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Trevor McGowan
Associate Assistant Deputy Minister
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Proposed amendments to section 84.1 of the Income Tax Act for intergenerational business transfers

Dear Mr. McGowan:

On behalf of the small business sector, we at Baker Tilly Canada thank you and your team within the Department of Finance for your hard work and dedication to the intergenerational transfer rules.

In reviewing the proposed amendments to section 84.1 contained in Budget 2023, we noted some issues that could produce results inconsistent with the intended policy. Recognizing the diversity of intergenerational business transfers, it is our goal to use our vast client experiences to provide information that may positively influence minor revisions to the draft legislation, thereby ensuring the proper balance between taxpayer certainty and maintaining the integrity of the Income Tax Act. Herein, these issues are concisely explained, along with brief recommendations for your consideration.

Baker Tilly's National Tax Advisory Committee represents Baker Tilly offices from coast to coast. The following committee members have contributed to this letter and express their appreciation of your consideration in this matter:

Mike Hayward, CPA, CA, CPA (Illinois)	Ottawa, ON
Rosa Iuliano, M.Acc., FCPA, FCA	Ottawa, ON
Rock Lapalme, CPA, CA, TEP	Sudbury, ON
Greg Leslie, CPA, CA, TEP	Dartmouth, NS
Sarah Netley, MAcc, MTax, CPA, CA, TEP	Courtice, ON
Mark Sherritt, CPA, CA	Vancouver, BC
Riccardo Zerbino, LLM, CPA	Montréal, QC

We would be pleased to discuss our recommendations with you should they require elaboration or clarification. Please contact Brenda Scott at blscott@bakertilly.ca.

Yours truly,

Mike Hayward, CPA, CA, CPA (Illinois)
Chair, National Tax Advisory Committee
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Baker Tilly Canada National Tax Advisory Committee

Issues and recommendations on the proposed intergenerational business transfer (IBT) rules

<u>Issue 1: Control immediately before disposition time [84.1(2.31)(a) & 84.1(2.32)(a)]</u>

Description: The proposed IBT rules dictate who may or may not control the subject corporation immediately prior to sale. This control rule requires that "*the taxpayer – either alone or together with a spouse or common-law partner of the taxpayer – controls the subject corporation, and no other person or group of persons controls, directly or indirectly in any manner whatever, the subject corporation.*"

Concern #1: The requirement that a taxpayer control the subject corporation "together with" another person may prevent many legitimate IBTs from benefiting from the new rules, which seems inconsistent with the tax policy behind the proposals. Case law has established that, where one person or group of persons controls a corporation, another person or group of persons cannot be said to also control that corporation. Paragraph 256(1.2)(b) was enacted in response to that case law, but it applies only for the purposes of the association rules in section 256. This creates uncertainty in the context of these proposed rules. Take an example where a taxpayer owns 49 per cent of the voting shares while their spouse owns 51 per cent of the voting shares of the subject corporation. In the absence of a provision similar to paragraph 256(1.2)(b), the taxpayer would not control the subject corporation together with their spouse because the spouse has de jure control. If a provision similar to 256(1.2)(b) was implemented to rectify this situation, allowing a taxpayer and spouse to control together, consideration should also be given to taxpayers who do not own any voting shares and would be unable to form a controlling group with their spouse.

Concern #2: The requirement that control rest only with the taxpayer and/or their spouse or common-law partner does not recognize dynamic family situations where control is spread out over various family members or arm's length persons, and may likewise prevent many legitimate IBTs from benefiting from the new rules, which appears inconsistent with the tax policy behind the proposals. Take an example where a taxpayer owns 50 per cent of the voting common shares of a family farm or fishing corporation, while their child owns the remaining 50 per cent of the voting common shares of the corporation. Both the taxpayer and their child are actively involved in the business. This share structure has been in place since incorporation of the subject corporation, and the taxpayer is retiring and wishes to transfer their 50 per cent interest to their child's corporation. A further example would be a taxpayer and her sister who each own a 50 per cent interest in a small business corporation that operates a manufacturing business. Both siblings wish to retire and transfer the business to their respective children. Neither sibling has control of the subject corporation. In both of these common examples, the requirements of paragraphs 84.1(2.31)(a) and 84.1(2.32)(a) would be unmet, resulting in unequitable tax treatment between family businesses for genuine IBTs, especially when considering the diverse family ownership of farm corporations.

Concern #3: The requirement that "*no other person or group of persons controls, directly or indirectly in any manner whatever, the subject corporation*" may also lead to situations where a genuine IBT is prevented from benefiting from the new rules. Take an example where a taxpayer, their spouse and their sibling each own 1/3 of the voting common shares of a corporation. The taxpayer and their spouse, who may be viewed as having control of the subject corporation, want to sell their combined 2/3 interest to a

corporation controlled by their children. The requirement that *"no other… group of persons controls*" may cause concern if the taxpayer's sibling was viewed as part of a group that controls the subject corporation, rendering the requirement unmet.

Concern #4: The wording "*directly or indirectly in any manner whatever*" prevents family members, other than the taxpayer and their spouse, from having de facto control immediately before the disposition time. With the broadened application of de facto control under subsection 256(5.11), many family farm corporations would be prevented from accessing the IBT rules. For example, whether or not the child(ren) hold voting shares, in most successful intergenerational successions, the child(ren) have gradually become experienced in the business and assumed roles in operational and strategic management. By the time it is practical and appropriate for their parents to surrender de jure control, the child(ren) are almost certainly part of a group possessing de facto control.

Recommendation: We believe paragraphs 84.1(2.31)(a) and 84.1(2.32)(a) are not required and could be removed without impacting the integrity of genuine IBTs. The combination of all remaining paragraphs in subsections 84.1(2.31) and 84.1(2.32) provide the critical provisions that maintain the integrity of the IBT rules.

If this is not desirable, we recommend paragraphs 84.1(2.31)(a) and 84.1(2.32)(a) be amended to provide language that allows diverse family ownership structures to also qualify, resulting in a more equitable application of the IBT rules. The effect of the legislative example provided below will not expand the scope of the IBT rules beyond the underlying tax policy of limiting access to genuine IBTs, such as the examples provided above:

> *(a) immediately before the disposition of the subject shares (referred to in this subsection as the "disposition time"), the subject corporation is controlled by*
>
> > *(i) the taxpayer,*
> >
> > *(ii) a child of the taxpayer,*
> >
> > *(iii) a person related to a person described in subparagraph (i) or (ii), or*
> >
> > *(iv) any group of persons described in subparagraphs (i) through (iii).*

Issue 2: Interaction between paragraphs (a) and (c) of subsections 84.1(2.31) & 84.1(2.32)

Description: Paragraphs 84.1(2.31)(c) and 84.1(2.32)(c) require that "*at all times after the disposition time, the taxpayer does not – either alone or together with a spouse or common law partner of the taxpayer – control…the subject corporation.*"

Concern: The interaction between the control rule in each respective paragraph (a) and the relinquishment of control rule in each respective paragraph (c) does not allow for a genuine IBT to take place in two separate transactions. Paragraph (a) requires the taxpayer to have control, either alone or together with their spouse, immediately prior to disposition, while paragraph (c) requires the taxpayer, either alone or together with their spouse, to forever relinquish control immediately after disposition. Take an example

where a taxpayer owns 100 per cent of the voting common shares of a qualified small business corporation, meeting the control test in paragraph (a). As part of their plan to transition the business to their child, they sell 51 per cent of their shares to their child, thus meeting the relinquishment of control test in paragraph (c). To complete the IBT, one or more subsequent dispositions would need to occur for the remaining 49 per cent share equity. Any subsequent disposition would not meet the control test of either paragraphs (2.31)(a) or (2.32)(a). There may be valid business or regulatory reasons for the taxpayer's retention of a 49 per cent interest, whether it be in the form of 49 per cent common shares or whether those shares were exchanged for other shares (e.g., shares of a specified class). Preventing the taxpayer from benefiting from the new IBT rules on the second disposition appears inconsistent with the tax policy behind the proposed rules.

Recommendation: The concern raised above can be remedied if paragraphs 84.1(2.31)(a) and 84.1(2.32)(a) are removed entirely, as suggested in our first issue above. If those paragraphs remain in place, this concern could be addressed by adding a deeming rule to subsection 84.1(2.3), which could state that a taxpayer is deemed to meet the condition of paragraphs 84.1(2.31)(a) or 84.1(2.32)(a), as the case may be, where, in respect of any prior disposition of shares of the same corporation, the taxpayer met the conditions of both paragraphs (a) and (c). Alternatively, the transfer of control for purposes of these provisions could be assessed in a broader manner; that is, the transaction must be part of a series of transactions where, prior to commencement of the series, the taxpayer or other related parties (as recommended in Issue 1) controls the subject corporation and, at the end of the series, the taxpayer has forever relinquished control.

<u>Issue 3: Active engagement of the children [84.1(2.31)(f)(ii) & 84.1(2.32)(g)(ii)]</u>

Description: Subparagraphs 84.1(2.31)(f)(ii) and 84.1(2.32)(g)(ii) require that "*the child, or at least one member of the group of children, as the case may be, is actively engaged on a regular, continuous and substantial basis (within the meaning of paragraph 120.4(1.1)(a)) in a relevant business of the subject corporation or a relevant group entity.*"

Concern: The 20 hours per week "bright-line test" in paragraph 120.4(1.1)(a) is very rigid and may not provide sufficient flexibility that a factual test would provide. This may lead to instances where a genuine IBT does not qualify, even though the entire operations of the subject corporation have effectively been taken over by the child. For example:

1. Two or more children share in the management duties previously performed by the taxpayer, resulting in each child working less than 20 hours per week.

2. The bright line test would not be met if the subject corporation contained more than one business and the child's duties or role was divided between multiple businesses, reducing their average hours to below 20 hours per week per business.

3. The child(ren) may not meet the requirement of 20 hours per week because of business closures due to extraordinary events (such as a pandemic) or due to temporary leaves such as maternity, paternity or sickness.

In some cases, it may not be clear whether a corporation carries on one multi-divisional business or several distinct businesses, adding complexity and confusion for small business owners and farmers.

Recommendation: We recommend changes to the wording in subparagraphs 84.1(2.31)(f)(ii) and 84.1(2.32)(g)(ii) to address the issues identified above and provide flexibility for truly genuine IBTs to qualify, while also preventing abuse of the rules inconsistent with the underlying tax policy. For example, these two subparagraphs could instead require that a child is actively engaged on a regular, continuous and substantial basis for the purposes of the definition of *excluded business* in subsection 120.4(1), if that definition were read without reference to paragraph (b). If the 20-hour bright-line test remains, it would be beneficial to add a provision factoring the cumulative hours performed by one or more children of the taxpayer in all relevant businesses.

Issue 4: Interaction between actively engaged and management tests [84.1(2.31)(f)/(g) & 84.1(2.32)(g)/(h)]

Description: Subparagraphs 84.1(2.31)(g)(i) and 84.1(2.32)(h)(i) require the transfer of management to the child(ren) referred to in subparagraphs 84.1(2.31)(f)(ii) and 84.1(2.32)(g)(ii), respectively.

Concern: These provisions require transferring management to the child(ren) referred to in subparagraphs 84.1(2.31)(f)(ii) and 84.1(2.32)(g)(ii), potentially forcing the transfer of management to one or more children who are actively engaged in the business but have no intention or ability to manage the business. There may be many situations in which one child is well-suited to manage the business of the company while another child provides skilled labour. A further concern may be multiple businesses; one child may be the appropriate manager (and worker) in one business, while another child may be the appropriate manager (and worker) in a second business.

Recommendation: We recommend subparagraphs 84.1(2.31)(g)(i) and 84.1(2.32)(h)(i) be modified to require that management be transferred to the child(ren) who has control or is a member of a controlling group, rather than the children actively engaged in a business. A focus on ensuring one or more of the controlling children assume the management role, and the founder(s) withdraw from the management role, seems sufficient to limit the application of the proposed rules to genuine IBTs where management is transitioned to the next generation.

Issue 5: Exceptions under subparagraphs 84.1(2.3)(c)(i) and (ii)

Description: These provisions provide that a taxpayer will be deemed to meet the conditions of paragraphs 84.1(2.31)(f) and (g) and paragraphs 84.1(2.32)(g) and (h), respectively, where they would otherwise not meet those conditions because their child(ren) dispose of shares prior to the 36-month anniversary after the taxpayer's disposition. This deeming rule requires "*all equity interests in all relevant businesses…held, directly or indirectly, by the child or children are included in the disposition.*"

Concern: The requirement that the child dispose of "*all equity interests in all relevant businesses*" ties all businesses together, limiting the child's ability to make certain business decisions within the legislative period. Take an example of a child who acquired two corporations from their parent. One corporation ("Opco") carries on an active business, and the other corporation ("Realco") owns the land and building used exclusively by Opco. Opco is a subject corporation, and its shares are qualifying small business corporation (QSBC) shares. Realco is also a subject corporation, and its shares are also QSBC shares. Opco is a relevant group entity in respect of Realco because the QSBC status of Realco's shares is

dependent on the relevant business of Opco. If the child elects to sell the shares of Realco prior to the 36-month anniversary of the IBT in order to reinvest in a more environmentally sustainable building better-suited for Opco's expansion plans, they would be forced to also sell the Opco shares to meet the requirements of the deeming rule in paragraph 84.1(2.3)(c). The requirement in paragraph 84.1(2.3)(c) that the shares of Opco be included in the disposition is also problematic for the purchaser of Realco who may be uninterested in acquiring Opco.

Recommendation: We recommend the requirement for a child or children to dispose of all equity interests in all relevant businesses in subparagraphs 84.1(2.3)(i) and (ii) be removed. Alternatively, this exception could be limited to the disposition of the equity interest of the specific relevant business being sold instead of all relevant businesses. This could be coupled with a requirement that the child(ren) remain actively engaged in all other relevant businesses not subject to the disposition throughout the remaining legislative time period.

Issue 6: Relevant group entity

Description: The definition of "relevant group entity" in subparagraphs 84.1(2.31)(c)(iii) and 84.1 (2.32)(c)(iii) is "*any other person or partnership…that carries on, at the disposition time, an active business…that is relevant to the determination of whether the subject shares satisfy the condition in subparagraph (b)(iii).*"

General concern: As currently worded, the definition can result in the linkage of two or more independent business entities. Such linkage could force entrepreneurs with multiple independent businesses to either fail the IBT conditions or make inappropriate business decisions to meet the IBT conditions. Here are a few specific situations of concern.

Concern #1: The definition is not limited to persons or partnerships within the control of the taxpayer or the taxpayer's spouse or common-law partner. The IBT condition requiring transfer of management of all relevant businesses may result in an inappropriate transfer of management to a child. Take an example where a subject corporation that is a family farm derives all or substantially all of its value from a 50 per cent interest in a family farm partnership. The active business of the partnership would be a relevant business in respect of the subject corporation. Assume the other 50 per cent interest in the partnership is controlled by the taxpayer's sibling who manages the farm. The taxpayer sells the subject corporation representing their 50 per cent interest in the farm partnership. In this scenario, the requirement of subparagraph 84.1(2.31)(g)(i) or 84.1(2.32)(h)(i) would not be met because the taxpayer's sibling manages the farm, preventing the taxpayer from transferring management. As a result, either the taxpayer does not qualify for the IBT, or the sibling is forced to give up all or a portion of management, which may not be in the best interest of the farm business.

Concern #2: As the word "relevant" is not limited in any way, this could mean any business that tends to increase or decrease the likelihood that the qualified small business corporation (QSBC) share status or family farm or fishing corporation status is met is a relevant business. This broad interpretation could force independent businesses of an entrepreneur taxpayer to be accidently linked and included in the IBT. For example, a taxpayer owns all the shares of two companies. One company operates a restaurant and the other operates a hardware store. The hardware store owns the building used by both companies. Based on the term "relevant", the business of the restaurant tends to increase or decrease the likelihood of the

hardware store qualifying as a QSBC, making the restaurant a relevant business of the hardware store. For the taxpayer to ensure the sale of the hardware store qualifies for the IBT, the taxpayer must also include the restaurant as part of the IBT, otherwise various conditions in subsections 84.1(2.31) and 84.1(2.32) will not be met.

Concern #3: Our concern of accidental linkage of independent businesses can also occur in arm's length situations. For example, a subject corporation carries on an active business and owns an exclusive license (intangible asset) to distribute a product of an unrelated key supplier. The license has significant value and has a direct impact on the company qualifying as a QSBC. Here, the existence or continuance of the supplier's business is relevant to the determination of the QSBC share status of the subject corporation, making the supplier's business a relevant business of a relevant group entity subject to the IBT conditions. Specifically, the supplier would need to assign the child all or some portion of management of their business to meet the requirement of subparagraph 84.1(2.31)(g)(i) or 84.1(2.32)(h)(i).

Recommendation: We would suggest the terms *relevant business* and *relevant group entity* be reviewed to narrow their scope, minimizing unintended linkage of independent businesses.

Issue 7: No exception for bankruptcy, insolvency or cessation of business

Description: Paragraphs 84.1(2.3)(c) and (d) provide exceptions to the legislative time periods for the conditions under paragraphs 84.1(2.31)(f) and (g) and 84.1(2.32)(g) and (h). The exceptions are available in the following situations:

- arm's length sale,
- death of child(ren), and
- severe and prolonged impairments in physical or mental functions of child(ren).

Concern: The exceptions do not provide for other unfortunate circumstances in which some or all of the requirements in paragraphs 84.1(2.31)(f) and (g) and 84.1(2.32)(g) and (h) cannot be met. For example:

- bankruptcy or insolvency of the subject corporation or a relevant group entity,
- a global pandemic that closes supply chains or results in government-mandated closures,
- a natural disaster that destroys the business premises, and
- other situations in which the business or businesses are required to shut down prematurely.

Recommendation: We recommend adding additional exceptions in subsection 84.1(2.3) to account for situations where the business or businesses of the subject corporation or a relevant group entity are required to close prematurely, such as in the examples above. For example, a rule could deem the requirements of paragraphs 84.1(2.31)(f) and (g) and 84.1(2.32)(g) and (h) to be met in respect of a subject corporation or relevant group entity described in any of subparagraphs 50(1)(b)(i) through (iii), or where the conditions would otherwise not be met under extraordinary circumstances where the Minister (of Revenue) would consider waiving a penalty or interest that could be payable by the person pursuant to subsection 220(3.1). Effectively, any cessation of the business due to circumstances beyond the control of the children should qualify for the exception, which would seem consistent with the tax policy underlying the current exception for the death or mental or physical impairment of the child.

Issue 8: The term "non-voting preferred shares"

Description: Paragraphs 84.1(2.31)(d) and 84.1(2.32)(d) provide for an ability to retain a specified class of shares (as defined in subsection 256(1.1)), which are then referred to as "non-voting preferred shares."

Concern: The term "non-voting preferred shares" may mislead taxpayers to assume preferred shares that are non-voting meet the requirements.

Recommendations: Rather than referring to shares of a specified class as defined in subsection 256(1.1) as "non-voting preferred shares," the provisions could refer to "shares of a specified class," prompting taxpayers to review the definition.

Issue 9: De facto control, share valuation and share attributes for shares of a specified class

Description: Paragraph 84.1(2.31)(c) requires that "*at all times after the disposition time, the taxpayer does not – either alone or together with a spouse or common law partner of the taxpayer – control, directly or indirectly in any manner whatever,*" the subject corporation, purchaser corporation or relevant group entity. Use of the words "directly or indirectly in any manner whatever" means the taxpayer may not retain de facto control.

Concern: The taxpayer is permitted by paragraph 84.1(2.31)(d) to own shares of a specified class as defined in subsection 256(1.1) after the disposition. In some circumstances, this could allow the taxpayer to retain de facto control. There is no restriction regarding the retractable feature of a specified class of shares. For valuation purposes, the Canada Revenue Agency (CRA) has a longstanding administrative position that preferred shares received as consideration should give the holder the right to retract the shares. This was acknowledged in guidance provided by the CRA at the 1980 Canadian Tax Foundation annual conference.

It should also be noted, as documented in IT-64R4, the CRA considers a substantial investment in retractable preferred shares as a general factor in determining de facto control. Therefore, if a taxpayer exchanges shares for shares of a specified class and adheres to the CRA's valuation policy by establishing a retraction feature, this could result in de facto control being retained by the taxpayer.

Recommendation: We recommend adding a provision to clarify that a retraction right attached to shares of a specified class shall not, in and of itself, result in the holder of shares of a specified class being considered to control, directly or indirectly in any manner whatever, the corporation. This provision could apply to paragraph 84.1(2.31)(c) or the entire Income Tax Act. Alternatively, commentary could be provided in accompanying explanatory notes.

Issue 10: Difference between the preambles to subsections 84.1(2.31) and 84.1(2.32)

Description: The preamble to subsection 84.1(2.31) states that paragraph 84.1(2)(e) applies "at the time of a disposition," whereas the preamble to subsection 84.1(2.32) states that paragraph 84.1(2)(e) applies "to a disposition."

Concern: It is unclear whether the difference in terminology is an oversight or intentional.

Recommendation: Please clarify whether the difference in the wording was intentional or, alternatively, if the two preambles could be made the same.

Issue 11: Difference between “each” and “any” used in subparagraphs 84.1(2.31)(g)(i) and 84.1(2.32)(h)(i)

Description: Subparagraph 84.1(2.31)(g)(i) requires the transfer of management of “each” relevant business, whereas subparagraph 84.1(2.32)(h)(i) requires the transfer of management of “any” relevant business.

Concern: It is unclear if the difference in wording is an oversight or intentional. For example, “any” could be interpreted to require the transfer of management of “just one” relevant business rather than “all” relevant businesses.

Recommendation: Please clarify if the difference in wording was intentional or, alternatively, if the two provisions could be made the same.

Issue 12: Opening words to paragraphs 84.1(2.31)(f) and (g) compared to paragraphs 84.1(2.32)(g) and (h)

Description: Paragraphs 84.1(2.32)(g) and (h) begin with “subject to subsection (2.3).” The equivalent provisions in subsection 84.1(2.31), being paragraphs (f) and (g), do not include this wording. Subsection 84.1(2.3), however, also applies to paragraphs 84.1(2.31)(f) and (g).

Concern: Based on the wording of subsection 84.1(2.3), it appears paragraphs 84.1(2.31)(f) and (g) should also contain the wording “subject to subsection (2.3).”

Recommendation: Based on our understanding of the wording in subsection 84.1(2.3), we recommend modifying paragraphs 84.1(2.31)(f) and (g) to include the wording “subject to subsection (2.3).”

Issue 13: Subject corporation does not appear to have a “relevant business”

Description: The phrase “relevant business of the subject corporation” appears eight times in the proposed IBT rules.

Concern: Based on our review of the IBT rules as currently drafted, it appears a subject corporation cannot have a “relevant business.” A relevant business is defined in subparagraphs 84.1(2.31)(c)(iii) and 84.1(2.32)(c)(iii) as an active business of “*any other person or partnership*” with the word “other” possibly excluding the subject corporation itself.

Recommendation: We would suggest subparagraphs 84.1(2.31)(c)(iii) and 84.1(2.32)(c)(iii) be amended to make it clear the subject corporation may have a relevant business. For example, these subparagraphs could instead refer to “*any other person or partnership that carries on, at the disposition time, a relevant business (referred to in this subsection as a “relevant group entity”)*” and a relevant business of the subject corporation or a relevant group entity could be defined separately, perhaps in subsection 84.1(2.3).

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