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Changes to capital gains taxation: insidious consequences for the intergenerational transfer of Canadian controlled companies?

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Two weeks after the budget was tabled, Finance Minister Chrystia Freeland now intends to ask Parliament to approve proposed changes to capital gains taxation in a stand-alone bill.

This measure has met with an abundance of reactions. The people affected are an assorted group with very high incomes, of course, but these incomes often reflect, among other things, a unique situation: a significant capital gain arising from the sale of a business, a revenue property, a family cottage, etc. Few comments have been heard about the taxpayers who are by far the most affected, and for good reason: these are people who die and are taxed on their capital gains, calculated as if they had sold all their assets at the time of their death and for which payment must be made immediately, often forcing the estate to sell the assets to raise the necessary cash.

Even before the increase in the inclusion rate, capital gains taxation was already a major issue of concern for many entrepreneurs and families who control their businesses, and it's one that should be of concern to governments as well.

Indeed, how is it possible to transfer the company to one's estate, when the calculation of the tax payable on the transfer is based on the value of the shares used to maintain control? And, as is also often the case, the family that holds this control—although appearing to be wealthy on paper—does not have the liquidity to pay this tax bill, as the family fortune is largely tied up in the value of the shares. So, to settle the tax bill, the choices are limited and disconcerting to say the least: sell shares and reduce the stake below the threshold of control (and thereby make the company vulnerable to hostile takeover bids) or sell the company.

Of course, there are ways to ensure a temporary deferral, notably by setting up trusts. Some tax experts will suggest schemes to prolong this deferral somewhat. But all in all, these solutions are highly imperfect since they involve sophisticated planning and extremely restrictive choices.

More than 35% of the companies making up the S&P/TSX Composite Index are controlled companies, including many of the major companies often referred to as flagships in different provinces or regions of Canada. At a time when a review of tax measures associated with capital gains taxation is underway, our governments have an opportunity to act by adjusting the tax system to allow tax deferral on the transfer of a controlled company: this is a lever that our governments must explore.

Why take action?

The tax collected by the government at the time of transfer can be a seemingly large amount that helps make up for deficits. But the risk of seeing a company sold for the purpose of paying tax is an ill-advised gamble for our governments. Numerous studies have demonstrated the essential role played by the head offices of large—and not-so-large—companies in provincial or regional economic ecosystems. Indeed, these companies are deeply rooted in the social and financial fabric of their communities, helping maintain well-paid jobs in addition to providing a significant revenue source for numerous direct and indirect suppliers, including services provided by professionals of all kinds.

The amount of the taxes collected by governments on all the employment income associated with these companies, not to mention the direct tax revenues from the companies themselves, represents much more attractive annual and sustainable revenue than a one-off collection from the transfer to the estate.

Offering a tax deferral to families who control a company is therefore an investment. And a deferral means that, unless these families maintain control, any sale will eventually result in the payment of the amounts owing to the government.

However, an investment is not a gift. Several G7 countries have introduced rules to facilitate such transfers by allowing a form of tax rollover, conditional on preserving employment thresholds and maintaining activities locally. The ideas and solutions proposed by these countries to help maintain local businesses should be considered.

In the absence of any other mechanism for deferring the tax owing on the transfer of shares, it may seem preferable—all the more so since the announced increase in the inclusion rate—for the controlling shareholder to sell the company before their departure; in this way, they will potentially obtain a 30-40% premium for their shares, which, after the tax bill is paid, will leave them (and any heirs) with a net after-tax value equivalent to their current value, but without any increased wealth for the stakeholders and the community.

For those entrepreneurs who can still maintain control and transfer it, let's hope we don't, one day, have to announce the sale of their company to foreign interests for tax reasons. It's not too late to act. The long-term control of our economy is at stake.