Advanced Wealth Planning Group

Intergenerational Business Transfers: Where are we now?

The transfer of family businesses to the next generation has long been a contentious tax issue. Owners rightfully expect the same tax benefits when selling their businesses to their children or other relatives as if they had sold to a third-party purchaser. Fiscal policy, meanwhile, aims to ensure that such sales to family are authentic and that business owners don’t use transfers “in form” only to extract corporate surplus in a tax-preferred manner, a practice known as surplus stripping.

With over 60% of family enterprises expected to change hands in the next decade[1], the need to strike a balance between facilitating legitimate intergenerational business transfers and preventing surplus stripping has become a pressing one.
Enter the 2023 Federal Budget, which introduced a framework of rules within which genuine intergenerational transfers may occur while discouraging surplus stripping via an artificial transfer.
The proposed rules also mean that business owners will be limited in *how* they transition their business to the next generation and *when* they step away from management and control.

Two new possible transfer routes

The new framework applies where **an individual Vendor sells shares** of “a qualified small business corporation” (QSBC) or “the capital stock of a family farm or fishing corporation” (QFFP) (i.e., shares that qualify for the Lifetime Capital Gain Exemption (LCGE)) which they control both legally (>50% of voting shares) and in fact (exert controlling influence), **to a corporation controlled by one or more of their “Children”** (18 years or older).

“Children” includes grandchildren, nieces and nephews and their children, and spouses or common-law partners of any Children.

To apply the framework and receive the desired tax consequences, the Vendor and Children must file a joint election selecting the desired transfer route and meet certain requirements for the **transfer of control, management,** and **economic interest** in the business, as well as the **retention of control** and **active involvement** in the business by the Children.

The proposed rules provide for two possible intergenerational business transfer routes:

1. An **immediate intergenerational business transfer** akin to an arm’s length sale. In effect, ownership and control is transferred on sale and management is transitioned over 36 months.

2. A **gradual intergenerational business transfer** that mimics an estate freeze with redemption over time. The Vendor's economic interest in the corporation becomes fixed at the time of sale and must be reduced below certain thresholds within 10 years. The Vendor can continue to exert influence over the business post-sale but must fully transition management within 60 months.

The new rules apply starting on January 1, 2024. For those wanting more flexibility in transferring their businesses to the next generation, planning should be completed by the end of 2023.

[1] Family Enterprise Foundation, “Ready, Willing And Interested – or Not? Canadian Family Business Transition Intentions” 2021.

Choosing a transfer route

The choice of transfer route depends on the intentions of the Vendor and the Children. With either route, the Vendor must sell the majority (>50%) of participating equity interests and voting shares of the corporation immediately, and the remainder within 36 months.

CHOOSE

Immediate intergenerational business transfer if...	Gradual intergenerational business transfer if...
• The time horizon for transitioning the business is 0-3 years. • The Vendor is prepared to relinquish legal and factual control of the business immediately. • The Vendor does not want to be tied to a timeline for reducing their fixed economic interest in the corporation (in the form of non-voting fixed value preferred shares). • The Vendor intends to fully transfer management of the business within 36 months.[2] • The Vendor's Children are ready and willing to: - maintain control of the corporation and purchaser corporation; - carry on the business; and - be actively engaged in the business[3] for at least 36 months.[2]	• The time horizon for transitioning the business is up to 10 years. • The Vendor wants to maintain factual control and influence over the business. • The Vendor's fixed economic interest in the corporation is reduced below 30% of the pre-sale value of QSBC shares, or 50% for QFFP shares ("final sale time") within 10 years. • The Vendor wishes to be involved in the management of the business for longer (up to 60 months).[2] • The Vendor's Children are ready and willing to: - maintain control of the corporation and purchaser corporation; - carry on the business; and - be actively engaged in the business[3] for at least 60 months or until the final sale time, if later.[2]

What are the planning benefits?

If all the conditions are met, the Vendor:

- ✔ Receives capital gains treatment on the sale, instead of paying higher dividend tax rates.
- ✔ Can claim their LCGE on the sale to the extent available.
- ✔ Can use the capital gains reserve over 10 years, rather than the usual five years.

Know before you buy!

At least one purchasing Child must remain active in the business throughout the first 36 or 60 months following the sale. Should the Child decide that running a business is not for them, or if the business fails within that period, the Vendor will lose the favourable tax treatment of a genuine intergenerational business transfer. The Child is then jointly and severally liable with the Vendor for any additional tax liability that results.

There are several tax and estate planning elements to consider when transitioning your business. Whether you are planning to retire in the near term or several years from now, your Wellington-Altus advisor has the resources to help you ask the right questions and identify the next steps for a seamless transfer to the next generation.

[2] There are exceptions in the event of an arm's length sale or the death or disability of the Child.
[3] Though not required of all Children, at least one of the purchasing Children must be active in the business.