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TAX LETTER

IN THIS ISSUE

THE FAMILY BUSINESS AND THE CAPITAL GAINS EXEMPTION

People wishing to pass on a family business to the next generation have, up until recently, been met with a tax problem – the availability (or more accurately non availability) of the lifetime capital gains exemption.

The lifetime capital gains exemption currently allows for up to $971,190 per person of capital gains arising from the sale of certain shares to be realized tax free. (This is the amount for 2023; it is automatically increased annually for inflation.)

However, although the sale of eligible shares to non-relatives may benefit from this tax exemption, sales to "related" persons (immediate family members, grandchildren, etc.), until recently, could not.

This was recognized as unfair, and in some cases a barrier to keeping a business in the family.

For example, on the sale of a business in Ontario, if qualifying for the capital gains exemption, up to around $260,000 in tax may be saved per shareholder through the use of the exemption.

This tax saving, which was not available if the business was kept in the family, may have influenced a decision to sell when a parent decided to step back from the business.

To address this unfortunate situation, a Private Member's Bill was introduced in Parliament in 2021 – known as Bill C 208 – which sought to allow the sale of certain businesses to **adult children** to finally qualify for the capital gains exemption.

The intention was to place genuine business sales to the next generation on the same tax savings footing as sales to third parties.

As part of this levelling of the playing field, it was intended that the parent would have to sell most, if not all of their shares. They would also have to give up control of the business, like in a third-party sale.

Bill C-208 was passed by Parliament against the wishes of the Department of Finance and the (minority) governing Liberals. Although Bill C-208 was well intentioned, its wording was not as precise as required, which created what many people described as a "loophole" in the rules.

Instead of applying only to outright business sales, the rules allowed parents to transfer just **some** of their shares to their children, and to claim their capital gains exemption. In addition, the parent **did not have to give up control of the business**.

This allowed the parent to sell enough shares to take advantage of the capital gains exemption and no more.

Therefore, where a family business was owned by a combination of mom and dad, almost $2M of growth in the business could be withdrawn tax free without mom or dad having to sell the business or give up control of it.

Budget 2023 announced that the rules would be amended to fix this. Mom and dad would still be able to claim their capital gains exemption on the sale of family business shares to their children; however outright control would have to be given over to the child. The child would also have to be actively involved in the business from the time of sale (which is not required under the current rules).

The revised rules provide the option of two time periods for the parent to give up control – a three year period and a five-to-ten-year period.

In both cases, the parent is required to transfer the majority of their voting shares (and therefore give up control of the business) to the child at the time of sale.

The remainder of the shares and the management of the business (subject to some exceptions) must be given up by the parent within 3 years or 5 years, depending on the time period selected.

Although this is more restrictive than the current rules, the scope of related people who can buy the business is being widened at the same time to include nieces and nephews (as well as grandnieces and grandnephews). This adds increased flexibility in passing the business down through the family.

The rules around which business sales are eligible for the capital gains exemption, both before and after the revised rules take effect, are complex.

The shares must be shares of a "qualified small business corporation". This definition itself contains specific requirements.

The majority of the assets held by the business must be used in the business itself (rather than being, for example, excess cash or unrelated investments). The parent must also hold the shares for two years before selling.

Some businesses may not immediately meet these requirements, meaning that parents may have to wait for up to two years before the business can be passed down. In some circumstances, it may be possible to undertake pre-sale planning to ensure some of the tests are met, if they are not met currently.

There are also strict requirements regarding elections that must be made to claim the capital gains exemption, and the length of time the child must hold the shares and be actively involved in the business after the sale.

For example, after purchasing the shares, the child cannot immediately sell the shares to another person; otherwise the parent's capital gains exemption would be denied, and the parent would pay tax on the full gain they previously realized.

To enforce some of these requirements, the revised rules extend the period of time that the Canada Revenue Agency (CRA) can reassess the parent's tax year in which the sale to the child takes place.

Normally, the CRA has three years from the date that they issue a notice of assessment for a tax year. However, this period is to be increased by a further three years if the three-year transfer period is used, and by a further ten years if the five-to-ten transfer period is used.

This allows the CRA to monitor the child's involvement in the business after the sale, and to retroactively deny the tax-free capital gains treatment to the parent if the child does not continue to control the company, or stay active in its management.

The revised rules are scheduled to take effect on **January 1, 2024. The current rules remain in effect until the end of this year.**

Although the current rules do not operate as originally intended, this does not mean that they are invalid. Until the revised rules take effect, the current rules can be used to pass value in the family business to an adult child (the extension to nieces and nephews is not yet in effect).

Also, the current rules do not require parents to give up business control. All that is required is that the parent's shares be sold to an adult child (more accurately, a corporation controlled by the adult child), and that those shares be held by the child for at least 60 months.

For example, if the family business is worth at least $1 million, the parent could sell non voting shares to the child and retain the voting shares (therefore retaining business control). It may be possible to plan the sale in a way that allows the child to purchase the shares without having the immediate cash necessary for the purchase.

As you may suspect, this type of sale falls under the category of "complex" tax planning!

Under both the current and revised rules, there are several requirements to meet to successfully claim the capital gains exemption. Failing to comply with any one of these requirements could result in a denial of the exemption, making the sale fully taxable.

For advice on passing on your business to the next generation in a way that lets you claim your capital gains exemption, speak with an experienced tax advisor or tax lawyer.

CAN YOU BORROW FROM YOUR RRSP WITHOUT PAYING TAX ON THE WITHDRAWAL?

In short, yes — though to be a little more accurate, the real answer is "It depends"!

RRSPs are popular for their immediate tax deferral when making contributions. They also allow contributions to grow tax-free until money is withdrawn in the future.

There are many misconceptions about RRSPs. For example, many people think funds in an RRSP cannot be withdrawn until retirement. Funds can actually be withdrawn at any time, although withdrawals are subject to tax. (Of course, if the funds are in a long term GIC or other investment that can't currently be cashed out, then in practice there may be no way to get at them.)

However, it is also possible to "borrow" funds from an RRSP to use for certain purposes without paying tax on the amount borrowed (which is essentially a withdrawal from the RRSP). This option is particularly attractive given the current high interest rates and uncertainty as to what the near future holds in terms of borrowing and the associated costs.

Buying a home

One of the most common situations where people borrow from their RRSP is to buy a home. Under the **Home Buyers' Plan**, you can borrow up to $35,000 from your RRSP if you use the funds to purchase your "first" home.

The word "first" is included in quotes above, as the home does not actually have to be your first home. Instead, you or your spouse must not have owned a home that you lived in either in the part of the year leading up to the withdrawal, or in any of the four previous calendar years.

The amounts withdrawn must be repaid equally to your RRSP over 15 years, starting the second year after withdrawal. Any missed repayments are taxed as income, as if you had withdrawn the repayment amount from your RRSP in that year.

The Home Buyers' Plan can be used in conjunction with the newly created tax-free First Home Savings Account (FHSA).

The FHSA is a hybrid between a TFSA and an RRSP. It allows you to save up to $8,000 per year (up to $40,000 in total) in a separate account. When making contributions, you receive an up front tax deduction similar to an RRSP, and withdrawals can be made tax free provided the funds are used to purchase your "first" home (which has the same "first" home requirement as the Home Buyers' Plan). The FHSA was discussed in the May 2023 tax letter.

Financing education

The Lifelong Learning Plan allows you to borrow RRSP funds to finance ongoing education. This plan allows you to borrow $10,000 per year, up to a maximum of $20,000, for you or your spouse to pursue full time education. Withdrawals can be made over four years.

There are strict requirements for the type of course eligible for the Lifelong Learning Plan. You should confirm with the course provider that your intended course is eligible.

As with the Home Buyers' Plan, borrowings must be repaid to your RRSP, and you will be taxed on any missed repayments. Repayments start one year after the course is completed (or the fifth year after the first amount borrowed if this is sooner), and must be repaid in equal instalments over ten years.

The Lifelong Learning Plan is generally most beneficial to individuals who want to undertake full time study but will still receive taxable income while doing so. Low income individuals may be better advised to make a taxable RRSP withdrawal instead. Although this would be subject to tax, the tax rate may be low. In addition, the withdrawal may be covered by the basic personal amount (the amount of income that can be earned before any tax is payable), which is currently $15,000.

Important points to note

Borrowing from your RRSP may not be suitable for everyone, and professional financial advice should be obtained before making any withdrawal.

Any third-party interest charges that can be saved by borrowing from your RRSP, rather than approaching a commercial lender, must be weighed against the tax free returns in your RRSP that will be lost during the time the borrowed funds are not invested in your RRSP.

The Home Buyers' Plan and Lifelong Learning Plan come with strict reporting and repayment requirements. There are significant tax implications if they are not complied with. You should involve your accountant at an early stage if you are considering any of these plans.

Information on these plans can be found on the Government of Canada website at this link.

TAXABLE BENEFIT UPDATES, INCLUDING NEW POLICIES FOR VIRTUAL SOCIAL EVENTS

In an age when remote working and team events have become the norm, the CRA has recently updated their taxable benefit policies to reflect this evolving way of working.

Employers who make service awards, subsidize parking, or provide in person and remote social events for their staff should review these updated policies to ensure that they are not inadvertently providing taxable benefits.

Gifts, awards and long-service awards

Gifts and awards to employees made in cash or "near-cash" (for example, a prepaid card or something easily convertible into cash) are generally taxable.

However, the CRA has an administrative policy that considers "non-cash" gifts and awards to not constitute a taxable benefit in certain circumstances.

The total value of non-cash gifts to an employee must not exceed $500 in one year (other than trivial items and long service awards), and the gift must be in relation to a special occasion (for example, a birthday) or a general recognition of the employee's contributions. The amount must not be given for performance-related reasons.

CRA's recent policy addition in relation to gifts and awards treats gift cards as "non-cash" if certain requirements are met.

The gift card must be pre-loaded with the amount of the gift, and the card must only be able to be used to purchase goods or services from a single retailer (or group of retailers) identified on the card.

The terms and conditions of the card must prohibit the value being converted to cash, and the employer must keep a log with certain information, including the name of the employee, the reason for providing the card, and details of the card amount and the retailers where the card may be used.

If the gift card does not meet all required conditions, it will be treated as near-cash, and a taxable benefit.

Parking

The CRA has added an administrative policy regarding 'scramble' parking offered to employees (i.e., where there are fewer spaces available than employees who want parking).

The provision of this type of parking will not be considered a taxable benefit where certain requirements are met.

There must not be more than two parking spaces for every three employees who want parking. Also, the spaces must not be assigned to any employee (their use must be random or uncertain). The spaces must be offered to all employees who want parking.

This concession eases the burden of employers calculating benefits where parking use is sporadic. This is particularly helpful when remote working and in person schedules vary week to week.

Social events

The CRA's administrative policy for social events has also been updated to cover events where the cost of virtual attendance is covered by the employer.

In-person social events will not constitute a taxable benefit where the event is available to all employees and the cost per employee is **$150 or less (including taxes)**. Where there are virtual attendees, there is a further requirement that any gift cards provided for meals etc., must meet the "non cash" requirements, discussed above.

Virtual social events will not constitute a taxable benefit if the event is available to all employees and the cost per employee is **$50 or less (including taxes)** if the event only includes meals, beverages and delivery services, or **$100 or less (including taxes)** if the event also includes entertainment.

If amounts are forwarded to the employee in advance, or reimbursed to the employee after the virtual event, receipts must be provided. As with in-person events, gift cards must meet the "non-cash" requirements.

In both situations, the maximum annual limit for social events (in-person, virtual, and a mixture of both) is **six employer paid** events. Any events in excess of this number will automatically constitute a taxable benefit.

It is critical to note the lower monetary limits for virtual events, compared to in-person events. If these limits are exceeded, the full amount will be a taxable benefit.

More information can be found on the Government of Canada website.

AROUND THE COURTS

GAAR upheld

In the June 2023 tax letter, recent rule changes that increased the risks of undertaking “aggressive tax planning” were discussed.

In *Dean’s Knight Income Corp. v. Canada*, 2023 SCC 16, the Supreme Court of Canada landed a further blow against such planning. The court found that the tax plan undertaken in the case was subject to the General Anti-Avoidance Rule (GAAR).

In *Dean’s Knight*, the plan fell just short of triggering a provision in the Income Tax Act (in this case, an acquisition of legal control of a corporation), to the benefit of the corporation.

However, the Supreme Court found that the corporation had achieved the “functional equivalent” of an acquisition of control through a separate agreement. By doing so, the Court found that the Act had been abused, and the GAAR was applied to deny the tax benefit.

This case demonstrates the Court’s willingness to apply the GAAR to deny tax benefits where the Act is abused.

As discussed in the June 2023 tax letter, there are proposals to soon amend the GAAR in order to make it easier to apply against taxpayers and to introduce penalties where it is found to apply. At present, the only negative impact of a GAAR finding is the denial of the tax benefit, and the imposition of interest on tax due.

Given these proposed changes, and the Supreme Court’s recent decision, the GAAR is a hot topic for discussion with your professional advisor prior to undertaking any tax planning.

This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.

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