purchaser's company, allowing the vendor to use their lifetime capital gains exemption to offset a portion of the gain from tax. The purchaser would fund the acquisition with corporate taxed dollars. This type of planning has generally not been possible where shares are sold within the family. The introduction of Bill C-208 attempts to alleviate the differing tax treatment for family business succession.

June 29, 2021: Bill C-208 Royal Assent

On June 29, 2021, the Private Member's Bill C-208 received Royal Assent and represented a significant positive change to support family business succession in Canada.

July 19, 2021: News Release

In a July 19, 2021 news release, the Government announced its intent to *bring forward legislative amendments to the Income Tax Act that honour the spirit of Bill C-208 while safeguarding against any unintended tax avoidance loopholes that may have been created by Bill C-208.*

April 7, 2022: Budget 2022

Summer 2022: Public consultation commences

Budget 2022 announced a consultation process for stakeholders to share their views on how the existing rules in Bill C-208 could be strengthened to protect the integrity of the tax system while continuing to facilitate genuine intergenerational business transfers.

Preserving the intent of Bill C-208 Legislation

Bill C-208 legislation amended the Income Tax Act (the Act) for two important aspects of family business succession which is a welcome change:

Family Business Succession: Bill C-208 enables children (and grandchildren) to purchase private company shares from their vendor-parent (and grandparent) using a corporate purchaser. This allows the purchaser to fund the acquisition with lower taxed dollars, while allowing the parent(s) to use their lifetime capital gain exemption (LCGE). This removes the inherent disadvantage on family business succession compared to a third party transaction, and should be maintained.

Divisive Reorganizations: Bill C-208 also enables a division of a company on a tax-deferred basis between siblings, similar to existing rules available for closely related family members. It is often necessary to split a business as a component of family succession and these provisions should be maintained.

Considerations to Strengthen Legislation Supporting Family Business Succession

While the legislation contains important elements that should be maintained, there are other improvements that should be considered to facilitate family business succession:

Holding Period (60 months) – there are ambiguities in the legislation surrounding the requirement to hold the purchased shares for 60 months after the purchase:

- It is common in a post-closing restructure to include share exchanges or amalgamations, which do not change the economic impact of a transaction. However, in a family succession a post-closing reorganization would cause negative tax consequences to the parent-vendor under the current legislation.
- When there is a future disposition, the legislation should be clear that there are not two dispositions by the parent-vendor (being the actual disposition and a second deemed disposition).
- Exceptions to the holding period should be broadened to include not only death, but personal disability or bankruptcy, to be congruent with other areas of the Act.
- The holding period should be 36 months to be within the normal reassessment period and to be consistent with other areas of the Act.

Control of Purchaser Company – The legislation should require children and grandchildren to own common shares of the purchaser corporation (legally and beneficially) versus only requiring legal ownership of shares with voting control. This will support the objective of the legislation to ensure a bona-fide family business succession.

Taxable Capital – Budget 2022 expanded taxable capital for purposes of the small business deduction. The legislation in Bill C-208 should be adjusted to parallel this change and increase the upper limit from $15M to $50M.

Transition to Family Members other than Children / Grandchildren – The legislation should be expanded to allow for transition to a sibling. In addition, in the event of a death of a child, the corporation should have the ability to be transferred back to the parents.

Comments on Potential Hallmarks of Succession

In the July 19, 2021 News Release, the Department of Finance highlighted four hallmarks of succession that amended legislation would address:

Transfer of legal and factual control of the corporation carrying on the business from parent to child – while it may make sense that the child has equity in the business and owns some voting shares, this requirement would be difficult to comply with. Many family successions take time, and parents retain ownership through preferred shares or a vendor-take back promissory note to protect their economic interest until they are repaid in full.

Level of ownership the parent can maintain for a reasonable time after the transfer – family succession takes time to complete, and parents are paid over a period of time. Any remaining value is often transitioned in a Will. Having parents retain some ownership provides the following benefits: protection of value held by parents without causing undue burden for the child to fund the full purchase in a short period of time; allows the family business to remain in the family; and in third party sales, vendors are often required to maintain employment and ownership as part of transition. Family succession should be the same.

Timeline for parents to transition involvement in the business to the next generation – many family businesses operate as multi-generational for years leading up to the full retirement by parents. Parents continue to provide valuable experience and labour in times of need.

Level of involvement of the children in the business after the transfer – Ensuring the child is active in the business would be a valuable hallmark for family business succession. However, measuring the level of involvement could prove to be difficult.

Recommendations

The changes outlined in Bill C-208 were welcome for family business succession. We recommend the following:

- Family business succession should not be held to a higher (more difficult) standard than a transition to a third party.
- The concepts of a divisive reorganization which allows siblings to split up a company into separate companies should be maintained, as it is a key component of family succession.
- The use of $10M to $15M of taxable capital as a limit to deny access to the LCGE in a family transition should be eliminated. It negatively impacts different businesses that are capital intensive, earlier in their life cycle, or located in high cost jurisdictions. The calculation should be eliminated, or alternatively, tied to the changes announced in Budget 2022 for small business deduction limits to an increased upper limit of $50M.
- Capital gain treatment on sale of shares should be maintained where the LCGE is not available or already used, such that if a vendor has paid tax on the disposition, a corporation can be used to acquire the shares.
- Family business succession is not prescriptive, and any legislation should provide flexibility. Overly prescriptive hallmarks will make it difficult to transition a family business within the rules, thereby reducing the objective of the legislation.

TECHNICAL DISCUSSION

PRESERVING THE INTENT

Family Business Succession

Section 84.1 of the Income Tax Act ("ITA") was introduced to prevent individual shareholders from extracting corporate surplus without paying tax by utilizing their lifetime capital gains exemption ("LCGE")[1]. However, as this provision was drafted in a broad manner to apply to all non-arm's length sales of shares, it has historically caused family succession to be taxed more punitively than a sale to an arm's length party, resulting in a tax disadvantage for family succession.

Bill C-208 provided amendments to these provisions to allow access to the LCGE for intergenerational sales providing certain conditions are met:

1. The shares being sold ("subject shares") must be qualified small business corporation ("QSBC") or family farm or fishing corporation ("FFFC") shares;
2. The purchaser must be a company controlled by one or more of the vendor's adult children and/or grandchildren; and
3. The purchaser corporation cannot dispose of the subject shares for 60 months following the share transfer.

There are additional restrictions if the aggregate taxable capital of the associated group of companies in the previous taxation year was greater than $10 million, and the ability to claim the LCGE is eliminated if the taxable capital of the associated group was $15 million or greater in the previous taxation year.

The policy intentions of Bill C-208 were welcome and should be preserved. The new provisions attempt to bring tax parity to family successions by allowing parents to use their LCGE on a transition to a child's company in certain circumstances. This also allows the purchaser to finance the acquisition with corporate funds. This vital change removed the inherent disadvantage family businesses had with succession transactions compared to an arm's length sale and should be maintained.

Vendors of family businesses should not be denied capital gain treatment or the ability to use their LCGE if they are transferring their businesses to a related party in a bona fide succession if no such denials apply to arm's length transactions. Failure to preserve this policy intent will once again place family successions at an income tax disadvantage.

Divisive Reorganizations

ITA subsection 55(2) was enacted to prevent "capital gains stripping", or the use of the intercorporate dividend deduction to convert capital gains to deductible dividends for preferential tax treatment. This provision recharacterizes intercorporate dividends as a capital gain in certain situations unless certain exemptions apply. One such exemption, commonly referred to as the "related party exemption", allows for companies to transfer assets and reorganize shareholders on a tax-deferred basis if no unrelated parties are involved in the series of transactions. For the purposes of ITA section 55, siblings are generally not considered related persons and as such, the related party exemption is limited to closely related groups of parent-child or spouses. As a result,

[1] The provision was intended to target situations where a shareholder sells shares of a private corporation to another corporation owned by the shareholder and any resulting capital gain on the sale is sheltered by the LCGE. This is commonly referred to as "surplus stripping".

divisive reorganizations involving siblings generally cannot be done on a tax-deferred basis unless a full butterfly reorganization, which is more complex and costly to implement, is completed. In our view, this deeming rule has hindered genuine family succession planning, particularly for second and third generations of family business owners. There are many instances where transactions that make sense from both a business and family perspective cannot be undertaken without significant tax consequences yet involve no sale of business assets outside the family and provide no means by which to fund the payment of a current tax liability. Faced with these circumstances, sibling shareholders often undertake transactions that are not fully compatible with their objectives nor facilitate effective business succession planning.

Bill C-208 somewhat relaxes the deeming rule in ITA paragraph 55(5)(e). Following this amendment, siblings are deemed to be unrelated with each other only where the resulting dividend is received or paid by a company that does not meet the definition of a QSBC or a share of the capital stock of the FFFC. There are many situations, particularly in farming families, where this change will be beneficial as transactions involving siblings may qualify for the related party exemption to facilitate a more efficient and less costly divisive reorganization.

As it is often necessary to separate a corporation into various business components as part of a family business succession, the amendment to the deeming rule in ITA paragraph 55(5)(e) for siblings should be maintained. Doing so will preserve the equitable tax treatment of family succession involving siblings.

CONSIDERATIONS TO STRENGTHEN THE LEGISLATION

While the legislation contains important elements that should be maintained, there are other improvements that should be considered to facilitate family business succession.

I. Post-Closing Holding Period

There are ambiguities in current ITA paragraph 84.1(2.3)(a) surrounding the requirement to hold subject shares for 60 months following the purchase.

1. The exception from the 60-month holding period “by reason of death” requires further clarification. It is unclear which person’s death is being contemplated in this provision: the vendor shareholder or the controlling shareholders of the purchaser corporation? Consideration should also be given to broadening exceptions to the holding period for circumstances involving personal disability or bankruptcy, to be congruent with other provisions of the ITA.

2. Following an arm’s length purchase of shares, post-closing restructuring transactions involving share exchanges or amalgamations are commonly undertaken. These transactions do not change the economic impact of a transaction to the purchasing organization but commonly serve to streamline organizational structures. Under current ITA section 84.1 (as amended by Bill C-208), any post-closing reorganizations completed within the first five years after the initial sale by the parent/grandparent vendor would cause negative tax consequences to that vendor. There is a lack of clarity regarding how this would be reassessed by the Canada Revenue Agency (“CRA”); under the current provisions, the exemption from ITA section 84.1 is deemed to not have applied and the taxpayer is deemed to have disposed of the shares to the person who acquired them from the purchaser corporation. If the exception outlined in ITA paragraph 84.1(2)(e) is deemed to not have applied, it is unclear if the deemed dividend in ITA paragraph 84.1(1)(b) applies to the original share transfer. The current provision does not deem the first disposition

to the child's company to not have taken place. This could mean the parent/grandparent vendor is considered to have sold the shares to the child's company and later is also deemed to sell those shares to another party, potentially resulting in two dispositions of the same shares. The legislation should be clear that there are not two dispositions by the vendor in this situation, as this would result in double taxation.

3. The holding period of 60 months is incongruent with the normal reassessment period for transactions and tax returns; it is questionable whether transactions otherwise qualifying for ITA paragraph 84(1)(e) treatment except for other transactions which violate the conditions of the 60-month holding period, but which take place after the tax return reporting the original transaction has become statute-barred, may be reassessed. This holding period should either be reduced to 36 months to be within the normal reassessment period and to be consistent with other provisions of the ITA, or amendments should be introduced to ITA section 152 to clarify the circumstances under which transactions that would otherwise qualify for ITA paragraph 84(1)(e) treatment but for subsequent transactions within the holding period may be reassessed.

4. The Bill C-208 provisions may allow for a taxpayer to be adversely impacted by the actions of another taxpayer. The parent-vendor's children or grandchildren are required by legislation to control the purchasing corporation; the parent vendor may have no control over the decisions and actions made regarding the subject shares once the initial sale has closed yet may be accountable for those decisions and actions. This would not be an equitable result for the vendor in a family succession, given that a vendor of shares sold to an arm's length party would generally never face tax consequences that are dependent on the subsequent actions of that party.

II. Control of Purchaser Corporation

Under current ITA paragraph 84.1(2)(e), the only requirement for this provision to apply is for the children or grandchildren to control the purchasing corporation. This appears to refer only to *de jure* control. Accordingly, it appears possible for the vendor to have a non-controlling interest in the purchaser corporation, or even hold the majority of its share value. The legislation should require the children/grandchildren to both legally and beneficially own common shares of the purchaser corporation versus only requiring legal ownership of the shares with voting control. This will support the policy intent of the legislation to ensure a bona fide business transfer from one generation to the next.

Additionally, the requirement that the purchaser corporation be controlled by the vendor's children/grandchildren appears to only apply at the time of the initial share disposition, but this is not entirely clear. Clarity is required if the intention is for the taxpayer's children/grandchildren to maintain control of the purchaser corporation subsequent to the share disposition. We submit that ought to be the intention at the time of the of the share transfer but note that the rules need to be flexible enough to accommodate unforeseen future circumstances pertaining to the children/grandchildren such as death, disability, or bankruptcy.

Both of the above considerations will support the objective of the legislation to ensure a bona fide family business succession.

III. Taxable Capital

We respectfully submit that taxable capital may not be an appropriate benchmark for the ability of taxpayers to access these amendments. In a true business succession, taxable capital is rarely a consideration for the parties. As noted earlier, ITA paragraph 84.1(2.3)(b) provides for a reduction of the LCGE that may be claimed on a disposition to which the exception in ITA paragraph 84.1(2)(e) applies. In other words, if a vendor is selling to a child/grandchild purchaser corporation, the maximum LCGE available to the vendor is reduced if the taxable capital of the corporation being sold is greater than $10 million and completely eliminated once the taxable capital of the corporation reaches $15 million.

In 1989, when the concept of large corporations tax (the basis for taxable capital) was introduced, $15 million of taxable capital may have been an appropriate benchmark for a “large” corporation. However, $15 million in 1989 dollars is over $30 million in current dollars when accounting for inflation since that time[2]. As an example, with the rising cost of land, quota and equipment, farms and feedlots have become increasingly capital intensive, such that even a small family farm can easily exceed $15 million of taxable capital. If the Department’s intention is to exclude larger businesses from certain provisions, then the definition of a “large corporation” must be reassessed to reflect current economic conditions.

Example

Mr. Lafleur owns the shares of ABC Co, a small business corporation, the shares of which qualify as QSBC shares. ABC Co has taxable capital totaling $15 million in the current and preceding taxation years.

Mr. Lafleur is currently contemplating two options to sell ABC Co. One option is to sell the shares of ABC Co to an arm’s length corporate purchaser. The other option is to sell the ABC Co shares to his daughter’s corporation, XYZ Inc.

If the ABC Co shares are sold to the arm’s length corporation purchaser, Mr. Lafleur can shelter the capital gain on the sale of the shares with his LCGE.

However, if the ABC Co shares are sold to XYZ Inc., the sale would be considered a non-arm’s length transaction and the capital gain realized on the ABC Co shares would not be eligible for LCGE because ABC Co had taxable capital of $15 million. Due to ITA paragraph 84.1(2.3)(b), Mr. Lafleur must report the proceeds of the disposition of the ABC Co shares as a capital gain with no LCGE claim.

As illustrated by the above example, imposing a taxable capital limit does not produce an equitable result for family succession.

The 2022 Federal Budget proposed to extend the taxable capital range over which the small business limit would be phased out such that access to the small business income tax rate would be reduced on a more gradual basis. If the Department wishes to maintain the taxable capital limitation in ITA paragraph 84.1(2.3)(b), a parallel adjustment to this paragraph is recommended, such that the upper limit is increased from $15 million to $50 million for purposes of ITA paragraph 84.1(2)(e). This would allow more Canadian business owners to utilize the LCGE in a transfer of a business, allowing more family businesses to stay family businesses.

[2] Based on the Bank of Canada’s Inflation Calculator, from 1989 to 2022.

IV. Transition to Family Members other than Children / Grandchildren

The legislation should be expanded to allow for transition to additional relatives. There are many situations in family businesses where children sell shares to their parents, or where siblings farm together and one may be the successor of the farm. Consideration should be given to expanding ITA paragraph 84.1(2)(e) to contemplate a sale to parents and to siblings in certain circumstances, for example where shareholders have died with no living spouse or children, or where a retiring farmer has no children but wants the farm to stay in the family.

V. Division of Family Businesses to Siblings

As noted earlier, prior to Bill C-208, ITA paragraph 55(5)(e) deemed siblings to not be related with one another in all cases where ITA section 55 is concerned. The ITA paragraph 55(3)(a) related party exemption was only available for very closely related groups, which limited access to the exemption to transactions between corporations controlled by parents and children or spouses. As siblings were deemed to be unrelated, access to the related party exemption was generally denied in any series of transactions involving corporations controlled by siblings. As a result, a divisive tax-deferred reorganization involving siblings could usually only be accomplished through a full butterfly reorganization. These are complex, costly and generally require a fully proportionate division of each asset type. Most advisors and taxpayers seek advance tax rulings from the CRA which are lengthy and the costs prohibitive. The process is often particularly challenging where shareholders have combative relationships which affect the daily operations of a business.

As siblings frequently farm together and/or jointly inherit a farming business from their parents, many farm families have a frequent need to complete full butterfly reorganizations. There are many reasons for this, some of the more common being:

- Changes in life circumstances for the siblings;
- Philosophical differences regarding the manner in which the farming business should be carried on;
- Differing willingness or ability of the siblings to contribute physically and financially to the farming business; and
- Desire of individual siblings to undertake inter-generational succession planning with their own children or grandchildren, which can be very difficult where the business is jointly owned by one or more siblings.

If not for the rule in ITA paragraph 55(5)(e), most of the full butterfly reorganizations involving farming corporations that we have been involved with would have been undertaken using the “related party exemption” provision to the extent available. Now that the exception for FFFC and QSBC corporations has been introduced, it should be maintained.

To further align current legislation with the Department’s policy intent to facilitate genuine business transactions between family members, consideration should be given to modifying the deeming rule in ITA paragraph 55(5)(e) such that the related party exemption can apply to siblings to treat them as related even where the divisive reorganization involves a corporation that is not a QSBC or FFFC.

Example

Nathan and Jim are brothers who actively run a farming operation. They do not work well together and want to pursue different ideas for the farm. Nathan is focused on the wheat farming operation and Jim is focused on cattle farming operations. The assets are held in a single corporation that does not qualify as a FFFC or QSBC, as defined in ITA section 110.6. Their parents owned all of the common shares at one point, but several years ago they undertook an estate freeze which resulted in Nathan and Jim owning non-voting common shares and their parents owning voting redeemable "freeze" preferred shares. When their father passed away, their mother (Mary) inherited his preferred shares. Prior to Bill C-208 being implemented, it was recognized that the corporation was neither a FFFC or a QSBC, but this was not considered to be a problem.

Mary is not actively involved in the farming operation and recognizes that having all of the farming assets in a single corporation with both Nathan and Jim as shareholders is not ideal. Mary plans on implementing a divisive reorganization of the corporation. The plan is for the wheat and cattle farming operations to be split into two separate companies: Nathan will continue to hold non-voting shares of the current corporation which will own and run the wheat operation, while Jim is to receive non-voting shares of a new corporation that will own and run the cattle operation. All of this can be accomplished on a tax-deferred basis during Mary's lifetime as long as she maintains voting control over each corporation. Nathan and Jim are agreeable to that because they recognize that Mary will need to realize the value of her preferred shares over time to fund her retirement.

Unfortunately, Mary takes ill and passes away suddenly before the transactions can be completed. Following her death, the preferred shares are redeemed through Mary's estate. After the settlement of the estate, Nathan and Jim are left as equal holders of the common shares and the voting shares of the corporation. For the purposes of ITA section 55, any corporations owned and controlled by Nathan and Jim will be considered to be unrelated. If the contemplated divisive reorganization is completed, it will result in large capital gains being realized to split the farm operations into two separate corporations. Owing to uncertainty regarding the value of some of the corporation's assets which cannot be easily resolved, a full butterfly under ITA paragraph 55(3)(b) is not considered to be a viable option.

A tax-effective division of this bona fide family business is not available under the current provisions of the ITA, because the shares do not qualify as QSBC or FFFC. In this scenario, a "purification" transaction to remove the assets that are causing the corporation to not qualify as a QSBC or FFFC likely cannot be undertaken on a tax-deferred basis.

Some clarification is also needed on the timing of the transaction. It is unclear if the corporations receiving or paying the dividend in question in the course of a divisive reorganization must be either a QSBC or a FFFC immediately before the dividend is received or paid, or if the definitions must be met throughout any series of transactions involving the dividends.

VI. Adjusted Cost Base Considerations

In situations where vendors do not deal at arm's length with purchasers, the concept of hard and soft adjusted cost base ("ACB") must be considered. Hard ACB is often referred to as "tax-paid" ACB. Soft ACB exists if the vendor sheltered a capital gain with the LCGE on a sale to a non-arm's length party, there are 1971 valuation day issues, or the vendor utilized the capital gains reserve on a non-arm's length sale instead of claiming LCGE. Once soft ACB is characterized as such, it is tainted forever for the purposes of ITA section 84.1.

With the introduction of ITA paragraph 84.1(2)(e), it appears that the capital gains reserve can be used to bring the capital gain into income over several years, without causing the ACB of the shares to be soft. This significantly impacts family business transitions where the parent vendors want to utilize the capital gains reserve for proceeds not yet received, and still preserve access to the tax treatment made available through Bill C-208. It continues to be imperative to protect the concept of hard ACB where the LCGE is not utilized as part of a family transition in order for capital gain treatment to remain available on future non-arm's length transfers of the business.

COMMENTS ON POTENTIAL HALLMARKS OF SUCCESSION

In its July 19, 2021, news release, the Department provided an illustrative list of four main issues that potential amendments would address with respect to the measures introduced through Bill C-208. We provide our comments with respect to each issue below.

1. ***The requirement to transfer legal and factual control of the corporation carrying on the business from the parent to their child or grandchild***. While it is logical for a child taking over a family business to have equity and some voting influence in the business, it may be difficult to comply with a requirement to immediately transition full control of the business from the parent/grandparent vendor to the child/grandchild. Many family successions take time, and in practice, parents or grandparents retain ownership through preferred shares or a vendor-take back promissory note to protect their economic interest until they are repaid in full.

2. ***The level of ownership in the corporation carrying on the business that the parent can maintain for a reasonable time after the transfer.*** Family succession is often done over time for various reasons. It is not uncommon for the purchasing child/grandchild to lack the financial ability to fund the entire purchase in a short period of time. Prospective lenders are often hesitant to lend to children who have an unproven track record in the business. As such, maintaining partial ownership in the hands of the parents provides protection of the value of the business without causing undue financial hardship for the child. A longer transition period also provides a level of protection from the impacts of potential marital breakdowns of their children and the children's spouses. Any remaining value still held by the parents is often transitioned to the heirs in a will. In arm's length sales, vendors are commonly required to maintain employment and ownership as part of the transition to preserve goodwill; the same principle should apply for transitioning family businesses.

3. ***The requirements and timeline for the parent to transition their involvement in the business to the next generation.*** Many family businesses involve the contributions of multiple generations for years leading up to the full retirement by parents or grandparents. Elder generations continue to provide valuable expertise and labour in times of need. Implementing an unrealistically short transition period would preclude many family businesses from accessing the relief the Bill C-208 amendments provide. In many arm's length sales, particularly where the vendors hold preferred shares or debt, or have earn-out agreements for a specified period, the vendors maintain some involvement in the business for a number of years subsequent to the sale. Family businesses should be afforded the same amount of transition time as arm's length sales.

4. ***The level of involvement of the children and grandchildren in the business after the transfer*.** Ensuring the child/grandchild is active in the business is a valuable hallmark to support a true family business succession. However, it will be difficult to establish bright-line tests to measure the level of involvement due to the many nuances often present in family relationships and businesses. Establishing hallmarks that are too prescriptive

may make the legislation they support ineffective. For example, similar measures in Quebec tax legislation intended to facilitate the transfer of family businesses are subject to very stringent conditions, and as such, these measures are rarely used in practice as the majority of family business successions cannot fit within the rigid framework.

To further emphasize the importance of establishing meaningful and practical hallmarks, we provide our observations on the existing hallmarks[3] for the Quebec tax measures noted above.

- **The parent (or spouse) must have been actively engaged in the business during the 24 months immediately preceding the transition.** This may restrict the ability for a parent to transition ownership at the time that makes sense for the family, when the child/grandchild successor is financially secure to be able to fund the transition. It may also force the sale to happen in a shorter timeframe than may be desired.
- **The parent (or spouse) must cease involvement with the business after the sale.** This is not conducive to a thorough transition and is in fact contrary to common arm's length transactions where vendors are required to transition their knowledge and goodwill over a period of years, as discussed earlier. In addition, the Quebec legislation has restrictions on the amounts of income the parent vendors can receive from the business.
- **The parents may not control the transferee corporation.** In situations where parents still hold equity or debt in the subject corporation, this may unduly impair their ability to protect this value if they cannot retain voting shares during their redemption/payout period.
- **The parents cannot retain common shares of the transferee corporation.** This creates a prescriptive nature where the parents cannot transition over time and continue to own common equity. Many family business succession plans involve a period whereby the parents transition from being sole owners to full business partners alongside one or more of their children, with both sides holding significant ownership stakes. Such arrangements can then exist for years or even decades and encompass active involvement from both generations. Such successions are no less genuine than those involving a full transfer of ownership from parents to children over a short period of time. In our experience, these are often the most successful business successions.
- **There is a specific timeline of when the parents must divest of their financial interest in the company.** Quite often, parents will gift any remaining shares or shareholder loans to their children on death. Doing so may cause the transition to not comply with the legislation.
- **The child must be actively engaged in the subject corporation's business.** While we concur there needs to be some demonstration of active involvement in the business, the hallmark should take into consideration that involvement can take many forms and through different business structures. For example, the subject corporation's assets could be used in an existing business of the child, which may not be the exact business of the subject corporation.

Creating prescriptive hallmarks that every family business transition must adhere to for access to the intergenerational transfer exceptions will significantly restrict the family transitions that would be able to access these changes. These hallmarks should not be more restrictive than a typical arm's length business sale. As discussed earlier, it is common for a vendor to transfer ownership and remain active in the business over a period of time to ensure an effective transition. This is done to support continued success of the business; the vendor's knowledge, skills, and client/supplier relationships are transitioned as the vendor provides mentorship to the new business owners following the sale. A vendor that is doing the same in the course of transitioning a business to a family member should not be disadvantaged from a tax perspective.

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[3] Sections 517.5.6 to 517.5.11, *Quebec Taxation Act*.

SUMMARY AND RECOMMENDATIONS

While the changes introduced in Bill C-208 were welcome for family business succession, the additional recommendations below should be considered to further support equitable income tax treatment for family successions as for arm's length business sales.

1. To remain true to the policy intent of Bill C-208, family business succession should be permitted without being held to a higher, more difficult standard than a transition to an arm's length party.

2. The concepts of family business succession and divisive reorganizations should be amended to contemplate transitions to family members other than children or grandchildren to more accurately reflect family succession as seen in practice. Examples discussed earlier include transitions from one sibling to another and sales by a child to a parent.

3. The use of taxable capital as a measure to limit or deny access to the LCGE in a family transition should be eliminated. Alternatively, the taxable capital limit should be amended to align to the changes announced in the 2022 Federal Budget for small business deduction limits to an increased upper limit of $50 million.

4. Protect the concept of hard ACB where the LCGE is not used on family transition, so businesses can continue to be sold with capital gain treatment in non-arm's length transactions. This is important for transitions where the capital gain exceeds the LCGE, or where the LCGE is not otherwise used. If taxes have been paid by the vendor at capital gain rates, the purchaser corporation should be able to fund the purchase with corporate-taxed dollars.

5. Family business succession is not prescriptive, and no two situations are alike; therefore, any legislation should allow for flexibility. Overly prescriptive hallmarks will make it difficult to transition a family business within the rules, thereby reducing the overall spirit and objective of the legislation.

MNP would like to continue to work with the Government, other members of Parliament and policy makers across Canada to further discuss our observations, comments, and recommendations in this submission. We would be pleased to take on a formal role in the ongoing consultation process.