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Budget 2023

Proposed New Rules For Selling a Business

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My last two articles focused on some tax-planning strategies and options when selling your business. So, the coincidence was uncanny when the 2023 federal budget, which was announced on March 28, 2023, included some significant changes that made me think that my Part I and Part II in my series needed a Part III.

While there were more issues covered in the budget, this article will focus on two specific proposals that will be of interest for those looking to sell their business.

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I. Changes to the Inter-Generational Transfer Rules; Applies to the disposition of shares that occur on or after January 1, 2024.

The Issue? At a high level, section 84.1 of the Income Tax Act applies where an individual or trust disposes of shares of a Canadian-resident corporation to another corporation that the vendor does not deal at arm's length. Secondly, if immediately after the disposition, the corporations are "connected," i.e., one company owns more than 10 per cent of the other company, or one company, together with other related entities, owns more than 50 per cent of the voting shares. When this happens, capital gains that would have been recognized on the transfer are recharacterized as a taxable dividend. This typically results in a higher tax rate and the loss of the lifetime capital gains exemption.

The Amendment? Bill C-208 (introduced in 2021) provided an exception to the above rule where an individual (Vendor) disposed of "qualified small business corporation shares" (QSBC shares). I discussed these shares in last month's article on the sale of Targetco to a Purchaseco that was controlled by an adult, child or grandchild of the vendor.

The Change? With budget 2023, the following requirements in Bill C-208 were removed:

- ☛ A requirement that Purchaseco cannot dispose of shares of Targetco within 60 months;
- ☛ A purported reduction in the availability of lifetime capital gains exemption in certain situations relating to Targetco's taxable capital; and
- ☛ A requirement to obtain an independent assessment re. FMV (Fair Market Value) of the Targetco shares.

The scope of "child" is also expanded to include niece/nephew of the vendor or their spouse/common-law partner, or spouse/common- law partner or child of such person It is also important to note that if a trust is involved in the structure, the proposed rules deem, for the purposes of these rules, that each beneficiary of

the trust owns everything owned by the trust.

The Rules Today? Budget 2023 now requires that the parties involved meet one of two transfer options:

1. The Immediate Intergenerational Business Transfer (the "Immediate Transfer"); or
2. The Gradual Intergenerational Business Transfer (the "Gradual Transfer")

Immediate Transfer vs. Gradual Transfer? The pros of the Gradual Transfer are that: (i) it is not required that the vendor (and spouse, if applicable) give up factual control immediately after disposition; and (ii) the vendor has up to 60 months (as opposed to 36 under Immediate Transfer) to take steps to transition management to active children.

However, there are significant cons associated with the Gradual Transfer. For vendors with outstanding shareholder loan receivables and preferred shares (that do not satisfy certain prescribed conditions), the Gradual Transfer requires that they must decrease such interests down to the 30 per cent (assuming QSBC Shares) within 10 years from the time of disposition. It could also create a cash-flow issue on the operating companies' /significant dividend income taxation to the vendor (the threshold is increased to 50 per cent for shares of the family farm or fishing corporations). As well, the active business test must continue until the latter of 60 months and the time the vendors reduce their interests to 30 per cent as per above.

Important to note. The current proposal also contemplates extending the limitation period for reassessing the vendor's liability for tax from such business transfers by an additional 3 years for Immediate Transfers, and by 10 years for Gradual Transfers.

II. Employee Ownership Trust - Coming into force January 1, 2024

A brand new concept was also introduced in budget 2023. It is the Employee Ownership Trust ("EOT").

What is it? An EOT refers to a specific, special-purpose trust vehicle that is designed to provide a succession-planning option to owners of privately-held corporations. It aims to facilitate increased employee ownership of privately-held businesses without requiring employees to directly pay for such shares.

What are the conditions? The following qualifying conditions must be met:

1. The trust must be a Canadian resident and exist solely (i) to hold shares of a qualifying business for the benefit of the employee beneficiaries; and (ii) to make formula-based distributions to such employee beneficiaries;
2. The trustees (including any corporate trustees) must (i) be Canadian residents and (ii) be elected every 5 years by the beneficiaries;
3. EOT must hold a controlling (51 per cent+) interest in one or more qualifying businesses;
4. All or substantially all (90 percent or more) of the assets of the EOT must be shares of one or more of such qualifying businesses;
5. A qualifying business (i) cannot be carried out as a partner to a partnership; and (ii) all or substantially all (90 per cent or more) of the FMV of its assets must be used to carry out an active business in Canada (the "Asset Test");
6. The EOT cannot directly allocate shares of a qualifying business to specific beneficiaries of the EOT; and
7. Once the owner-operator sells the business to an EOT, they (or anyone related who also has a significant interest {10 per cent or more} in the business) cannot form more than 40 per cent of the trustees, the board of directors of the businesses or the board of directors of a corporate trustee.

Who are the beneficiaries of the EOT? They are the employees of the qualifying business. Generally, this captures all employees employed directly by the qualifying business (as well as employees of other businesses that the qualifying business controls). However, the following employees are excluded:

☛ Employees who were significant shareholders pre-sale; and Employees who have not been employed for at least 12 months pre-sale.

It should be noted that if there are non-resident employees who are beneficiaries, a withholding tax will be required to be made by the Trust for any distributions. Moreover, if an employee passes away or becomes disabled, their surviving family members cannot benefit from the EOT.

How does it work? At a high level, the mechanics are as follows:

1. An owner-operator enters into a purchase-and-sale agreement with the EOT (or a corporation wholly owned by the EOT);
2. Shares are sold for an amount not in excess of FMV,

and as a result of the sale, the EOT must either directly or indirectly hold a controlling interest in the qualifying business.

The funds required for the purchase are either advanced from the corporation itself (as a shareholder's loan), or through a third-party bank or private financing.

The new rules extend the normal repayment period of the shareholder loan to 15 years (instead of having to be repaid within one taxation year after the year in which the loan was made). Although a bona fide repayment arrangement must be made, there is no requirement that the loan actually be repaid. However, there will be certain deemed-interest inclusions to the EOT.

What to watch for? The Asset Test must be met at all times. This means that an accumulation of excess cash will need to be justified as it relates to maintaining active business pursuits and building cash reserves that may cause a business to become offside.

Legislative provisions that apply to trusts generally apply to EOT. Importantly, this means that income that is retained and not distributed will be taxed at the top personal marginal rate applicable to the province of residence of the EOT. Any income allocations to a beneficiary would be taxed in the hands of the beneficiary.

Note however, that an EOT is not subject to the 21-year deemed disposition rule as long as it maintains its status as an EOT.

From the vendor's perspective, if the purchase price that the EOT pays is paid over time, the new proposals allow for an expanded capital-gain reserve so that they can take the capital gain over 10 years as opposed to 5 years.

While the EOT sounds like an interesting proposition, it remains to be seen if this will actually become a practical option for a seller. ❑

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