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Business Transition Planning
Income Tax Considerations

Jack Kingma, CPA, CA
Senior Manager, Tax

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This presentation is current as of February 22, 2023.

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Transition planning strategies

Capital gains deduction

$1,000,000 capital gains deduction on qualified farm property

Transfer of other farming assets

Transfers of farm equipment and inventory

Intergenerational transfer

Transfer to children/grandchildren at an elected amount between cost and fair market value

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Transition planning strategies (cont'd)

Bill C-208 tax planning

More complex strategies used to facilitate transfer of ownership

Life Insurance

Equalization of inheritance

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Capital gains deduction

Increasing the cost base on a successive transfer to the next generation

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Lifetime capital gains exemption (LCGE) Key definitions:

Qualified farm property pre-1987

- Acquired by the individual before June 17, 1987 and **no 1994 election made**
- In at least 5 years during which property was owned by **a qualifying owner**, the property was used more than 50% in the business of farming in Canada by a **pre-1987 qualifier**; **OR**
- In the year of disposition, property was used more than 50% in the business of farming by a **pre-1987 qualifier**

Qualified farm property post-1987

- Property owned continuously for at least 24 months before disposition by any combination of qualifying users and:
- In at least two years during ownership:
  - **Gross revenue** of qualifying owner from farming must be greater than all other sources of income
  - Property was **used more than 50% in a farming business** where a qualifying user was actively engaged ***OR***
- Throughout a period of at least 24 months, property was used in a farming business in which a qualifying user was actively engaged by either a Family Farm Corporation of Family Farm Partnership

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Key definitions (cont'd)

Qualified family farm corporation "FFC"

- Canadian controlled private corporation
- In any 24 month period
  - > 50% of fair market value of property owned by corporation was used more than 50% of the time in carrying on a farming business by an eligible farmer
- At time of sale > 90% of fair market value attributable property used more than 50% of time in the course of carrying on a farming business by an eligible farmer

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Capital gains deduction in a succession plan

- Sell the qualified farm property to the next generation
- **Works best with bare farmland/proprietorship**
- Exiting owner(s) reports capital gain in either year of transfer or death

- Must have consideration (p-note) to have valid increase to ACB
- Land transfer tax – exemptions are available
- Alternative minimum tax likely to apply
- Generally was not practical for shares of corporation (prior to Bill C-208 changes)

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Transfer of other farming assets

Tax implications of transfer of equipment and inventory

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Transfer of farming equipment

Tax implications: Transfer of farming equipment from a parent to a child/grandchild will occur at fair market value (FMV) and may trigger income tax, it is not eligible for the LGCE

Generally equipment does not increase in value so the tax implications may not be significant (if the FMV is equal to the undepreciated tax cost)

Tax implications are consistent whether transfer is made either while living or upon death

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Transfer of farming equipment (cont'd)

Tax implications: If the FMV of equipment is higher than the undepreciated tax cost then it could result in recapture income and a possible capital gain

Possible tax planning could be done to incorporate a farm to allow for a more tax efficient transfer of farming assets to the next generation

Any tax planning involving a corporation would have to be completed prior to death

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Transfer of farming inventory

Tax implications: A transfer of farm inventory from a parent to a child/grandchild would occur at FMV, not eligible for the LCGE

Generally no immediate tax implications as long as consideration received for farming inventory is not cash

May be opportunity to transfer farm inventory on death to a child without triggering tax immediately

Upon death of a farmer, operating under the cash method of accounting, farm inventory can be transferred on a tax deferred basis to a child or grandchild and the inventory will be taxed as income when it is ultimately sold for cash

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Intergenerational transfer

Avoiding the application of income tax on a transfer of qualifying farm property to the next generation

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Key concepts: intergenerational rollover

Qualifying transfer: Must be to children/grandchildren only

Qualifying property: property has been used principally (>50% of years and >50% of acres) in a farming business in which the individual, spouse, child, or parent was actively engaged on a regular and continuous basis.

Can apply either while living or upon death

Property transfers at amount between cost and fair market value (elected amount)

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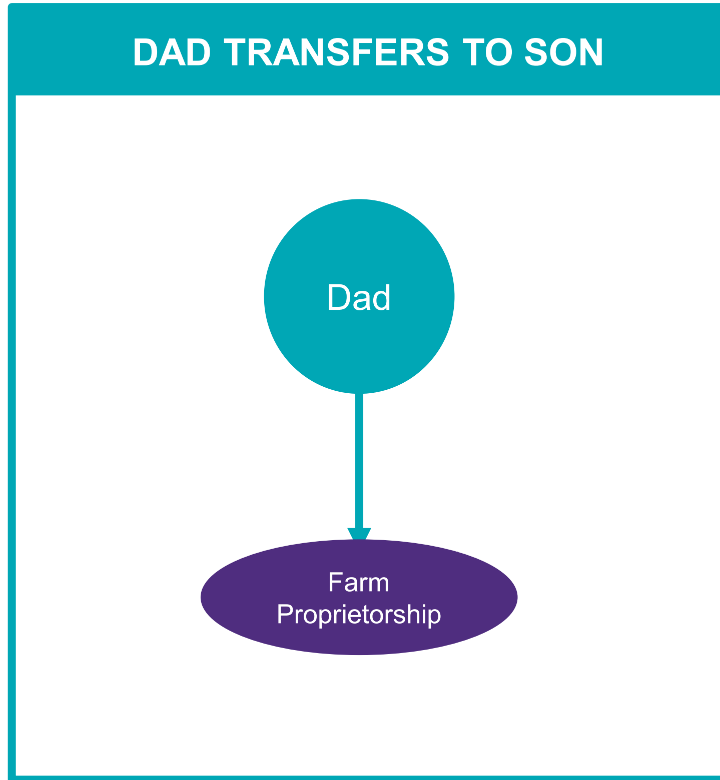
Putting it together – transfer of ownership



- **Farm Proprietorship** is carried on by Dad and is an active farming business
- **Dad** wishes to retire and transfer the farmland to Son.
- **Son** is currently active in the farming business as an employee of the proprietorship and wishes to purchase the farming assets.
- **Dad** owns farmland used in the proprietorship with a cost of $1M

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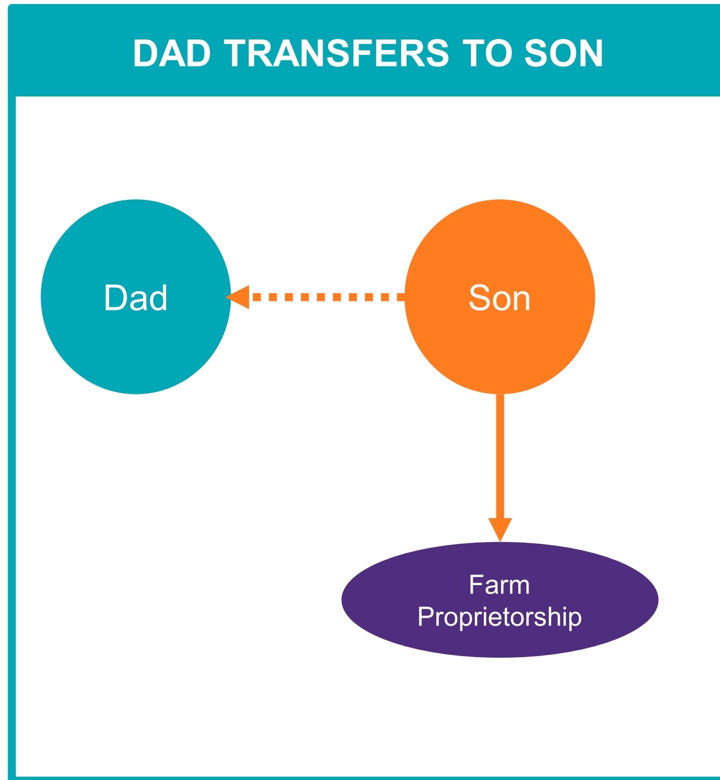
Putting it together – transfer of ownership



- Dad sells the land to Son for $2 million
- Son is issues Dad a promissory note with repayment terms.
- Dad reports a capital gain (and potential reserve) with proceeds - $2M
- Dad updates his will such that the promissory note is forgiven upon death

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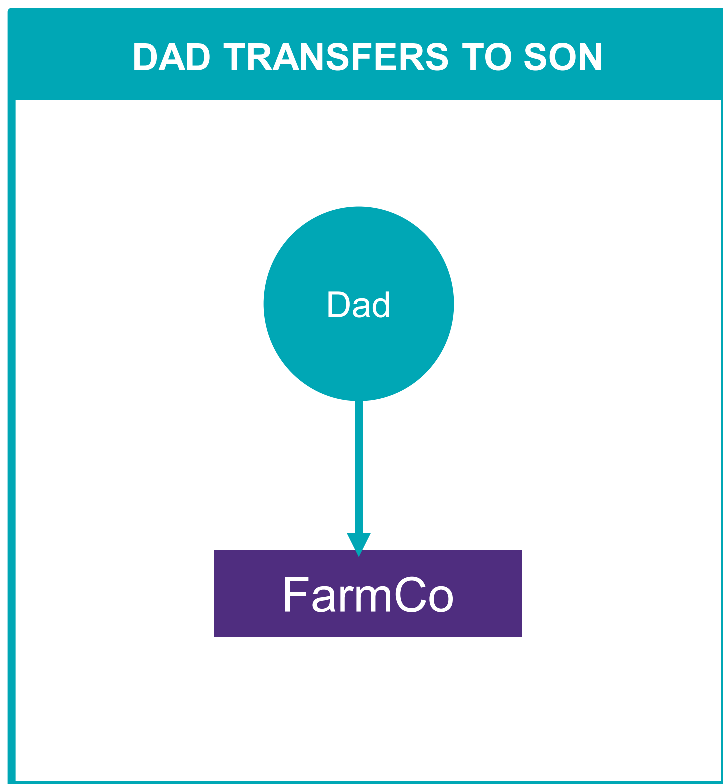
Putting it together – transfer of ownership corporation



- **FarmCo** is qualified family farm corporation (“FFC”) and meets both the 50% and 90% active business asset test.
- **Dad** wishes to retire and transfer FarmCo Son.
- **Son** is currently active in the farming business and wishes to purchase FarmCo.
- **FarmCo**’s value (per valuation) is $8 million.

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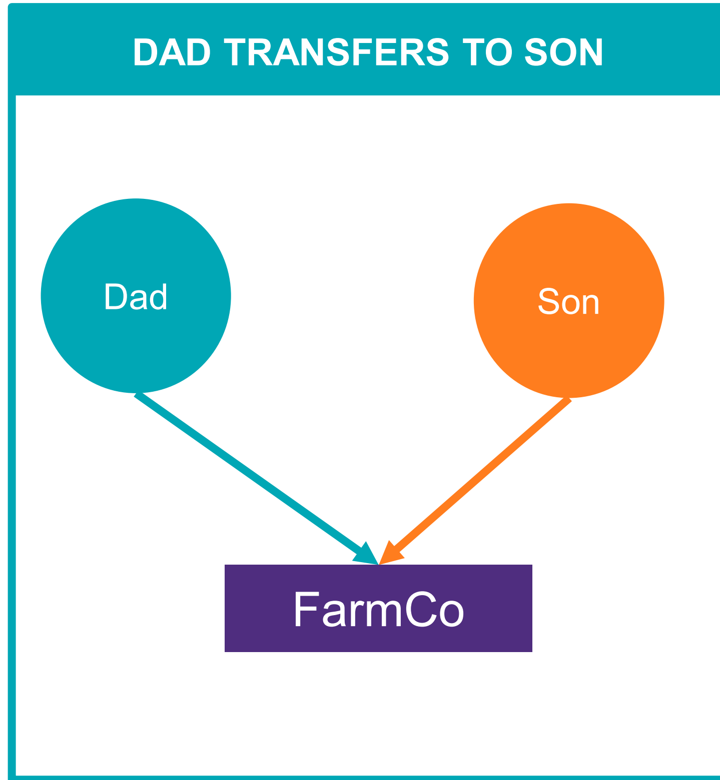
Putting it together – transfer of ownership corporation



- **Dad** exchanges his common shares for preference shares worth $8M
- **Son** subscribes for new common shares
- **Dad** redeems a portion of his shares annually
- **Dad** leaves preference shares to children in his will
- As long as FarmCo continues to qualify as a FFC, the transfer of the shares of FarmCo on death can occur at an amount between FMV and cost.
- **Dad** transfers the preference shares of FarmCo to Son on death at an elected amount of $1 million to utilize his LCGE.
- Disadvantage: the increase in cost of the shares will likely never be utilized

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Bill C-208 tax planning

Involves the intergenerational transfer of qualified small business corporations, and farming corporations

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Why is Bill C-208 important?

Changes to Section 84.1 of the Income Tax Act (ITA) allow a business owner to sell or transfer their shares in a small business or family farm corporation to another corporation (Holdco) owned by the taxpayer's child or grandchild without the adverse tax consequences that previously applied.

Application date and changes:

Royal Assent: June 29, 2021

DoF: Amendments are coming, but so far, no further announcements have been made

Bill C-208

$1,000,000

2023 capital gains exemption for qualified farm property.

47%

The top dividend tax rate when shares are sold to a corporation owned by a child or grandchild.

>50%

Percentage of businesses and farm corporations transfer to family.

The purpose of Bill C-208 is to allow share capital restructurings and intergenerational transfers within a family, which were previously caught by two anti-avoidance provisions in the Income Tax Act.

Avoids punitive measures that recharacterize capital gains as dividend income.

Introduced an exception to rules that previously overlooked siblings as related individuals.

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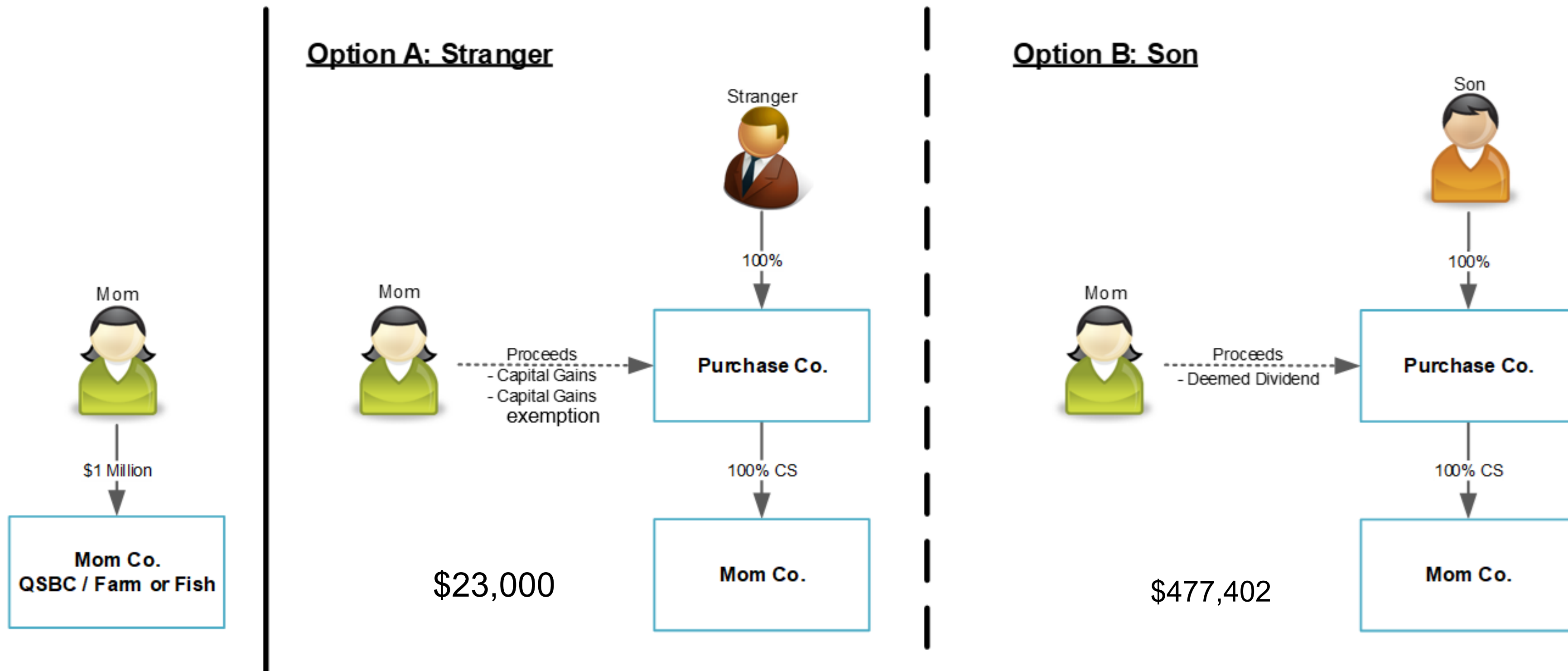
Previous rules



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Qualifying for treatment under Bill C-208

Bill C-208 exempts certain intergenerational transfers from the punitive section 84.1 rules if the following conditions are met:

To get capital gains treatment, the OpCo shares must be Qualified Small Business Corporation (“QSBC”) or a family farm corporation (“FFC”).

The Purchaser Corporation is controlled by the vendor’s children or grandchildren, who are at least 18 years of age.

The Purchaser Corporation does not dispose of the shares within 60 months of acquiring them (for any reason other than death).

Bill C-208 includes a provision that intends to grind the CGE if the taxable capital employed in Canada exceeds $10 million.

Rules also require the business owner to obtain an independent assessment and affidavit signed by the taxpayer and third party attesting to the disposal of the shares.

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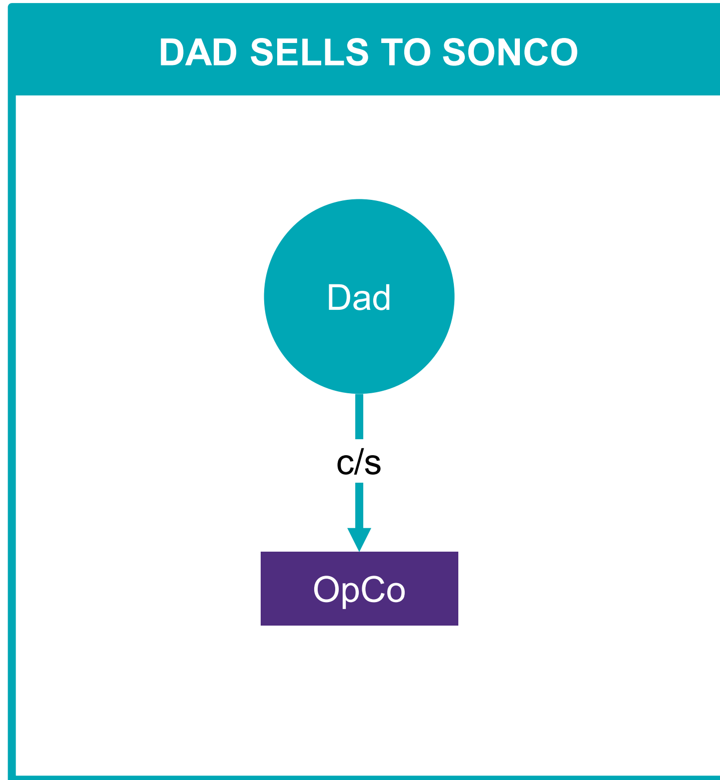
Transfer of ownership – under Bill C-208



- **OpCo** is a qualified family farm corporation and meets both the 50% and 90% active business asset test.
- **OpCo** had taxable capital of less than $10 million in the prior taxation year.
- **Dad** is the sole shareholder of OpCo and wishes to retire.
- **Son** is currently active in the business and wishes to purchase OpCo.
- **OpCo**'s value (per valuation) is $8 million

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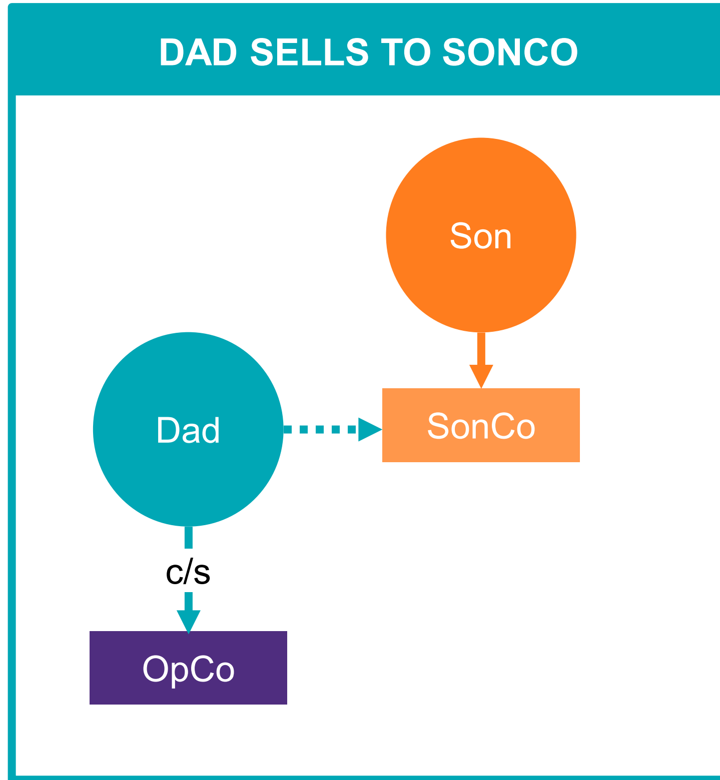
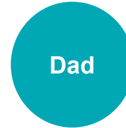
Transfer of ownership – under Bill C-208



Son incorporates **SonCo** to purchase Dad's shares of **OpCo**



Dad claims CGE on FFC shares and pays capital gains rates on balance of share proceeds.

Factors

- **Son** controls SonCo
- Sale from parent to corporation controlled by child or grandchild
- No capital gains exemption grind based on current legislation
- Third party valuation
- Genuine intergeneration transfer

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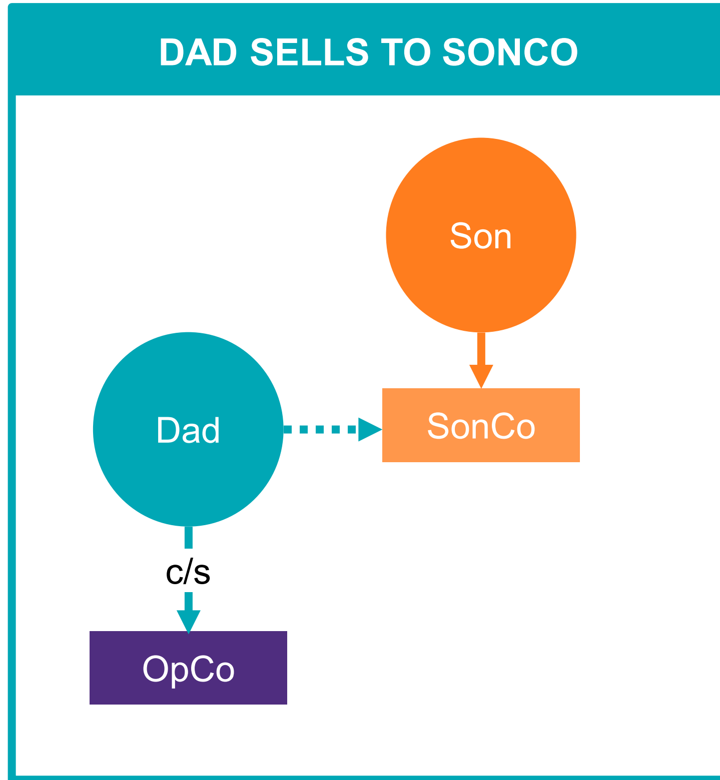
Transfer of ownership – under Bill C-208



Old 84.1

- **Dad** has ACB of $1 in shares and sells to **SonCo** (no planning)
- **Dad** has dividend under 84.1 of $7,999,999 (in ON tax of 47.74% or approximately $3.8 million)

New 84.1

- **Dad** sells shares to **SonCo** and claims CGE of approximately $1M
- Capital gain of $7,999,999 less CGE of $1M = capital gain subject to tax $6,999,999
- ON capital gains rate = $1.6 million
- Tax savings of ~ $ 2.2 million!

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Risks

“

Intention of legislation:

“The federal Government is committed to facilitating genuine intergenerational transfers, while preventing tax avoidance that undermines the equity of the Canadian tax system”

”

Current legislation could allow for "artificial tax planning" - July 19th, 2021 Department of Finance release –amendments to be introduced to prevent tax avoidance (still pending)

Quebec legislation - activity and ownership requirements

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Bill C-208: Independent assessment of value

Requirement for the taxpayer to provide an independent assessment of the fair market value of the shares transferred and an affidavit signed by the taxpayer and a third party attesting to the value as part of the transaction is required.

Canada Revenue Agency's guidance:

- Valuation report must be completed by someone who:
  - is unrelated to the parties involved and does not have any financial interest in the transaction
  - has sufficient knowledge and experience in valuation and the industry being dealt with (this will vary depending on the size and complexity of the business)
- Summary of what should be included in the valuation report
- Summary of requirements for the affidavit and a sample affidavit
- The guidance specifically mentions that a report by a Chartered Business Valuator will meet the CRA's expectations but is NOT required.

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Life insurance

Can be a good investment and tax strategy for dealing with equalization of assets on death where there are children who are not active in farming, particularly in situations were a farm is incorporated

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Current tax alerts – new filing requirements

- *Underused Housing Tax*

- *Trust Reporting Requirements for Bare Trusts*

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Defined: Underused Housing Tax

- Underused House Tax (UHT) came into effect on January 1, 2022
- Filing requirement for all “affected owners” must be filed by April 30, 2023
- UHT calculated as 1% of the taxable value of the property as of December 31 of the previous year

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Reportable properties

- Residential properties captured
- Includes detached houses with no more than three units
- Semi-detached houses, row-house units, residential condominium units, coach or laneway houses
- Although not specifically mentioned, help houses are included

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Who has to report?

- Affected owner – title holder of the residential property in the land registration system
- Life tenants, life lease holders or a person that has continuous possession under a long-term lease
- **Privately held corporations** that are incorporated in Canada
- Corporations incorporated outside of Canada
- Individuals who are non-residents of Canada
- **Partnerships**
- **Trusts and trustees (some exceptions)**

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Who is excluded from reporting?

- Most **Canadian citizens and permanent residents of Canada** (unless trustees or partners of partnership)
- **Publicly listed Canadian Corporations** – shares must be listed on Canadian stock exchange on December 31
- **Registered charities and indigenous governing bodies** – includes their wholly-owned corporations.
- Cooperative housing corporations, hospital authorities, municipalities, public colleges, school authorities, universities
- **Trustee of mutual fund trust, real estate investment fund trust, specified investment flow-through trust**

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Exemptions from paying the tax (but not filing!)

Location & use of the property	If residential property is owned in a prescribed area of Canada and used personally by the owner or the owner's spouse for at least 28 days during the calendar year
Availability of the property	If property is limited for a variety of reasons, then the UHT will not be levied against the property owner
Occupant of the property	**Exemption available when home is primary place of residence for owner, spouse/common law partner or there is a written-agreement with a qualifying tenant**
Type of Owner	Most common exception **– Specified Canadian Corporation which is a Canadian corporation where less than 10% of the votes or equity value are owned by foreign individuals**

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New penalties are significant!

Late-filing	Penalties for late filing

If a return is filed later than December 31 of the following year, exemption from UHT will be denied and the UHT will be charged in addition to a late-filing penalty for failing to meet the April 30 deadline	The amount of the penalty to which the person or partnership is liable to is equal to the greater of:
	• $5,000 for individuals
	• **$10,000 for corporations** and
	• The total of:
	    • 5% of the UHT payable and
	    • 3% of the UHT payable x # months after the due date that the balance is paid

The owner of the property must keep sufficient evidence to support any exemptions claimed or the CRA may deny it.	

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Bare Trusts

- A specific kind of trust arrangement where the trustee have no obligation other than to deal with the trust property as instructed by the beneficial owners of the property. The legal title of the trust property is held by the trustee, but the beneficial ownership of the property remains with the beneficiary
- Consider legal vs beneficial ownership (typically regarding property)

  Legal owner is the one who has the registered title

  Beneficial owner is the one who continues to make all decisions regarding the property

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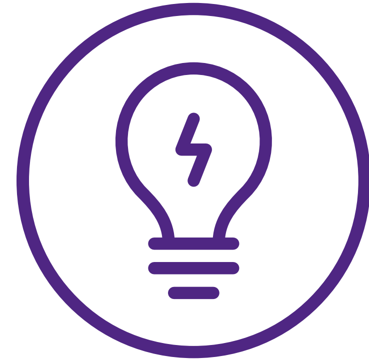
Examples of Bare Trusts

- A parent co-signing a mortgage with an adult child might constitute a bare trust
- A bank account opened by a parent for the benefit of a minor child
- A corporation holding legal title of a property



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Additional reporting

Certain trusts, including bare trusts, are required to disclose all identities of

- ✓ Trustees
- ✓ Beneficiaries
- ✓ Settlors

- Each person who has the ability through trust terms or other agreement to exert control or override trustee decisions over the appointment of income or capital of the trust
- Each corporation who has the ability through trust terms or other agreement to exert control or override trustee decisions over the appointment of income or capital of the trust

Information for disclosure

Name

Address

Date of Birth

TIN (Taxpayer Identification Number)

Country of Residence

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New penalties are significant!

Liabilities	Penalties
New gross negligence penalty where a trust is subject to the new trust reporting rules and where a person/partnership knowingly or under circumstances amounting to gross negligence: • made (or participates in/agrees to) a false statement or an omission in the trust return; or • failed to file the trust return (or comply with a demand to file/provide info)	The amount of the penalty to which the person or partnership is liable to is equal to the greater of: • $2,500 • **5% of the highest amount at any time in the year that is equal to the total fair market value of all property held by the trust.**

Where a trust return is filed late, there is also the late-filing penalty of $25 a day (minimum $100, maximum $2,500) for each failure to file. Therefore, if a bare trust is overlooked, penalties are even more significant.

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Key takeaways

- The new trust reporting rules are expansive
- Assess what trusts are now required to file
- Be proactive and be prepared for difficulty in obtaining required information
- Non-compliance now carries significant penalties

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Thank you

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