Bill C-208: Instrument for Intergenerational Prosperity or Tool for Tax Avoidance?

CONNOR JONSSON

VII. INTRODUCTION

On June 29, 2021, Bill C-208, an *Act to Amend the Income Tax Act* (the "Act"), received royal assent. The Act amends two sections of the Income Tax Act in order to facilitate intergenerational share transfers of small family businesses. The Act is currently in force; however, the Government of Canada has indicated that amendments will be forthcoming in order to close certain legal loopholes.

This article will outline the changes that have been made to each section of the Income Tax Act, describe the policy considerations behind the changes, and comment on the tax avoidance loopholes which the Act potentially creates and what the forthcoming amendments may look like.

In October 2017, the then-majority Liberal government released its fall economic statement, in which it 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."[1] Historically, it has been more tax efficient for Canadian small business owners, farmers, and fishers to sell their business to a stranger than to a member of their own family.[2] Since 2015, several bills aimed at resolving this issue were tabled, but not passed,

1 Government of Canada. "Progress for the Middle Class" (24 October 2017), online: *Government of Canada* <www.budget.gc.ca/fes-eea/2017/docs/statement-enonce/fes-eea-2017-eng.pdf.>

2 Leo Almazora, "Does Bill C-208 contain a big tax loophole?" (5 July 2021), online: *Wealth Professional* <www.wealthprofessional.ca/news/industry-news/does-bill-c-208-contain-a-big-tax-loophole/357798>.

until Conservative Party Member of Parliament Larry Maguire from Manitoba put forth a private member's bill which gained support, primarily among Conservative MPs, and was ultimately passed this past June.[3]

Bill C-208 amends sections 84.1 and 55 of the Income Tax Act, specifically the provisions that contain exceptions to an anti-surplus stripping rule and a capital gains stripping rule.[4] The amendments will allow a qualified small business corporation ("QSBC"), family farm, or fishing corporation to take advantage of these exceptions when dealing with family members. The result is massive tax savings for small business owners who wish to pass their business on to their children and for siblings who wish to reorganize shares of their small business. To qualify as QSBC the corporation must be privately owned, Canadian-controlled and actively carry on business in Canada. Additionally, the share must not have been owned by anyone who was not a relative in the 24-month preceding the Determination Time.[5] If these conditions, along with other minor technical requirements, are met, the corporation is a QSBC and may be eligible under the exceptions outlined in this new amendment.[6]

VIII. CHANGES TO SECTION 84.1

Prior to Bill C-208, when a small business owner sold shares of their company to a corporation owned by their child or grandchild, they would be taxed at the dividend rate.[7] If the same transaction occurred with an arms-length corporation, the small business owner would be taxed at the much lower capital gains rate and was even allowed to access their lifetime capital gains exemption (if they qualified), resulting in no tax on the first

[3] Government of Canada, "Bill C-208 (Historical)", online: Government of Canada <openparliament.ca/bills/43-2/C-208/>.

[4] Bill C-208, *An Act to Amend the Income Tax Act*, 2nd Sess, 43rd Parl, 2021 (assented to 29 June 2021), SQ 2021, c 21 [Bill C-208].

[5] *Income Tax Act*, RSC 1985, c 1 (5th Supp) at s 110.6(1) [*ITA*].

[6] For a more complete explanation of a QSBC see Mondaq, "Canada: Qualified Small Business Corporation and Lifetime Capital Gains Exemption", online: *Mondaq* <https://www.mondaq.com/advicecentre/content/3568/Qualified-Small-Business-Corporation-and-Lifetime-Capital-Gains-Exemption>.

[7] EY Canada, "2021 Tax Alert" (12 July 2021), online: *EY Canada* <https://www.ey.com/en_ca/tax/tax-alerts/2021/tax-alert-2021-no-25>.

$892,218 of the transaction.[8] This statutory regime incentivized third-party sales over intergenerational transfers as there were significant tax advantages in the former. The rule governing this differential tax treatment is found in section 84.1 and is known as an anti-surplus stripping rule. It should be noted that this rule poses no problems for farmers or fishers who want to sell their shares directly to a child or grandchild; the issue only arises when done so through a purchaser corporation.

Anti-surplus stripping rules prevent an individual shareholder from accessing corporate surplus in a sale of shares to a non-arm's length corporation. The rule is meant to prevent purposeful tax avoidance through an artificial transfer of business shares to a family member or other close party. As a result, when parents or grandparents who own a small business want to genuinely transfer shares to their kin, the proceeds are deemed to be a dividend, which results in a much higher tax rate. Section 84.1(1)(b) states:

> (1) Where… a taxpayer resident in Canada… disposes of shares that are capital property of the taxpayer… of any class of the capital stock of a corporation resident in Canada… to another corporation… with which the taxpayer does *not deal at arm's length*…
>
> (b) for the purposes of this Act, a *dividend* shall be deemed to be paid to the taxpayer by the purchaser corporation and received by the taxpayer from the purchaser corporation as the time of the disposition.

Since a transfer of shares from a parent to their child is not an arm's length transaction, traditionally these payments have been deemed to be dividends. Bill C-208 amends section 84.1 by adding a narrow exception to this anti-surplus stripping rule in paragraph (2)(e). The new exception states:

> (e) if the subject shares are qualified small business corporation shares or shares of the capital stock of a family farm or fishing corporation within the meaning of subsection 110.6(1), the taxpayer and the purchaser corporation are deemed to be dealing at arm's length if the purchaser corporation is controlled by one or more children or grandchildren of the taxpayer who are 18 years of age or older and if the purchaser corporation does not dispose of the subject shares within 60 months of their purchase.

This new exception allows certain qualified businesses to now treat transfers to their children or grandchildren as arm's length transactions for tax purposes. The exception will apply where the transferred shares are

---

8 *Ibid.*

Qualified Shares, the purchaser corporation is controlled by an adult child or grandchild of the transferor, and the purchaser corporation does not dispose of the transferred shares within 60 months of the transaction.

If these criteria are met, the purchaser and the transferor will be deemed to be dealing at arm's length and the transferor will be allowed to realize capital gains on the sale of shares to their child or grandchild's corporation. 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.[9] The ability to utilize the lifetime capital gains exception in this circumstance is reduced where the taxable capital exceeds $10 million and is fully eliminated at $15 million.[10] This limitation ensures the amendment will primarily benefit small businesses.

It is worth noting that, according to the wording of the Act, the children and/or grandchildren do no need to actually 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 full 60 months.[11] This has led the federal government to voice concern about the effect of this bill on the integrity of the tax system as it could lead to disingenuous share transfers. This issue will be discussed in more detail later in this paper.

This amendment fundamentally changes the tax distortion that has historically favoured third-party sales. The section 84.1 amendment tells only one half of the family tale though. The section 55 amendment is equally as important for family businesses as it changes the tax distortion that has historically treated siblings as unrelated third parties and thus not entitled to favourable tax considerations when reorganizing their business.

IX. CHANGES TO SECTION 55

In certain respects, section 55 of the Income Tax Act deals with the opposite scenario of section 84.1, in that when it applies it deems a capital gain to have occurred, instead of what would have otherwise been a

---

9 *ITA*, *supra* note 5, s 84.1(2.3)

10 *Ibid*.

11 *Supra* note 7.

dividend.[12] Section 55 protects against what's known as capital gains stripping.[13] Capital gains stripping is when a business owner uses inter-corporate dividends to reduce capital gains.[14] Subsection 55(1) to 55(5) provide a "complex set of rules designed to prevent the conversion of a taxable capital gain into a tax-free inter-corporate dividend"[15]and subsection 55(3)(a) provides an exception to the capital gains stripping rule often referred to as the "related party butterfly rule".[16] This exception provides the basis for what is known as a butterfly transaction, which is used to distribute assets from a corporation (the "Transferor Corporation") to a corporation controlled by the shareholders of the Transferor Corporation.[17] The rule is helpful in facilitating genuine internal business reorganizations on a tax-efficient basis. The exception in paragraph 55(3)(a) is available only when the shareholders of the Transferor Corporation are related, in which case it will apply to treat the transfer as a tax-free inter-corporate dividend.[18]

Paragraph 55(5)(e) holds that siblings are not considered related for this purpose.[19] This meant that, prior to Bill C-208, siblings controlling shares in small business corporations, family farms, and fishing corporations were not eligible for a butterfly transaction under 55(3)(a) and thus not entitled to tax-free transfers. While the butterfly transaction was still available under 55(3)(b), this section was far more restrictive and made these sorts of transactions difficult and significantly more complicated.[20] Bill C-208 carves out a space for siblings controlling qualified shares to be considered related under 55(3)(a) and able to convert a taxable capital gain from an inter-family transfer into a tax-free inter-corporate dividend. Section 55(5)(e)(i) now reads:

> (e) in determining whether 2 or more persons are related to each other, in determining whether a person is at any time a specified shareholder of a

---

12 ITA, *supra* note 5, s 55.

13 Arthur Cockfield, Martha O'Brien & Catherine Brown, *Materials on Canadian Income Tax,* 16th ed (Toronto: Thomson Reuters Canada, 2020) at 684.

14 *Ibid*.

15 *Ibid*.

16 *Supra* note 7.

17 *Supra* note 7.

18 *Supra* note 8, s 55(3)(a).

19 *Ibid*, s 55(5)(e).

20 *Supra* note 7.

> corporation and in determining whether control of a corporation has been acquired by a person or group of persons,
>
> (i) a person shall be deemed to be dealing with another person at arm's length and not to be related to the other person if the person is the brother or sister of the other person, *except in the case where the dividend 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 the capital stock is a qualified small business corporation share or a share of the capital stock of a family farm or fishing corporation within the meaning of subsection 110.6(1)* (emphasis added).[21]

Bill C-208's amendment to section 55 appears to broaden the potential application of the related party butterfly rule to permit siblings to reorganize their corporate affairs by relying on it. It is important to note that under the new amendment, siblings shall still be deemed to be dealing with each other at arm's length and unrelated *unless* they are transferring shares of a qualified small business corporation, a family farm, or a fishing corporation, in which case they will be deemed to be related and dealing at non-arm's length.

X. POLICY CONSIDERATIONS AND FORTHCOMING AMENDEMENTS

These changes are intended to facilitate genuine intergenerational transfers and promote re-organization of family businesses without a disproportionate tax burden. When it was passed, Bill C-208 was seen as a big win for small businesses across the country[22] as it meant significant tax savings for those who wished to keep their business in the family, and it was a signal from the Canadian government that they were committed to supporting family-run Canadian small businesses by facilitating intergenerational prosperity and maintaining business legacies.

Despite the universal praise the new bill has received from small business owners however, the federal government has signaled that it will take steps to close what it considers legal loopholes for non-genuine

---

21 *ITA*, *supra* note 8, s 55(5)(e)(i).

22 Jeff Labine, "Ag Sector Welcomes Clarified Tax Bill After Weeks of Confusion" (20 July 2021), online: *iPolitics* <ipolitics.ca/2021/07/20/ag-sector-welcomes-clarified-tax-bill-after-weeks-of-confusion/>. See also Leo Almazora, "A Tax Planning Win for Canadian Family Business" (2 July 2021), online: <https://www.wealthprofessional.ca/news/industry-news/a-tax-planning-win-for-canadian-family-businesses/357754>.

transfers. During their study of the bill, the Department of Finance expressed concerns about Bill C-208 to the House of Commons.[23] They were concerned that the relaxed rules would trigger a flood of tax-avoidance schemes, warning that it could enable business owners to conduct surplus stripping transactions aimed at extracting cash from a business. Under such a tactic, there is no real transfer of control, and no real transfer of the business; business owners would simply be motivated to extract cash tax-free or at a significantly reduced tax rate.[24] This tactic does not require deception on the part of the transferring family members and there are legitimate reasons that a child or grandchild would be willing to take de facto control of a corporation but not actually carry on the day-to-day business, but the Department of Finance also has legitimate policy reasons for being skeptical of such transfers.

On June 30th, 2021, one day after the bill was enacted, the Government of Canada stated its intention to introduce legislation that would delay Bill C-208's application date to January 1st, 2022.[25] However, this attempt to delay stalled after blowback from opposition parties and on July 19th they backtracked, and conceded the new rules were in effect.[26] The Minister of Finance, Chrystia Freeland, provided a statement and explained that, while Bill C-208 was now in force, amendments to the bill would soon be coming, and pointed to an implementation date for amendments as early as November 1st, 2021.[27] After a lengthy silence from the federal government, Budget 2022 announced a consultation process for stakeholders to share their views as to how the existing rules could be strengthened to protect the integrity of the tax system while continuing to facilitate genuine intergenerational transfers. The government indicated that they will likely

---

23 *Supra*, note 7.

24 *Supra*, note 7.

25 Department of Finance Canada "Government of Canada provides details on Next Steps for Private Member's Bill C-208" (30 June 2021), online: *Government of Canada* <https://www.canada.ca/en/department-finance/news/2021/06/government-of-canada-provides-details-on-next-steps-for-private-members-bill-c-208.html>.

26 Department of Finance Canada, "Government of Canada Clarifies Taxation for Intergenerational Transfers of Small Business Shares" (19 July 2021), online: *Government of Canada* <https://www.canada.ca/en/department-finance/news/2021/07/government-of-canada-clarifies-taxation-for-intergenerational-transfers-of-small-business-shares.html>.

27 *Ibid*.

bring forward legislation to address this issue in a bill to be tabled in the fall of 2022 after the consultation process has concluded.

In their July statement the government said its amendments could include provisions to prevent surplus stripping. For example, it said it could introduce a provision requiring a certain level of involvement in a business by a child or grandchild following a transfer. It also said it could introduce a requirement to transfer legal and factual control of a corporation to a child or grandchild, specify the level of ownership that a parent could maintain for a "reasonable time" after such a transfer, and include requirements and timeline for a transition.[28] The rules would ensure that real, genuine control of the company is transferred to the child or grandchild in order to deter schemes aimed solely at tax avoidance.

XI. CONCLUSION

According to a survey done by the Canadian Federation of Independent Business in 2018, 72% of business owners in Canada intend to exit their business by 2028.[29] Bill C-208 ensures that business owners don't have to choose between a comfortable retirement and keeping their business in the family, as they will no longer be penalized for selling to a family member.

Initially, when the Trudeau government voiced concern about the bill and even attempted to delay its implementation, business owners were wary that any changes made to the bill would be retroactively applied and they could end up paying a tax penalty for not adhering to the new rules. In the weeks after their initial opposition to the bill however, the federal government made it clear that any amendments that are likely to be made will not be retroactively applied. The government has made reasonable efforts to make known its intentions in amending Bill C-208 and has described publicly what those amendments will look like[30] in order to ease any uncertainty small business owners may be feeling. There is still an air

---

28 *Ibid.*

29 CFIB, "Nearly Three Quarters of Small Business Owners Plan to Exit Their Business Within the Next 10 Years" (28 November 2018), online: *CFIB* <//www.cfib-fcei.ca/en/media/nearly-three-quarters-small-business-owners-plan-exit-their-business-within-next-10-years>.

30 *Supra* note 26.

of uncertainty though, as without knowing more details of the intended changes it is unclear how one is supposed to abide by them.

It is too soon for the Canada Revenue Agency to have any data on business owner behaviour related to the new rules so time will tell if the federal government's fear of increased tax avoidance is justified. Whatever the outcome, it is clear that Bill C-208 was much-needed for small businesses, family farms, and fishing corporations. In his sponsor speech, Larry Maguire summarized the purpose of his bill in a few short words: "It is unfair that selling a business to [the business owners] children should be more expensive than selling to a stranger... in passing Bill C-208... we can support entrepreneurs, small businesses, farmers, and fishers who make up the backbone of our economy".[31] In many important respects, Bill C-208 appears to have achieved this goal.

---

31 Larry Maguire, "Private Members Business" (25 November 2020), online *Parliament of Canada* <www.parl.ca/LegisInfo/en/bill/43-2/C-208?view=details>.