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Business Succession (including Bill C-208 and Employee Ownership Trusts)

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A. Introduction

Near the end of a long and successful career, a business owner has almost innumerable factors to consider when structuring their retirement and the transition of their business. How will they extract value from the business to fund their retirement? Who will assume control and ensure the long-term success of the business? What legacy will be passed on to the next generation?

This paper discusses the succession of a business from the perspective of an owner-manager when they seek an exit but do not plan for a sale to an arms-length third-party. Specifically, this paper addresses both classic and novel methods of succession planning, including estate freezes, the proposed new rules for employee ownership trusts, the proposed amendments to Bill C-208 with respect to intergenerational share transfers of qualified small business corporation shares, and soft issues that may play a role in these types of planning.

B. The Tried and True: Estate Freeze

The estate freeze is one of the most common methods of transitioning a family-owned business to the next generation as it can achieve both tax-related and practical succession planning goals. Simply put, an estate freeze describes a transaction in which the value of an owner's shares in a corporation are transferred or "frozen" into fixed-value preferred shares and new common shares are issued to one or more successors (often the children of the original owner), to whom the new growth will be attributed, while often times still allowing the owner to maintain adequate control.

When properly implemented, an estate freeze can meet some or all of the following tax-driven objectives: (i) crystalize the amount of income tax that will arise on the deemed disposition of the owner's shares on death, (ii) reduce probate fees, (iii) provide opportunities for income splitting with family members (subject to the Tax on Split Income ("TOSI") rules), and (iv) multiply the lifetime capital gains exemption. Other objectives such as funding retirement, deferring tax payable on investments, and transitioning control of the corporation can also be achieved. Given the multitude of factors and implications at play, estate freezes often require the consideration and cooperation of all of a client's professional advisors.

Estate freezes can also be used to transition ownership to key employees over time while deferring the owner's tax on the disposition and reducing the financial burden on the incoming employee owner. Doing so may incentivize dedication and loyalty to the business; however, it can also present challenges to both the owner and the employee. An owner may wish to provide a valued employee with generous entry terms to reward past performance, but this can be caught under the employee benefit provisions of the *Income Tax Act,* RSC, 1985, c 1 (5th Supp.) (the "Act") and expose the employee to reassessment. Issuing participating shares to an employee can lead to problematic consequences if doing so confers a benefit as a result of a transfer of existing value.[1] The employee stock option provisions may mitigate some of these risks but there are still situations in which the use of a freeze can provide more flexibility than other modes of sale or transfer. Another option that enables employees to purchase a business without directly

[1] Act, s 6

paying for the shares is the new “employee ownership trust” mechanism announced in the 2023 Canadian Federal Budget (“Budget 2023”), as discussed in more detail later in this paper.

Common Types of Estate Freezes

Depending on the complexity of the situation and the goals of the existing owner (the “Freezor”), one of four commonly-used methods of estate freeze may be recommended:

1. Section 85;
2. Section 86;
3. Section 51; and
4. Stock dividend.

Section 85

In a section 85 freeze, the Freezor transfers their eligible property (which can include capital property, depreciable property, and/or inventory) for fixed-value preferred shares on a rollover basis.[2] This can be done internally (i.e. with no new corporation required) by the Freezor transferring their shares to the corporation, or externally by the Freezor transferring their shares to a holding company. The Freezor and transferee must file a joint election in Canada Revenue Agency (“CRA”) Form T2057 to ensure the deferral of any capital gain that may otherwise arise on the disposition of the Freezor’s eligible property; however, in certain circumstances the Freezor may elect at a value between cost and fair market value to crystallize a capital gain.[3] If the tax is deferred, it will then eventually be payable on the Freezor’s death or disposition of their preferred shares.

Section 86

In a section 86 freeze, the Freezor exchanges an entire class of shares for new shares in that same corporation and, potentially, additional non-share consideration. Most commonly, the Freezor exchanges an entire class of common shares for new fixed value preferred shares. If certain conditions are met, including:

1. the Freezor has disposed of their shares in exchange for a new class of shares issued by the corporation;
2. the exchanged shares are considered capital property of the Freezor;
3. an entire class of shares are exchanged; and
4. the exchange occurred in the course of a capital reorganization of the corporation;

no election needs to be filed and the transaction will be afforded an automatic rollover.[4]

What constitutes a “reorganization of capital” is not defined in the Act. The CRA has formally taken the position that in the context of a subsection 86(1), “a reorganization of the capital of a corporation should normally require amendments to the articles of a corporation”.[5] That being said, in practice, the CRA has routinely accepted that share exchanges occurring immediately subsequent to an amendment to the articles are occurring “in the course of a reorganization of

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[2] Ibid, s 85(1)
[3] Ibid
[4] Ibid, s 86(1)
[5] CRA Views 2010 – 0373271C6, APFF – 2010 Conference, Round Table on Federal Taxation, Question 7

share capital", which has the benefit of allowing price-adjustment clauses to be included in the share purchase and sale agreement.[6]

Section 51

A section 51 freeze only requires the first two conditions of a section 86 freeze and similarly does not require an election to be filed to defer the tax.[7] In such a freeze, the Freezor exchanges all or a portion of their shares for a new class of shares in that corporation. This is the simplest form of freeze and may be used in occasions where the conditions for a section 86 freeze are not met, most commonly when an alteration of share capital is not required or when not all of a class of common shares is to be exchanged.

Stock Dividend Freeze

In a stock dividend freeze, a stock dividend is issued on the Freezor's common shares in the form of fixed-value preferred shares, having an aggregate redemption value equal to the fair market value of the Freezor's common shares (commonly 90-95% of the fair market value). To avoid a significant immediate taxable dividend to the Freezor, the paid up capital should be nominal.[8] The Freezor can then subsequently exchange their common shares (with reduced value, e.g. 5-10%) for a separate class of preferred shares with a price adjustment clause (as a "protective freeze" against potential valuation problems) pursuant to sections 51, 85 or 86.

In order to affect a stock dividend freeze, the corporation's articles must allow for "high-low" stock dividend shares to be issued (i.e. the shares must have high redemption value but low paid-up capital). In British Columbia, practitioners should be mindful of subsection 72(1) of the BC *Business Corporations Act*, SBC 2002, c 57 (the "BCA") if issuing preferred shares without par value on the stock dividend. Pursuant to the BCA, the amount added to capital for shares without par value is the declared amount of the dividend. Although it is recognized that capital for corporate law purposes does not have to be the same as the "paid up capital" for income tax purposes, it is helpful if they are, and so it is generally best practice to issue preferred shares with a nominal par value.

A major advantage of stock dividend freezes is the avoidance of corporate attribution, as a stock dividend does not involve the Freezor transferring any property to the corporation. As a result, a majority of the equity value of the corporation will be shifted to the stock dividend preferred shares to which corporate attribution does not apply, and the balance will be held in the freeze preferred shares.

Similarities and Differences

These methods of estate freeze all share certain benefits for both the Freezor and their adult children. Post-freeze, adult children can either purchase, or receive by way of gift, common shares in the corporation for a nominal value, dividends can be paid on these common shares owned by the adult children (subject to TOSI) without dividend or interest income being attributed back to the Freezor, and all future growth of the holding corporation will accrue to the adult children, potentially reducing the Freezor's capital gains tax liability on death. Additionally, in a section 85 or 86 freeze the corporation may give non-share consideration to the Freezor as part of the

[6] CRA Views 9134555, "Estate Freezes"

[7] Supra note 1, s 51

[8] In doing so, and per the definition of "amount" in subsection 248(1) and section 82 of the Act, the taxable dividend being received for tax purposes will then be a nominal and only in the amount of the stated capital addition.

exchange (e.g. an assumption of debt, a promissory note, etc.) as long as some shares are included in the consideration.[9] While section 85 requires the transferee to be a taxable Canadian corporation, section 86 and 51 freezes do not. Below is a chart summarizing some of the key similarities and differences between the types of freezes discussed in this paper:

Type of Freeze	Non-share consideration permitted	Transferee must be a taxable Canadian corporation	Election required to defer tax	Entire class of common shares must be exchanged	Price Adjustment Clause can be used
Section 85	Yes	Yes	Yes	No	Yes
Section 86	Yes	No	No	Yes	Yes
Section 51	No	No	No	No	Yes
Stock Dividend	No	N/A	No	N/A	No

Generally speaking, the preferred shares issued in an estate freeze (i) are redeemable and retractable, (ii) enjoy preferential entitlement to dividends and priority on dissolution, wind-up or liquidation, (iii) can include voting rights or not, and (iv) should have a set dividend rate limited to a reasonable percentage of the redemption amount (as opposed to unlimited dividends) and a price adjustment clause.[10] The CRA has previously commented that the dividend requirement can be satisfied by specifying that the board of directors can pay non-cumulative dividends at its discretion.[11] To avoid the possibility of triggering Part IV.1 or Part VI.1 tax under the Act when the shares are later redeemed, the dividend rate should be specified in the freeze documentation (as opposed to by way of a formula). It is within the lawyer's scope of responsibility to ensure that the freeze share rights meet these requirements.

The estate freeze is not necessarily complete after the implementation of one of the four above-noted methods. Post-freeze, new common growth shares in the corporation need to be issued either directly to the next generation individually or via a family trust.

The Role of the Family Trust

The discretionary family trust is a key tool in succession planning and it can afford great benefits when introduced as part of an estate freeze. For example, consider a scenario in which the parents who control the family corporation are ready to implement a freeze but their children have not yet demonstrated an interest in or aptitude for the business. By issuing the new growth shares to the family trust, the parents (as trustees of the trust) are given the time and flexibility to wait to see which of their children is best suited to take over while the value of the company grows inside the trust and income can be allocated amongst the trust beneficiaries at the discretion of the

[9] Supra notes 3 and 5

[10] CRA Document No. 2008-0285241C6, "Attributes of Estate Freeze Preferred Shares", dated April 22, 2009

[11] See Deloitte & Touche LLP and Fraser Milner Casgrain LLP, *Taxation of Private Corporations and their Shareholders*, 4th Ed. (Canadian Tax Foundation - 2010), p. 3-22.

trustee (often the Freezor). If all of the children choose different paths, or if the right opportunity comes along, the parents can simply sell the shares to a third party and distribute the proceeds through the trust. Alternatively, if the parents do identify one or more children to take over the business, they can distribute the family trust's shares to such children on a tax-deferred roll-out basis provided that the recipient child meets the requirements of subsection 107(2) of the Act.

The discretionary nature of the family trust also provides parents the opportunity to protect the wealth in the growth shares by avoiding distributions to children who are subject to creditor or matrimonial claims or are simply financially irresponsible. Assuming that no such issues are present, the family trust can split dividend income from the corporation by allocating such income to one or more adult children or, subject to the TOSI and corporate attribution rules,[12] to the spouse with the lower marginal tax rate.

Another benefit of using a family trust is the potential access to the lifetime capital gains exemption of more than one family member upon the sale of the corporation to a third party. As long as the trust deed has been intentionally drafted and the corporation qualifies as a small business corporation, the trustees can allocate capital gains on the sale of shares to multiple beneficiaries, each of whom can use their lifetime capital gains exemption to shelter their gain up to the eligibility limit. For 2023, this value is $971,190,[13] meaning that for each qualifying beneficiary in the highest marginal tax bracket, the savings will be significant.

When determining if a family trust fits into an estate freeze, or any estate plan for that matter, the "21-year-rule" must be kept in mind. This rule provides that certain kinds of trusts, including the sort typically used in estate freezes, are deemed to have disposed of all of their capital property on their 21st anniversary and every 21 years thereafter to prevent the indefinite postponement of capital gains recognition.[14] Although there are ways to plan for the application of this rule, care must be taken when drafting a discretionary family trust that will be used as part of an estate freeze.

Drafting Considerations

Given the technical nature of freeze transactions, there are many issues that can arise as a result of careless or deficient drafting of a family trust. While not exhaustive, some of the items that should be considered when drafting a family trust are as follows:

- *Attribution*: The settlor of the trust should be someone other than the Freezor – a grandparent or family friend is a common choice. The settlor must not be or become a beneficiary of the Trust to reduce the risk of application of the reversionary trust rules in subsection 75(2) of the Act (discussed further below).

- *Settlement Property*: The trust can be settled with a coin, ingot, bill or other valuable token. The settlor must provide the settlement property as a gift, evidenced by a receipt, and not be reimbursed, directly or indirectly. It is recommended that the settlement property, or at least a portion of it, be kept with the original trust deed.

- *Beneficiaries*: The beneficiaries of a family trust typically include children and grandchildren of the Freezor, but can include anyone that the Freezor wishes to include. Prior to settling the family trust, the Freezor should consider what "classes" of individuals

[12] Supra note 1, ss 74.4
[13] Supra note 1, ss. 110.6(2.1)
[14] Supra note 1, ss 104(4)

they may wish to include as beneficiaries in the future. In general, including permitted classes of beneficiaries can provide a measure of certainty with respect to the potential beneficiaries of a trust, especially when a family may have more children or grandchildren subsequent to the creation of the trust. When including a class of beneficiaries in a trust instrument, the drafter should be mindful of the trust disclosure rules and potential filing requirements under the *Land Owner Transparency Act*, SBC 2019, c 23 ("LOTA") (both as discussed elsewhere in this paper). It may also be beneficial to include the Freezor themselves as beneficiaries in case circumstances change and they wish to exercise greater control than what is afforded in their freeze shares or they wish to wind up the trust.

Additional classes of beneficiary also commonly include:

- Canadian-resident corporations, the shares of which are wholly owned by a beneficiary of the trust or trusts for the benefit of a beneficiary of the trust (to allow for a roll-out of assets to or for the benefit of a beneficiary who is no longer a Canadian resident); and
- investment corporations (to allow for retained earnings to be removed from an operating company in a tax-efficient manner. Doing so can help the corporation maintain QSBC status by staying on-side of the 90% business asset test).

Although there is always a risk in doing so, including the power to appoint additional beneficiaries to a trust instrument can increase flexibility for the future. The CRA has previously commented that adding new beneficiaries does not constitute a resettlement of the trust, nor does it constitute a deemed disposition of the trust's property, as long as the power to add new beneficiaries is included in the original trust instrument.[15] Notwithstanding the foregoing, when new beneficiaries are added to a trust, the bundle of rights of the existing beneficiaries are arguably diminished, resulting in each existing beneficiary potentially realizing a disposition of a portion of their rights forming their interest in the discretionary trust.[16] The power to add or remove beneficiaries should therefore always be exercised with caution.

- *Power of Appointment:* A power of appointment can allow the Freezor to direct how the trust will benefit the various beneficiaries upon their removal or resignation as trustee, or upon their death. This provides the flexibility to update the trust as a family's needs change.
- *Power of Amendment:* A power of amendment in the trust instrument to permit terms of a trust to be altered without seeking court or beneficiary approval[17] should always be included, and can be useful either to rectify inadvertent errors in the instrument or to vary the terms for some other unforeseen purpose.
- *Winding Up*: Rather than dictating that the trust must distribute all of its assets and be wound up on the day before the 21st anniversary, flexibility can be added by permitting the trustee to declare the division date and wind-up the trust at any time. This allows for the distribution of appreciated property and the continuation of the trust, in addition to the opportunity for a freeze or refreeze.

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[15] Tax Interpretations - 20 November 2008 Internal T.I. 2008-0281411I7 - Addition of Beneficiaries
[16] Ibid
[17] Schmidt v Air Products of Canada Ltd [1994] 2 SCR 611

- *Real Estate Considerations*: Although uncommon for a trust in this context to own real estate directly, if a trust owns or acquires real estate in British Columbia or has an indirect interest through a corporation, additional reporting and tax filings may apply as follows:

  - *Land Owner Transparency (BC)*– when a trust acquires an interest in land in British Columbia, the trustees may be required to prepare and file a Transparency Report pursuant to the requirements of the LOTA.[18] If a Transparency Report is required, the trustees will need to disclose information on the settlor, current and future trustees and beneficiaries of the trust. The trustees will be required to:
    - collect the name, address, date of birth, jurisdiction of residence, and SIN (or ITN) of each individual;
    - disclose whether each individual is a citizen or permanent resident of Canada;
    - disclose whether each individual is a resident of Canada for the purposes of the Act;
    - if the trustees become aware that an individual may be incapable of managing their financial affairs, determine and disclose whether the individual has been officially determined to be incapacitated (pursuant to section 22 of LOTA); and
    - provide written notice to each individual as required by section 24 of LOTA.[19]

    Updated Transparency Reports may need to be filed if changes are made to the beneficiaries of a trust.

  - *Speculation and Vacancy Tax (BC)* - could apply when a beneficiary of the trust is not a BC resident, unless another exemption can be applied (such as the property being rented out for at least 6 months in a calendar year);[20]

  - *Additional Property Transfer Tax (BC)* - could apply when a beneficiary of the Trust is not a Canadian citizen or permanent resident of Canada and when there is a change in trustee of the Trust (i.e. after the initial trustee(s) lose capacity or pass away);[21] and

  - *Underused Housing Tax (Federal)* - could apply when a non-resident, non-Canadian owns residential real estate in Canada that is considered vacant or underused.[22]

  The above-noted considerations may apply to real estate in British Columbia, but trustees and advisors should be mindful of province-specific legislation that may apply to real estate owned in other jurisdictions. When trusts have an interest in real estate, trustees should always be aware of the residency status of all beneficiaries and, ideally, remove any beneficiaries who will be leaving the jurisdiction before they have done so. Alternatively, the trust document can be drafted with a provision confirming that if any beneficiary becomes a non-resident, they will cease to be a beneficiary of the trust for the duration of their non-residency.

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[18] LOTA, s 10
[19] Ibid, ss 18-20
[20] See *Speculation and Vacancy Tax Act*, SBC 2018, c 46
[21] See *Property Transfer Tax Act*, RSBC 1996, c 378
[22] See *Underused Housing Tax*, SC 2022, c 5, s 10

Technical Considerations

Valuation and the Conferral of Benefits

When implementing an estate freeze, it is imperative that the value of consideration returned to the Freezor is proportionate to the value of the property transferred in the freeze. Failing to do so can expose either the Freezor or the beneficiary to assessment by the CRA under one or more provisions of the Act relating to shareholder benefits, indirect payments, or conferred benefits.[23] Pursuant to section 69 of the Act, when property passes between non-arms-length persons, the CRA has the ability to re-value such property for tax purposes if the consideration is deemed inadequate. For example, if a transfer is made under section 85 at an elected amount in order to defer tax, the re-valuation may trigger a benefit conferral under subsection 15(1) or a capital gain inclusion for the Freezor.

It can be very challenging to determine the fair market value of an operating company when nebulous factors such as the nature of the business, assets held in the company, status and relationships of owners, managers and employees, value of goodwill and intellectual property, upcoming contracts or work orders, etc. must be taken into consideration. Even the valuation of a corporation solely holding an investment portfolio, while on its face seems straightforward, can be complicated by trading restrictions, liquidity issues or shareholders agreements.

Working with valuation and accounting professionals, valuations of the business and its underlying assets should be obtained and well documented in a timely manner to ensure that the fair market value of the freeze shares is equal in value to the property being exchanged in a freeze. This will reduce the risk of CRA determining that a benefit has been conferred upon the new shareholders.

Out of an abundance of caution, it is recommended to include a price adjustment clause in both the articles of the freeze corporation and the share exchange agreement. Doing so can "back stop" the retraction rights with respect to potential "conferral of benefit" problems by avoiding a transfer of property for consideration worth more or less than the fair market value of the transferred property and also avoiding a resulting income inclusion and tax liability pursuant subsections 69(1), 15(1) and 86(2) and/or paragraph 85(1)(e.2). However, even with such a clause included, the parties still must make a bona fide effort to ascertain an appropriate value at which the freeze should occur.[24] The CRA is typically more inclined to accept and give effect to a price adjustment clause to eliminate the conferral of benefits or other negative tax consequences if the parties are shown to have made an effort to determine the fair market value.

Attribution Rules

There are several attribution rules in the Act which, if applicable, deem that a taxpayer has received income that has actually been received by another person. If any of these provisions are applied they can frustrate not only the estate freeze, but the overall succession plan. The attribution rules are broadly broken up into the following categories:

- *Personal Attribution Rules – sections 74.1, 74.2 and 56(4.1) of the Act*: These rules typically apply to income, losses, capital gains and capital losses relating to gifts or loans from a taxpayer to their spouse, and to income and losses relating to gifts or loans to a

[23] See subsection 15(1), subsection 56(2), subsection 246(1), paragraph 85(1)(e.2), subsection 86(2), subsection 51(2), subsection 87(4) and subsection 15(1.1) of the Act

[24] Supra note 22

non-arm's length minor. By structuring the freeze such that the parents are not making a gift or transfer, the personal attribution rules should be avoided. In cases where they may otherwise apply, the beneficiary should pay for and directly subscribe for the shares from the corporation using their own funds.

- *Corporate Attribution Rules – section 74.4 of the Act*: When a loan or transfer is made by an individual to a corporation, and when one of the main purposes of the loan or transfer can reasonably be considered to have been to reduce the income of the individual (including taxable capital gains), or to benefit a spouse, a non-arm's length minor, or certain other related minors, the individual may be liable to be assessed with a benefit. Because the assessment of the benefit does not allow for any tax relief for the beneficiary of the freeze, double taxation can result. This rule can apply to freezes implemented under sections 85, 86 or 51 as they each involve a transfer from the Freezor to a corporation. Pursuant to subsection 74.4(2)(c), an exception can be made to this rule when the freeze corporation is a small business corporation (i.e. it meets the 90% active business assets test). If, at any point in the future, the freeze corporation ceases to qualify, corporate attribution will apply from then onwards. Corporate attribution can be avoided by including a provision in the trust instrument that prevents distributions to spouses or non-arm's length minors, or by implementing the freeze through a stock dividend instead.

- *Trust Attribution Rules – section 74.3 of the Act*: This rule can apply when a taxpayer uses a trust to attempt to benefit a spouse or non-arm's length minor. When such an individual is a beneficiary of a family trust and a freeze is made in favour of that trust, the trustees should pay for and directly subscribe for the shares from the corporation. If the trust does not have its own assets to pay for the shares, the trustees should arrange for a bona fide loan with a reasonable interest rate and repayment terms to finance the purchase. If the lender is a non-arm's length person, interest must be charged at (at least) the prescribed rate and interest be paid no later than January 30th of the following year.

- *Trust Reversion Rules – subsection 75(2) of the Act*: Essentially this rule requires that a person who transfers property to a trust must relinquish control of that property or be required to pay taxes arising from it. This rule can apply when a freeze has been implemented in favour of a family trust and becomes tainted for the purposes of this provision. If that occurs, it can result in attribution of income and losses, and capital gains and capital losses to the parents, and also prevent subsequent tax-deferred rollouts of assets from the trust (per subsection 107(4.1) of the Act). Attribution can apply if property held in a trust is held on the condition that the property (or substitute property) may revert to the transferor, pass to persons determined by that person after the creation of the trust, or during the existence of the person, the property cannot be disposed of without their direction.

Trust Disclosure Requirements

On December 15, 2022, the Federal Bill C-32, *Fall Economic Statement Implementation Act, 2022,* SC 2022, c 19 received royal assent. This Bill implemented the 2018 budget proposal to introduce new tax return filing and information reporting requirements for trusts with an aim to increase the collection of beneficial ownership information and allow the CRA to assess the potential tax liability of trusts and their beneficiaries.

Previously, trusts that did not engage in activity during the year and did not have income tax payable would not be required to file a T3 return; however, these exemptions no longer apply for certain trusts, starting with taxation years ending after December 30, 2023. Additionally, the new

T3 return filing rules apply to "bare trust" arrangements (defined as "an arrangement where a trust can reasonably be considered to act as an agent for its beneficiaries with respect to all dealings in all of the trust's property").[25]

Further, for taxation years ending after December 30, 2023, express trusts (i.e. *inter vivos* trusts created by a settlor during their lifetime or at death in their will), non-resident trusts that are required to file T3 returns, and bare trusts will be required to report the name, address, date of birth (for individuals), jurisdiction of residence and taxpayer identification number for each settlor, trustee, beneficiary, and any person who has the ability to exert control over a trustee (e.g. a "protector" or "trustee appointer").[26] It is important to note that the new rules use the definition of "settlor" found in subsection 17(15) of the Act, which includes both the legal settlor and any persons who transfer property to the trust (with exceptions for commercial loans and transfers for value by an arms-length person).This information must be reported by the trust's T3 filing deadline. If any of the information requested is subject to solicitor-client privilege, disclosure of such information will be exempt from these expanded reporting requirements.[27]

Similarly, as a side note, if any of the above-noted individuals qualify as a "significant individual" as defined by the BCA with respect to the business, certain information about such individual must be maintained in the corporation's transparency register.

The expansion of these reporting requirements increases the burden on trustees to gather and report information, which can be difficult especially with respect to bare trust arrangements. It will be important for both advisors and clients to be aware of the new rules, potential penalties, and any relevant exemptions as provided by the legislation. The requirement for increased disclosure may impact a settlor or trustee's decision to include certain individuals as beneficiaries of a trust, or their decision to use a trust at all in their estate and succession planning.

Business Succession Post-Freeze

Once the estate freeze has been implemented, the type of freeze will dictate the timing and method of the Freezor's exit from the business. In a classic full estate freeze in which a family trust is not used, all of the future growth in the business is shifted directly to the Freezor's children in the newly-issued common shares and the Freezor can redeem their preferred shares over time to fund their retirement (this is sometimes referred to as a "wasting freeze"). Accordingly, in this type of freeze, the Freezor must ensure that there is enough accrued value in the company to justify the transaction and provide the Freezor with sufficient funds to support their lifestyle until death. The advice of a financial planner is essential, as inflation, life expectancy, illness or market conditions can significantly impact the Freezor's long-term needs and resources. Though it is possible for the Freezor to "re-freeze", "thaw", "melt", or otherwise modify a previous estate freeze,[28] any method that would allow the Freezor to re-access some of the appreciation of the business may have detrimental tax consequences, cause family tension, or be impossible if the corporation has subsequently been sold to a third party.

In addition to the tax and financial implications, the transfer of control of the corporation is a separate but key consideration informing the timing and use of estate freezes. While in some cases the Freezor may be ready to transition control of the business to their children in conjunction

[25] *Fall Economic Statement Implementation Act*, 2022, SC 2022, c 19, ss 35(1.3)
[26] Ibid at ss 204.2.
[27] Ibid at ss 35(1.4)
[28] Further discussion of these transactions is outside the scope of this paper.

with an estate freeze, in others, the Freezor may wish to delay or gradually transfer control over time.

To maintain control while still implementing a full estate freeze, the Freezor can be issued voting preferred shares so that the Freezor retains a majority of votes until they have been significantly paid out. Control can also be maintained by issuing the common freeze shares to a discretionary family trust as beneficiary, rather than directly to the Freezor's children. The Freezor, as trustee, would therefore continue to maintain control. Alternatively, the Freezor can maintain voting control using a separate additional class of voting retractable shares with fixed nominal value and no entitlement to dividends. These shares can then be sold or distributed to the eventual successor upon the Freezor's death or at their discretion.

Despite the potential benefits of business succession planning through estate freezes, historically there have been greater tax benefits afforded to owners who sell the family business to an arm's length third party. Fortunately, the Department of Finance has introduced measures that intend to equalize intergenerational and third party business transfers in Bill C-208.

C. Intergenerational Share Transfers

The Act created a clear tax disadvantage for an owner wishing to sell their business to a child or grandchild, either personally or through their child's corporation, as opposed to an arm's length third party. Bill C-208 is a Private Member's bill that received Royal Assent on June 29, 2021. Bill C-208 made substantive amendments to sections 55 and 84.1 of the Act to address these tax disadvantages. Budget 2023 proposed further amendments to the rules created by Bill C-208.

Pre-Bill C-208: Problems Posed by the Application of Sections 84.1 and 55(2) of the Act

Section 84.1 of the Act is an anti-avoidance provision that prevents surplus stripping, or the extraction of corporate surplus on a tax-free basis through non-arm's length transfers. Section 84.1 generally applies when an individual disposes of shares of a Canadian corporation to another corporation, and immediately after the transfer, the two corporations are connected. If section 84.1 applies, then any non-share consideration (cash or promissory note) received from the purchaser for the shares is deemed to be a dividend equal to the amount of the capital gain.[29]

For example, consider a business owner who has successfully grown her business from scratch and who is now ready to retire. She strongly desires to keep her business in her family and transition it to her daughter. However, she is also entertaining an offer from an arm's length third party. If she sells her business to the third party, section 84.1 would not apply so her proceeds of sale would be taxed as a capital gain. She may then be able to utilize her lifetime capital gains deduction to significantly reduce taxes payable on the sale.

On the other hand, even if her daughter was willing to pay the same amount in cash as the third party offer, if she sold her business to a corporation owned by her daughter prior to the enactment of Bill C-208, section 84.1 would have deemed the sale proceeds to be a taxable dividend rather than a capital gain and the business owner would have been taxed on the full amount of the proceeds at the dividend tax rate. This means that she would not be able to utilize her lifetime capital gains deduction on the sale of her shares to her child's corporation. For sale proceeds of $1,000,000.00, this business owner could potentially face over $450,000 in extra taxes payable by selling her business to her daughter's corporation as opposed to the third party due to the

[29] A detailed technical analysis of the rules and application of section 84.1 is beyond the scope of this paper.

application of section 84.1.[30] Alternatively, the owner could sell their shares in the business to their child personally to avoid section 84.1 from applying. The owner may be able to utilize their lifetime capital gains deduction, but their child would face an unfair financing position by having to purchase their parent's shares with after tax personal cash rather than after tax corporate income.

Section 55 of the Act is another anti-avoidance provision that prevents capital gains surplus stripping, or the payment of excessive tax-free intercorporate dividends. Subsection 55(2) is deemed to apply if one of the purposes of the dividend is to reduce the capital gains that would have been realized had those shares been sold at fair market value immediately before the dividend.[31] If subsection 55(2) applies, it converts the intercorporate dividend into a taxable capital gain in the hands of the recipient corporation.

There are several exceptions to the application of subsection 55(2), including payment of the dividend out of "safe income", and certain reorganizations of related parties, such as a related party butterfly transaction.[32] A related party butterfly transaction is a tax effective way for family businesses to separate underlying assets of one corporation into two or more corporations, such that the resulting separate corporations are owned by related parties. These transactions are commonly used among related parties who wish to go their separate ways, such as in a breakdown of a marriage, or parents wishing to divide and allocate certain portions of the family business among their children.

Prior to Bill C-208, siblings were deemed not to be related parties for the purposes of section 55. As such, the exceptions to subsection 55(2), and in particular the related party butterfly transaction, were not available for divisive reorganizations involving sibling shareholders.[33] This created a tax disadvantage for family businesses trying to separate siblings' interests into separate corporations, or practical difficulties to implement as it required the parents to remain controlling shareholders in order to avoid the application of subsection 55(2). It also prevented siblings from being able to accomplish a divisive reorganization after their parent's death.

2021 Bill C-208 Amendments

Upon enactment in 2021, Bill C-208 made the following amendments to sections 55 and 84.1 of the Act when applied to situations involving a qualified small business corporation share or a share in the capital stock of a family farm or fishing corporation[34]:

1. Subsection 55(5)(e)(i):

   The amendment to subsection 55(5)(e)(i) adds an exception to the rule that siblings are deemed to deal with each other at arm's length and are not related for the purposes of section 55. As such, post-amendment, if the transaction involves a share of a qualified small business corporation or a share in the capital stock of a family farm or fishing corporation, siblings <u>are</u> deemed to be related to each other.

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[30] In this example the following assumptions are made: (1) the business owner's shares are QSBC shares and (2) she has her full lifetime capital gains exemption available.
[31] Subsection 55(2.1)
[32] A detailed technical analysis of the rules and application of section 55 is beyond the scope of this article.
[33] Subsection 55(3)(b) "related butterfly transaction" is another exception that is available for siblings who are deemed not to be related, but it is a more complex provision and beyond the scope of this article.
[34] "qualified small business corporation share" and a "share in the capital stock of a family farm or fishing corporation" are both defined in subsection 110.6(1) of the Act.

The amendment to subsection 55(5)(e)(i) is applicable for determining whether a transaction or series of transactions will benefit from the related party butterfly exception in paragraph 55(3)(a) for family divisive reorganizations, or post-mortem divisive reorganizations by siblings.

2. Subsection 84.1(2)(e):

New subparagraph (e) deems the disposition of shares by a taxpayer to their child or grandchild's corporation to be at arms length and therefore avoid the application of section 84.1, if the following conditions are met:

(a) the subject shares are qualified small business corporation shares or shares in the capital stock of a family farm or fishing corporation;

(b) the purchaser corporation is controlled by one or more children or grandchildren of the parent who are at least 18 years of age; and

(c) the purchaser corporation does not dispose of the subject shares within 60 months of the purchase.

If the conditions of 84.1(2)(e) are met, the proceeds of sale would not be recharacterized as a deemed dividend for the parent, and the parent may utilize their lifetime capital gains deduction on the sale.

3. Subsection 84.1(2.3):

New subsection 84.1(2.3) created three additional rules for the application of paragraph 84.1(2)(e):

(a) New paragraph 84.1(2.3)(a) acts to deny relief from section 84.1 if the purchaser corporation disposes of the subject shares within 60 months of the purchase, other than by reason of death. As a result, the taxpayer is deemed to have disposed of the subject shares to the person who acquired them from the purchaser corporation, subject to additional complex tracing rules. In May 2022, CRA clarified that it has taken the view that if the taxpayer had disposed of the subject shares directly to the subsequent purchaser and section 84.1 would not have applied to that disposition (i.e the subsequent purchaser is a person dealing at arm's length with the taxpayer), then the original disposition will also not be subject to section 84.1.[35]

(b) New paragraph 84.1(2.3)(b) reduces the lifetime capital gains deduction if the corporation's taxable capital employed in Canada exceeds $10,000,000 and completely eliminates access to the lifetime capital gains deduction when the corporation's taxable capital employed in Canada exceeds $15,000,000.

(c) New paragraph 84.1(2.3)(c) creates an administrative obligation for the taxpayer to provide the Minister (via CRA) with an independent assessment of the fair market value of the subject shares, and an affidavit by the taxpayer and by a third party attesting to the disposal of the shares.

[35] CRA Views 2022-0928721C6, Conference for Advance Life Underwriting, May 2022 Roundtable.

In April 2022, the CRA released further guidance[36] on the affidavit required under paragraph (c), including that:

(i) the valuation must be completed by someone who is unrelated to the corporation, does not have any financial interest in the transactions and who has sufficient knowledge and experience in valuation and the industry being dealt with; and

(ii) the affidavit must include:

(A) the name, address and social insurance number of the individual disposing of the shares,

(B) name and business number of the subject shares corporation,

(C) name and business number of the purchaser corporation,

(D) date the shares were sold to the purchaser corporation,

(E) an attestation that the disposed shares are qualified small business corporation, family farm, or fishing corporation shares,

(F) an attestation that the children or grandchildren control the purchaser corporation and are at least 18 years of age,

(G) the names and social insurance numbers of the children and grandchildren who control the purchaser corporation,

(H) the signature of a commissioner of oaths or notary public, and

(I) the signature of the individual disposing of the subject shares.

The amendments to section 84.1 of the Act made by Bill C-208 were much needed to level the playing field for intergenerational transfers of family businesses; however, there was immediate criticism of its shortcomings and lack of safeguards to protect against potential misuse. Shortly thereafter, the Minister announced intentions to bring forward amendments that would honor the spirt of Bill C-208 while safeguarding against any unintended tax avoidance loopholes[37].

In particular, Bill C-208 created difficulty in assessing whether a sale to a child or grandchild was a genuine transfer or a sham, as it overlooked the "hallmarks" of a genuine intergenerational transfer. The requirement of a child or grandchild to "control" the purchaser corporation was limited to *legal* control only; thus, there was no requirement that the child or grandchild have *factual* control over the purchaser corporation, nor any requirement for the parent to cease to control the business post-transfer. The child could simply hold the voting only shares without any participation in the equity going forward. Furthermore, there was no requirement for the child or grandchild to actually work in or be engaged in the business.

[36] Affidavits and valuations for the transfer of a small business, family farm or fishing corporation (Bill C-208) - https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-12700-capital-gains/whats-new-capital-gains/affidavits-valuations-transfer-small-business-family-farm-fishing-corporation-bill-c-208.html

[37] Department of Finance News release – "Government of Canada clarifies taxation for intergenerational transfers of small business shares", July 19, 2021

Bill C-208 also created practical problems. For example, the usual 3-year reassessment period would not be able to adequately enforce the provisions of paragraph 84.1(2.3)(a), and ambiguities in the language (such as the reference to "by reason of death" in new paragraph 84.1(2.3)(a)) made application of the new amendments difficult.

Although amendments were expected to be announced by the Minister before the end of 2021, proposed amendments were not announced until March 28, 2023 in Budget 2023.

Budget 2023 Proposed Amendments

Budget 2023 proposed amendments to section 84.1 of the Act. Further legislative proposals and explanatory notes were published on August 4, 2023 by the Department of Finance. No amendments were announced to subsection 55(5)(e)(i).

Budget 2023 recognized that "although the stated purpose of Bill C-208 was to facilitate intergenerational business transfers in circumstances where section 84.1 inappropriately applied, the rules introduced by Bill C-208 contain insufficient safeguards and are available where no transfer of a business to the next generation has taken place."[38] The proposed amendments therefore seek to address these issues to "ensure that they apply only where a genuine intergenerational business transfer takes place."[39]

Relief from the application of section 84.1 is still only available on the sale of qualified small business corporation shares or shares in the capital stock of a family farm or fishing corporation by an individual to a purchaser corporation controlled by one or more adult children of the individual. However, the definition of "child" for these purposes will be expanded to include grandchildren, great-grandchildren, step-children, children-in-law (including those who were children-in-law immediately before the death of the child), nieces and nephews, and grandnieces and grandnephews. Budget 2023 proposes to replace the newly added subsection 84.1(2.3) created by Bill C-208 in 2021 with proposed new subsections (2.31) and (2.32). The proposed new subsections create two options for taxpayers who wish to undertake a genuine intergenerational transfer:

(a) an immediate intergenerational business transfer under proposed subsection 84.1(2.31), and

(b) a gradual intergenerational business transfer under proposed subsection 84.1(2.32).

Under each transfer method (described in more detail below), a joint election must be filed by the seller and the child(ren), and four additional conditions are proposed with respect to (i) transfer of control of the business, (ii) transfer of ownership of the business, (iii) engagement in the business, and (iv) transfer of management of the business.[40]

Immediate Intergenerational Business Transfer[41]

The following is a summary of the immediate intergenerational business transfer under proposed subsection 84.1(2.31):

[38] Budget 2023
[39] Ibid
[40] Please see Appendix A for a table summary of the proposed conditions and differences between immediate and gradual transfers.
[41] Proposed subsection 84.1(2.31)

Before the sale (the "disposition time"): the seller (with or without their spouse) must control the subject corporation.[42]

At the disposition time:

(a) the seller must be an individual (other than a trust),

(b) the purchaser corporation must be controlled by one or more children of the seller who are over 18 years of age, and

(c) the shares being sold (the "subject shares") must be qualified small business corporation shares or shares in the capital stock of a family farm or fishing corporation.[43]

At all times after the disposition time:

Condition 1 - transfer of control of the business

(a) The seller must not have legal or factual control[44] over the subject corporation, the purchaser corporation, or any other person or partnership that carried on an active business relevant to determining whether the subject shares qualify as qualified small business corporation shares or shares in the capital stock of a family farm or fishing corporation (the "relevant group entity").[45]

As a result, condition 1 requires the parent to transfer a majority of their voting shares in the subject corporation together with factual control to the purchaser corporation immediately at the time of the sale.

Condition 2 - transfer of ownership of the business

(a) The seller must not own, directly or indirectly, 50% or more of any class of shares, other than shares of a specified class ("non-voting preferred shares"),[46] of the subject corporation or purchaser corporation at the disposition time.[47]

(b) The seller must not own, directly or indirectly, 50% or more of any class of equity interests, other than non-voting preferred shares, in any relevant group entity.[48]

(c) The balance of the voting and growth shares (other than non-voting preferred shares) of the subject corporation or purchaser corporation and equity interest

[42] Proposed paragraph 84.1(2.31)(a)
[43] Proposed paragraph 84.1(2.31)(b)
[44] Legal control means the right to elect a majority of the directors of a corporation. For example, holding a majority of the voting common shares of the subject corporation provides legal control. Factual control means economic and other influence that allows for effective control of a corporation. For example, a shareholders agreement providing the seller with certain rights could provide factual control.
[45] Proposed paragraph 84.1(2.31)(c)
[46] The characteristics of a specified class of shares are defined in subsection 256(1.1) as non-convertible or exchangeable, non-voting, fixed value, entitled to dividends at a rate not exceeding a fixed percentage of their fair market value (which cannot exceed the prescribed rate).
[47] Proposed paragraph 84.1(2.31)(d)(i)
[48] Proposed paragraph 84.1(2.31)(d)(ii)

(other than non-voting preferred shares) in any relevant group entity must be transferred from the seller within 36 months of the disposition time.[49]

As a result, condition 2 requires the parent to transfer a majority of their common growth shares to the purchaser corporation immediately at the time of the sale, and to transfer the balance of their voting and common growth shares, but specifically excluding non-voting preferred shares, within 3 years of the sale. There is no time limitation for holding debt or non-voting preferred shares, and thus, the parent can continue to hold debt and non-voting preferred shares indefinitely.

For 36 months following the disposition time:

Condition 3 - engagement in the business

(a) The child(ren) must control the subject corporation and the purchaser corporation,

(b) The child (or at least one child from the group) must be actively engaged on a regular, continuous and substantial basis[50] in the underlying active business[51], and

(c) Each relevant business of the subject corporation and any relevant group entity must carry on as an active business.

Within 36 months of the disposition time (or such greater period as is reasonable in the circumstances):

Condition 5 - transfer of management of the business

(a) the seller must take reasonable steps to:

   (i) transfer management of each relevant business of the subject corporation and any relevant group entity to the child(ren), and

   (ii) permanently cease to manage any relevant business of the subject corporation or relevant group entity.

Proposed paragraph 84.1(2.3)(j) provides rules on interpreting the meaning of “management” as being the “direction or supervision of business activities but does not include the provision of advice.” Under this interpretation it would be reasonable for the parent to continue advising the business on a consulting basis, but such parent should not take on any role as an employee, manager or officer where they may have day-to-day influence over business decisions and activities. That said, the distinction between what constitutes “direction” or “supervision” as opposed to “advice” remains unclear.

Gradual Intergenerational Business Transfer[52]

The following is a summary of the gradual intergenerational business transfer under proposed subsection 84.1(2.32):

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[49] Proposed paragraph 84.1(2.31)(e)

[50] “actively engaged on a regular, continuous and substantial basis within the meaning of paragraph 120.4(1.1)(a)

[51] A child who works on average 20 hours per week is deemed to satisfy this condition, pursuant to paragraph 120.4(1.1)(a)

[52] Proposed subsection 84.1(2.32)

Before the disposition time: the seller (with or without their spouse) must control the subject corporation.

At the disposition time:

(a) the seller must be an individual (other than a trust),

(b) the purchaser corporation must be controlled by one or more children of the seller who are over 18 years of age (including grandchildren, step-children, nieces and nephews, and grandnieces and grandnephews), and

(c) the subject shares must be qualified small business corporation shares or shares in the capital stock of a family farm or fishing corporation.

At all times after the disposition time:

Condition 1 - transfer of control of the business

(a) The seller must not have legal control over the subject corporation, the purchaser corporation or any relevant group entity.

As a result, condition 1 requires the parent to transfer a majority of their voting shares in the subject corporation to the purchaser corporation immediately at the disposition time, but no transfer of factual control is required.

Condition 2 - transfer of ownership of the business

(a) The seller must not own, directly or indirectly, 50% or more of any class of shares, other than non-voting preferred shares, of the subject corporation or purchaser corporation at the disposition time.[53]

(b) The seller must not own, directly or indirectly, 50% or more of any class of equity interests, other than non-voting preferred shares, in any relevant group entity.[54]

(c) The balance of the voting and growth shares (other than non-voting preferred shares) of the subject corporation or purchaser corporation and equity interest (other than non-voting preferred shares) must be transferred from the seller within 36 months of the disposition time.[55]

(d) Within 10 years of the disposition time (the “final sale time”), the seller must not, directly or indirectly, own an interest (debt or equity):[56]

  (i) for a qualified small business corporation, that is equal to more than 30% of the value of their interest in the subject corporation at the disposition time, or

  (ii) for a farm or fishing corporation, that is equal to more than 50% of the value of their interest in the subject corporation at the disposition time.

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[53] Proposed paragraph 84.1(2.32)(d)(i)
[54] Proposed paragraph 84.1(2.32)(d)(ii)
[55] Proposed paragraph 84.1(2.32)(e)
[56] Proposed paragraph 84.1(2.32)(f)

As a result, condition 2 requires the parent to transfer a majority of their common growth shares to the purchaser corporation immediately at the disposition time, and to transfer the balance of their voting and common growth shares, but specifically excluding non-voting preferred shares, within 3 years of the sale. Furthermore, within 10 years of the sale, the parent must reduce the value of their non-voting preferred shares and debt by 70% for a qualified small business corporation, or 50% for a family farm or fishing corporation. Therefore, unlike under an immediate transfer where the parent can retain their non-voting preferred shares and debt indefinitely, under a gradual transfer there is a requirement for the parent to reduce their debt.

For 60 months following the disposition time:

Condition 3 - engagement in the business

(a) The child(ren) must control the subject corporation and the purchaser corporation,

(b) The child (or at least one child from the group) must be actively engaged on a regular, continuous and substantial basis in a relevant business of the subject corporation or a relevant group entity, and

(c) Each relevant business of the subject corporation and any relevant group entity must carry on as an active business.

Within 60 months of the disposition time (or such greater period as is reasonable in the circumstances):

Condition 4 - transfer of management of the business

(a) the seller must take reasonable steps to:

(i) transfer management of each relevant business of the subject corporation and any relevant group entity to the child(ren), and

(ii) permanently cease to manage any relevant business of the subject corporation or relevant group entity.

Although in a gradual transfer, the parent was not required to give up factual control at the disposition time, it appears that condition 4 would require the parent to transfer management, and therefore factual control, to the child within 5 years of the disposition time.

Additional Amendments

In addition to the two stream approach proposed, the proposed amendments:

1. create the following relieving rules to deem the conditions for an immediate or gradual transfer to be met as of the time of the disposition:

   (a) paragraph 84.1(2.3)(f) provides relief where a child subsequently disposes of all the shares of the purchaser corporation, the subject corporation or all relevant group entities to an arm's length purchaser;

(b) paragraph 84.1(2.3)(g) provides relief where a child subsequently disposes of shares of a purchaser corporation, subject corporation or relevant group entity to another child or group of children of the parent;

(c) paragraph 84.1(2.3)(h) provides relief where a child dies or becomes incapacitated and is unable to meet the engagement and control requirements; and

(d) paragraph 84.(2.3)(i) provides relief where the business cannot be carried on due to the assets of the business being disposed of to satisfy creditors of the corporation and therefore is unable to meet the requirement to be carried on as an active business;

2. permit the parent to utilize the intergenerational business transfer exception only once in respect of a relevant business;[57]

3. increase the capital gains reserve from 5 years to 10 years for where the conditions of the immediate or gradual transfer are met to permit the seller to spread their capital gain over up to 10 years,[58]

4. extend the reassessment period by an additional 3 years in the case of an immediate transfer and 10 years in the case of a gradual transfer;[59] and

5. impose joint and several liability on the seller and the child(ren) for any tax payable by the seller if section 84.1 applied due to the parties failing to meet the conditions for a genuine intergenerational business transfer.[60]

Practice Points

The proposed changes will apply to transactions occurring on or after January 1, 2024. Until enacted, the existing rules under Bill C-208 can still be utilized. Although the proposed changes are more restrictive than the existing rules under Bill C-208, they offer more clarity and better guidelines for the transition of a business to the next generation using one of these methods.

Time will tell whether or not business owners utilize these new rules. Although it provides viable business succession options, not all family businesses will be able to fall neatly within the conditions of either stream. Ongoing assessment will be required to ensure that the conditions are continually satisfied over the required time period. The transaction itself, regardless of whether the immediate or gradual transfer is chosen, will have to be as commercially reasonable as possible. It is likely safe to assume that CRA is not a fan of Bill C-208, given its origins as a private member's bill, and may therefore be reviewing these transactions closely.

Meeting the conditions of the transaction appears complex and will require a team of professional advisors to ensure all aspects of the requirements are met, including the grey areas of factual control and management. Not only will tax accountants and reorganization lawyers be involved, but we envision transactional lawyers playing an integral role in advising on the commercial terms of the sale, including provisions for security and default, given the extended transition period. In order to ensure factual control is relinquished right away by the parent on an immediate transfer, thought must be put into how the consideration is structured, as a demand promissory note or

[57] Proposed paragraph 84.1(2.31)(a)(ii) and 84.1(2.32)(b)(ii)
[58] Proposed paragraph 40(1.2)
[59] Proposed paragraph 152(4)(b.8)
[60] Proposed section 160(1.5)

retractable preferred shares could create uncertainty as to whether the parent has actually relinquished factual control.

With increased complexity comes higher professional fees to accomplish the transaction. A business owner's decision as to whether to utilize Bill C-208 will therefore not be black and white and may boil down to whether the tax savings outweigh the additional professional fees, increased complexity and risk.

D. Employee Ownership Trusts

For business owners who are not looking to transition their business to a family member, the newly proposed employee ownership trusts may provide an alternate opportunity.

Other common-law countries have encouraged employee ownership of a business through employee ownership trusts but only recently have such options been considered in Canada. In Budget 2021, the Canadian federal government noted it intended to engage with stakeholders to examine what barriers existed to the creation of this type of trust in Canada, and how employees and owners of private businesses in Canada could potentially benefit from the use of this type of trust.

Further to that note, Budget 2023 announced the introduction of the employee ownership trust ("EOT"), a new form of employee ownership that will "enable employees to share in the success of their work"[61] using a new type of trust that holds shares of a corporation for the benefit of the company's employees. The Department of Finance (Canada) has introduced changes to the Act which would facilitate the creation of EOTs and incentivize business owners to sell to employees while allowing such employees to re-invest more of their profits in growth.[62]

The government noted that EOTs support participation in business decisions, allow workers to receive their share of profits, and can be used as a mechanism to enable employees to purchase a corporation without requiring them to pay directly for the shares. Additionally, an EOT can be used as an additional option for succession planning for business owners who do not intend to pass the business along to children or family members and who, for any reason, cannot or do not wish to sell it to an arms-length third party. While this introduction is considered by many to be a welcome development, the currently-drafted rules are highly structured and it remains to be seen if the incentives are great enough to generate widespread adoption of EOTs. The proposed EOT regime is slated to come into effect on January 1, 2024.

Key Concepts

To facilitate a discussion of the key terms and concepts of an EOT, we must first identify what an EOT is.

Employee Ownership Trust

An EOT is an irrevocable trust that, at all relevant times, meets the following conditions:[63]

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[61] Budget 2023, chapter 3

[62] Ibid

[63] Budget 2023 Tax Measures: Supplementary Information, Notice of Ways and Means Motion to amend the *Income Tact Act* and the *Income Tax Regulations,* proposed amendment to subsection 248(1) of the Act

1. **Residency Requirement -** The EOT must be resident in Canada (i.e. its central management and control must be resident in Canada).

2. **Beneficiaries Requirements** - The EOT is exclusively for the benefit of individuals:

   (a) each of whom must be an employee (or, if the trust permits, a former employee or the estate of a former employee that meets the same conditions applicable to current employees) of the "qualifying business" (as herein defined) controlled by the EOT, not including individuals who are on probation (though such probation period cannot exceed 12 months in duration);

   (b) who do not own, directly or indirectly (other than through an interest in the EOT), 10% or more of the fair market value of any class of shares of the qualifying business controlled by the EOT (i.e. the former owner could not be included);

   (c) who do not own, directly or indirectly, together with related or affiliated persons, shares of a class of the capital stock of the qualifying business worth 50% or more of the fair market value of that class;

   (d) who, immediately before the time of a qualifying business transfer, do not own, directly or indirectly, together with related or affiliated persons, shares or indebtedness of the qualifying business worth 50% or more of the fair market value of the shares or indebtedness of the qualifying business; and

   (e) the interest of each beneficiary must be determined in the same manner based on the beneficiary's hours worked, pay, and/or period of employment (i.e. the EOT cannot act in the interests of one beneficiary or group of beneficiaries at the expense of another).[64]

3. **Trustees Requirements -** The trustees of the EOT:

   (a) must be elected by the beneficiaries for a period not exceeding five years;

   (b) must each be either a licensed Canadian resident trust company or a Canadian resident individual, and at least one third of the trustees must be beneficiaries of the EOT as current employees of a qualifying business controlled by the EOT;

   (c) must each have an equal vote in the conduct and affairs of the EOT; and

   (d) can be individuals who, together with related or affiliated persons, held a significant interest in the qualifying business immediately before such business was transferred to the EOT, but such individuals cannot represent more than 40% of the trustees.

[64] Note: EOTs can develop different distribution formulas, using these factors, for distributions of income and capital for current or former employees, as long as they are applied to each group of people in the same way. For example, if an EOT is established to benefit both current and former employees, it could have different distribution formulas for: 1) income distributions to current employees, 2) capital distributions to current employees, 3) income distributions to former employees, and 4) capital distributions to former employees.

4. **Trust Property Requirements -**

(a) all or substantially all of the fair market value of the property of the EOT must be attributable to the shares of a qualifying business controlled by the EOT and which employs the beneficiaries;

(b) more than 50% of the beneficiaries must pre-approve i) any transaction(s) or event(s) that would cause the EOT to cease controlling a qualifying business, ii) a disposition of all or substantially all of the qualifying business's assets, and iii) a winding-up, amalgamation or merger of a qualifying business; and

(c) the EOT must be prohibited from distributing shares of a qualifying business to any beneficiary.

It is worth noting that EOTs will be taxable trusts and will generally be subject to the same rules as other personal trusts.[65] For example, undistributed trust income will be taxed in the EOT at the top personal marginal tax rate whereas beneficiaries will be taxed (at their respective rates) on any income distributed by the EOT.

Qualifying Business and Qualifying Business Transfer

A "qualifying business" is a Canadian-controlled private corporation (a "CCPC"), 90% or more of the fair market value of the assets of which are used principally in an active business carried on primarily in Canada. The CCPC must be at arm's length and not affiliated with any individuals who owned 50% or more of the fair market value of the shares or indebtedness of the corporation prior to the EOT acquiring control.[66] Furthermore, the directors of the qualifying business are restricted and only up to 40% may be individuals that, immediately before the time the EOT acquired control of the corporation, owned, directly or indirectly, together with related or affiliated persons 50% or more of the fair market value of the shares or indebtedness of the corporation.

A "qualifying business transfer" refers to a share disposition (i.e. not an asset disposition) to an EOT or a CCPC controlled by an EOT. At the time of disposition, all or substantially all of the fair market value of the assets which is attributable to assets (other than an interest in a partnership) must be used principally in an active business carried on primarily in Canada by the particular corporation or a corporation that the particular corporation controls. The vendor must be at arm's length at the time of the disposition and thereafter, and the EOT must acquire control as a consequence of the transfer such that there is no *de facto* control by the vendor, whether alone or together with related or affiliated persons.[67]

Benefits to the Vendor

Though more clarity is required on the proposed rules, some of the potential benefits of EOTs are immediately apparent. Theoretically, the process should be faster, easier, and less adversarial than engaging in a sale to an arms-length third party. Proposed vendors would be involved in the establishment and structure of the EOT and qualifying business transfer, and less expansive representations, warranties and indemnities would be required than in an arm's length third-party sale.

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[65] Ibid
[66] Supra, note 61
[67] Ibid

In most cases, a capital gains reserve can be claimed over a maximum five-year period, with at least 20% of the applicable gain being recognized each year. This allows taxpayers to defer the recognition of a capital gain in a situation where all or some of the proceeds from a disposition are receivable after the end of the tax year. Budget 2023 and the new subsection 40(1.3) of the Act extend this capital gains reserve to 10 years for dispositions of a qualifying business to an EOT, with at least 10% of the gain recognized each year.[68] If implemented, this rule would benefit a vendor that receives proceeds from a sale to an EOT over a period longer than the standard five-year capital gains reserve, reducing its tax burden in those years and aligning it with the receipt of cash proceeds from the disposition.

Benefits to the Employees

An EOT will be permitted to designate dividends distributed to beneficiaries such that they retain their character and will be eligible for the dividend tax credit. In addition, the 21-year deemed disposition rule (applicable to certain trusts) that deems a trust to dispose of its capital property will not apply to EOTs, meaning they can hold shares of the qualifying business corporation for an indefinite period without a deemed taxable event every 21 years.[69] If a trust ceases to meet the requirements of an EOT, the 21-year-rule would apply until if or when the trust next meets the EOT requirements.

Another benefit is that the EOT can fund the purchase of the qualifying business using funds borrowed from the corporation itself, and take advantage of the expanded repayment period for certain shareholder loans. Typically, shareholder loans received by a non-corporate shareholder are included in the shareholder's income unless the loan is repaid within one year after the end of the corporation's tax year in which the loan was made. As doing so may not be financially feasible, Budget 2023 and the new subsections 15(2.51) and 80.4(3)(c) of the Act will allow EOTs to repay certain shareholder loans over a 15-year period without including the loan in income if the funds were borrowed from a qualifying business to fund the purchase of the qualifying business, as long as bona fide arrangements are made to repay the balance of the loan within those 15 years.[70]

Application and Practice Points

At a time when the federal government is proposing additional and more onerous requirements for intergenerational business transfers,[71] an EOT may present another succession planning option for business owners who cannot or do not wish to find a third-party purchaser and who do not have family members suited to taking over the business. The practical viability and attractiveness of the EOT option has yet to be seen and may be impacted by changes made to the proposed rules or additional guidance provided by the Department of Finance or the CRA.

Upon a review of Budget 2023 and the proposed EOT rules and explanatory notes,[72] several potential issues, areas requiring clarification, and proposed recommendations for revision have been identified for consideration by the Department of Finance:

- *Incentives for business owners* – There is a concern that the EOT regime does not provide enough incentive for business owners, especially in light of the fact that selling to an EOT

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[68] Ibid
[69] Ibid
[70] Ibid
[71] See discussion of Bill C-208 in section C of this paper
[72] Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations, https://fin.canada.ca/drleg-apl/2023/ita-lir-0823-n-1-eng.html

may result in payouts over time as opposed to the lump-sum payment received in a sale to a third party. Accordingly, the risk of non-payment of the full purchase price is greater, as it would likely depend on the long-term success of the business post-sale. In the UK, the use of EOTs has been incentivized by allowing the owner to dispose their shares into the trust free from capital gains and inheritance taxes, pay annual bonuses up to a specified amount to employees free from income tax, and providing corporate tax deductions for the value of such bonuses.[73]

- *Threshold for Qualified Business asset test* – As set out above, the proposed EOT rules provide that at the time of disposition, all or substantially all of the fair market value of the assets which is attributable to assets (other than an interest in a partnership) must be used principally in an active business carried on primarily in Canada by the particular corporation or a corporation that the particular corporation controls. By reducing this threshold or only requiring periodic satisfaction (e.g. at the outset of each tax year), the use of EOTs may be available to many more small business owners in Canada.

- *Wind-up or disposal of shares* – The proposed rules do not provide much guidance with respect to the disposal or winding-up of a business owned by an EOT, simply providing that the shares cannot be distributed to a beneficiary. Based on the drafting of the proposed legislation,[74] it would seem that the only way to end an EOT is to sell the shares of the CCPC to an arms-length third party. Consider the situation where one employee wants to continue the business and buy the others out – could that employee (as opposed to an arm's length third party) purchase the EOT's shares and what would the consequences be? It is unclear if the sale of shares to an employee-beneficiary would be considered a prohibited "distribution" of the shares under the EOT rules. If an EOT inadvertently fails to meet the requirements of an EOT at a given time (e.g. an employee quits and is not automatically or immediately removed as a beneficiary of the EOT) and the EOT sold the shares to a third party, would the beneficiaries of the EOT still be eligible to claim the lifetime capital gains exemption? If the EOT voluntarily ceases to qualify as an EOT, could it then roll out the shares to the beneficiaries pursuant to subsection 107(2)? Additional guidance or commentary from the Department of Finance or the CRA may be helpful in answering some of these questions in the future.

- *Restriction on former owner control* – As currently proposed, the EOT rules prevent a vendor from maintaining control of the business post-sale. Relinquishing control immediately and before receiving a full payout may discourage owners from availing themselves of the EOT option. Adding flexibility in this regard may provide more comfort to prospective vendors.

- *Application of specific tax rules* – It is unclear how or if certain rules will apply to EOTs. For example, will subsection 84(2) apply to cash borrowed by the EOT from the qualifying business that is then paid to the vendor? Will sections 84.1 or 212.1 apply to consideration received in respect of a qualifying business transfer if the vendor becomes a trustee of the EOT? As an EOT is not an employee benefit plan or an employee trust for purposes of the Act, will its exclusion from those rules extend into a period of time after the trust ceases to qualify as an EOT to allow for proper wind-up? Can beneficiaries claim the lifetime

[73]PwC, "Employee Ownership Trusts", <https://www.pwc.co.uk/services/tax/employee-ownership-trusts.html#:~:text=Employee%20Ownership%20Trusts%20(EOTs)%20are,free%20from%20capital%20gains%20tax.>, accessed 08/20/23

[74] Budget 2023 Tax Measures: Supplementary Information, Notice of Ways and Means Motion to amend the *Income Tact Act* and the *Income Tax Regulations*

capital gains exemption for gains distributed to them by the EOT if the EOT disposes of the business and the share would otherwise qualify? Additional clarity on the application of these rules would be necessary to allow owners to assess the viability of a sale to an EOT.

When considering methods to transfer ownership of a business to one or more employees, business owners may also consider using employee stock option plans or selling to a holding company incorporated by the employees (for this section, an "Employee HoldCo"). While employee stock option plans provide incentives for new employees and theoretically allow them to buy into the company at a reduced price in the future, implementing such a plan is likely not feasible at the time when a business owner is planning their exit as share value is likely at or close to its peak. Further, employing a stock option plan does not provide any cash to the exiting owner for their retirement.

Alternatively, selling to an Employee HoldCo may provide comparable or greater, though different, benefits to the vendor and employees than an EOT. Selling to an Employee HoldCo would remove any concerns about the 21-year-rule as no trust is involved. With respect to financing, the qualifying business could loan funds to the Employee HoldCo without the risk of subsection 15(2) shareholder loan income inclusion (as it does not apply when the borrowing corporation is resident in Canada).[75] Further, by selling to an Employee HoldCo, the vendor would not have to relinquish control of the business until they are fully paid out, as they would if selling to an EOT. Though doing so would not allow the vendor to take advantage of the extended capital gains reserve period, for the reasons set out above, selling to an Employee HoldCo may currently be more attractive than selling to an EOT.

The proposed EOT rules in Budget 2023 are an exciting development, providing a potential new route for business succession that was previously unavailable to owners and employees in Canada. The popularity and uptake of EOTs remains to be seen. We look forward to insights that may be gained through the practical use of EOTs, additional guidance or commentary provided by the government or the CRA, and potential amendments of the EOT legislation as currently drafted.

E. Soft Issues in Business Succession

When we consider business succession in the family business context, the two immediate considerations are often (i) the financial transition of equity, and (2) the leadership transition of management and control. The use of an estate freeze and the new genuine intergenerational transfer rules help execute these two elements. The third factor to consider, and that cannot be addressed through tax rules and legislation, are the soft issues.

Soft issues in business succession include elements such as:

1. Family dynamics - Evaluate the dynamics among the children, and also between the parents and children. What personalities exist among the group, who possesses what types of skills, what emotional attachments exist, and what conflict and issues have they faced. Understanding the family's dynamics can help advisors propose solutions that will work for everybody and prevent family disharmony.

2. Family values - Have conversations about what values are important to the family and how wealth should be created and used, and put it in writing. What business do they

[75] Supra note 1, ss 15(2)

agree they will never enter into, no matter how profitable? What philanthropic goals do they have? Clearly articulated family values that embrace all generations' ideas can help foster open communication and transparency.

3. Readiness - What does "readiness" look like to the parent and the child? Have both parties participate in designing a standard of readiness to include everything from education, experience, and skills. Having a mutually agreed upon standard can help manage expectations and help plan for a timely transition.

Some tools that can be helpful in addressing and incorporating the "soft issues" include a family shareholders agreement, enduring powers of attorney, wills or *inter vivos* trusts, and family law agreements.

Family Shareholders Agreement

A family shareholders agreement is not unlike a typical shareholders agreement. It will cover all the typical issues covered by a shareholders agreement, such as the composition of the board of directors, and buy out provisions on death, disability, divorce and bankruptcy, as well as right of first refusal. However, unlike in a traditional shareholders agreement, a family shareholders agreement will address these issues in a manner that helps manage the family members' expectations, set ground rules for a common framework and will focus on the family's shared values and unique personalities and relationships.

A family shareholders agreement is a creative tool for dealing with "soft" issues and asking the "what if" questions unique to the family's needs and circumstances. What if a shareholder divorces? Does the family want to be in business with an ex in-law? What if sibling shareholders are not all capable of running the business? Should all family members have a right to be employed by the business? If so, how is compensation determined? What if there is great disparity in the siblings' wealth? Does the family value helping those who have less? What if a shareholder's employment is terminated due to a falling out? Do they need to exit the company, and if so, how and at what price?

Ideally the agreement should be an ever-evolving document that is reviewed at regular intervals, as family members participating and not participating in the business change, and as family members gain experience and skills applicable to the management and leadership of the business. Whereas a typical shareholders agreement is designed with the intention that it is in place to set black and white rules for settling disputes among shareholders, and therefore only really reviewed when a dispute arises, a family shareholders agreement is designed with the intention of keeping the communication among the family members open, to commit to a transparent and fair process for governance.

When a genuine intergenerational transfer is being elected, certain rules will need to be included to ensure the continued compliance with the conditions of the transfer, such as management, control and continuing the business as an active business. In an immediate intergenerational transfer care must be taken to ensure that the parent is not afforded veto rights or rights to decisions as a minority shareholder (including requirements for unanimous decisions) that could inadvertently deem them to have factual control.

Enduring Power of Attorney

What happens if the leader of the family business becomes incapacitated? Without an Enduring Power of Attorney, there is no default for who can manage your corporate interests. A

shareholders agreement will typically cover disability of a shareholder, but how will those terms play out? Does the person you appointed to manage your business affairs in the event of incapacity have the skills and knowledge to be able to protect your business interests?

Separate Enduring Powers of Attorney can be used to distinguish the area of authority you are granting to your chosen attorney. Business owners should therefore consider whether a separate Enduring Power of Attorney to deal specifically with their business and corporate affairs is appropriate. Perhaps it would be more appropriate to appoint the child who is actively engaged in the business, or the trusted business advisor as attorney over corporate affairs, whereas it would be more appropriate to appoint your spouse as Enduring Power of Attorney over your general financial affairs (such as your personal real estate and bank accounts).

Just as it is important to choose the right successor, choosing the right representative to step into your shoes in the event of your incapacity can help minimize disruption to business operations and help avoid deadlocks in decision making.

Dual Wills and Inter-vivos Trusts

A business succession plan is not complete without also considering what happens to the shares left in the hands of the parent after the estate freeze or genuine intergenerational transfer on their death. Ideally the fate of those shares would be addressed in a family shareholders agreement, but if the shares remain in the personal hands of the parent, those shares would form part of the parent's estate regardless. The parent needs a personal estate plan in place to direct how to distribute their remaining shares on their death. If their shares fall into their estate, those shares could be subject to the probate process and probate fees. To manage this, the use of dual Wills[76] in British Columbia has become a common planning tool for will-makers who hold significant interests in private companies.

In British Columbia there is no legislated requirement for a private company to require a grant of probate to transfer shares held by a deceased shareholder.[77] Therefore, private company shares can typically be transferred on the death of a shareholder without a grant of probate (and subject to any terms of a shareholders agreement that may impact the treatment of such shares on death). Therefore, by creating two separate wills - one dealing with assets that will require probate (such as real estate and bank accounts, the "Probate Will"), and a second dealing with assets that will not require probate (such as private company shares and shareholder loans, the "Non-Probate Will") - probate can be bypassed on the assets covered by the second Non-Probate Will. Not only will this reduce the overall probate fees payable by the estate (which can be significant at approximately $14,000 per $1,000,000 of assets),[78] but it also provides privacy as the Non-Probate Will does not go through the very public court process of probate.

The parent can distribute their shares to the beneficiaries of their choice in their Non-Probate Will, keeping in mind their overall business succession goals. However, if the parents have a distribution goal that treats children unequally, or bypasses their spouse entirely (which is not uncommon in second, third or fourth marriage scenarios), they need to be alert to British Columbia's wills variation rights.

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[76] The *Wills, Estates and Succession Act* allows for the use of multiple wills in British Columbia.

[77] The BC *Business Corporations Act* only requires that a true copy of the Will and death certificate, or a true copy of the Grant of Probate be provided to the company. Therefore, it is up to the company whether to require the deceased shareholder's estate to produce a Grant of Probate or not.

[78] Probate fees are currently nil for the first $25,000; 0.6% for the portion between $25,000 and $50,000 and a filing fee of $200 where the gross value of the estate exceeds $25,000; and 1.4% for the balance.

In British Columbia, a spouse or child may challenge a will-maker's Will if they are not adequately, justly and equitably provided for. If the parent's succession goal is to leave the family business to one child only and they structure their Will so that all shares held by the parent are distributed to that one child, there is an inherent risk of the other children commencing a court action to vary the Will. This creates uncertainty as to how your shares will ultimately be distributed and could jeopardize the future of your business.

To mitigate this risk (and in some circumstances, eliminate it altogether), a parent who faces these potential wills variation issues should consider an alter ego or joint spousal trust as an alternative planning tool.

Family Law Agreements

Family law factors are some of the most difficult to address, as individuals may be hesitant to approach their partner about signing domestic agreements. Although a shareholders agreement can be drafted to trigger a re-purchase of the individual's shares in the event of marital or relationship breakdown, having a standalone family law agreement between the shareholder and their spouse sets clear expectations and understanding between them. It is an effective way to protect ownership of a business. Otherwise, the risk is that you could end up in business with your ex-spouse (or your child's ex-spouse), or the business or other assets may need to be sold to raise funds to settle the division of property.

Protecting a family business from the potential marital and relationship breakdown of the next generation should be top of mind for every business owner contemplating succession planning. If a full blown marriage agreement is not palatable for the next generation, a scaled-back agreement that deals with just their inheritance, including their future interest in the family business, can sometimes be more acceptable.

F. Conclusion

Just as no two families are alike, no two family business succession plans will be exactly alike. Family, financial, tax and practical factors will all interact and play a role in an owner's plan to retire and transition their business into the next phase, whether that be a gradual transfer of value and control to children, a sale to employees, or a controlled winding down. While some methods of business succession such as an estate freeze are well-established and commonly used, the government is constantly proposing new structures and amendments to existing regimes in response to economic and societal shifts. The new developments provided by Bill C-208 and EOTs provide welcome and varied opportunities for prospective retirees and their successors to explore with their advisors.

APPENDIX A

Summary of Genuine Intergenerational Business Transfers under S. 84.1(2.31) and (2.32)

	Immediate Business Transfer	**Gradual Business Transfer**
Common Conditions	**Prior to Sale:** 1. Parent has not previously sought exception under s. 84.1(2)(e) in respect of the same business 2. Parent controls subject corporation **At Time of Sale:** 3. Parent (seller) is an individual (not a trust) 4. Purchaser corporation is controlled by one or more "children" of parent 5. Subject shares are qualified small business corporation shares ("QSBC shares") or shares of the capital stock of a family farm or fishing corporation ("FFFC shares")	
	After Sale:	
Condition 1 - Transfer of Control	Parent gives up factual and legal control immediately at time of sale (majority of voting shares and factual control)	Parent gives up legal control immediately at time of sale (majority of voting shares)
Condition 2 - Transfer of Ownership	Parent transfers majority of common growth shares immediately at time of sale Within 3 years of sale, parent transfers balance of common growth and voting shares	
	Non-voting preferred shares and debt can continue to be held indefinitely	Within 10 years, parent reduces their debt and equity by 70% for a QSBC share and 50% for a FFFC share
Condition 3 - Child Engagement	For 3 years following the sale, child remains in control of the subject corporation and purchaser corporation, child remains actively engaged in the business, and continues as an active business	For 5 years following the sale, child remains in control of the subject corporation and purchaser corporation, child remains actively engaged in the business, and continues as an active business
Condition 4 - Transfer of Management	Within 3 years after sale (or such greater period of time as is reasonable in the circumstances), the parent must transfer management to the child and cease to manage the business	Within 5 years after sale (or such greater period of time as is reasonable in the circumstances), the parent must transfer management to the child and cease to manage the business