Fiscal Regime Beneficial to a Progressive Transfer of Companies

Issue

Since many Canadian entrepreneurs will soon retire, a proper framework for company transfer is becoming a key pillar of entrepreneurial dynamism. Since the majority of Canadian SMEs are family-owned, the fiscal inequity contained in section 84.1 of the Income Tax Act undermines economic development. Beyond the sustainability of companies and the financing of entrepreneur retirement, transfer processes are greatly facilitated in family companies thanks to the identification of the buyer, while the long term vision, a characteristic of family-owned businesses, promotes strategic planning and investment.

Background

Capital gains from the transfer of a business between related persons are considered as a dividend by the Income Tax Act. This prevents entrepreneurs who wish to transfer their business to a family member from using the Lifetime Capital Gains Exemption (LCGE). Fiscal rules encourage these entrepreneurs to transfer their business to external buyers, sometimes to foreign investors or competitors. Family business owners consider this as tax unfairness.

Family-owned businesses are particularly important for economic development; by nature, they seem more constant in their strategic orientations and benefit from an intergenerational culture and reputation favorable to long-term investment planning. Family-owned businesses are relatively independent financially and in terms of ownership, which a priori favours patient capital. Moreover, they developed their activities based on local roots, promoting the stability of regional activities.

The opportunity cost of unfavourable taxation for family transfer is measured by the level of deferred investments in the business. Entrepreneurs more interested in transferring their business to an unrelated buyer, choose to lower debt and raise liquidities. They tend to forego, several years before their departure, investments favorable to the growth of the family business. Yet, the new economic environment favours a quick adaptation to new technologies whose management is more accessible to new generations of entrepreneurs. The new economic context suggests accelerating all processes and business transfer planning.

Denied the LCGE, many entrepreneurs delay their retirement, particularly because it is difficult to find an unrelated buyer. When the entrepreneur has failed to make investments favorable to business performance, these delays translate into a loss of competiveness potentially harmful to business valuation. This loss of value harms the financial situation of the transferor, whose delayed departure also translates into unrealized consumer spending. It is also important to consider the fiscal revenue aspect, due to the consequent reduction of capital gains.

In the case of sales to businesses outside Quebec, in addition to a possible relocation of activities sometime in the future, the repatriation of profits abroad translates into a lower investment capacity in Canada that is unfavorable to economic development.

Recognizing the urgent need to encourage business transfers, the Quebec government recently modified its fiscal rules to allow Quebec entrepreneurs to use the capital gains exemption in the context of a family business transfer. Although the Quebec government showed its willingness to tackle the issue, this improvement is not complete without full harmonisation with federal rules. Fiscal conditions are still considered unjust, and thus inadequate for a cession. Since the family transfer issue is common to all Canadian provinces, an amendment to section 84.1 of the Income Tax Act, as suggested by the Quebec government, will contribute to the vibrant entrepreneurial spirit all over Canada.

Although the economic importance of supporting business transfer is increasingly recognized, banks rarely finance the entire buyout while the progressive transfer of business shares seems to be an increasingly frequent financing model. It allows financial partners to share the risk, and the transferor to support the buyer during the transition period, to the benefit of the company's future.

Globally, if fiscal rules governing family transfer are calibrated to counter fiscal evasion, the demographic context and characteristic robustness of family SMEs favour reconsidering the parameters of the rules in order to reduce economic opportunity costs.

Recommendations

That the federal government:

1. Remove any fiscal inequity for family businesses and introduce provisions allowing full capital gains exemption in the case of business transfers among related persons.
2. Adjust fiscal rules by taking into account financing constraints on business buyouts and, in particular, by facilitating progressive share transfers.