expense for no good reason. There is, therefore, a compelling case for further amending the IBT rules to explicitly allow for dispositions to separate purchaser companies, each controlled by a child of the taxpayer. This should be a simple change, given that no requirement exists in the current legislation for the children to control the subject corporation; they are required only to control the purchaser corporation.

Consideration could also be given to adding flexibility to the gradual IBT alternative so as to allow the taxpayer to dispose of portions of his or her shares to different children at different times. A taxpayer with multiple children may want to sell a portion of the business to each child; however, the children may not all be in a position to purchase their portion of the business at the same time. If, for example, there are significant age differences between siblings, the siblings' economic or personal circumstances may be very different, such that it doesn't make sense for the siblings to purchase the business jointly or simultaneously. A simultaneous purchase in these circumstances could lead to resentment if (for example) one sibling ends up taking on a substantial amount of work in the business transition while the other siblings contribute relatively little work but reap the same benefits as the busy older sibling. To avoid losing the ability to elect under paragraph 84.1(2)(e), a taxpayer may be required either to wait until all of his or her children are in a position to purchase the business, or to sell to the first child who is in a position to buy. Such a choice may leave younger siblings at a disadvantage. Further changes to section 84.1 should be considered to accommodate this type of family situation.

Conclusion

The new IBT framework is an important change to the ITA. It will allow many taxpayers to transition their business to the next generation without incurring adverse income tax consequences. As currently drafted, however, the rules leave siblings at a disadvantage when a business is being sold, and changes are warranted to address this disadvantage. The rules also fail to accommodate situations where business owners seek to transfer the business to multiple children, potentially at different times.

Every family is different, and the IBT framework should include enough flexibility to address different family dynamics. By properly addressing and removing the disadvantages to which siblings and transfers to multiple children have historically been subject, the new IBT framework will further incentivize genuine business transfers, allowing business owners to make optimal decisions for their businesses and families without having to consider these decisions' tax implications. In this article, I have identified the changes that represent the next logical step in reforming the ITA so as to eliminate the tax incentive for selling family businesses to third parties. ■

Let Them Have Their Cake and Enjoy It, Too

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Have you ever tried to bake a cake? You have a vision of soft, fluffy textures and velvety sweet icing. You take time to study recipes and baking techniques, and you spend money to buy the ingredients. You finally put the recipe to the test and you bake, watching and waiting for the timer to go off. The cake looks beautiful, and you feel proud. You are ready to share it with your family . . . but it tastes awful, an inedible clump of wasted time and money.

Have you ever thought about a small business this way? An entrepreneur with a great concept is passionate about their ideas and pours their time, energy, and money into making the concept a success. So many entrepreneurs are confident that they have the recipe for success, and yet so many fail. Some do succeed in baking that beautiful cake. They do so, however, only to learn, in time, that their dreams of passing their businesses on to their children are complicated by unfair tax consequences and unworkable rules. They can't enjoy their cake.

The Intergenerational Business Transfer (IBT) Rules: Underlying Themes

The IBT rules were originally introduced in Bill C-208, a private member's bill that took effect in 2021. However, the rules were later amended and restricted by provisions in Bill C-59, which apply to share dispositions starting in 2024. In theory, the IBT rules level the playing field, for a business owner, between selling the business to an arm's-length party and passing on the business to the owner's children. Before Bill C-208, an intergenerational transfer was at a clear tax disadvantage because of the broad application of section 84.1 of the ITA—a surplus-stripping rule that had the effect of taxing a transfer to the owner's child more harshly than a third-party sale. Parliament's underlying intention in enacting Bill C-208 was to remove this anomaly.

This underlying intention and some key themes emerge from a review of Hansard for the House of Commons' second reading of Bill C-208 on November 25, 2020 and February 1, 2021.

Theme 1: "Small business owners make up the backbone of our economy"

They put everything on the line to make their operations a success. Hopefully, after many years of hard work, they slowly and surely pay off their debt, expand their business and create even more jobs in their own communities. (Mr. Larry Maguire, Brandon—Souris, CPC)

Theme 2: "This is for small business, not big businesses"

The bill refers to family operations in fishing, farming and other small businesses in Canada that have been built on the pride of

ownership and the hard work that their families have done throughout Canada, and it in no way is trying to provide any kind of loopholes. . . . [I]t would be pride of ownership for people to be able to build a small business into a larger business, but once they do that, the things we are talking about in this bill are not relevant to those businesses. (Mr. Larry Maguire, Brandon—Souris, CPC)

Theme 3: "We need to fix the unfairness"

What message are we sending? Are we trying to discourage people from going to business? . . . We need to act quickly to fix this anomaly in the Income Tax Act to prepare for the demographic reality we are facing. (Mr. Bernard Généreux, Montmagny—L'Islet—Kamouraska—Rivière-du-Loup, CPC)

The purpose of the IBT rules is not only to level the playing field for business succession but also, more broadly, to encourage entrepreneurship in Canada. To do this, we need to make the IBT rules accessible enough to work effectively for the average small business owner.

Meeting the Legislative Tests

The average small business owner is not operating their company with complex tax rules in mind. They likely do not have the budget to keep a tax adviser on their team. They run their business with a singular focus until it's time to retire. Only then do they start considering their exit strategy. Will they sell to a competitor, sell to their employees, transfer to their children, or shut down the business?

In order to access the IBT exception from the surplus-stripping rules, a set of complex conditions must be satisfied. The IBT rules contemplate either an "immediate" or a "gradual" intergenerational transfer, and each of these alternatives requires strict compliance with distinct and detailed provisions. (These conditions are discussed in more detail in the 2023 Atlantic Provinces Tax Conference paper by Daren Baxter and Susan M. Johnson.)

One of the conditions for accessing the IBT rules is that, at the time of disposition, the shares being sold by the business owner are qualified small business corporation (QSBC) shares or shares in the capital stock of a family farm or fishing corporation. This condition is similar to those for access to the lifetime capital gains exemption. To qualify as a QSBC share, three main conditions (detailed in this 2017 British Columbia Tax Conference paper by Ian Worland) must be met:

1) The selling shareholder must have owned the shares for at least 24 months before the time of sale.
2) The company must be using all or substantially all (meaning, generally, at least 90 percent) of its assets in active business operations in Canada at the time of sale.
3) At least 50 percent of the company's assets must have been used in active business operations for 24 months before the time of sale.

Unsurprisingly, without careful and sometimes complex tax planning, very few businesses will qualify for QSBC share status. An average small business owner may (understandably) not be paying attention to the value of any passive assets accumulating in the business. It can easily happen that a small business owner has excess cash or marketable securities, or owns a property in the company that is not being used by the business. If this is the case, the business owner must take steps to "purify" the corporation by removing or repurposing these passive investments into active business assets in order to meet the tests noted above.

These steps are obviously artificial, designed only to meet the requirements of the QSBC definition, and the purification process can be complex and expensive for the average small business owner—simply not feasible, in some cases. Is it appropriate to burden a business owner in this way, if the goal of the IBT rules is to encourage entrepreneurship and intergenerational transfers? Should QSBC status really be necessary to qualify for the IBT rules, especially when we consider the rules' underlying purpose and themes? Wouldn't a simpler test make more sense? For example, to allow more small business owners to qualify for an IBT, the rules could require only that the company be a CCPC with a value of, say, $10 million or less (adjusted to inflation). To ensure that the IBT rules are used only in true business successions, the rules could define the types of businesses that qualify or could exclude certain types of businesses, such as personal services businesses.

Giving Up Control

A sale to an arm's-length third party is certain, in a commercially reasonable way: the terms are clear, the vendor gets paid for their business, and the two parties move on. If one party breaches a term of the agreement, remedies are available, and the aggrieved party can and often does take legal action to enforce these remedies.

An IBT to the business owner's child is less certain. In many cases, the vendor may get paid gradually (slowly, over time) for their business. The IBT rules, as enacted, force the vendor to give up control immediately and move on; yet they also handcuff the vendor, who is forced to rely on the purchaser to hold up their end of the deal.

The purchaser's subsequent actions may trigger adverse tax consequences for the vendor, and the rules provide that both parties are jointly and severally liable for these consequences. For example, what if the business fails after the transfer, and the purchaser-child wants to walk away? How can a vendor-parent force the child to maintain the business for the requisite period prescribed by the IBT rules? How can a parent punish the child, in practical terms, for not keeping their end of the deal? As a practical reality, the parties to an IBT cannot be expected to sue one another for a breach of contract: family relationships and harmony need to be protected.

The treatment of control and management under the IBT rules is, arguably, the reverse of what it should be. The rules require the owner to give up control immediately; management must be transferred over a stipulated period, with the precise time limit depending on whether the transfer is "immediate" or "gradual." In my view, this is backward. Parent-owners should be able to retain some aspect of control until they have been paid or, at least, mostly paid.

The requirement to relinquish control before being paid and the imposition of subjective conditions that are entirely out of the vendor's control are problematic aspects of the IBT rules. As a lawyer, I would never advise a client to sell their business to an arm's-length buyer under payment terms that leave them uncertain as to whether they will ever get paid, and under contractual terms that leave them at the mercy of the buyer's ongoing good behaviour. I would instead include protective provisions—for example, a provision to the effect that the vendor retains an element of control until payment is received in full.

Many business transfers fail because the child was not ready to take over. A successful business succession plan includes long-term mentoring to prepare the child to take over the management role. In such a case, parents are ready to give up management or have already given it up by the time they are ready to transfer the business. Yet the IBT rules permit them to transfer management over three years (for an immediate IBT) or five years (for a gradual IBT). The IBT rules would more accurately reflect commercial reality if the parent were required to cease management immediately, and if the rules tied the transfer of control to payment of the purchase price.

The IBT rules should strike a better balance between these considerations. When we contemplate the transaction after three years (for an immediate IBT) or after five years (for a gradual IBT), the real question should be whether the transaction was a surplus strip or a genuine transfer. For example, if the parent has still not been paid out and has retained control and management, the transaction was evidently a surplus strip, and the IBT exception from section 84.1 should be denied. On the other hand, if the parent has been paid out and has ceded control and management, a genuine transfer has clearly taken place, and the transaction should not be treated as a surplus strip. Other intermediate fact patterns should be evaluated, with an eye to whether it is reasonable, given all of the circumstances, to treat the overall transaction as a surplus strip. Let the CRA determine whether there was abuse of the rules and, if so, penalize those responsible. This type of approach may not catch all of the bad apples, but it will catch most.

> *If a transaction is fraudulent, the government can investigate it, kind of like how a police officer would ticket someone speeding on Highway 50, but would let everyone who obeys the speed limit carry on.* (Mr. Gabriel Ste-Marie, Joliette, BQ)

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Conclusion: Let Them Have Their Cake and Enjoy It, Too

The goal of the IBT rules is to promote and protect *small* businesses. In my experience, the average small business owner does not want to complicate their life with ongoing compliance requirements or risk damaging their relationship with their children for a few dollars of tax savings. Unless the IBT rules are simplified, the traditional estate freeze may still be the safer, easier, and more flexible choice for transferring a business to the next generation.

We can all agree that there is no easy recipe for success; starting a business is risky and hard. We can also agree that small businesses are integral to the Canadian economy. Let's give entrepreneurs who manage to perfect their recipes and build successful small businesses the ability to pass on their businesses to the next generation, and let's allow them to do so while enjoying the same tax savings as if they were selling to a third party. It's time to let small business owners have the cake they've worked so hard to prepare; and let them enjoy it, too. ■

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