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**CHANGES TO THE RULES APPLICABLE TO THE DESIGNATION
OF A DEEMED CAPITAL GAIN ON AN ELIGIBLE BUSINESS TRANSFER
FOLLOWING THE ASSENT OF BILL C-208**

Both federal and Québec tax legislation provide for an integrity rule that applies where an individual disposes of shares in the capital stock of a particular corporation resident in Canada in favour of another corporation (hereinafter referred to as the “purchaser corporation”) with which the individual does not deal at arm’s length, if the individual is resident in Canada and, immediately after the disposition of the shares, the particular corporation is connected with the purchaser corporation.¹ Under this integrity rule, the capital gain that would otherwise result from such a disposal, and which in some cases might qualify for the capital gains exemption, is generally treated as a taxable dividend.

In budget 2015-2016, the Ministère des Finances du Québec announced an easing of this integrity rule to reduce its scope when qualified small business corporation shares or shares of the capital stock of a family farm or fishing corporation (hereinafter collectively referred to as “eligible shares”) are disposed of as part of an eligible business transfer.² The criteria selected for a series of transactions that includes the disposal of eligible shares to qualify for this easing were made public at the time of budget 2016-2017.³

The criteria thus adopted take into account several elements regarding the involvement, in whatever form, of the individual or of his or her spouse in the business before and after the disposal of the eligible shares, and the active part played in carrying on the business by at least one of the purchaser corporation’s shareholders, or by their spouse, following the disposal. Together, these criteria ensure that the series of transactions constitutes a genuine transfer of a family business.

This easing applies where eligible shares of an individual (other than a trust) are disposed of in connection with an eligible business transfer of the individual and for a consideration other than shares of the capital stock of the purchaser corporation. It allows the individual who disposes of the eligible shares, and is deemed to have received a taxable dividend as a result, to designate all or part of that dividend as a deemed capital gain. The amount that he or she may so designate is, however, limited by, among other things, the amount of the dividend calculated under the Québec integrity rule⁴ and that calculated under the federal integrity rule.⁵

¹ This rule is found in section 84.1 of the *Income Tax Act* and in chapter III.1 of Title IX of Book III of Part I of the *Taxation Act*.

² MINISTÈRE DES FINANCES DU QUÉBEC, *Budget 2015-2016 – Additional Information 2015-2016*, March 26, 2015, pp. A.113-A.117. Initially, this easing was to apply to dispositions of qualified shares in the primary and manufacturing sectors. It was extended to all sectors in the *Information Bulletin 2017-3* of February 21, 2017.

³ Id., *Budget 2016-2017 – Additional Information 2016-2017*, March 17, 2016, pp. A.38-A.44. The conditions and rules applicable to the designation of a deemed capital gain in the context of an eligible business transfer are found in sections 517.5.3 to 517.5.11 of the *Taxation Act*.

⁴ *Taxation Act*, s. 517.2.

⁵ *Income Tax Act*, para. 84.1(1)b).

On June 29, 2021, Bill C-208, *An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)* (hereinafter referred to as “Bill C-208”) received Royal Assent.⁶ The changes made to the *Income Tax Act* by Bill C-208 aim, among other things, to exclude from the application of the federal integrity rule, under certain conditions, the disposition of qualified small business corporation shares and shares of the capital stock of a family farm or fishing corporation by an individual in favour of a corporation that is controlled by one or more of the individual’s children or grandchildren who are 18 years of age or older.

On July 19, 2021, the Minister of Finance of Canada confirmed that Bill C-208 had become a part of the *Income Tax Act* of Canada and that the amendments it made to the *Income Tax Act* now apply in law.⁷ The Department of Finance Canada has moreover indicated that the Government of Canada is committed to protecting the integrity of the tax system and intends to introduce amendments to the *Income Tax Act* that will respect the spirit of Bill C-208, facilitate genuine intergenerational business transfers and protect against unintended tax avoidance loopholes that may have been created by Bill C-208, such as surplus stripping.⁸ These changes will apply as of the later of either November 1, 2021 or the date of publication of a final bill on the subject.

By ensuring that the federal integrity rule in section 84.1 of the *Income Tax Act* does not apply to certain dispositions of shares, the amendments made to the *Income Tax Act* by Bill C-208 have consequences for the Québec taxation system, as they prevent the application of the easing of the Québec integrity rule.

Where a disposition of eligible shares is subject to the Québec integrity rule, but is no longer subject to the federal integrity rule because of the amendments made by Bill C-208, the individual who disposes of the shares cannot designate as a capital gain, for the purposes of the Québec taxation system, all or part of the dividend deemed to have been received on the disposition of the shares, since no amount is determined under paragraph *b* of subsection 1 of section 84.1 of the *Income Tax Act* in respect of the disposition of the shares.

Accordingly, Québec’s tax legislation will be amended so that the easing of the Québec integrity rule announced in 2015 and 2016 can take effect despite the coming into force of Bill C-208.

Thus, where eligible shares of an individual (other than a trust) are disposed of in connection with an eligible business transfer of the individual and in circumstances where, but for the amendments to the *Income Tax Act* in Bill C-208, section 84.1 of the *Income Tax Act* would apply to the disposition of the shares, the maximum limit for determining the amount that may be designated as a deemed capital gain that is “the amount determined in respect of the disposition of those shares under paragraph *b* of subsection 1 of section 84.1 of the *Income Tax Act*”⁹ will be replaced by the amount that would have been determined in respect of the disposition of those shares under paragraph *b* of subsection 1 of section 84.1 of the *Income Tax Act* but for the amendments to the *Income Tax Act* introduced by Bill C-208.

⁶ S.C. 2021, c. 21.

⁷ DEPARTMENT OF FINANCE CANADA, “Government of Canada clarifies taxation for intergenerational transfers of small business shares,” [online], July 19, 2021, [<https://www.canada.ca/en/department-finance/news/2021/07/government-of-canada-clarifies-taxation-for-intergenerational-transfers-of-small-business-shares.html>].

⁸ Ibid.

⁹ *Taxation Act*, s. 517.5.5, 1st para., subpara. a.

In addition, when these conditions are met and the individual designates an amount as a deemed capital gain from the disposition of the shares, the provisions of the Québec tax legislation that circumscribe the amount of the capital gains exemption that an individual may claim or the amount that he or she may deduct as a capital gains reserve, for the purposes of the Québec tax system, based on the amount allowed as a deduction, respectively, for such an exemption or reserve for the purposes of the federal tax system, will apply.

For greater certainty, all other conditions and rules applicable to the designation of a deemed capital gain on an eligible business transfer remain unchanged.

□ Application date

The amendments to the Québec tax legislation will apply in respect of a disposition of eligible shares on June 29, 2021 or after.

To obtain information on the matter dealt with in this information bulletin, contact the Secteur du droit fiscal, de l'optimisation des revenus et des politiques locales et autochtones at secteurdroitfiscaletdelafiscalite@finances.gouv.qc.ca.

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